



Scottish Law Commission  
*promoting law reform*

| (SCOT LAW COM No 252)

# Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses

report



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*promoting law reform*

# Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses

Laid before the Scottish Parliament by the Scottish Ministers  
under section 3(2) of the Law Commissions Act 1965

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The Scottish Law Commission was set up by section 2 of the Law Commissions Act 1965 (as amended) for the purpose of promoting the reform of the law of Scotland. The Commissioners are:

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# SCOTTISH LAW COMMISSION

*Item No 1 of our Tenth Programme of Law Reform*

## **Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses**

To: Michael Matheson MSP, Cabinet Secretary for Justice

We have the honour to submit to the Scottish Ministers our Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses.

(Signed) PAUL B CULLEN, *Chairman*  
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Malcolm McMillan, *Chief Executive*  
16 March 2018

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# Abbreviations

## General

Chitty	H G Beale (ed), <i>Chitty on Contracts</i> (32nd edn, 2015)
CISG	UN Convention on Contracts for the International Sale of Goods (1980), available at: <a href="https://goo.gl/YnDQHg">https://goo.gl/YnDQHg</a>
DCFR	C von Bar and E Clive (eds), <i>Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference</i> (2009) Outline Edition available at: <a href="https://goo.gl/C2gjEr">https://goo.gl/C2gjEr</a>
CLJ	Cambridge Law Journal
Edin LR	Edinburgh Law Review
ERPL	European Review of Private Law
Gloag, <i>Contract</i>	W M Gloag, <i>The Law of Contract: A Treatise on the Principles of Contract in the Law of Scotland</i> (2nd edn, 1929)
<i>Gloag and Henderson</i>	H L MacQueen and the Rt Hon Lord Eassie (eds), <i>Gloag and Henderson: The Law of Scotland</i> , (14th edn, 2017)
JBL	Journal of Business Law
JCL	Journal of Contract Law
JR	Juridical Review
LQR	Law Quarterly Review
LMCLQ	Lloyds Maritime and Commercial Law Quarterly
McBryde, <i>Contract</i>	W W McBryde, <i>The Law of Contract in Scotland</i> (3rd edn, 2007)
McGregor Code	H McGregor, <i>Contract Code: Drawn up on behalf of the English Law Commission</i> (1993)
<i>McGregor on Damages</i>	J Edelman (ed), <i>McGregor on Damages</i> (20th edn, 2018)
MacQueen and Thomson, <i>Contract</i>	H L MacQueen and J Thomson, <i>Contract Law in Scotland</i> (4th edn, 2016)
OJLS	Oxford Journal of Legal Studies
PECL	Principles of European Contract Law Parts I and II (revised 1998) and Part III (2002) available at: <a href="https://goo.gl/sMmqPa">https://goo.gl/sMmqPa</a>

PICC	The UNIDROIT Principles of International Commercial Contracts (3rd edn, 2010), available at: <a href="https://goo.gl/LWBQvy">https://goo.gl/LWBQvy</a>
<i>SME, Obligations</i>	<i>The Laws of Scotland (Stair Memorial Encyclopaedia) Obligations</i> (vol 15)
ULIS	Uniform Law on the International Sale of Goods (see Schedule 1 to the Uniform Laws on International Sales Act 1967)

## Part 2: Formation of Contract

1993 Report	Report on the Formation of Contract: Scottish Law and the United Nations Convention on Contracts for the International Sale of Goods (Scot Law Com No 144, 1993), available at: <a href="https://goo.gl/gr7uSX">https://goo.gl/gr7uSX</a>
2012 DP	Discussion Paper on Formation of Contract (SLC Discussion Paper No 154, 2012), available at: <a href="https://goo.gl/A4FiCn">https://goo.gl/A4FiCn</a>
Furmston and Tolhurst, <i>Contract Formation</i>	M Furmston and G J Tolhurst, <i>Contract Formation: Law and Practice</i> (2nd edn, 2016)
Hogg, <i>Obligations</i>	M Hogg, <i>Obligations</i> , (2nd edn, 2006)

## Part 3: Interpretation of Contract

1997 Report	Report on Interpretation in Private Law (Scot Law Com No 160, 1997), available at: <a href="https://goo.gl/wbMmXG">https://goo.gl/wbMmXG</a>
2011 DP	Review of Contract Law: Discussion Paper on Interpretation of Contract (SLC Discussion Paper No 147, 2011), available at: <a href="https://goo.gl/LiMFcU">https://goo.gl/LiMFcU</a>
Lewison, <i>Interpretation</i>	K Lewison, <i>The Interpretation of Contracts</i> (6th edn, 2016)

## Part 4: Remedies for Breach of Contract

1988 Report	Report on Civil Liability—Contribution (Scot Law Com No 115, 1988), available at: <a href="https://goo.gl/xm1PGt">https://goo.gl/xm1PGt</a>
1999 DP	Discussion Paper on Remedies for Breach of Contract (SLC Discussion Paper No 109, 1999), available at: <a href="https://goo.gl/rudja2">https://goo.gl/rudja2</a>
1999 Report	Report on Remedies for Breach of Contract (Scot Law Com No 174, 1999), available at: <a href="https://goo.gl/ArveWR">https://goo.gl/ArveWR</a>
2017 DP	Discussion Paper on Remedies for Breach of Contract (Scot Law Com No 163, 2017), available at: <a href="https://goo.gl/GzkWut">https://goo.gl/GzkWut</a>

Edelman, <i>Gain-based Damages</i>	J Edelman, <i>Gain-Based Damages: Contract, Tort, Equity and Intellectual Property</i> (2002)
Glanville Williams, <i>Joint Torts</i>	Glanville Williams, <i>Joint Torts and Contributory Negligence: A Study of Concurrent Fault in Great Britain, Ireland and the Common-Law Dominions</i> (1951)
Kramer, <i>Contract Damages</i>	A Kramer, <i>The Law of Contract Damages</i> (2nd edn, 2017)
Liu, <i>Anticipatory Breach</i>	Q Liu, <i>Anticipatory Breach</i> (2011)
Rowan, <i>Remedies for Breach of Contract</i>	S Rowan, <i>Remedies for Breach of Contract, a Comparative Analysis of the Protection of Performance</i> (2012)
SME, <i>Remedies</i>	<i>The Laws of Scotland (Stair Memorial Encyclopaedia)</i> Remedies (Reissue)
Steven, <i>Pledge and Lien</i>	A J M Steven, <i>Pledge and Lien</i> (2008)
Virgo and Worthington, <i>Commercial Remedies</i>	G Virgo and S Worthington (eds), <i>Commercial Remedies: Resolving Controversies</i> (2017)
Winterton, <i>Money Awards</i>	D Winterton, <i>Money Awards in Contract Law</i> (2015)

## Part 5: Penalty Clauses

1997 DP	Discussion Paper No 103 on Penalty Clauses (1997), available at: <a href="https://goo.gl/WD9ujw">https://goo.gl/WD9ujw</a>
1999 Report	Report on Penalty Clauses (Scot Law Com No 171, 1999), available at: <a href="https://goo.gl/dANurR">https://goo.gl/dANurR</a>
2016 DP	Discussion Paper No 162 on Penalty Clauses (2016), available at: <a href="https://goo.gl/12de4z">https://goo.gl/12de4z</a>

# Glossary

Word or phrase	Definition
<i>Ab initio</i>	From the beginning.
<i>Actio quanti minoris</i>	An action derived from Roman law whereby the purchaser of goods could, while retaining defective goods, obtain reduction of the contract price to the goods' actual value. Misinterpreted as providing a claim where property (defective or not) was not worth its price, and rejected in the 19th century. Implication taken to be that a purchaser could not claim damages for defective goods unless the contract was rescinded; this was corrected by Contract (Scotland) Act 1997 section 3.
Acceptance	Expression, by words or conduct, by the recipient of an offer or unqualified assent to the terms of the offer with the effect that a contract is concluded. As a general rule silence or inactivity on the part of the offeree does not in itself amount to acceptance.
Account of profits	An account of profits operates to strip a fiduciary of unauthorised gains.
<i>Ad factum praestandum</i>	For the performance of an act. In modern practice a decree or an obligation <i>ad factum praestandum</i> requires the performance or fulfilment of some physical rather than monetary obligation.
Advanced electronic signature	An advanced electronic signature is a secure method of applying a signature electronically. It guarantees both the identity of the signatory and also the integrity of the data to which it is attached. In other words, it is a guarantee that a certain person applied the signature and that the document to which the signature relates has not been subsequently altered. The Land Registration etc. (Scotland) Act 2012 makes it possible for an advanced electronic signature to confer formality and probativity upon any electronic document (see further Electronic Documents (Scotland) Regulations 2014 (SSI 2014/83).
Alimentary debts	Sums owed for the purposes of aliment, in other words, for maintenance for the support of a spouse, civil partner, or child.
Avoidance (of a contract)	To reduce or set aside a contract.

Compensation	The extinction of mutual similar claims by setting one off against the other. Each party must be both debtor and creditor, in their own right, at the same time. Sometimes loosely (but inaccurately) termed “set-off” (qv).
<i>Contra proferentem</i>	The rule of construction which says that where a term of a contract has more than one possible meaning, the meaning least favourable to the party which included that term is to be preferred.
Contributory negligence	Some careless or blameworthy act or omission by the pursuer which contributed, with the defender’s fault or negligence, to the pursuer’s loss or injury. Since 1945 the court may reduce an award of damages in proportion to the pursuer’s share of responsibility for what happened.
Counterpart	A counterpart is a copy (often a duplicate, but there may be more than two copies) of a contract. Historically, a contract would be written out twice on a single piece of paper or other material, which would then be divided into two parts, called counterparts, one of which would be held by each party to the contract. In modern times counterparts are simply created by printing out the document the required number of times.
<i>Dominus litis</i>	The master of the litigation: the effective party to legal proceedings which may be carried on in the name of another. The <i>dominus litis</i> may be ordered to pay the expenses involved.
Entire agreement clause	A term in a written agreement stating that the agreement constitutes the whole terms of a contract. Under section 1 of the Contract (Scotland) Act 1997 such a contract term is effective to prevent enquiry beyond the written document for any further contract terms.
Equity	(1) In Scots law, the judicial assessment of fairness as opposed to the strict and rigid rule of common law; developed as a method of ensuring justice when the strict application of law may have prevented that.  (2) In English law, the system of rules and remedies (many discretionary) developed in the Court of Chancery and differentiated from the law administered in the Common law courts (King’s Bench, Common Pleas); the two systems were merged procedurally (but not substantively) in the 1870s.
Exclusionary rule(s)	The rule or rules which say that evidence of pre-contractual negotiations or about the conduct of contracting parties subsequent to the conclusion of their contract may not be considered for the purpose of interpreting the contract.

Execution in counterpart	This refers to the process by which a contract or other document may be signed ("executed") by each party signing its own copy ("counterpart") and then exchanging it with the other party for that party's signed counterpart. This is a commonly used method for forming contracts subject to English law.
Extrinsic evidence	Evidence from outside a document about the meaning of that document.
Fiduciary	A fiduciary is a person who is exercising particular powers or undertaking particular transactions for the benefit of another (the principal) and thus has as a matter of law an obligation to prefer the interests of the principal should there be a conflict with those of the fiduciary. Fiduciary obligations contrast with those arising in ordinary or "arm's-length" transactions, in which each party is generally entitled to consider only its own interests.
<i>Force majeure</i>	Something beyond the control of parties to a contract, preventing its performance.
Good faith	In obligations, the imposition of objective standards of behaviour between parties, such as honesty, cooperation and fair dealing.
Invitation to treat	A statement or conduct demonstrating a willingness to negotiate a contract.
Juridical act	Any act of will or intention which has, or which is intended by the maker of the act to have, legal effect, but not including any legislative or judicial act.
Offer	A statement of terms which a party (the offeror) proposes to another party (the offeree) as the basis of a contract between them, coupled with a promise, express or implied, that the offeror will adhere to these terms if the offer is accepted. An offer contemplates the constitution of binding contractual obligations as from the moment when it is met by an unqualified acceptance.
Parole evidence rule	The rule, now abolished in Scotland under section 1 of the Contract (Scotland) Act 1997, under which it was normally incompetent to lead evidence of contract terms other than those contained in any writing embodying a contractual agreement. In so far as the rule also disallowed evidence from outside the contractual writing to modify or contradict its terms, it continues to apply. Both parts of the rule continue to apply in English law.

Probativity	A document is probative if, by visual inspection, it appears to be signed by the granter and also by a witness. The witness' name and address must also be stated. The Land Registration etc. (Scotland) Act 2012 makes it possible for probativity to be conferred upon any electronic document (see further Electronic Documents (Scotland) Regulations 2014 (SSI 2014/83).
Qualified acceptance	An acceptance of an offer subject to a qualification so that until the qualification is itself accepted or withdrawn, the contract is not concluded.
Reduction (of a contract)	To set aside or annul, usually by an action of reduction, a deed, contract, decree or award.
Repudiation	Denial of the existence of a contract and/or refusal to perform a contractual obligation.
Rescission	The termination or cancellation of a contract which has been rescinded.
<i>Restitutio in integrum</i>	Entire restoration; the restoration of a person to the position they would have been in had the transaction or event not taken place.
Retention	(1) The withholding by one party to a contract of performance of its obligations under the contract until the other party performs its obligations under it.  (2) More particularly, retaining moveable property until a debt due by its owner is paid; a lien.  (3) The operation of the balancing of accounts in bankruptcy.
Set-off	<i>(English law)</i> An equitable remedy which denotes the right of a debtor to balance mutual liquid debts with a creditor. Each party must be both debtor and creditor, in their own right, at the same time and there must be a close connection between the claims. In Scotland, sometimes used loosely for compensation (qv).

Simple electronic signature	In contrast to an advanced electronic signature, a simple electronic signature is a signature created and / or transmitted electronically (eg a name typed at the end of an email or a signature sent on a fax) but without any guarantee that the person who appears to have signed did actually do so nor that the document has remained unaltered after signing. A simple electronic signature can be used to enter into a contract except one connected with land or one which is to be probative. The Land Registration etc. (Scotland) Act 2012 makes it possible for some forms of such an electronic signature to confer formal validity upon a contract written as an electronic document (see further Electronic Documents (Scotland) Regulations 2014 (SSI 2014/83).
<i>Solatium</i>	Damages given for injury to feelings or reputation, pain and suffering and loss of expectation of life caused by breach of obligation.
Special retention	The retention of a liquid debt on the basis of an illiquid claim that will shortly become liquid in order for compensation (qv) to extinguish the two debts to the amount of whichever is the lesser. There need not necessarily be a close connection between the claims.
Specific implement	A court order for the performance of a contractual or common law obligation, other than by the payment of money. It is enforced by decree <i>ad factum praestandum</i> , but damages may be awarded instead.
Specific performance	<p>(<i>Scots law</i>) A court order for the performance of a non-contractual/statutory duty (see section 45 of the Court of Session Act 1988).</p> <p>(<i>English law</i>) A court order for the performance of a contract, requiring its actual execution according to its stipulations and terms.</p>
Testing clause	A testing clause appears in certain formal and non-electronic documents for which probativity (see above) is sought. Although less commonly used nowadays than in the past, the testing clause is a means of recording a witness' name and address. It may also contain other details about the signing process, such as where and when it took place. It generally appears just above the signatures at the end of the document. A testing clause or an equivalent (eg a handwritten note, close to the witness' signature, of his or her name and address) is required in order for a nonelectronic document to be probative.

Transferred loss	When a breach of contract occurs and loss results, but that loss is sustained by a person who is not party to the contract.
<i>Ubi jus ibi remedium</i>	Where there is a right, there is a remedy; a right of action to protect the right.



# **PART 1**

## **Introductory matters**

# Chapter 1 Introduction

1.1 This is the final Report of our general review of Scots contract law in the light of the Draft Common Frame of Reference (DCFR). Although now being published within our Tenth Programme of Law Reform, the work began under the Eighth Programme of Law Reform which ran from 2010 to 2014,<sup>1</sup> and continued as part of our Ninth Programme of Law Reform which ran from 2015 to 2017.<sup>2</sup> The Report deals with four major topics: formation of contract, interpretation of contracts, remedies for breach of contract, and penalty clauses.

1.2 The starting point for our review of contract law was a series of Reports on these topics which we published in the 1990s but the recommendations of which remained unimplemented.<sup>3</sup> The reasons for their non-implementation are not easy to discern. There does not seem to have been any significant opposition to the substance of the Reports at the time. But with the passage of two decades and more since they were published, we did not think it right simply to press for their implementation without further consideration of the issues that they raise.<sup>4</sup> Quite apart from the general evolution of the law and related practice in Scotland over that period, international and European developments in contract law needed to be taken into account. There was, therefore, a case for reconsidering the topics of the Reports, but this time using the DCFR text as well as the preceding instruments, plus any other relevant developments in other jurisdictions, not least England and Wales.

1.3 We published a Discussion Paper on Interpretation of Contract in February 2011, one on Formation of Contract in March 2012, one on Penalty Clauses in November 2016, and one on Remedies for Breach of Contract in July 2017. This Report relates to all four of these Discussion Papers.<sup>5</sup> We also published a Discussion Paper on Third Party Rights in March 2014, but that was the subject of a separate Report in July 2016.<sup>6</sup>

## General policy

1.4 We have had various general policy considerations in mind while preparing this Report. The aim of the whole exercise was to conduct a health check for the Scots law of contract in the light of international comparators, in particular the DCFR. It elaborated the preceding Principles of European Contract Law (PECL), completed and published in 2003. That in turn had elaborated the contract law rules in the Vienna Convention on the International Sale of Goods 1980 (CISG).<sup>7</sup> As a model law rather than legislation, the DCFR

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<sup>1</sup> The Eighth Programme can be found at: <https://goo.gl/heJtZ6>.

<sup>2</sup> The Ninth Programme can be found at: <https://goo.gl/G74ORJ>.

<sup>3</sup> The unimplemented Reports can be found at: <https://goo.gl/kGV3do>.

<sup>4</sup> A 2010 consultation on penalty clauses as a possible candidate for fast track legislation suggested that there was a need for further work on that topic in particular.

<sup>5</sup> Part 3 of the Discussion Paper on Formation of Contract was concerned with the topic of execution in counterpart. It formed the subject of a separate Report on Formation of Contract: Execution in Counterpart (Scot Law Com No 231, 2013), and so is not dealt with in this Report.

<sup>6</sup> Report on Third Party Rights (Scot Law Com No 245, 2016).

<sup>7</sup> The CISG has been ratified by 86 states, although not by the United Kingdom, one of the very few major trading nations not to do so.

was part of an effort to promote more consistent and coherent legislation across the EU in the field of contract law.

1.5 The text of the DCFR is in codal form, along with explanatory commentary on each of its provisions plus short notes on the relevant law of each jurisdiction within the EU Member States (including Scotland). In previous publications in this project we have drawn attention to the influence that the DCFR is having in the reform of the domestic laws of the EU member states:<sup>8</sup> more so, perhaps, than on EU legislation itself.<sup>9</sup>

1.6 The impending exit of the United Kingdom from the EU has not lessened in any way the need to ensure that Scots contract law is kept up-to-date and in line with (or ahead of) international standards. The importance of the EU and its individual member states as trading partners for Scotland as well as the rest of the UK will continue notwithstanding the UK's departure. Nor is there any diminution of the need to make our law as useful and useable as possible in order to ensure its value, not only to any person from outside Scotland wishing to do business in the jurisdiction, but also to those doing business from (as well as entirely within) it.

1.7 To continue to use the DCFR as an international benchmark has thus seemed sensible in our considerations of contract law reform, while not of course neglecting other possible sources of guidance. These include, not only the CISG and its forerunner the Uniform Law of International Sales (ULIS),<sup>10</sup> but also (more significantly) the other soft law international instruments such as the PECL and the UNIDROIT Principles of International Commercial Contracts (PICC).<sup>11</sup> We have also made use of the Contract Code drafted in the 1960s by the late Harvey McGregor QC. This originated in a joint project between the Scottish Law Commission and the Law Commission for England and Wales to prepare such an instrument in advance of the United Kingdom's joining the European Economic Community, as it was then, in 1973. The document was never implemented, although it was eventually published in 1993.<sup>12</sup>

1.8 The objective of our review of contract law has never been the adoption of the DCFR as a legislative statement for Scots law. First and foremost, the review has used the DCFR as a yardstick against which to assess the existing Scots law of contract. The results of the exercise may indicate whether legislative intervention is required in pursuit of this Commission's general objectives of simplification and modernisation of the law. This is exemplified by our recommended reform of third-party rights in contract, which led to the Contract (Third Party Rights) (Scotland) Act 2017.<sup>13</sup> The check has however thrown up

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<sup>8</sup> See most recently the 2017 DP, para 1.4, which references our Report on Third Party Rights (Scot Law Com No 245, 2016) para 1.2.

<sup>9</sup> The European Commission's now abandoned proposal for a Common European Sales Law (based on the DCFR) was replaced in 2015 by two draft Directives on contracts for the supply of digital content (COM/2015/0634) and to contracts for the online and other distance sales of goods (COM/2015/0635). These show little trace of the DCFR. They are still making their way through the EU's legislative process, with the latter now to apply to face-to-face as well as online and distance sales: see European Commission COM/2017/0637.

<sup>10</sup> The ULIS was implemented in the UK by the Uniform Laws on International Sales Act 1967, which remains in force but is, so far as we know, a dead letter in practice.

<sup>11</sup> The third edition was published in 2010.

<sup>12</sup> The Code was published in Italy as H McGregor, *Contract Code Drawn Up on Behalf of the English Law Commission* (1993).

<sup>13</sup> See Report on Third Party Rights (Scot Law Com No 245, 2016). The Report was implemented by the Contract (Third Party Rights) (Scotland) Act 2017, which came into force on 26 February 2018.

issues not directly considered in the DCFR, such as execution in counterpart, legislated for in the Legal Writings (Counterparts and Delivery) (Scotland) Act 2015 following our 2013 Report.<sup>14</sup>

1.9 Contract law has three main functions. First and perhaps foremost, it is about enabling parties, whether individuals or other legally recognised persons, to make arrangements with other such parties that will be obligatory in law between them. Second, the law must provide means by which these obligations can be enforced by a party should another party not carry out its side of the contract. These two functions are sometimes respectively epitomised in the ideas of freedom and sanctity of contract. They also lead to the power of contracting parties to make their own rules about when obligations come into existence between them, and about their enforcement. In this way contract law rules are generally “default” in their nature rather than prescriptive or mandatory; they apply when the parties themselves have not otherwise provided.

1.10 The third function of contract law is however the regulation of freedom of contract. This is achieved by the provision of rules on when obligations apparently undertaken by the parties are not treated as binding them, or when obligations are imposed upon them by the law rather than their agreement. Within the present review, the main example of this is the law on penalty clauses. Others include the rules on essential validity (duress, fraud, error and misrepresentation), implied terms, unfair terms, and consumer and employment protection. The law on interpretation of contracts can also be seen as an aspect of this regulatory function. It is for the law, in the form of the courts, to say what the substance of the parties’ obligations is where that is disputed between them, even where the parties have sought to set up their own regime of rules on the formation and enforcement of their contract.

1.11 It is important for all these functions that the law of contract is as clear and certain as possible. If parties negotiating a contract are being advised by lawyers, this enables the advice to be given with a reasonable degree of confidence; and this will also hold good where contracting parties in dispute about the contract’s meaning seek professional advice on the matter. But professional advisers are not the only ones for whom clarity and certainty of law are important. Many contracts are made, carried through, and become the subject of disputes between parties who have no professional assistance. For such parties it is even more important that the law be clear so that, further, it is relatively readily understood. The rules should not be surprising or too far out of line with ordinary common sense, especially in business.

1.12 The Scots law of contract has largely developed as a matter of common law, that is, through the decisions of the courts and the rationalisations of writers on the law. While this has given it a degree of flexibility and responsiveness to changing social conditions, that can only happen as and when cases come before the courts. A small legal system like Scotland may not produce sufficient case law to enable the law to keep moving with the times.

1.13 Further, its common law character limits the law’s accessibility to those without legal training or knowledge of its sources. Some rules also become so firmly fixed over time that,

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<sup>14</sup> Report on Formation of Contract: Execution in Counterpart (Scot Law Com No 231, 2013).

even when plainly inappropriate in contemporary conditions, they cannot be easily shifted by way of judicial decision alone (at least below the level of the UK Supreme Court). Further, the continuity inherent in the common law has also led to the ongoing use of technical words and phrases which may once have been meaningful to non-lawyers but are now instead sources of mystification to the population at large.

1.14 A Report by the Business Experts and Law Forum in 2008, just a year before our project began, highlighted the lack of comprehensibility and accessibility of Scots law as a major factor for businesses when opting for English law rather than Scots law in the drafting of their contracts. It explained that whilst many of the terms used in contract law are individual and historic, they may “alienate those unfamiliar with Scots law”.<sup>15</sup> The report goes on to state that these terms:

“...may hinder the creation of an impression among businesses (both local and international) of the Scottish courts as modern, accessible, and user-friendly. The fact that Scotland is an English language jurisdiction should give it a competitive advantage over many other international jurisdictions as a dispute resolution forum; retaining archaic procedural terminology could limit this advantage.”

1.15 There are also the problems of gaps (or incompleteness) in the common law and of differences of view as to what the law is. The first problem arises where there are no, or only very few, judicial decisions on a particular issue. The second may arise from the same difficulty; but it can also arise from a plethora of decisions which cannot readily be reconciled with each other. The result can be varying analyses of the law by both judges and writers, with no way for the user of the law to determine which view is to be preferred. “Law which can only be tentatively identified after a trawl through extensive authorities must be condemned as not fit for purpose.”<sup>16</sup>

1.16 Our aim in recommending reforms in this Report has been therefore to produce rules that are as clear and certain as they can be made in a form that is comparatively accessible to lawyer and layperson alike, that is, in statute. We have sought to remove rules that are no longer justified in contemporary conditions and to supply ones providing answers to questions thrown up by these same conditions. We have also looked to produce clear answers on matters where differences of view have persisted over time with no resolution in sight. Finally we have sought to fill gaps, or remedy incompleteness, where such difficulties seem to cause real problems for legal practitioners and others using the law.

1.17 A last policy issue has been brought home to us repeatedly by commercial legal practitioners. That is a need to avoid making Scots law too divergent or distinctive in relation to English law in particular. Clients whose business crosses the jurisdictional frontiers of the United Kingdom will not be happy with rules meaning that costly extra steps need to be taken when transacting under Scots law by comparison with the position in England, or that outcomes differ significantly if what is done quite normally south of the border is carried out to the north only with expensive adjustments.

1.18 We have not taken this concern to mean that the Scots law of contract must be fully aligned with its English counterpart (although in most of the areas brought under review the

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<sup>15</sup> [Report by the Business Experts and Law Forum](#), November 2008, para 1.2.1.

<sup>16</sup> N Andrews, *Contract Rules: Decoding English Law* (2016), p vii.

two systems are already quite close to each other). It is entirely possible that present English law imposes unnecessary costs upon the conduct of business within and outwith the United Kingdom where Scots law does not.<sup>17</sup> Rather, therefore, we think it important to be sure that where change to Scots law is proposed it will not introduce difficulties of the kind mentioned in the previous paragraph.

## **Structure of the Report**

1.19 We have divided the Report into 22 Chapters. Chapter 2 summarises the main conclusions of the Report, and Chapter 21 contains a summary of its recommendations for legislation. The remaining Chapters are arranged in Parts corresponding to the Discussion Papers. Part 2 concerns formation of contract:

- Chapter 3 Formation: an introduction
- Chapter 4 General Principles
- Chapter 5 Offer and Acceptance
- Chapter 6 Change of Circumstances

Part 3 concerns interpretation of contracts:

- Chapter 7 Interpretation: an introduction
- Chapter 8 Developments since 2011

Part 4 (the largest of the Parts) concerns remedies for breach of contract plus some other areas for potential reform identified in the relevant Discussion Paper:

- Chapter 9 Remedies for breach of contract: an introduction
- Chapter 10 Recommendations for Reform
- Chapter 11 Retention and Withholding Performance
- Chapter 12 Anticipatory or Anticipated Breach
- Chapter 13 Termination
- Chapter 14 Other Self-Help Remedies
- Chapter 15 Enforcing Performance

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<sup>17</sup> See for example N H Andrews “Breach of Contract: A Plea for Clarity and Discipline” (2018) 134 LQR 117 (“although commercial parties desire clear rules which are easy to apply, it is doubtful whether English law satisfies this need in the context of breach. [A] second concern is whether the rules concerning breach uphold commercial expectations of contractual discipline. A legal system which successfully embodies these contractual values of clarity and commercial discipline will provide an efficient regime for use by resident parties. Such a system will also attract foreign custom. The need for clarity has been emphasised by leading judges. However, under a common law system, pin-pointing answers to contractual problems can require painstaking excavation of vast seams of case law and ‘minute critical examination of the prior decisions’”).

- Chapter 16 Damages
- Chapter 17 Gain-Based Damages
- Chapter 18 Transferred Loss Claims

Part 5 deals with penalty clauses:

- Chapter 19 Penalty Clauses: an introduction
- Chapter 20 Proposed Reforms: Analysis of Responses

### **Advisory Group**

1.20 We are very grateful to those who have provided advice to us in the course of the preparation of our Discussion Papers from 2011 to 2017. In order to set our review of Scots law against the DCFR in context, we needed to gain an understanding of the problems currently faced in practice. The Advisory Groups for each Discussion Paper, whose members are listed in Appendix B, provided invaluable assistance in this regard. We also received valuable help for each Discussion Paper from Judicial Advisory Groups of Senators of the College of Justice, and they are also listed in Appendix B.

### **Impact assessment**

1.21 With this Report we publish online a Business and Regulatory Impact Assessment (“BRIA”). It is essential for us to attempt to assess the impact, particularly the economic impact, of any reform proposal that we recommend in this Report. The BRIA concludes that the economic impact of the recommendations made in this Report is unlikely to be adverse and will, in some respects, be positive in removing existing uncertainties in the law which could otherwise only be resolved by judicial decision obtained at the expense of litigating parties. The law will also be brought abreast of modern communications technology. The accessibility of the law in the areas upon which recommendations are made, particularly formation of contract, would be improved for both lawyers and non-lawyers, offering potential savings in time and other costs for those needing to know what the law is in order to carry through transactions and resolve disputes. There would be initial training and familiarisation costs, principally for solicitors but perhaps also for other professionals in the relevant fields. But these costs (which have been quantified in the BRIA) would be small and incurred only on first implementation of the proposed legislation.

### **Legislative competence**

1.22 A provision is outside the legislative competence of the Scottish Parliament if any of the matters specified in section 29(2) of the Scotland Act 1998 apply to it. They are:

- “(a) it would form part of the law of a country or territory other than Scotland, or confer or remove functions exercisable otherwise than in or as regards Scotland,
- (b) it relates to reserved matters,
- (c) it is in breach of the restrictions in Schedule 4,

- (d) it is incompatible with any of the Convention rights or with EU law,
- (e) it would remove the Lord Advocate from his position as head of the systems of criminal prosecution and investigation of deaths in Scotland.”

1.23 In our view, none of the recommendations made in this Report would trench upon these reservations. The Report is concerned with the law of obligations and in particular contract, which is an aspect of Scots private law as defined in the Scotland Act 1998.<sup>18</sup> Scots private law also includes the law of actions, including remedies. None of these are reserved matters (as set out in Schedule 5 to the Scotland Act 1998). Reform is proposed to the defence of contributory negligence under the Law Reform (Contributory Negligence) Act 1945, but in relation to a Scotland-only section of that Act, making the Act apply generally in cases of breach of contract.

1.24 The Report examines remedies that are currently found in Scots law only under bespoke statutory regimes, such as the Consumer Rights Act 2015. Consumer protection is a reserved matter.<sup>19</sup> However, the Report does not propose any change to those regimes. It merely considers them as examples of particular remedies. Accordingly, we do not consider that any of the recommendations made in the Report relate to reserved matters. We do not consider that they would breach any of the restrictions in Schedule 4 to the Scotland Act 1998 either.

1.25 Finally, we do not consider that any of the recommendations, if enacted, would be incompatible with any of the Convention rights or with EU law.

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<sup>18</sup> Within the meaning given by section 126(4) of the Scotland Act 1998.

<sup>19</sup> Scotland Act 1998, Schedule 5, Part II, section C7.

# Chapter 2 Overview of the Report

## Formation of contract

2.1 The most significant recommendations made in this Report concern formation of contract. The principal substantive reform concerns the abolition of the postal acceptance rule whereby a contract is formed when an acceptance of a preceding offer is put in the post or sent as a telegram. As we explain in detail in Chapter 4,<sup>1</sup> this is an example of a rule fixed early in the nineteenth century when post was the primary means of communication between distant or remote parties. In the modern world, however, there are many other quicker forms of communication between such parties, and the policy considerations underlying the establishment of the postal acceptance rule seem obsolete in consequence. In that context there is no good reason to privilege postal over other forms of acceptance.

2.2 We understand that well advised parties in both Scotland and England already commonly exclude the postal acceptance rule because of the uncertainty it creates. But, as we explain in more detail in Chapter 4,<sup>2</sup> some online traders operate on the footing that posting ordered goods to their customers concludes the contract of supply, while notifying the latter by email that the posting has taken place. There will be nothing in the proposed reform precluding that practice continuing to be valid, since parties will remain free to establish their own rules on contract formation.

2.3 The general default rule at present with regard to offers and acceptances (and indeed their withdrawal, revocation and rejection) is that each such statement takes effect as such upon communication to the intended addressee. Communication is understood objectively: that is, not when the recipient actually reads or hears the statement, but rather when it ought to have been read or heard. We think that this is the correct approach in general.

2.4 A problem in modern conditions, however, is how to apply this principle to communications made electronically, in particular by email. It has been suggested that the postal rule should be the default rule where the communication is an acceptance of an offer. But we think that rule is just as problematic in the electronic as it is in the hard-copy world. So instead we propose a rule that a “notification” in relation to contract formation should in general take effect on “reaching” its intended addressee. “Reaching” occurs when the notification is made available to the addressee in such circumstances as make it reasonable to expect that person to be able to access it without delay. In the case of the notification transmitted by electronic means, this occurs when it becomes available to be accessed by the addressee. This, we believe for reasons explained fully in Chapter 4,<sup>3</sup> fills a gap in the present law, and does so in a way consistent with current international understandings of how to deal with the question.

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<sup>1</sup> See paras 4.86 to 4.90 below.

<sup>2</sup> See para 4.50 and fn 56 below.

<sup>3</sup> See paras 4.59 to 4.71 below.

2.5 In a number of areas of importance within the law of formation of contract we were unable in the relevant Discussion Paper to identify Scottish authority directly in point. While some of these gaps can be filled by reference to English authority, this is not always so. Particular examples are the effects of supervening insolvency or incapacity or death of an offeror or offeree during the formation process. It is uncertain whether the principles underlying English law in these areas are necessarily shared with Scots law. There are conflicting views on the subject in the Scottish books.<sup>4</sup> The Report recommends clear rules by which these conflicts of view may be authoritatively brought to an end.

2.6 The 2012 DP also reviewed the difficulties caused for the law of formation by the battle of the forms, which consultation confirmed as a regular and problematic occurrence in modern business. Each of the parties negotiating a contract attaches to what purports to be an offer on one side and an acceptance on the other a set of standard or non-negotiated terms of business which it normally uses in transactions, on the basis that these will be the terms of the resulting contract. On the ordinary rules of offer and acceptance no contract results from such an exchange of standard forms. That answer is however commercially unacceptable, and the courts have therefore sought to provide contractual solutions, often of an ad hoc rather than a principled nature. The law is thus difficult to state and even harder to apply.

2.7 Following the consultation on the 2012 DP, we have decided not to seek to create any new special regime for the battle of the forms. We agree with consultees who said that this would only mean new uncertainty in place of the old. We believe instead that the right approach can be found by remembering that offer and acceptance is not the only method by which a contract is formed. The governing principle is that a contract is an agreement between parties which they intend to have legal effect, which contains all the essentials of the kind of contract they are seeking to conclude, and which is sufficiently certain in its content to be legally enforceable.

2.8 We have therefore recommended a provision to this effect in this Report. But the significance of that provision is not limited to the battle of the forms. There are various other situations in which offer-acceptance analysis is rather strained. They include multi-party contracts, contracts executed in writing and subscribed by all parties, and contracts executed in counterpart. These examples often overlap in practice. We therefore think that this recommendation should free the law from rather empty doctrinal debates, bearing little relation to any commercial reality, on how to apply the offer-acceptance analysis in such situations.

2.9 In the 2012 DP, we asked consultees whether they thought that there would be an advantage in having a statutory statement of the law on formation of contract. This was driven mainly by the policy considerations advanced in Chapter 1. Legislation which confined itself to specific reforms would simply add to the complexity of the law, and the difficulty of finding it. Bringing all (or at least as much as possible) of the law into one place would make it more accessible to all types of potential users, within and without the legal profession. The question would cease to be “what are the rules?” and become instead “how to apply these rules to the facts of the case?”

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<sup>4</sup> We discuss this in Chapter 6 below.

2.10 The 2012 DP advanced two further considerations. The first of these was the difficulty of reforming the postal acceptance rule (and also providing for execution in counterpart) unless these reforms were given a clear setting in an overall scheme. The same could also be said about the other specific problems of the battle of the forms, electronic communications in contract formation, and the effects of death or other supervening incapacity or insolvency of offeror or offeree before any contract is concluded. The second consideration was the absence of direct Scottish authority on a number of points (especially the effects of supervening incapacity or insolvency), with some conflict as a result in the textbooks and difficulties in supplying the want from English authorities.

2.11 The responses that we received to the suggestion of a statutory restatement on contract formation were broadly positive, and only one was definitely opposed. Our draft Bill, which follows upon consultation on an earlier version, gives an indication of how the resulting statute might look.

2.12 Some consultees were concerned about how such a scheme might be seen in relation to the pre-existing common law on the subject, and also that it might contribute to a potentially damaging perception that Scots law had diverged in some possibly non-obvious way from English law. In response to this point, we would wish to highlight that our detailed recommendations for substantive law reform are limited. The major change relates to the law on postal acceptances, which we believe will bring the law into line with general legal practice on both sides of the border. Further, the clarification of the law on electronic communication in contract formation is consistent with existing principles of Scots and English law. Otherwise the statutory statement is conservative and we do not think that it would in fact result in Scots and English law diverging any more significantly than they do at present.

### **Interpretation of contract**

2.13 When we began the review of contract law in 2011 with a Discussion Paper on interpretation, the courts appeared to be in some state of uncertainty as to the law, and it seemed worthwhile to test opinion on possible ways of resolving the dilemma. The consultation response was mixed; but meantime the UK Supreme Court embarked upon an exercise of clarification which culminated in the case of *Arnold v Britton* in 2015 and was further consolidated in 2017 by a significant passage in Lord Hodge's judgment in *Wood v Capita Investments*.<sup>5</sup> This is described and analysed in detail in Chapter 8. The views developed by the Supreme Court appear to have commanded general (if not complete) acceptance in the Court of Session.<sup>6</sup>

2.14 In light of the mixed response to our 2011 suggestions on the subject and the subsequent emergence of a much greater degree of consensus in the courts, we do not think it right to propose legislative reform or a statutory restatement of this topic at this time. We think that the law should be left for further development under the framework now established by the courts. In Chapter 7, however, we draw particular attention to one long-

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<sup>5</sup> *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619; *Wood v Capita Investments* [2017] UKSC 24, [2017] AC 1173.

<sup>6</sup> See in particular *@SIPP Pension Trustees v Insight Travel Services Ltd* [2015] CSIH 91, 2016 SC 243.

established rule of Scots law which has been rejected for English law<sup>7</sup> but which we believe to be preferable to the English rule. This is the rule that, where a negotiating party knows that the other party attaches a particular meaning to a word or phrase in the contract but has not indicated that it gives that word or phrase a different meaning, the first meaning prevails.<sup>8</sup>

## Remedies for breach of contract

2.15 In our 2017 DP we raised the possibility of a statutory restatement of the law on the subject. For the reasons given in Chapter 9,<sup>9</sup> we have not recommended that this be pursued. The decision not to produce a statutory restatement of the law on remedies for breach means that we cannot pursue the possible modernisation and clarification of the terminology used in this area, which was one of the major themes of the 2017 DP on the subject.<sup>10</sup> It may be however that this task will be taken up in an academic project for the restatement of Scots contract law which has begun under Professor Martin Hogg of the Edinburgh Law School.<sup>11</sup>

2.16 This decision does not mean that we have abandoned all attempts at reforms in the area of remedies for breach, however. Three individual reforms attracted support and little or no opposition on consultation.

2.17 The first of these is on a topic where there are inconsistent decisions from the courts and some confusion in practice. This is the doctrine of mutuality of contract in so far as it seems to say that a party in breach of contract is thereby disabled from claiming any performance due to it by the other party. We think that the law can be made clearer by stating that a party in breach of contract can claim performance from the other party unless (1) the performance in question is being lawfully retained or withheld by that other party (that is, the latter is exercising the remedy of retention); or (2) the performance in question fell due only after the other party had lawfully terminated the contract (that is, the latter has rescinded the contract for the first party's material breach). The Report so recommends in paragraph 10.12 and the draft Bill has an appropriate provision.

2.18 The second recommendation for reform aims to develop the law by filling a gap or dealing with a problem where the common law is incomplete. The subject is restitution after rescission (or termination) of a contract for a party's material breach. There has been much writing and not a few cases on this matter over the last quarter century but no consensus has emerged on how the issue should be treated by the law. In the 2017 DP we asked whether the well-developed scheme on the matter to be found in the DCFR might be adopted (or adapted) for Scots law. Consultees who responded to this question generally gave positive answers, albeit with some caveats. We have accordingly recommended such a reform in paragraph 10.26 of this Report and made appropriate provision in the draft Bill.

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<sup>7</sup> See *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, [2009] 1 AC 1101.

<sup>8</sup> See paras 8.53 to 8.60 below.

<sup>9</sup> See paras 9.9 to 9.12 below.

<sup>10</sup> See the comment on the 2017 DP in a blog by the law firm Jackson Boyd that "there is undoubtedly a need to make the law in this area clearer" (<https://goo.gl/UaKxEs>).

<sup>11</sup> The project is modelled on A Burrows (assisted by an advisory group of academics, judges, and practitioners), *A Restatement of the English Law of Contract* (2016). Another example of such a project for English law can be found in N Andrews, *Contract Rules: Decoding English Law* (2016), from which see also N Andrews, "Codification of Remedies for Breach of Commercial Contracts: A Blueprint", in Virgo and Worthington, *Commercial Remedies*, ch 23.

2.19 The third recommendation is for the introduction of a system for limiting the damages recoverable for a breach of contract in cases where the party seeking the damages (the creditor) has contributed by its conduct to its own loss. As the law is currently thought to be,<sup>12</sup> it appears that the defence of contributory negligence under the Law Reform (Contributory Negligence) Act 1945 (the 1945 Act) is available to a defender in a breach of contract claim (the debtor) if its contractual obligation was concurrent with a delictual obligation, or an obligation that would give rise to a breach of statutory duty. This is the case regardless of whether the creditor chooses to frame its action solely in terms of breach of contract.<sup>13</sup> The defence does not otherwise arise.

2.20 The present law's dependence on the nature of the breach before the creditor's contribution to its own loss can be taken into account leads to strange anomalies. The debtor must argue that the breach constituted negligence while the creditor must claim that it did not. We commented in the Discussion Paper that it was not obvious to us that this approach leads to just results in all, or even many, cases.

2.21 We therefore recommend in paragraph 10.54 of this Report that the 1945 Act be amended to make available to the debtor in an action of damages for breach of contract a defence of the creditor's contributory negligence whatever the nature of the breach. Negligence of the debtor will cease to be a prerequisite for the defence to apply. The draft Bill contains an appropriate provision.

## **Penalty clauses**

2.22 In 2015 the UK Supreme Court substantially re-wrote the law of England and Wales on penalty clauses but did not, as some had hoped, abolish it altogether.<sup>14</sup> Our previous Report on the topic was used by the Supreme Court in reaching its decision.<sup>15</sup> We had already commenced fresh work on the subject when the Supreme Court published its decision. It seemed worthwhile to canvas in our 2016 DP the possibility of abolition by way of legislation, given that judicial abolition of a long established common law doctrine or rule is probably not possible. Our consultation also included a tentative scheme for abolition plus replacement by a scheme building upon but also moving beyond the Supreme Court decision. We invited consultees to tell us if they thought that the decision should be given time to bed in before any further reform was undertaken.

2.23 The consultation responses showed no appetite for outright abolition of the penalties doctrine, and a fairly consistent view that the Supreme Court decision should be given bedding-in time. Few difficulties had been encountered with it in practice thus far. There was also a view that in this area Scots law should not move any further apart from English law. While consultees offered a number of valuable comments on the tentative reform scheme proposed in the 2016 DP, it could not be said to enjoy clear support across the board.

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<sup>12</sup> As is noted in Chapter 10, there is a doubt as to whether this is the law.

<sup>13</sup> See McBryde, *Contract*, para 22.36.

<sup>14</sup> *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67, [2016] AC 1172.

<sup>15</sup> See *Cavendish/ParkingEye* paras 38 (Lords Neuberger and Sumption), 163 to 164 (Lord Mance), 263 (Lord Hodge), and 292 (Lord Toulson).

2.24 Since we indicated in the 2016 DP that we would be strongly guided on this topic by the consultee responses, we have reached the view that the Supreme Court decision should indeed be left to bed in. No doubt if it is found to cause difficulties or injustice in practice stakeholders will bring that to the attention of government and law reform bodies both north and south of the border. But we do not think that we can recommend any reform at present.

### **Party autonomy**

2.25 In general, the principle of party autonomy underlies the reforms proposed in this Report: that is, the new or re-stated rules will be subject to the power of parties to provide otherwise by agreement between them. The point is explored in more detail at the appropriate points in the Report.<sup>16</sup>

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<sup>16</sup> See paras 4.46 to 4.55, 9.3, 10.11, 10.26 and 10.56 below.

## **PART 2**

# **Formation of Contract**

# Chapter 3      Formation: an introduction

## Background

3.1      In March 2012, we published a Discussion Paper on Formation of Contract (the 2012 DP). It was the second paper published in our review of contract law, and it built upon a significant amount of earlier work which had culminated in the publication of a Report in July 1993 (the 1993 Report). The 1993 Report has not been implemented. When we published the 2012 DP, Part 2 broadly dealt with the subject-matter of the 1993 Report, focusing on two issues of particular importance: the postal acceptance rule and the battle of the forms. It also canvassed the possibility of producing a statutory statement of the law on formation of contract.

3.2      Part 3 of the 2012 DP was concerned with the topic of execution in counterpart. We do not discuss that topic further in this Part because it formed the subject of a separate Report and draft Bill in April 2013.<sup>1</sup> That Report was subsequently implemented by the [Legal Writings \(Counterparts and Delivery\) \(Scotland\) Act 2015](#), which came into force on 1 July 2015.

## Structure of this Part

3.3      This Part of the Report is divided into four Chapters:

- Chapter 3      Formation: an introduction
- Chapter 4      General principles
- Chapter 5      Offer and acceptance
- Chapter 6      Change of circumstances

3.4      As we outline below, there appears to us to be broad support for the production of a statutory statement of the law of formation. That being the case, we have set out the general principles that would underpin that statement in Chapter 4. In Chapter 5, we turn to the detailed rules that surround the formation of contract by offer and acceptance, setting out in greater detail the principles that would form part of the statement. In Chapter 6, we consider the effect of a material (or fundamental) change of circumstances on offers and acceptances, focusing on death, incapacity and insolvency.

3.5      The principal substantive reform proposed in this Part concerns the abolition of the postal acceptance rule. This topic is canvassed fully as part of our commentary on the general principles of formation.<sup>2</sup> The battle of the forms was the other potential area of substantive reform canvassed in the 2012 DP. We set out our reasons for not

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<sup>1</sup> Report on Formation of Contract: Execution in Counterpart (Scot Law Com No 231, 2013).

<sup>2</sup> See paras 4.86 to 4.90 below.

recommending specific reform at this stage in Chapter 4, where however we also point out the scope for using the general principles to be set out in the statutory statement (in particular, contract as agreement) to address the problem.<sup>3</sup>

### **A statutory statement: policy considerations**

3.6 In the 2012 DP, we asked consultees whether they thought that there would be an advantage in having a comprehensive statutory statement of the law on formation of contract. This was driven mainly by the policy considerations advanced in Chapter 1, in particular improving the law's accessibility to all types of users, within and without the legal profession. Legislation which confined itself to specific reforms would simply add to the complexity of the law, and the difficulty of finding it. Bringing all (or at least as much as possible) of the law into one place would simplify its use. The question would cease to be "what are the rules?" and become instead "how to apply these rules to the facts of the case?"

3.7 We advanced two further considerations. The first of these was the difficulty of reforming the postal acceptance rule (and also providing for execution in counterpart) unless these reforms were given a clear setting in an overall scheme. The same might have been said about the specific problems also identified in the 2012 DP, the battle of the forms and electronic communications in contract formation. The second consideration was the number of areas within the law of formation of contract where we had been unable to identify direct Scottish authority in point. While some of these gaps might be filled by reference to English authority, this was not always so. We gave the examples of the effects of supervening insolvency or incapacity of an offeror or offeree during the formation process. It was not certain that the principles underlying English law in these areas were necessarily shared with Scots law. There are conflicting views on the subject in the Scottish books.<sup>4</sup> Such questions could be authoritatively answered in a statutory statement of the law.

3.8 The responses that we received were broadly positive, with only one opponent (Morton Fraser LLP).<sup>5</sup> Those in support agreed with our reasoning, although some suggested alternative approaches. Some consultees were concerned about how such a scheme might be seen in relation to the pre-existing common law on the subject, and also about how it might contribute to a potentially damaging perception that Scots law had

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<sup>3</sup> See paras 4.23 to 4.45 below.

<sup>4</sup> We discuss this at paras 6.25 to 6.29 below.

<sup>5</sup> In responding to the 2017 consultation on a draft Contract (Formation) (Scotland) Bill the Law Society of Scotland further commented: "We also support the objective of ensuring that Scottish contract law keeps pace [with] the DCFR. Irrespective of Scotland's position within the EU, it is clearly desirable to have a law of contract which measures up to international comparators." The consultation also sparked comment on law firm blogs. Gillian Craig of MacRoberts observed: "The reform and codification of the law of contracts has been long overdue" (Gillian Craig (MacRoberts), "Contracting into the 21<sup>st</sup> Century – Contract (Formations) (Scotland) Bill", 12<sup>th</sup> October 2017, at <https://goo.gl/UZKa44>). CMS's Law Now blog noted: "The Bill aims to provide clarification and align law of formation of contract with modern common practice, moving away from archaic rules and implementing provisions to reflect today's wide range of modern communication methods" (CMS, "Contract Formation: So Long, Postal Acceptance?", 27.09.2017, at <https://goo.gl/mTVDzy>). Shepherd and Wedderburn gave a summary and useful comments on the detail, and concluded: "the draft Bill is one to watch with interest" (Shepherd & Wedderburn, "Goodbye 'Postal Acceptance Rule', Hello 'Out-of-Office Message' Rule?", 05 Sep 2017, at <https://goo.gl/5evhjK>).

diverged in some possibly non-obvious way from English law. In response, we would wish to highlight that our detailed recommendations for substantive law reform are limited. The major change relates to the law on postal acceptances, which we believe will bring the law into line with general legal practice on both sides of the border. In addition, we propose legislative clarification of the law on electronic communication in contract formation. The clarification is consistent with existing principles of Scots and English law. As a result, we do not think that a statutory statement of the law would in fact result in Scots and English law diverging any more than they do at present.

3.9 We also consider that a statutory statement of the law would provide a useful opportunity to set in context our proposed substantive reforms, rather than adding piecemeal statutory provisions to the present patchwork of case law and commentaries. In our view, stating the law in a single statute would significantly improve the accessibility of the law. Our draft Bill gives an indication of how that statute might look.

3.10 We therefore recommend that:

- 1. There should be a statutory statement of the law on formation of contract.**

(Draft Bill, Part 1)

#### *Scope of the statutory statement*

3.11 In preparing the 1993 Report, our predecessors also examined the possibility of a statutory statement of the law on formation. However, the 1993 Report instead recommended that certain aspects of the UN Convention on Contracts for the International Sale of Goods (CISG) should be incorporated into domestic law.<sup>6</sup> It was made clear that the draft Bill annexed to the 1993 Report was not intended to be an exhaustive statement of the law relating to the formation of contract. Its scope was therefore carefully regulated by clause 1(2), which contained a number of savings for other matters that affected formation (such as the unfair contract terms legislation, and rules of law requiring writing for the constitution of a contract<sup>7</sup>), as well as a general saving for the existing law on formation so far as the Bill did not make provision about it.

3.12 Underlying this, however, it was apparent that the 1993 Report was concerned to limit the scope of its recommendations to formation alone, specifically excluding any encroachment into questions of the essential validity of a contract (for example, on the ground of error or incapacity).<sup>8</sup>

3.13 We think that something similar would be of value in a statutory statement. It might well have to be differently focused, given the wider intention now to have a comprehensive statement of what the law is. However, the incorporation of specialist regimes (such as the

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<sup>6</sup> 1993 Report, paras 1.10 and 1.11.

<sup>7</sup> The 1993 Report preceded the implementation of the Report on Requirements of Writing (Scot Law Com No 112, 1988) by the Requirements of Writing (Scotland) Act 1995.

<sup>8</sup> 1993 Report, paras 1.11 and 2.2. Our present Report deals with incapacity only in so far as it arises for a party *during* a formation process, and not with the more general questions of a party's incapacity *before* that process starts or of incapacity affecting a party *after* a contract has been concluded.

Requirements of Writing (Scotland) Act 1995) is outwith the scope of this report, and so it would make sense to include a specific saving provision which would have the incidental benefit of drawing users' attention to other potentially relevant matters. Equally, as no statutory statement is likely to cover every possible scenario, we can see a benefit in preserving the common law on formation so far as may be needed to deal with matters that have not been envisaged and included in the draft Bill.

3.14 In 1993, the actual rules on formation were contained in a Schedule to the draft Bill. It opened with this statement:

“1. The rules in this Schedule govern only the formation of contract... In particular, except as otherwise expressly provided in this Schedule, they are not concerned with ... the validity of the contract or of any of its provisions or of any usage ...”

3.15 Since only the formation of contract is governed, the rules do not apply to the formation of unilateral promises. Our draft Bill contains similar provisions, although the rules are stated in the main body of the statute rather than in a schedule. Accordingly, we recommend that:

**2. The statutory statement of the law on formation of contract should make clear that it is not concerned with:**

- (a) providing protection against unfair contract terms;**
- (b) providing protection for a particular category of contracting person;**
- (c) the requirements of writing;**
- (d) prescribing the form for a contract;**
- (e) the essential validity of the contract or of any of its provisions.**

(Draft Bill, section 23(b) to (f))

**3. The statutory statement should also specify that existing enactments and the common law continue to apply in relation to any question relating to the formation of a contract that is not otherwise provided for in the statement.**

(Draft Bill, section 23(a)(i))

# Chapter 4      General principles

## Introduction

4.1      The major focus of the 1993 Report was the formation of contract by way of an offer from one party met by an acceptance from the offeree. In the 2012 DP we considered a number of other important issues relating to the formation of contract which were not touched upon in the 1993 Report but which we have become convinced warrant inclusion in any statutory statement of the law on formation of contract. In the remainder of this Chapter, we discuss the general principles that underpin our proposed statutory statement. For the most part they are also reflected in the current law.

4.2      The first of these general principles is that contracts are agreements between two or more parties which they intend to take legal effect between them.

4.3      Recognising the importance of the general principle that contracts are formed by parties' agreement leads naturally to another principle, that of party autonomy in contracting. The recognition of party autonomy in contracting has the vital consequence that most of the other rules to be discussed on formation are default rules: it is open to parties to provide their own, different, rules on how and when a contract is concluded between them.

4.4      Contracts are generally formed by a process of communication between parties, usually analysed as offers (or not, as the case may be) and acceptances. The third general principle therefore concerns when communications between parties take effect. The international comparator instruments which have underpinned our contract law review agree that, in principle, communications can only take effect when they reach the party to whom they are addressed, and again we think that in general this is also the position in Scots law. A notable exception in the present law is, however, the postal acceptance rule.

4.5      We turn now to discuss each of these principles in turn, having in mind their application in our proposed statutory statement.

## Contract as agreement

4.6      Professor McBryde, having reviewed the approach of the Institutional writers to the definition of contract, suggests that the master concept of contract may best be defined as:

“...the agreement of two or more parties which is intended to establish, regulate, alter or extinguish a legal relationship and which gives rise to obligations and has other effects, even in respect of one party only.”<sup>1</sup>

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<sup>1</sup> McBryde, *Contract*, para 1.03 (quoting H McGregor, “European Contract Code”, published as a special issue/supplement in (2004) 8 Edin LR). Gloag, *Contract*, p 6, also defines contract in terms of agreement: “the consent of two or more parties to form some engagement or to rescind or modify an engagement already made”; the agreement may be “expressed in words, writing or conduct”. See also MacQueen and Thomson, *Contract*, paras 1.9 to 1.14 and 2.2 to 2.8; *SME, Obligations*, paras 611 and 619; Walker, *Contracts*, paras 1.19 to 1.20; *Gloag and Henderson*, paras 5.03 to 5.08. The principal example of a contract having other effects is that parties have available to them a range of remedies to enforce or terminate the obligations that have been entered into.

This is not dissimilar to the formulation found in the DCFR:

“A contract is an agreement which is intended to give rise to a binding legal relationship or to have some other legal effect. It is a bilateral or multilateral juridical act.”<sup>2</sup>

4.7 As McBryde later observes, offer and acceptance is a useful tool for deciding whether that agreement exists, but it should not be regarded as necessary for formation of contract.<sup>3</sup> Offer and acceptance is but one means of showing that the parties have reached agreement, and there are other possibilities.<sup>4</sup> The most significant practical example of formation without offer and acceptance is the formal written document which the parties intend to be their contract only after they have each signed it. Contracts may also be created by parties' performances or conduct,<sup>5</sup> or by complex oral negotiations resolved at some decisive meeting of the parties. Another example may be multi-party contracts to which the several parties agree at different times without necessarily going through a series of exchanges of offer and acceptance.<sup>6</sup>

4.8 We therefore think that in a statutory statement of the law on formation of contract it would be necessary to go further than a simple provision that a contract can be formed by offer and acceptance.

4.9 McBryde's chapter on offer and acceptance is preceded by one entitled “The Formation of a Contract”, and in this he explores requirements for enforceable agreements in general—notably, for present purposes, agreement on the “essentials” of the contract, an intention to create legal relations, and certainty of terms.<sup>7</sup>

#### *The essentials of a contract*

4.10 The essentials which must be agreed for there to be a contract vary according to the type of contract.<sup>8</sup> The usual minima are the parties to the agreement, the subject-matter of the contract (which may for example be the property to be transferred or the principal performance to be rendered), and the price if any (or the mechanism by which that is to be determined, or at least agreement that payment is to be made for the principal performance). It is possible for parties who have agreed the essentials of a particular contract to be bound

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<sup>2</sup> DCFR II.1–101(1). See also DCFR II.1–101 Commentary A para 2, which elaborates on the “other legal effects” contemplated. Examples given include an agreement to vary the terms of an existing contract, or to terminate an existing legal relationship, as well as an agreement that immediately transfers proprietary rights.

<sup>3</sup> McBryde, *Contract*, para 6.05.

<sup>4</sup> See McBryde, *Contract*, paras 6.04 and 6.05, where many everyday situations such as the purchase of a ticket to travel on a local bus are referenced. See also *SME, Obligations*, para 655.

<sup>5</sup> For an example of a contract formed entirely by the parties' conduct, see *Morrison-Low v Paterson* 1985 SC (HL) 49 (proprietor admitted another into possession of agricultural ground and regularly accepted rent; irresistible inference that tenancy created; not necessary to show a particular occasion on which a tenancy was agreed).

<sup>6</sup> The classic example in the books is *Clarke v Earl of Dunraven (The Satanita)* [1897] AC 59 (yacht race competitors bound by competition rules as contract to which all had at various points subscribed). Other examples might be partnerships, unincorporated associations and the rules of tender competitions which bind all tenderers.

<sup>7</sup> McBryde, *Contract*, chapter 5. See also Gloag, *Contract*, pp 8 to 12; Walker, *Contracts*, paras 3.13 and 7.1, and chs 8 and 9; *SME, Obligations*, paras 656 to 658; MacQueen and Thomson, *Contract*, paras 2.4 and 2.64.

<sup>8</sup> McBryde, *Contract*, para 5.15.

in a contract even although they continue to negotiate on other matters.<sup>9</sup> For McBryde, “[t]he touchstone is whether it is possible to enforce the contract.”<sup>10</sup>

4.11 A useful statement of principle on both intention and the essentials is also to be found in the Supreme Court decision in the English case of *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH*:

“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. Even if certain terms of economic or other significance to the parties have not been finalised, an objective appraisal of their words and conduct may lead to the conclusion that they did not intend agreement of such terms to be a pre-condition to a concluded and legally binding agreement.”<sup>11</sup>

#### *Intention to create legal relations*

4.12 The intention to create legal relations is objectively determined and does not depend on the existence of an actual intention of the parties (although an express declaration of non-intention to create legal relations can be effective).<sup>12</sup> While a number of presumptions apply, legally enforceable relations are most likely to arise where a party’s patrimonial interests are engaged.<sup>13</sup> Commercial arrangements will generally be seen as creating legally enforceable relations between parties, while social ones will not. For example, it is unlikely that accepting an invitation to a party or agreeing to attend a sporting event with a friend would be seen as intended to create legally enforceable relations. The concept is probably at its most important in its negative mode, that is, where parties expressly state that they do not intend an agreement to be a binding contract. Examples of this include statements that the agreement is binding in honour only, or that it will become binding only when executed by the parties in a formal document or upon the occurrence of some event otherwise not certain to happen.

4.13 The objective approach to intention to effect legal relations is also relevant to the even more basic question of whether or not parties have actually achieved agreement, or consensus.<sup>14</sup> As Lord President Dunedin famously said:

“...commercial contracts cannot be arranged by what people think in their inmost minds. Commercial contracts are made according to what people say.”<sup>15</sup>

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<sup>9</sup> The classic Scottish case is *Wight v Newton* 1911 SC 762 where the parties were held bound by their agreement on the essentials of a lease even although they continued to bargain on other terms to be included in a later, formally executed lease agreement.

<sup>10</sup> McBryde, *Contract*, para 5.14.

<sup>11</sup> [2010] UKSC 14, [2010] 1 WLR 753, para 45.

<sup>12</sup> On the increasing significance attached to intention to be legally bound in recent Scottish case law, see G Black, “Formation of Contract: the Role of Contractual Intention and Email Disclaimers” 2011 JR 97.

<sup>13</sup> McBryde, *Contract*, paras 5.02 to 5.09; MacQueen and Thomson, *Contract*, para 2.64.

<sup>14</sup> McBryde, *Contract*, paras 6.08 to 6.13.

<sup>15</sup> *Muirhead & Turnbull v Dickson* (1905) 7 F 686, 694.

This is usually taken to apply to all and not just commercial contracts. An objective approach, based on what the reasonable person would think the parties had done or intended, informs contract law in a number of respects which we explore elsewhere in this Chapter and, indeed, Report (notably questions of communication and interpretation).<sup>16</sup>

4.14 A further aspect of objectivity in formation, however, is how to approach the individual (or unilateral) statements that parties make to each other in negotiations in order to determine whether these statements are invitations to treat, offers, acceptances, qualified acceptances, counter-offers, rejections or revocations. Here the classic statement (approved by the House of Lords in *McCutcheon v MacBrayne*) is by Gloag:

“The judicial task is not to discover the actual intentions of each party; it is to decide what each was reasonably entitled to conclude from the attitude of the other.”<sup>17</sup>

This may differ slightly from the objective approach to a single document said to be a contract between the parties to it. There, the search is for the objective common intention of all of the parties as derived from their document and the admissible surrounding circumstances. But that is not necessarily exactly the same as the perspective of the reasonable recipient of another’s statement, in that the latter may allow for slightly wider consideration of the recipient’s particular circumstances at the time of the statement’s receipt.<sup>18</sup>

#### *Certainty of terms*

4.15 On certainty, McBryde categorises three types of case where an agreement is insufficiently certain to be a contract: (1) the words used are too vague in meaning; (2) the agreement is incurably incomplete; and (3) parts of the agreement are mutually contradictory. He adds: “The categories are not completely distinct.”<sup>19</sup> The classic instance of uncertainty leading to unenforceability is the agreement to agree, where the parties agree that they will seek to negotiate a contract later.<sup>20</sup> Lord President Inglis once held that the test was whether the court could frame a decree of specific implement to give the pursuer exactly what was bargained for.<sup>21</sup> But Gloag was critical of the test so stated:

“[I]t is not to be inferred that it must be possible to frame a decree for specific implement without going beyond the words of the contract; their uncertainty may be overcome by legal implication. It is one of the main functions of a Court of Justice to give a concrete meaning, in particular circumstances, to the word ‘reasonable’, or other expressions equally indeterminate.”<sup>22</sup>

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<sup>16</sup> See further paras 4.56 to 4.99 below and more generally Part 3 (Interpretation).

<sup>17</sup> Gloag, *Contract*, p 7; approved in *McCutcheon v MacBrayne* 1964 SC (HL) 28 at 35 per Lord Reid.

<sup>18</sup> See for a recent example *Royal Bank of Scotland v Carlyle* [2015] UKSC 13, 2015 SC (UKSC) 93.

<sup>19</sup> McBryde, *Contract*, para 5.23. *Gloag and Henderson* para 5.08 adds the (very rare) category of cases of “irresoluble ambiguity” where the usual objective approach cannot determine the correct meaning of a contract term. The examples given include *Stuart v Kennedy* (1885) 13 R 221, *Falck v Williams* [1900] AC 176, and *Raffles v Wichelhaus* (1862) 2 Hurl & C 906.

<sup>20</sup> See *May & Butcher Ltd v The King* (1929) noted at [1934] 2 KB 17; *Scammell v Ouston* [1941] AC 251; cf *Hillas & Co Ltd v Arcos Ltd* (1932) 147 LT 503. Another well-known English example is *Walford v Miles* [1992] 2 AC 128,

<sup>21</sup> *Macarthur v Lawson* (1877) 4 R 1134.

<sup>22</sup> Gloag, *Contract*, pp 11 and 12. An example illustrative of Gloag’s point is the orders for implement made by the Court of Session in the “keep open” commercial lease cases of *Retail Park Investments Ltd v Royal Bank of Scotland plc* 1996 SC 227 and *Highland & Universal Properties Ltd v Safeway Properties Ltd* 2000 SC 297. See also *Brennan v Robertson* 1997 SC 36.

4.16 The idea of uncertainty making an agreement unenforceable is in general treated narrowly by courts conscious, as Lord Guthrie put it in 1964, that “[t]he object of our law of contract is to facilitate the transactions of commercial men, and not to create obstacles in the way of solving practical problems arising out of the circumstances confronting them, or to expose them to unnecessary pitfalls.”<sup>23</sup> In recent times, for example, agreements to use reasonable endeavours have been held enforceable by the courts.<sup>24</sup> It is also clear that uncertain parts of a contract may be treated as severable, with what remains being enforceable.<sup>25</sup>

#### *The draft Bill*

4.17 All the rules just discussed are of considerable practical importance. A statutory statement of the law of formation should therefore include similar rules. The draft Bill attached to this Report does so, in broadly similar terms. It provides that a contract is concluded on parties reaching an agreement which they intend to have legal effect and which taking any relevant enactment or rule of law into consideration has both the essential characteristics of a contract of the kind in question and sufficient content for it to be given legal effect as a contract of that kind. The relevant enactments or rules of law will include those providing for the essentials of any particular type of contract.<sup>26</sup>

4.18 The requirement that the agreement is one which, after taking any relevant enactment or rule of law into account, can be given legal effect also ensures that general concepts such as illegality and incapacity are recognised in the statutory formulation. In short, the contract that emerges from the agreement must not only meet any statutory or common law requirements for that specific type of contract: it must also be a contract which the courts would enforce.

4.19 We think that it will be helpful to make clear in the statutory statement what is the present law, that if parties are agreed on sufficient matter for the law to recognise that agreement as a contract, then there can be a contract even although the parties are continuing to negotiate on other matters relevant to their transaction.

4.20 This leads, we think, to a need for one further provision. A party wishing to guard against being found to be in a contract under the just-stated rule before it is ready for that can of course seek to specify the matters on which it and its co-contractors must be agreed before any contract is concluded. The DCFR contains a rule giving effect to such specifications to prevent contract.<sup>27</sup> But there is no direct authority to the same effect in Scots law, and there is a risk that such a pre-contractual statement is simply ineffective. We think a statutory provision to the same effect as the DCFR would be useful in giving negotiating parties a clear means of delaying the formation of a contract should that be their wish.

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<sup>23</sup> *R & J Dempster v Motherwell Bridge & Engineering Co* 1964 SC 308 at 332 per Lord Guthrie.

<sup>24</sup> See eg *R & D Construction Group Limited v Hallam Land Management Limited* [2010] CSIH 128, 2011 SC 286. In *Beaghmore Property Ltd v Station Properties Ltd* [2009] CSOH 133, however, Lord Hodge did not consider an express obligation to act in good faith to be enforceable.

<sup>25</sup> *Nicolene Ltd v Simmonds* [1953] 1 QB 543.

<sup>26</sup> The phrase also allows for the operation of the rules of validity (fraud, force, error, misrepresentation etc) and of illegality and public policy, which may prevent an agreement being binding or enforceable.

<sup>27</sup> DCFR II.-4:103(2): “If one of the parties refuses to conclude a contract unless the parties have agreed on some specific matter, there is no contract unless agreement on that matter has been reached.”

4.21 The draft Bill provides that the existence of an agreement is to be determined from the statements and conduct of the parties (whether or not such statements or conduct consist of, or include, the acceptance of an offer). We do not think it necessary to spell out in terms that the question of formation is to be approached objectively; this seems self-evident.

4.22 We recommend that:

**4. The statutory statement of the law on formation of contract should provide that:**

**(a) a contract is formed by the agreement of parties which is intended to have legal effect and which, after taking account of any other relevant legal rule, has both the essential characteristics of a contract of the kind in question, and sufficient content for it to be given legal effect as a contract of that kind;**

(Draft Bill, section 2(1))

**(b) if parties are agreed on sufficient matter for the law to recognise that agreement as a contract, they will be held to be bound by that contract even if they are continuing to negotiate on other matters relevant to their transaction;**

(Draft Bill, section 2(2))

**(c) if one of the negotiating parties refuses to conclude a contract unless the parties have agreed on some specific matter, there is no contract unless agreement on that matter has been reached; and**

(Draft Bill, section 2(3))

**(d) completion of agreement and intention of legal effect are to be determined from assessment of the relevant statements and conduct of the parties.**

(Draft Bill, section 2(4))

*Battle of the forms*

4.23 The principle of contract as agreement also has important implications for the so-called battle of the forms. This phenomenon arises where two parties appear to conclude a contract, but purport to do so respectively on their own standard terms and conditions. In that situation, the effect of testing for agreement solely by offer and acceptance is often the appearance that no contract has been formed, despite a real underlying agreement between the parties. The question is whether that underlying agreement should be given precedence over the apparent outcome of the offer-acceptance analysis.

4.24 These disputes often occur in cases where each of the parties send their offer and acceptance with the specifications for that transaction (such as price and delivery date) on the front of the forms, and the standard terms and conditions on the back.<sup>28</sup> This is, according to consultees, frequently the case in both supply of goods and supply of services contracts.

4.25 As standard terms may relate to matters such as delivery obligations, price calculations and liability for defective or non-performance, any lack of consensus could, at least in theory, result in a situation where there is insufficient agreement for the formation of the contract. If no contract is formed, then the parties may have to fall back on unjustified enrichment, but this could lead to difficulties.<sup>29</sup>

4.26 Accordingly, the courts have often held that a valid contract has been concluded, if there has been performance and there exists a demonstrable mutual intent to contract, despite conflict over the standard terms and conditions. It is difficult to reconcile this approach with the orthodox offer and acceptance analysis, although most judgments attempt to do so.<sup>30</sup>

4.27 In the 2012 DP, we suggested that the approach of the Scottish courts had generally meant that the battle of the forms is won by the party which is the last to send out its terms (the “last shot approach”). This is on the basis that an acceptance on conflicting terms is a counter-offer, which may then be accepted by conduct, for example where the original offeror goes on to perform the contract.<sup>31</sup> However, as noted in the 2012 DP, the last shot approach can be problematic in practice.<sup>32</sup>

#### Responses to the 2012 DP

4.28 Almost all consultees agreed that the problems around battle of the forms were indeed considerable in practice. The consensus appeared to be that when such difficulties arose, they could cause significant complications for the parties concerned.

4.29 While the Faculty of Advocates, the Senators of the College of Justice, the Law Society of Scotland and Anderson Strathern all observed that the battle of the forms commonly arises in sale of goods transactions, they also noted that it is encountered in contracts for the supply of services. Pinsent Masons commented that problems regarding the battle of the forms can arise in relation to a variety of types of contract because of the widespread use of standard forms by large businesses. However, Pinsent Masons cautioned that any alternative to the current approach would have to provide a better solution rather than a different source of uncertainty.

4.30 The 2012 DP outlined the possibility for reform of the current law by way of a special regime to resolve the problem. It was not the first time that the matter had been considered by the Commission: a consultation paper was issued in 1982,<sup>33</sup> although the 1993 Report did

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<sup>28</sup> 2012 DP, para 5.1.

<sup>29</sup> 2012 DP, para 5.2.

<sup>30</sup> See eg *Tekdata Interconnections Ltd v Amphenol Ltd* [2009] EWCA Civ 1209.

<sup>31</sup> 2012 DP, para 5.3.

<sup>32</sup> See 2012 DP, paras 5.4 to 5.7.

<sup>33</sup> Consultation Paper on Contract Law: Exchange of Standard Term Forms in Contract Formation (1982), available at: <https://goo.gl/RVhe3S>.

not recommend giving effect to the solution proposed in 1982.<sup>34</sup> The 2012 DP went on to review a variety of attempts to solve the battle of the forms, both in the comparator instruments<sup>35</sup> and in the Uniform Commercial Code of the USA.<sup>36</sup>

4.31 We asked consultees whether they thought that there was any need for a specific solution to the battle of the forms and, if so, whether that solution ought to be along the lines suggested in the PICC and the DCFR.<sup>37</sup> Only half of consultees expressed demonstrable agreement, although Anderson Strathern did state that a specific solution would be particularly helpful to “the less sophisticated commercial client” without the resources to resolve disputes in court.

4.32 The Law Society of Scotland considered that a specific solution, based on the approach in the DCFR, would provide greater legal certainty for commercial parties and avoid the possibility that no contract exists, leaving parties to rely on the law of unjustified enrichment. It considered the latter outcome to be flawed and out of touch with commercial realities. The Senators of the College of Justice, on the other hand, considered that the common law approach is adequate to deal with any problems surrounding the battle of the forms. In their view, such problems arise mainly in the business context and, because businesses prioritise concluding deals speedily, the approaches favoured by the international instruments are unattractive as they require close analysis of all parties’ terms prior to agreement.

4.33 Some consultees expressed concerns that the approach under the DCFR could potentially increase levels of uncertainty, due to difficulties in identifying terms that are common in substance. It might also result in a contract that neither of the parties intended. Pinsent Masons suggested that an alternative approach might be for a contract to be formed where there is consensus (for example on product, price and quantity) and for the common law to apply in other respects.

4.34 The 2012 DP went on to ask whether consultees would be in favour of a provision for long-term commercial relationships if they did not support a special regime to resolve the battle of the forms in all cases. This proposal did not receive support from any of our consultees. Pinsent Masons suggested that it should be clarified that it is for the court to decide what the terms of the contract are and that it can take into account the parties’ past course of dealing.

#### Subsequent developments

4.35 Since the publication of the 2012 DP, there have been several cases dealing with the battle of the forms, confirming the significance of the issue in practice. In particular, two

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<sup>34</sup> 1993 Report, paras 4.17 and 4.19.

<sup>35</sup> 2012 DP, paras 5.15 to 5.20.

<sup>36</sup> 2012 DP, paras 5.8 to 5.14.

<sup>37</sup> In the 2012 DP, we suggested that the gist of those solutions was that, if parties were in sufficient agreement on the substance of the contract then an exchange of standard forms would produce a contract, the terms being those actually agreed plus any common ground between the standard terms. See further 2012 DP, para 5.18.

recent Scottish cases are of note: one applies the last shot approach, and the other appears to apply a first shot approach.<sup>38</sup>

4.36 In *Specialist Insulation Ltd v Pro-Duct (Fife) Ltd*,<sup>39</sup> the issue in dispute was whether an adjudication clause formed part of the parties' contract. Each party, unusually, insisted that the other's standard terms and conditions ought to apply. The pursuer's quotation had stated the price, that the supply was subject to the pursuer's standard terms and conditions of trading, and that any of the defender's additional conditions were excluded unless agreed to in writing by the pursuer (an overriding clause). The defender then submitted a purchase order along with a document bearing to be a further agreement, the contents of which were internally inconsistent.

4.37 Lord Malcolm applied what he considered to be the traditional offer and acceptance analysis. He considered that the pursuer's quotation was an offer, that the document accompanying the defender's purchase order was a counter-offer containing a specific mechanism for its acceptance (which was however not accepted by the pursuer), and that the subsequent performance by the defender amounted to an acceptance of the pursuer's original offer. This is an apparent example of the first shot approach.<sup>40</sup>

4.38 In *Grafton Merchating Gb Ltd t/a Buildbase v Sundial Properties (Gilmerton) Ltd*,<sup>41</sup> the pursuer's terms (sent first) contained a purported overriding clause. The defender then submitted a purchase order, subject to its own terms. When a dispute over payment broke out, the pursuer attempted to rely on *Specialist Insulation* as authority for the first shot approach. However, the sheriff took the view that *Specialist Insulation* had been decided on the basis that the defender's terms required signature, and this had not taken place, so it could not be said to have been decided on a first shot basis. It was held, therefore, that the defender's terms applied. Hogg considers that this decision:

“...is more in line with the orthodox approach to the battle of the forms; by contrast, one has to do some work to make Lord Malcolm's decision in *Specialist Insulation* fit with orthodoxy.”<sup>42</sup>

4.39 Elsewhere in the UK, the courts have held that neither the first shot nor the last shot approach may be appropriate in some circumstances. In *Transformers and Rectifiers Ltd v Needs Ltd*,<sup>43</sup> an English High Court case, it was held that neither party's terms had been properly incorporated, and so the contract concluded did not include either set.

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<sup>38</sup> *Specialist Insulation Ltd v Pro-Duct (Fife) Ltd* [2012] CSOH 79; *Grafton Merchating Gb Ltd t/a Buildbase v Sundial Properties (Gilmerton) Ltd*, 2013 G.W.D. 17-349. M Hogg [“Two recent decisions on battle of the forms \(ie conflicting standard conditions of contract\)”](#), 9 July 2013, Obligations Law Blog, University of Edinburgh, discusses both cases in depth.

<sup>39</sup> [2012] CSOH 79.

<sup>40</sup> *Specialist Insulation Ltd v Pro-Duct (Fife) Ltd* [2012] CSOH 79, [20] per Lord Malcolm. Hogg, “Two Recent Decisions”, points out that it presents theoretical difficulties because, on traditional offer and acceptance analysis, any counter-offer rejects the original offer. Hogg does, however, suggest that the internal inconsistency of the defender's terms rendered it an invalid counter-offer, so that it was incapable of killing the original offer.

<sup>41</sup> 2013 GWD 17-349.

<sup>42</sup> Hogg “Two Recent Decisions”.

<sup>43</sup> [2015] EWHC 269.

4.40 In *John Graham Construction Ltd v FK Lowry Pilling Ltd*,<sup>44</sup> a Northern Irish case, it was also held that a contract had been formed but on neither party's terms. Although both parties had attached their respective terms, the High Court held that neither party could be objectively held to have accepted the other's.<sup>45</sup> Again, this demonstrates that the last shot approach is not infallible: the court must also be able to identify some conduct by the other party which can be interpreted as an acceptance of those terms.

4.41 These cases are broadly consistent with the earlier Scottish decision in *CR Smith Glaziers (Dunfermline) Ltd v Toolcom Supplies Ltd*.<sup>46</sup> In this case the parties exchanged, respectively, purchase requisition order and despatch note forms. Lady Clark found that the terms of neither form were incorporated into the contract. It was not disputed, however, that many different contracts had come into existence between the parties over a period of several years and that these had been successively performed. Despite the failure to incorporate the standard terms, Lady Clark (after a preliminary proof) held that the contract included a number of implied terms. It was not necessary for the purposes of the case for the judgment to go beyond that. The failure of each side to ensure that its form was the basis for the contract terms did not prevent the court reaching a method of resolving the dispute between them on a contractual basis.

4.42 Taken together, we think that these recent cases show that the courts are prepared to ameliorate the outcome of a strict offer and acceptance analysis in a battle of the forms. Instead, they seem to look to whether an agreement can be discerned from the whole circumstances which gives rise to a contract, rather than being unduly concerned about whether terms which are not necessarily material to the dispute in hand have all been accepted. We do not think that this infringes the principle articulated as follows by McBryde: "It is not correct for a court to imply terms which were not agreed and then, by adding express and implied terms, create a contract."<sup>47</sup> In the *CR Smith* case, for example, the parties had carried out several contracts together over a period of time, so that the terms implied in law in such contracts were clearly not excluded by them.

### Conclusions

4.43 Given the lack of consensus among consultees on the need for direct reform targeting the battle of the forms,<sup>48</sup> we do not recommend such reform at this time. It is apparent from the cases discussed above that the current law still generates uncertainty in this area. Consultees appear to have taken the view, however, that the proposed solutions would not produce significantly more certain outcomes. That is much the same position that was reached when this matter was last canvassed in 1993. If the question is ever referred to the Supreme Court, that may clarify the position and we think that greater certainty would be welcome.

4.44 It may however be that the courts will be able to develop solutions through use of the general principle that a contract is formed by an agreement of the parties which they intend to have legal effect and which can be given legal effect, after taking any relevant enactment

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<sup>44</sup> [2015] NIQB 40.

<sup>45</sup> [2015] NIQB 40 at para 18, per Weatherup J.

<sup>46</sup> [2010] CSOH 7, 2010 GWD 13-236. This case is discussed in detail in the 2012 DP, para 5.22.

<sup>47</sup> McBryde, *Contract*, para 5.14.

<sup>48</sup> See paras 4.31 to 4.34 above.

or rule of law into consideration. To some extent that is already happening, as can be seen from the cases just mentioned. But if section 2 of our draft Contract (Scotland) Bill were to be implemented in legislation, as recommended above,<sup>49</sup> further assistance would be available to the courts. The draft section provides that a contract is concluded on the parties coming to an agreement which they intend to have legal effect, and which taking any relevant enactment or rule of law into consideration has both (i) the essential characteristics of a contract of the kind in question, and (ii) sufficient content for it to be given legal effect as a contract of that kind. It will not be necessary for parties to have reached agreement on every point in negotiation between them so long as the court can discern from their respective statements and conduct sufficient agreement to be a contract.

4.45 In light of the lack of consensus among consultees on the subject, however, we think that the statutory statement of the law on formation of contract should not include specific provision about the battle of the forms. Instead the matter should be left to the application of the general principles set out in section 2 of the draft Bill and the rules of offer and acceptance so far as the latter are helpful.

## **Party autonomy**

### *Introduction*

4.46 We consider that it is necessary to set out the concept of autonomy briefly in context in order to underpin the following discussion of party autonomy in contract. We use “autonomy” here in the sense of personal autonomy (the individual’s capacity to decide upon and follow a course of action) rather than moral autonomy<sup>50</sup> or political autonomy.<sup>51</sup> In each case, autonomy is opposed by heteronomy, in which a person’s actions are determined by the rule or rules of another.

4.47 It is for the law, rather than the parties, to define what constitutes a contract by which persons are subjected to legally enforceable rights and duties, and to lay down what the minimum requirements are for there to be a contract. It is axiomatic that contract is achieved by a convergence of personal autonomies. Once a contract is formed, the parties’ individual autonomy is constrained by the requirements of the contract. This includes what the law may require or permit a contract to achieve as well as what the parties themselves have agreed.<sup>52</sup>

4.48 However, up to the point when a contract is formed in accordance with the law, the parties may each seek to exercise individual autonomy as to how the contract is to be formed and what the content of the contract is to be.

### *The contractual context*

4.49 While individual autonomy can never be used to create duties for other parties, it may be deployed to subject oneself to duties to other parties, thereby creating rights for those

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<sup>49</sup> Recommendation 4 above. The draft Bill may be found in Appendix A of this Report.

<sup>50</sup> By which the individual reflects on a course of action as a moral choice which can be universalised as also a rule for others.

<sup>51</sup> Under which the individual’s decisions about courses of action are taken into account within political communities.

<sup>52</sup> M Hogg, *Promises and Contract Law: Comparative Perspectives* (2011) 86 to 93 usefully distinguishes the extent of autonomy available to parties determining upon the existence of a contract as distinct from its content.

other parties. Rights include powers, the exercise of which is capable of affecting the legal position of the conferring party.<sup>53</sup> An offer to contract is an example of such a conferral of right as power: the offeree is enabled to change its own and the position of the offeror to that of parties bound in contract with each other. The offeror, in exercise of its personal autonomy, is entitled to spell out the conditions which the offeree needs to satisfy before the latter's power to bind the former is validly exercised. For example, the offeror might say that the offer is only open for acceptance for a certain period, or that the acceptance must be in writing. The offeror may also say that the offer is accepted and the contract formed by certain conduct by the offeree: this situation is most likely to arise with offers to the public, such as offers of rewards or prizes. Another example may be the "invitation to treat" where a party invites offers,<sup>54</sup> but spells out the form which offers must take, the matters they must cover, and the date, time and manner in which they must be submitted.<sup>55</sup>

4.50 By contrast, an offeree may, in the exercise of its own autonomy, reject or refuse an offer expressly. It can also seek to negotiate by neither rejecting nor accepting the offer but instead proposing other ways forward. It is also possible for the offeree to ask questions and seek clarifications from the offeror. It is within the autonomy of the offeree to make a counter-offer. If the offeror has stipulated a particular mode of acceptance, the offeree may seek to change that. If there has been no such stipulation, the offeree may seek to spell out what will constitute its acceptance. A modern example of this is the online trader who acknowledges receipt of a customer's order while also stating the offer will only be accepted and a contract formed when the ordered goods have been dispatched to the customer's address from the trader's place of business.<sup>56</sup>

4.51 The ultimate expression of an offeror's autonomy is the power to revoke the offer prior to its being accepted. Once an offer is accepted, each party is deprived of its individual autonomy in that none may withdraw from or change the contract unilaterally. Before that moment, individual autonomy prevails unless it has otherwise been given up: for example, by the offeror effectively undertaking not to exercise its power to revoke.<sup>57</sup> Neither an irrevocable offer nor an acceptance deprive the parties involved of a continuing ability to withdraw the offer or the acceptance by a statement taking effect before or simultaneously with the declaration of irrevocability or of acceptance.

4.52 There may be convergent exercise of autonomy if the parties agree that a contract is not to be formed despite their reaching agreement on all relevant matters or issues in their

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<sup>53</sup> See W N Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning* (1919) (summarised in our Discussion Paper No 157 Review of Contract Law: Third Party Rights in Contract (2014), para 2.25 and fn 48).

<sup>54</sup> Such as tenders to carry out building works or to perform services.

<sup>55</sup> As in *Blackpool & Fylde Aero Club v Blackpool Borough Council* [1990] 1 WLR 1995. Such invitations to make offers may in at least some cases be construed in Scots law as unilateral promises (ie claim-right-conferring undertakings) to consider compliant offers when made: Hogg, *Obligations*, paras 2.32 to 2.51.

<sup>56</sup> For example, Amazon uses the following clause on its website: "When you place an order to purchase a product from Amazon.co.uk, we will send you an email confirming receipt of your order and confirming the details of your order. Your order represents an offer to us to purchase a product which is accepted by us when we send email confirmation to you that we've dispatched that product to you (the 'Dispatch Confirmation E-mail'). That acceptance will be complete at the time we send the Dispatch Confirmation E-mail to you." We understand that clauses of this kind are in widespread use by commercial internet sellers of goods. Consumers are presumably protected against any unfairness by the application of Part 2 of the Consumer Rights Act 2015 to non-contractual notices as well as to standard form contract terms.

<sup>57</sup> See paras 5.23 to 5.26 below.

negotiations. They may for example provide that the agreement is to be binding in honour only, or is to become a contract only when reduced to writing which each party has subscribed, or is to be regarded as a contract only when some further matter is agreed between them. As we have already noted, this is recognised as an aspect of the lack of intention to effect legal relations between the parties.<sup>58</sup>

### *Recognition of party autonomy*

4.53 The 1993 Report stated that an equivalent to Article 6 of the CISG, giving parties the freedom to vary or opt out from the rules on formation, would be essential, and added:

“It would, for example, enable members of an electronic data interchange network to agree on rules among themselves on such matters as what would be regarded as an effective offer or acceptance or when a contract would be regarded as concluded.”<sup>59</sup>

The CISG approach is confirmed by both the PICC and the DCFR, none of whose relevant provisions on formation have mandatory effect.

4.54 Although it is difficult to find any direct statement to similar effect in Scots law sources, we think that in this regard the present law is consistent with the comparator instruments. Amongst other possibilities which could be mentioned, the principle of party autonomy allows parties to decide that no contract will be concluded between them until its terms are recorded in writing and signed by each person.<sup>60</sup> It also allows an offeror to specify a particular form or method of acceptance (for example, excluding the present postal acceptance rule by providing that an acceptance must reach the offeror to form a contract).<sup>61</sup> Finally, it enables a party to make agreement on some specific matter a requirement for the conclusion of a contract despite agreement having been reached on other issues, so that there is no contract unless agreement on that particular matter has been reached.

4.55 We therefore recommend that:

**5. The statutory statement of the law on formation of contract should provide that parties are free to exclude or derogate from its provisions.**

(Draft Bill, section 1)

## **The need for communication between the parties**

### *The DCFR and other comparator instruments*

4.56 The 1993 Report noted that under the CISG rules on contract formation it was important to know whether a statement from one party had reached the other party.<sup>62</sup> Such statements include an offer, an acceptance, or a withdrawal or revocation in either case. The importance of a statement reaching the other party is that, in general, it only has legal effect

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<sup>58</sup> See para 4.12 above.

<sup>59</sup> 1993 Report, para 2.3.

<sup>60</sup> See for example *W S Karoulias SA v The Drambuie Liqueur Co Ltd* 2005 SLT 813.

<sup>61</sup> McBryde, *Contract*, para 6.72. For an example see para 4.50 and fn 56 above.

<sup>62</sup> See 1993 Report paras 3.6 (offer) and 4.4 (acceptance).

from that point onward. Article 24 of the CISG accordingly defines what constitutes “reaching”.

4.57 The PICC and the DCFR adopt the concept of reaching and, in the case of the latter, elaborate on it. They apply the concept of reaching to notices, a further concept which covers a variety of communications including offers, acceptances and their withdrawal or revocation. The DCFR rules on when a unilateral juridical act becomes legally effective also apply to offers and acceptances.<sup>63</sup> The approach across the comparator instruments is an objective one: reaching does not necessarily involve the intended recipient's actual knowledge, either that there has been a communication from the sender or, even more so, what the contents of that communication may be.<sup>64</sup>

4.58 Unlike the CISG and the PICC, the DCFR does not contain any express mention of oral notices, although clearly face-to-face or telephonic communication are covered by its provisions. In these situations the recipient will generally have simultaneous knowledge both of the fact of communication and of the content of the communication. By contrast, any legal effect that non-oral forms of communication have depends on delivery<sup>65</sup> or making the notice accessible to the recipient. For example, a posted letter which has been delivered to a recipient's office but has not yet been opened will probably be regarded as having reached its recipient, at least from the point at which it would be reasonable for it to have been opened. On making a notice accessible, the commentary to the DCFR says that this covers “for example, leaving a message in a place which the addressee is known to check regularly”.<sup>66</sup> Whether this would extend to having notified the addressee of a registered or couriered letter awaiting collection from the local depot of the post office or courier is, however, not clear.<sup>67</sup>

#### *Scots law: general principles*

4.59 The Scots law on when offers, acceptances and their withdrawal or revocation have legal effect is clear, at least in terms of general principle. With two exceptions, communication to the other party is required.<sup>68</sup> Those exceptions are the postal acceptance rule<sup>69</sup> and the acceptance of general offers.<sup>70</sup> An objective approach is taken in determining whether or not communication has occurred, and this may make effective a communication about the existence and content of which the recipient is subjectively unaware.

4.60 The most striking Scottish example of this objective approach to communication is *Burnley v Alford*,<sup>71</sup> an Outer House case concerned with the revocation of an offer to sell property. The offeree (B) had been acting through an agent, whom he met on the morning of 12th September. The agent had left home that day before delivery of the post, while B had

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<sup>63</sup> DCFR II.-4:205.

<sup>64</sup> Vogenauer, *PICC Commentary*, pp 205 to 206; DCFR I.-1:109 Commentary C.

<sup>65</sup> To the recipient personally, or to the recipient's place of business or habitual residence.

<sup>66</sup> DCFR I.-1:109 Commentary E.

<sup>67</sup> Not under PICC provisions, according to Vogenauer, *PICC Commentary*, p 206; but PICC has no equivalent to DCFR I.-1:109(4)(d).

<sup>68</sup> The key case settling the general approach is *Thomson v James* (1855) 18 D 1. See also Gloag, *Contract*, pp 16 to 17; McBryde, *Contract*, paras 6.31 to 6.35, 6.53 to 6.55 and 6.109 to 6.113; *SME, Obligations*, para 6.28.

<sup>69</sup> See paras 4.86 to 4.90 below.

<sup>70</sup> See paras 4.95 to 4.99 below.

<sup>71</sup> 1919 2 SLT 123.

been away from home the previous night. Neither was therefore aware at the time of their meeting that the offeror (A) had sent to their respective home addresses a telegram revoking his offer which had been delivered in the first post that morning. B instructed his agent to send A a telegram of acceptance which was duly done in the early afternoon of 12th September. It was held that there was no contract, A's revocation having taken effect upon arrival at the home addresses of B and his agent prior to any acceptance. The Lord Ordinary (Ormidale) said:

“The rule of law in question appears to me to be applicable only when business rules and practices are observed. In my opinion therefore the pursuer is not entitled to plead that he accepted the offer of 4th September before he knew of the cancellation of the offer of sale. He ought to have known and would have known in the normal course of dealing. In none of the cases which were cited to me is there any indication that the bringing of the cancellation or recall of an offer home to the knowledge of the party holding the offer is of rigid application. In all of them the posting and the receipt of the letters of acceptance and recall were in the ordinary course of business transactions. It is one thing for the addressee to be absent from his office after business hours so that the delivery of the letter is delayed until his office opens the following day. It is a totally different thing for him to be absent from his office during business hours, with the result that the letter may lie on his desk unopened for a considerable length of time.”<sup>72</sup>

4.61 Although Lord Ormidale said that the facts of the case were special, the underlying principle of the decision appears to be reasonable, consistent with the approach found in the CISG, the PICC and the DCFR, and also supported by more recent House of Lords and Court of Appeal authority in England.<sup>73</sup>

4.62 The words of Lord Wilberforce in one of the leading modern English cases are often cited in this connection:

“No universal rule can cover all such cases: they must be resolved by reference to the intentions of the parties, by sound business practice and in some cases by a judgment where the risks should lie.”<sup>74</sup>

4.63 Scottish textbooks generally accept the decisions in English cases about telexes,<sup>75</sup> which also take an objective approach to the question of when communication is effected by such means. In general, the cases show that this occurs upon receipt at the point where, in the ordinary course of business, the recipient ought to have been aware that a communication had been made.

4.64 The objective approach to communication was more recently revisited in the Outer House by Lord Hodge in *Carmarthen Developments Ltd v Pennington*.<sup>76</sup> That case involved

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<sup>72</sup> 1919 2 SLT 123 at 128.

<sup>73</sup> *Eaglehill Ltd v J Needham (Builders) Ltd* [1973] AC 992 at 1011; *Tenax Steamship Co v Owners of the Motor Vessel Brimnes* [1975] QB 929.

<sup>74</sup> *Brinkibon Ltd v Stahag Stahl und Stahlwarenhandels GmbH* [1983] 2 AC 34 at 42, and see *Carmarthen Developments Ltd v Pennington* [2008] CSOH 139, 2008 GWD 33-494 at para 33 (Lord Hodge).

<sup>75</sup> *Entores Ltd v Miles Far East Corp* [1955] 2 QB 327 and *Brinkibon Ltd v Stahag Stahl und Stahlwarenhandels GmbH* [1983] 2 AC 34. See further McBryde, *Contract*, para 6.118; *SME, Obligations*, paras 629, 641 and 643; MacQueen and Thomson, *Contract*, para 2.35.

<sup>76</sup> [2008] CSOH 139. For commentary on other aspects of the case see M Hogg, “Contract Formation in the Electronic Age” (2009) 13 Edin LR 121.

a decision on whether a postal notice purifying suspensive conditions in a contract took effect before the recipient solicitor sent a fax resiling from the contract. The complicating factor was that the notice was not delivered to the recipient's office by the postal service but was instead collected from the sorting office by the recipient solicitor before his own office opened for business. The notice was but one of a collection of letters addressed to the solicitor's firm, gathered by the sorting office in a zipped bag for convenience; the whole process of collection was in accordance with the firm's usual practice. Lord Hodge held that in these circumstances the notice had been communicated when the solicitor uplifted the mail. As that was before the resiling fax had taken effect, the contract was upheld.<sup>77</sup>

4.65 The generally objective approach of Scots law to when a communication is made is consistent with the approach to reaching found in the comparator instruments forming the basis for our review, and we did not suggest any change to that position in the 2012 DP. We asked, however, whether it would be useful to introduce special rules of the kind found in the comparator instruments, defining delivery to the addressee or the latter's place of business or habitual residence as constituting communication. While Lord Wilberforce's more open approach is attractive in the context of resolving what may often be complex fact situations, it is open to the criticism that only by going to court will it be possible to get an answer to the question in any given case.

4.66 Most consultees agreed that any relevant statement of a party's intention should only be taken to have been communicated to its intended addressee when that party should have become aware that it had been made. Being a default rule, parties who wished to have different outcomes could make provision for that. Some further observations were made, however. John Craske proposed the addition of "in the ordinary course of business" to the default rule. While we can see the value of this in the business context, not all contracting parties are in the course of business; for example, consumers and non-business parties dealing with each other.

4.67 An alternative approach for such non-business parties would be to take communication to be achieved by delivery to such addressees personally or at their habitual residence (again, as a default rule). There was however much less support for such specificity. The Senators of the College of Justice and the Faculty of Advocates considered it undesirable because not every factual circumstance can be satisfactorily covered by such rules. The Faculty thought that provision needed to be made for usages and practices between the parties and for the addressee's consent to particular methods of communication. Burness suggested that it might be necessary for the courts to retain a residual power to determine particular cases. Dr Gillian Black proposed a rebuttable statutory presumption of a communication's delivery when it reaches the personal or business address of the addressee.

4.68 We accept the need for flexibility in this area, and have come to the conclusion that the best way to achieve this is by way of a rule stated at a high level of generality. We do not find presumptions or residual judicial discretions particularly attractive alternatives. The draft Bill accordingly provides that any notification in relation to formation of contract takes effect when it reaches the person to whom it is addressed. Notification is given a broad definition,

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<sup>77</sup> [2008] CSOH 139, paras 32 and 33.

including offers, acceptances, counter-offers, withdrawals, rejections and revocations. It also includes declarations made by the notifier, as well as that person's conduct.

4.69 The draft Bill goes on to provide that a notification reaches its addressee when the notification is made available to the addressee in such circumstances as to make it reasonable to expect the person to be able to access it without undue delay. We think that this is a broad and flexible test which enables contracting parties to deliver notifications to each other in the way which suits their needs best. As we discuss further below,<sup>78</sup> the test also allows the recipient's position to be taken into account in assessing the reasonable expectations of the sender. It is also capable, in our view, of adapting to future developments in technology.

4.70 We have supplemented that test with explanations of when reaching occurs in the most commonly-encountered situations: on personal delivery to the addressee, on delivery to that person's place of business or to that person's habitual residence if the person does not have a place of business or if the notification does not relate to a business matter, and when it is delivered by electronic means. These are illustrative rather than mandatory: it is open to parties to use other means to deliver a notification if those means satisfy the general test.

4.71 We therefore recommend that:

6. **The statutory statement of the law on formation of contract should provide that, in relation to formation of contract, a notification by one party takes effect when it reaches the person to whom it is addressed.**

(Draft Bill, section 13(1))

7. **The statutory statement should provide that a statement reaches the person to whom it is addressed when it is made available to the person in such circumstances that it is reasonable to expect the person to be able to access it without undue delay.**

(Draft Bill, section 13(3))

8. **The statutory statement should also set out examples of when a notification reaches a person in the following common situations:**

- (a) **personal delivery;**
- (b) **delivery to the person's place of business;**
- (c) **delivery to the person's habitual residence, if the person has no place of business or if the notification does not relate to a business matter;**

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<sup>78</sup> See para 4.81 below.

**(d) delivery by electronic means.**

(Draft Bill, section 13(4))

*Electronic communications*

4.72 In general, we do not think that special rules to deal with the situation where notifications about a contract are communicated electronically are necessary. But consideration of the comparator instruments suggests that some elaboration of what availability means in this context is useful.

4.73 Under the DCFR an electronically transmitted notice reaches its addressee when it becomes *accessible* to that party.<sup>79</sup> The other comparator instruments favour a broadly similar default rule.<sup>80</sup> The notification is generally taken to be accessible when the message enters the addressee's communications system in such a way that it is available when the addressee next makes use of the system. By emphasising accessibility to the addressee as the test of legal effectiveness, the DCFR seeks to avoid some of the technical difficulties that may arise from the nature of electronic communications (such as delays and failures in the transmission of emails between servers).

4.74 The comparator instruments are in line with Article 10(2) of the UN Convention on the Use of Electronic Communications in International Contracts,<sup>81</sup> which provides:

“The time of receipt of an electronic communication is the time when it becomes capable of being retrieved by the addressee at an electronic address designated by the addressee. The time of receipt of an electronic communication at another electronic address of the addressee is the time when it becomes capable of being retrieved by the addressee at that address and the addressee becomes aware that the electronic communication has been sent to that address. An electronic communication is presumed to be capable of being retrieved by the addressee when it reaches the addressee’s electronic address.”

4.75 It has been suggested elsewhere that the default rule as to when an email communication is received by its addressee should be arrival on the server that manages that party's email.<sup>82</sup> As noted in Chitty, this position “has the merit of certainty since that time is recorded in the email.”<sup>83</sup> Eliza Mik makes a distinction between instantaneous *transmission* and instantaneous *communication*, pointing out that the latter is not achieved by way of email. Therefore, “[t]he analytical point of departure must always be the principle of receipt”,<sup>84</sup> and “in principle ... receipt is generally associated with the arrival of a message at the addressee’s machine.”<sup>85</sup>

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<sup>79</sup> DCFR I.–1:109(4)(c).

<sup>80</sup> PICC Art 1.10; PECL Art 1:303.

<sup>81</sup> Available at: <https://goo.gl/PDJ7fX>.

The Convention builds upon the UNCITRAL Model Law on Electronic Commerce which was adopted in 1996. It is available at: <https://goo.gl/KmHmpS>.

Article 10 is derived from Article 15 of the Model Law.

<sup>82</sup> D Nolan, “Offer and acceptance in the electronic age” in A Burrows and E Peel (eds), *Contract Formation and Parties* (2010), p 76; Vogenauer, *PICC Commentary*, p 206; Chitty, para 2.080.

<sup>83</sup> Chitty, para 2.080.

<sup>84</sup> Mik, “Problems of Intention and Consideration in Online Transactions”, paras 6.34 to 6.36.

<sup>85</sup> Mik, “Problems of Intention and Consideration in Online Transactions”, para 6.37.

4.76 In Chitty two other possibilities are mooted: (1) when the addressee actually can access the email; (2) when the reasonable addressee would have accessed it (that is, within its business hours) or did actually access it. Both are however dismissed. For (1), this is due to too great uncertainty and also unfairness:

“because the causes of the [addressee’s] lack of access to the email will usually be, broadly speaking, within the [addressee’s] sphere of control (such as problems with the addressee’s computer or server or the connection between them, or the operation of spam filters or firewalls) and those risks should not be borne by the [sender].”<sup>86</sup>

4.77 For (2), the approach is again too uncertain. Business hours are too variable to be a good basis for a reasonableness test. Actual access places all the transmission risks on the sender when that access is entirely within the recipient’s sphere of control.

4.78 Mik, however, points to the possibility that transmission may fail as the result of problems with the sender’s system and questions whether in such circumstances the transmission risk should be borne by the sender rather than the addressee.<sup>87</sup> She also asks about the addressee’s right to reject an attempted communication (for example, by way of out-of-office messages) and to protect its system from external threats such as spam and virus-bearing emails. She suggests that the outcome in the latter kind of case should depend on the reasonableness of the addressee’s measures, since their settings and levels are within that party’s control.<sup>88</sup>

4.79 Chitty further suggests that if the sender knows or should know that its communication has not been successful (for example, if it receives an error or out-of-office message), or if the failure is due to something for which it is responsible (such as its own system, or misaddressing an email), then there is no communication. The recipient on the other hand will be bound if the communications failure is its responsibility (such as a full inbox, operation of firewall or anti-virus system). Where neither party is responsible for the failure, then no contract can be formed by the purported communication.<sup>89</sup>

4.80 Some consultees to the 2012 DP expressed concerns about using accessibility to the recipient as the test. Dundas and Wilson<sup>90</sup> drew our attention to several practical and evidential problems, observing that the resolution of disputes about whether an email had been received could involve large expense, forensic IT experts and possibly no physical evidence being found at all. They suggested that the solution was for the rule to focus on the sender confirming receipt, whether automatically or manually generated. It seems better to us, however, not to make this a statutory requirement, even as part of a default rule. It imposes an additional burden on parties and there would be a danger of the legislation failing to keep up with future technological developments. The default nature of the proposed rules in the statutory statement would, of course, leave it open to individual parties to require the use of read receipts or something similar if they so choose. We think that leaving matters to party autonomy is preferable here.

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<sup>86</sup> Chitty, para 2.080.

<sup>87</sup> Mik, “Problems of Intention and Consideration in Online Transactions”, paras 6.37 and 6.38.

<sup>88</sup> Mik, “Problems of Intention and Consideration in Online Transactions”, para 6.39.

<sup>89</sup> Chitty, para 2.084.

<sup>90</sup> Now part of CMS Cameron McKenna Nabarro Olswang LLP.

4.81 We think, however, that the accessibility rule, read in the light of the general provision already recommended (that a notification only reaches its addressee when it is made available to that person in circumstances making it reasonable to expect the person to be able to access it without undue delay<sup>91</sup>) is a workable one which enables fair apportionment of the risks of mis- or non-communication between the parties involved. For example, a sender who receives a sufficiently specific out-of-office message ought to know that the recipient's access will not occur until any date or time mentioned. The message might be sufficiently specific if it gave details of the absence and alternative contacts, although again, if the absence came unexpectedly for the original sender, that might make it unreasonable in all the circumstances for the recipient not to have made alternative arrangements in advance. The reasonableness of the recipient's security measures might also be taken into account in an appropriate case. In general, good business practice would be supported by the rule.

4.82 In any event, as a default, the accessibility rule can be varied by parties to meet particular circumstances in which it would be inappropriate. In its generality it is also capable of application to future technological developments in electronic communications, a point particularly stressed by the Law Society of Scotland and Pinsent Masons in response to the 2012 DP.

4.83 The Senators of the College of Justice suggested that any rule on electronic communications would have to provide for the sender having a reasonable expectation that the addressee is content to communicate electronically. Section 26 of the Interpretation and Legislative Reform (Scotland) Act 2010 enables the service of documents by electronic communications, but only where the person serving the document and the person on whom it is to be served have agreed in writing that the document may be sent to a specified electronic address and in a specified electronic form.<sup>92</sup> This is a more restrictive test than the Senators propose.

4.84 We do not, however, impose a similar requirement in relation to any other form of communication and it does not appear to us that there is any good policy justification for erecting additional barriers to the use of electronic communications. If an addressee simply does not use electronic communications, then there would be nowhere to send a notification so that it became accessible to that addressee electronically. By contrast, if an addressee uses electronic communications but does not wish to form a contract in that way, it would always be open to the addressee to issue a qualified acceptance stipulating the methods of notification that were acceptable for any response. As a result, we do not see that addressees would be exposed to having their legal position adversely affected simply because they have been sent a notification electronically.

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<sup>91</sup> See para 4.69 and recommendation 7 above.

<sup>92</sup> Section 26(2)(c) and (3).

4.85 We therefore recommend:

9. **The statutory statement of the law on formation of contract should provide that a party is to be taken as being aware of an electronic communication addressed to it when the communication becomes accessible to the addressee.**

(Draft Bill, section 13(4)(d))

*Scots law: the postal acceptance exception*

4.86 General rules as outlined in recommendations 7 and 9 above obviate the need to make particular provision for each kind of statement falling within them—be that offer, withdrawal or revocation of offer, rejection of offer, acceptance, or withdrawal of acceptance—unless there is some good policy reason to make an exception. In the 2012 DP we asked questions about when each of these types of statements should be regarded as having been effectively communicated.<sup>93</sup> The answers given by consultees were consistent in favouring an approach based on the objective general standard of reaching or communication to the addressee.

4.87 We also asked whether there was a need to retain the exception for postal acceptances that currently exists in Scots (and English) law. Under the exception, an unqualified acceptance takes effect when the acceptance is posted, rather than when it reaches the offeror.<sup>94</sup> The rule only applies to acceptances: postal offers, withdrawals and revocations of offers, and qualified acceptances do not benefit from it, and qualified acceptances in particular only become counter offers when actually communicated. The origins of the rule, the reasons for its existence and its consequences are examined in more detail in the 2012 DP.<sup>95</sup> In practice the rule is commonly excluded in offers.<sup>96</sup>

4.88 There was unanimity amongst consultees that there was no need to retain the postal acceptance exception in modern conditions, for the reasons that we set out in the 2012 DP. Law firm blogs commenting on the draft Contract (Formation) (Scotland) Bill on which we consulted in 2017 were also supportive: CMS Law Now commented that the postal acceptance rule was “out dated”.<sup>97</sup> Gillian Craig of MacRoberts observed that “The 21st century is a new-age digital era which requires updated and relevant protections to reflect today’s electronic communications.”<sup>98</sup> Shepherd and Wedderburn remarked:

“Having been imported into Scots law from England when Charles Dickens was just a lad, this 19th-century rule belongs to a bygone age where the postal system was the

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<sup>93</sup> Questions 14 (offer), 15 (withdrawal of offer), 16 (revocation of offer), 21 (rejection of offer), 27 (acceptance), 37 (withdrawal of acceptance).

<sup>94</sup> *Thomson v James* (1855) 18 D 1; *Dunlop Wilson & Co v Higgins & Son* (1848) 6 Bell 195; *Jacobsen, Sons & Co v Underwood & Son Ltd* (1894) 21 R 654. In England, the postal rule was held to apply to telegrams of acceptance: *Bruner v Moore* [1904] 1 Ch 305.

<sup>95</sup> 2012 DP, paras 4.8 to 4.14. See further H L MacQueen “It’s in the post!’ Distance Contracting in Scotland 1681-1855” in F McCarthy, J Chalmers and S Bogle (eds) *Essays in Conveyancing and Property Law in Honour of Professor Robert Rennie* (2015) Ch 4.

<sup>96</sup> 2012 DP, para 4.10. See also Furmston and Tolhurst, *Contract Formation*, para 4.106.

<sup>97</sup> CMS, “Contract Formation: So Long, Postal Acceptance?”, 27.09.2017, at <https://goo.gl/mTVDzy>.

<sup>98</sup> Gillian Craig (MacRoberts), “Contracting into the 21<sup>st</sup> Century – Contract (Formations) (Scotland) Bill”, 12<sup>th</sup> October 2017, at <https://goo.gl/UZKa44>.

primary means of communication between parties transacting at a distance. In the digital age, there is clearly no longer a justification for retaining special protection for acceptances sent by post.”<sup>99</sup>

4.89 We therefore think that there is now no need to provide for a postal exception to the general rule that an acceptance must reach the offeror to conclude a contract. This Commission has taken the view since 1977 that both offers and acceptances should be effective only when they have reached the other party.<sup>100</sup> Such a position would better accord with the reasonable expectations of most, in particular those of the commercial community in Scotland. In previous consultations, consultees have also indicated to the Commission that abolition of the postal acceptance rule is desirable. On this occasion the Faculty of Advocates wondered whether a more limited exception might exist for the situation where the offeror stipulates that the only mode of acceptance is by post without also stipulating for the acceptance to reach it. But in the end their conclusion was that a uniform rule is preferable.

4.90 We accordingly recommend that:

**10. The statutory statement of the law on formation of contract should provide for the abolition of the postal acceptance rule.**

(Draft Bill, section 14)

4.91 The comparator instruments contain a rule that prevents revocation of an offer being effective if the offeree had dispatched an acceptance before the revocation was communicated to it.<sup>101</sup> In the 2012 DP, we raised the possibility of the statutory statement containing such a rule. The response of consultees to this question was more mixed, perhaps because the proposal could be seen as qualifying quite significantly the effect of abolishing the postal acceptance rule. Dr Black pointed out that the proposed rule could result in there being a period of time when, despite its wish to revoke, the offeror in effect continues to be exposed to the possibility of an unwanted commitment. Pinsent Masons and the Faculty of Advocates queried whether in a competition between a revocation and an acceptance the offeree should be preferred. The Faculty eventually concluded that the proposal struck the right balance, the onus probably lying with the offeror to have revocation actually communicated to the offeree before an acceptance was posted. Pinsent Masons, on the other hand, thought there to be merit in returning the parties to their pre-contracting position. The Law Society of Scotland supported the proposal, while observing that the rule would be regularly contracted out of. The Senators of the College of Justice thought that there should only be such a rule where the offeror invited acceptance by post.

4.92 The debate seems to us to be finely balanced. It would still be necessary for such an acceptance to be communicated within any time limit stated in the offer. On the other hand, the speed with which written and oral communications may be made through modern technology and the practice of using the post to confirm statements already made by other

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<sup>99</sup> Shepherd & Wedderburn, “Goodbye ‘Postal Acceptance Rule’, Hello ‘Out-of-Office Message’ Rule?”, 05 Sep 2017, at <https://goo.gl/5evhjk>.

<sup>100</sup> Indeed, the postal rule is not found in the draft Contract Code prepared by Harvey McGregor QC for the Law Commissions between 1965 and 1973.

<sup>101</sup> PICC Art 2.1.4(1); DCFR II.–4:202(1).

means (which informs our recommendation that the postal acceptance rule be abolished) also suggests that there is also no real need to protect the offeree in the competition between revocation and acceptance. This is all the more so as a revocation need not be in the same form as the preceding offer, enabling the revocation of a formal written offer made by post by more instantaneous means such as a telephone call.

4.93 Although the debate is finely balanced, we have concluded that a rule of this sort should not be introduced. The reasoning set out above to justify the abolition of the postal acceptance rule appears to apply equally here: it would be inconsistent to recommend the abolition of that rule while introducing a new rule that treated postal communications differently to other forms of communication.

4.94 We therefore conclude that the statutory statement of the law on formation of contract should not provide for the sending of an acceptance by the offeree to prevent any subsequently arriving revocation of the offer from taking effect.

*Scots law: the acceptance of general offers exception*

4.95 As a general rule, an acceptance must reach the offeror in order to form a contract between the parties. As we recommend in the next Chapter, this holds good for acceptance by conduct.<sup>102</sup> However, the comparator instruments all make similar provision for an exception to this: in certain circumstances, a contract is formed if the offeree performs certain acts even though these are not notified or known to the offeror at the time they take place.<sup>103</sup> Those circumstances are where:

- the offer itself so provides, expressly or impliedly (most typically in a general offer);
- the parties have established a practice to that effect between themselves;
- there is a usage to that effect, for example in a particular trade.

They then provide that this unnotified acceptance is effective when the offeree begins performing the required act.

4.96 A similar exception for general offers is recognised in Scots (and English) law. Perhaps the most famous example of a general offer is *Carlill v Carbolic Smoke Ball Co Ltd*.<sup>104</sup> In that case, the Carbolic Smoke Ball Company made a general offer of a reward to anyone catching influenza despite using its product. Mrs Carlill's acceptance was held to be complete from the time she began to use the product in accordance with the company's directions. A contemporary example is provided by notices displayed in the car-parking areas of private domestic developments, advising non-residents that while they may park their cars there, to do so means entering a contract with the owners (or their representatives) and the incurring of a charge for doing so.<sup>105</sup> If the notice is an offer, the contract is

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<sup>102</sup> See para 5.41 and recommendation 20 below.

<sup>103</sup> PICC Art 2.1.6(3); DCFR II.-4:205(3).

<sup>104</sup> [1893] 1 QB 256 (CA), where it was held that by the terms of its offer the company had waived any requirement that acceptance be communicated to it.

<sup>105</sup> See eg *Vehicle Control Services Ltd v Mackie* 2017 SLT (Sh Ct) 111.

concluded by the act of parking whether or not known about at the time by those who put the notice up.

4.97 The exception is consistent with the overarching principle of party autonomy in that the offeror either explicitly allows for the possibility in its offer or impliedly permits it by a course of dealing with the offeree or more general customary usage. An explicit legislative statement to this effect would, however, avoid arguments about the extent to which the principle of party autonomy allows implicit departures from the default rule about acceptance having to reach the offeror through the general nature of the preceding offer, course of dealing between the parties, or customs of a trade or geographical area.

4.98 Consultees broadly responded positively to our proposal to include such an exception in a statutory statement. The Law Society of Scotland however thought that it would not be needed so long as it was clear that there could be acceptance by conduct. We are inclined to think that the rule in question is probably an exception to rather than an exemplification of the general rule about acceptance by conduct, and is particularly useful in relation to general offers. The Faculty of Advocates was of the view that a provision making the conclusion of the contract occur when the offeree begins to perform the required act is unnecessary because the question will be answered, either expressly or impliedly, by the offer, usage or practice. We tend to think, however, that making express provision would be helpful where there is no express statement or the usage or practice is unclear on such detailed matters.

4.99 We accordingly recommend that:

**11. The statutory statement of the law on formation of contract should enable a contract to be concluded by performance of an act unnotified to the offeror in cases where:**

- (a) the offer itself so provides, expressly or impliedly;**
- (b) the parties have established a practice to that effect between or among themselves; or**
- (c) there is a usage to that effect common to the parties.**

(Draft Bill, section 3(1))

**12. The rule should also state that a contract is concluded when the offeree begins to perform the required act.**

(Draft Bill, section 3(2))

### **Matters on which we make no recommendation**

4.100 In the 2012 DP, we suggested that there was no need to define “writing” so as to ensure recognition of electronic communications and documents. Consultees agreed. We observe that electronic communications and documents seem to be already well accepted by the courts and in legal practice. Since the 2012 DP was published, the Land Registration etc. (Scotland) Act 2012 has amended the Requirements of Writing (Scotland) Act 1995 to

facilitate the use of electronic documents where formal writing and signatures are necessary.<sup>106</sup> Both the Interpretation Act 1978 and the Interpretation and Legislative Reform (Scotland) Act 2010 contain an inclusive statutory definition of “writing” to be applied when the word is used in legislation:<sup>107</sup> the starting point that writing is about representing or reproducing words in a visible form. This seems apt to cover most forms of electronic communication, and while it might be usefully updated along the lines found in the DCFR,<sup>108</sup> an exercise devoted to the formation of contract does not seem the appropriate place to start such a project. We therefore conclude that the statutory statement of the law on formation of contract should not include any definition of “writing”.

4.101 We also took the provisional view in the 2012 DP that there was no need in an exercise about formation of contract to make provision on usages and practices such as is found in the comparator instruments, even though they may be particularly relevant to how parties communicate (including electronically).<sup>109</sup> In present Scots law, the issue is covered through general legal concepts such as custom (by which terms may be implied into contracts), incorporation of terms in contracts as the result of a prior course of dealing between the parties, and personal bar.<sup>110</sup>

4.102 Consultees agreed that it was not necessary to make express provision in relation to usages and practices, with this being left instead to the general law. Accordingly, we conclude that the statutory statement of the law on formation of contract should not contain any express provision on usages and practices between the parties.

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<sup>106</sup> See the Land Registration etc (Scotland) Act 2012 Part 10.

<sup>107</sup> See the Interpretation Act 1978 Sch 1, para 1, and the Interpretation and Legislative Reform (Scotland) Act 2010 sch 1, para 1.

<sup>108</sup> DCFR I.-1:106. See also the definition of “electronic” in the Annex.

<sup>109</sup> See paras 4.60 to 4.64 above: usual practice appears to have been significant in the cases discussed there.

<sup>110</sup> McBryde, *Contract*, paras 9.60 to 9.64.

# Chapter 5 Offer and acceptance

## Introduction

5.1 Offer and acceptance is not the only method of forming a contract or of determining that one exists.<sup>1</sup> However, it is perhaps the predominant method of analysing these questions and so the rules in this area are important in at least two contexts. First, they indicate to parties wishing to form a contract steps that they can take to do so. Second, in cases where it is disputed whether or not the conduct and communications between parties gave rise to a contract, the rules provide a framework within which the question can be decided.

5.2 As we pointed out in the 2012 DP, it is important that the rules in this area of contract law are as clear and certain as possible, and also congruent with what persons who may lack legal advice would reasonably expect the law to be.

5.3 The first section of this Chapter is concerned with offers. It covers the following issues:

- (i) definition of offer
- (ii) withdrawal and revocation of offer
- (iii) rejection of offer
- (iv) effects of delay on offer

5.4 The second section of this Chapter is concerned with acceptances. It covers the following issues:

- (i) definition of acceptance
- (ii) time limits for acceptance
- (iii) modified (or qualified) acceptance
- (iv) withdrawal of acceptance

5.5 We have already addressed the question of postal acceptances, and do not deal further with that subject here.<sup>2</sup> Nor do we think it necessary, in the light of the recommendation already made for what is section 2 in our draft Bill, to recommend further the inclusion in the Bill of a provision to the effect that a contract is concluded by the acceptance of an offer. From the definitions of offer and acceptance which we recommend below for inclusion in the Bill it is obvious that their coming together concludes a contract

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<sup>1</sup> See para 4.7 above.

<sup>2</sup> See paras 4.86 to 4.94 above.

under section 2. It is worth noting that neither the DCFR or its predecessor instrument, the Principles of European Contract Law, includes any provision saying in terms that an offer accepted is a contract.<sup>3</sup>

5.6 As we observed in the 2012 DP, in broad terms Scots law is generally consistent with the CISG and the DCFR in relation to the matters mentioned above.<sup>4</sup> Matters where Scots law differs are generally addressed elsewhere in this Part.<sup>5</sup>

## Offer

### *(i) Definition of offer*

5.7 In the 2012 DP, we proposed that in any statutory statement of the law on formation of contract, an offer should be defined as a proposal made to one or more specific persons containing sufficiently definite terms to form a contract and indicating the intention of the offeror to be bound if the offer is accepted by the other party or parties.<sup>6</sup>

5.8 We also suggested that a proposal made to the general public (and so not to one or more specified persons) should not be treated as an offer unless it otherwise met the criteria for an offer. Further, a proposal made to the general public (for example, to pay a reward for the performing of a specified act) may alternatively be analysed as a unilateral promise to pay to the person who satisfied the stipulated conditions.<sup>7</sup> In the 2012 DP, we indicated that this alternative analysis should not be prejudiced by what we suggested about general offers.<sup>8</sup>

5.9 Consultees were generally supportive of these suggestions. The Senators of the College of Justice were concerned that the reference to “sufficiently definite terms” might blur the division between formation of contract and contract terms. This may be met by avoiding the use of the word “terms”, as a number of the comparator instruments do.<sup>9</sup> Instead, the draft Bill provides that the proposal must be one which could be given legal effect, after taking into account any relevant enactment or rule of law, if accepted. We consider that this has the desired effect: in order for the proposal, if accepted, to be given legal effect, its content would have to be sufficiently definite.

5.10 The Senators were also critical of expressing the definition of offers to the general public in negative terms, while Professor Gretton thought that it simply said “An offer that is not an offer is not an offer”. On reflection, we agree that it would be preferable to adopt another formulation for general offers. The draft Bill provides that an offer may be addressed to a specific person or persons, persons in general, the public at large or persons of a particular description.

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<sup>3</sup> Contrast, however, Unidroit PICC art 2.1.1: “A contract may be concluded either by the acceptance of an offer or by conduct of the parties that is sufficient to show agreement.”

<sup>4</sup> 2012 DP, paras 3.4 and 4.1.

<sup>5</sup> See eg paras 4.86 to 4.94 above (postal acceptance rule); Chapter 6 (change of circumstances).

<sup>6</sup> 2012 DP, para 3.7.

<sup>7</sup> T B Smith “Pollicitatio—Promise and Offer”, in *Studies Critical and Comparative* (1962) pp 168 to 182; T B Smith, *A Short Commentary on the Law of Scotland* (1962), pp 747 to 751; *SME, Obligations*, para 627; McBryde, *Contract*, para 6.25 and fn 88.

<sup>8</sup> 2012 DP, para 3.8 and fn 12.

<sup>9</sup> See CISG 5(1); PICC 2.1.2. The now abandoned CESL spoke of “sufficient content and certainty” (Art 31(1)(b)).

5.11 We accordingly recommend:

**13. The statutory statement of the law on formation of contract should provide for an offer to be defined as a proposal (made to one or more specific persons, to one or more persons in general, the public at large or persons of a particular description):**

**(a) by which the offeree must have reasonable grounds to suppose that the proposer intends the proposal to result in a contract if it is accepted;**

**(b) that is capable of being given legal effect if accepted, after taking into account any relevant enactment or rule of law.**

(Draft Bill, section 4(1) and (2))

**14. Any provision on offers to the general public should state that it is without prejudice to the possible application of the law on unilateral promises.**

(Draft Bill, section 4(3))

5.12 In the 2012 DP,<sup>10</sup> we noted that the DCFR contains a rule that advertisements, catalogues and displays of goods or services for sale *by a business at a stated price* are offers to supply until the stock is exhausted or the business becomes incapable of supplying the service.<sup>11</sup> We noted that present Scots (and English) law would tend to see these as invitations to treat, so that it is the customer responding to the statement who makes the offer and the business whose stock or capacity is potentially affected which may then accept or decline that offer.<sup>12</sup>

5.13 We commented that the DCFR approach was apparently more protective of the customer's interests, and so it might well therefore be attractive to consumers. On the other hand, we noted the potential for it to cause serious difficulties for traders, who might inadvertently have mispriced goods or services advertised as available on their websites.<sup>13</sup> Such traders could therefore, under the proposed rule, find themselves bound to supply an indefinite number of customers placing orders at the stated price, with orders far outnumbering the available stock.

5.14 In the 2012 DP, we took the view that the attractions in a basic rule like that found in the DCFR, in particular from the point of view of consumer protection, are offset by these potential difficulties. While we observed that well-advised traders might reasonably protect

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<sup>10</sup> 2012 DP, paras 3.9 to 3.13.

<sup>11</sup> DCFR II.-4:201(3).

<sup>12</sup> See the cases cited in McBryde, *Contract*, para 6.15; *SME, Obligations*, paras 621 to 624; Walker, *Contracts*, paras 7.2 and 7.6 to 7.12; and discussion in MacQueen and Thomson, *Contract*, paras 2.13 to 2.15.

<sup>13</sup> See, eg, the Singaporean case *Chwee Kin Keong v Digilandmail.com Pte Ltd* [2004] 2 SLR 594, [2004] SGHC 71. The correct approach to this subject appears to us to be through the law of error rather than the law of formation. For useful discussions of websites as offers see Chitty paras 2.077 and 2.078; Mik, "Problems of Intention and Consideration in Online Transactions", para 6.13.

themselves against those difficulties,<sup>14</sup> we thought that small traders who might not be able to afford legal advice could be exposed to undue risk by a default rule that its exposure of goods and services at a stated price is an offer.

5.15 In any event, in appropriate cases a public statement by a business that goods or services are available from a particular stock or other source of supply at a stated price may be capable of interpretation as an offer under the rule about the definition of an offer to the public proposed above.<sup>15</sup> We suggested that this might be a more flexible way of dealing with the issue.

5.16 Most consultees agreed with this analysis, and even those who supported the introduction of the DCFR rule did so in a lukewarm manner. There was no support for extending the rule to contracts for the supply of services, on which we also asked a question. We accordingly conclude that the statutory statement of the law on formation of contract should not provide for a special rule about proposals by businesses to supply goods from stock, or to supply services, at a stated price.

*(ii) Withdrawal and revocation of offer*

The general rule

5.17 The comparator instruments distinguish between withdrawal of an offer and its revocation. The difference centres around whether the offer has reached the offeree or not. If it has not reached the offeree, then it has not taken effect and does not need to be revoked. If it has reached the offeree and has taken effect, it may in certain circumstances be revoked instead. The distinction matters most where, as some of the instruments specifically permit, an offer may be made irrevocable by a declaration to that effect by the offeror, whether within the offer itself or in some independent statement. Such a declaration will itself have to reach the offeree to be effective. It follows that although an offer bears to be irrevocable, it may still be withdrawn so long as the declaration of irrevocability has not yet reached the offeree.

5.18 Scots law has not addressed this question directly but it would, in principle, reach the same answer. It is established that offers can be terminated without liability unless either declared to be irrevocable in some way (a firm offer) or effectively accepted by the offeree.<sup>16</sup> But even the declaration of irrevocability probably requires objective communication to the offeree to be effective, so if the offeror communicates withdrawal before or at the same time as the declaration it is thought that the courts would find the offeror not bound.

5.19 It would however avoid any doubt were the point to be made clear by statute. Consultees unanimously supported this proposal. We accordingly recommend:

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<sup>14</sup> For an example see para 4.50 and fn 56 above.

<sup>15</sup> See recommendation 13 above.

<sup>16</sup> Walker, *Contracts*, para 7.37; *SME, Obligations*, para 617; McBryde, *Contract*, paras 6.45 to 6.46 and 6.57; Gloag, *Contract*, pp 35 to 36. This is the general rule under English law also: Chitty, para 2.088.

- 15. The statutory statement of the law on formation of contract should provide that an offer, even if it is irrevocable, may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer.**

(Draft Bill, section 10(a))

5.20 The comparator instruments also give the offeror freedom to revoke an offer which has reached the offeree provided that there has been no effective acceptance by the latter. Scots law is consistent with this in principle. In the 2012 DP, we proposed that there should be a rule that an offer may be revoked if the revocation reaches the offeree before the offeree has accepted the offer or, in cases of acceptance by conduct, before the contract has been concluded. We think the answers showed general support for that proposition, although with regard to cases of acceptance by conduct, the Law Society of Scotland thought that the freedom to revoke should be lost, not on conclusion of the contract but rather before the notice of the conduct has reached the offeror. We accept that point as being more consistent with the general principles outlined in Chapter 4. We accordingly recommend that:

- 16. The statutory statement of the law on formation of contract should provide that an offer may be revoked if the revocation reaches the offeree before the offeree has accepted the offer or, in cases of acceptance by conduct, before the offeror may determine from the conduct of the offeree that agreement has been reached, or before the offeree begins performance of certain acts which conclude the contract.**

(Draft Bill, section 5(1) and (2))

#### Revocation of general offers

5.21 The revocation of general offers to the public, where there is no specific offeree, presents certain difficulties, as we noted in the 2012 DP. There appears to be no authority on this matter in Scots law.<sup>17</sup> The DCFR provides an explicit rule on this subject, which enables offerors to revoke using the same method of communication as was deployed in making the offer in the first place. That rule appears to be a sensible and practical solution to the problem, not least to encourage those making general offers to consider whether or not to include in them express statements about their revocation. It is of course a default rule, and it remains open to a party making a general offer to specify time limits or other methods of revocation.

5.22 Consultees were generally supportive of there being an express rule in Scots law like the one in the DCFR. We therefore recommend:

- 17. The statutory statement of the law on formation of contract should provide that an offer made to the public can be revoked by the same means as were used to make the offer.**

(Draft Bill, section 5(3))

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<sup>17</sup> McBryde, *Contract*, paras 6.58 to 6.61.

## Irrevocable offers

5.23 An irrevocable offer arises if the offeror declares that the offer is irrevocable and this reaches the offeree. In Scots law any attempt to revoke such an offer is ineffective. As noted in the 2012 DP, the comparator instruments also generally provide for this to be the rule, but specifying in particular that fixing a time limit for the offer's acceptance is a declaration of irrevocability for these purposes. We drew attention to two Scottish cases on this point. In the first of these, it was held that an offer "made on condition of acceptance within three days" was one which could not be accepted after three days rather than one which was irrevocable within the same period.<sup>18</sup> Likewise in the second case an offer in which it was stated that the contract must be concluded by a particular date and time was held not to be irrevocable.<sup>19</sup> We therefore asked whether a statutory statement on formation of contract should include a rule like those in the comparator instruments making the fixing of a time limit for acceptance a declaration of irrevocability.

5.24 Consultees supported a rule that an offer stating itself to be irrevocable should indeed be irrevocable by the offeror. The Senators of the College of Justice thought that the proposal could go further to cover the case where an offer is silent on irrevocability but the offeror makes a separate or collateral declaration of its irrevocability. While such a statement might be enforceable through the law on unilateral promises, we agree that it would be useful to be clear on this point within the statutory provisions on formation of contract. Other consultees offered cogent doubts on making time-limited offers automatically irrevocable ones. Pinsent Masons in particular were concerned about the potential impact on small businesses, because the practical result of such a rule would be offerors simply stipulating shorter time limits for acceptance.

5.25 We therefore take the view that there should be no specific rule making offers containing a time limit irrevocable, while concluding that there should be a general rule that offers stated to be irrevocable, whether in their own body or in a separate declaration by the offeror, deprive the offeror of its freedom to revoke. It will be a question of construction whether a time-limited offer is or is not also irrevocable.

5.26 We therefore recommend that:

- 18. The statutory statement of the law on formation of contract should provide that where an offeror indicates that an offer is irrevocable, either in the offer or in a separate declaration, it may not be revoked.**

(Draft Bill, section 5(4))

5.27 The 2012 DP also noted that the comparator instruments differ from present Scots law in allowing for the possibility of an offer being irrevocable where it was reasonable for the offeree to rely on the offer being irrevocable and the offeree has acted in reliance upon it. The 1993 Report suggested that a typical case for the application of this rule would be "where the offer itself did not indicate irrevocability but where there was a collateral

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<sup>18</sup> *Heys v Kimball and Morton Ltd* (1890) 17 R 381 at 384 to 385.

<sup>19</sup> *Effold Properties Ltd v Sprot* 1979 SLT (Notes) 85 (OH).

assurance on which it was reasonable for the offeree to rely.”<sup>20</sup> We noted that such an assurance might now be rendered enforceable as a unilateral promise.<sup>21</sup> We have further recommended above that there be a rule to the effect that an offeror’s separate or collateral declaration of an offer’s irrevocability should be effective. It might therefore be thought that there was no need in Scots law for a reliance rule like that in the comparator instruments.

5.28 However, there is one further scenario upon which we have already touched: that of the general offer. If our recommendation on general offers is followed, then as a default rule such an offer would generally be revocable in the same way as it was made. McBryde expresses concern that this could work unfairly in a case where a party had acted in reliance upon the general offer without having any reasonable opportunity to become aware of the offeror’s revocation.<sup>22</sup> A reliance rule might give some protection to such a party by making a revocation ineffective so far as that party was concerned. Equally the offeror could make clear in the offer that a right to revoke was retained, thus making offeree reliance on its irrevocability not reasonable.

5.29 We accordingly asked whether an offeree’s reasonable reliance on the irrevocability of an offer should make any subsequent revocation of the offer by the offeror ineffective. But while Professor Brymer and the Faculty of Advocates were in favour of such a rule, other consultees were against it. Pinsent Masons foresaw a number of practical hurdles in proving reasonable reliance, and the Senators of the College of Justice suggested that such a rule would increase uncertainty. Mr Price thought the proposed rule would be “particularly useless” in relation to general offers, which are probably the only likely case within our overall structure for the suggested rule’s application. We have concluded in any case that it would not be common for a party to act in reasonable reliance on a general offer before communicating with the offeror.

5.30 We accordingly reach the view that the statutory statement of the law of contract should not provide that an offeree’s reasonable reliance on the irrevocability of an offer makes any subsequent revocation of the offer by the offeror ineffective.

5.31 In the 2012 DP, we also canvassed the interaction between irrevocable offers and the right of consumers to withdraw from certain contracts post-formation.<sup>23</sup> On reflection, it occurs to us that even if an offer made by a consumer were irrevocable (and in purely practical terms we question how likely that scenario is), that would have no effect on the ability of that consumer to withdraw after the contract had been formed.<sup>24</sup> Accordingly, we do not now consider that there is any need for legislation on this point, whether as part of a statutory statement or otherwise.

### *(iii) Rejection of offer*

5.32 The comparator instruments and present Scots law all hold that an offer falls when it is rejected by the offeree, even if it is irrevocable or time-limited. In the 2012 DP we took the

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<sup>20</sup> 1993 Report, para 3.14.

<sup>21</sup> For an example of difficulties of this kind, see the case of *Wylie v Grosset* 2011 SLT 609 (OH).

<sup>22</sup> See para 3.23.

<sup>23</sup> 2012 DP, paras 3.28 and 3.29.

<sup>24</sup> See the Cancellation of Contracts made in a Consumer’s Home or Place of Work etc. Regulations 2008 (SI 2008/1816), regs. 5 and 7.

view that this rule should be included in any statutory statement of the law on formation of contract, and consultees agreed. It is important to note, however, that this deals only with outright rejection or refusal of an offer by an offeree. An offer can terminate in other ways: for example, on the expiry of any time limit set in the offer, or in the absence of a time limit, on the expiry of a reasonable time.<sup>25</sup>

5.33 Consultees also drew our attention to issues posed by modified or qualified acceptances, and these are discussed later in this Chapter.<sup>26</sup> As a general rule on rejection, however, we recommend that:

**19. The statutory statement of the law on formation of contract should include a general rule that when a rejection of an offer reaches the offeror, the offer lapses.**

(Draft Bill, section 9)

*(iv) Effects of delay on offer*

5.34 A final matter not mentioned in the 1993 Report or in any of the comparator instruments is the effect when an offer is delayed in its transmission to the offeree. The scenario is one where the offer states a time limit within which an acceptance must be completed but it itself does not reach the offeree until after the time limit expires. In these cases the delay is generally not the offeror's fault, although delay may also be caused by the offeror having misaddressed the offer, this particularly being a risk with emails. Electronic offers may of course also be delayed by things that are the offeree's responsibility, such as its online security system. The likeliest scenario is however where the delay has been caused by persons or events beyond the control of either offeror or offeree, such as a postal strike or the collapse of the communication systems which they have been using.

5.35 The US Restatement (Second) of Contracts provides that the offeree "who knows or has reason to know of the delay"<sup>27</sup> cannot accept, even if the delay is due to the fault of the offeror. Furmston and Tolhurst suggest that:

"[s]ince a delay is normally apparent from the date of the letter or its postmark, in these circumstances the offeree will know or have reason to know of the delay and cannot accept the offer."<sup>28</sup>

The same holds true for emails.

5.36 However, the Restatement provides that if a delay is due to the fault of the offeror or to the offeror's means of transmission, and the offeree neither knows nor has reason to know that there has been delay, the time within which the offeree can accept is extended by the delay. It is difficult to imagine a case for the application of this rule other than one where

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<sup>25</sup> 1993 Report, para 3.16 citing CISG Art 19(2); see further paras 5.47 to 5.49 below.

<sup>26</sup> See paras 5.64 to 5.73 below.

<sup>27</sup> At section 49.

<sup>28</sup> Furmston and Tolhurst, *Contract Formation*, para 3.13 (citing, at fn 28, the case of *Chesebrough v Western Union Telegraph Co* 76 Misc 516, 135 NY Supp 583 (1912) affirmed 157 App Div 914, 142 NY Supp 1112 (1913), which, however, is about an acceptance telegram, rather than an offer, being delayed in transmission but held nonetheless, in an application of the postal acceptance rule, to be effective).

the time limit is stated in very imprecise terms and the offeror's communication cannot be dated, making it impossible to know when the period began.

5.37 We asked whether it would be useful to include in a statutory statement of the law on formation of contract a provision on delayed offers. Consultees told us that such scenarios are not common in legal practice, and the Faculty of Advocates and the Senators of the College of Justice thought it very likely that the common law would be able to deal with any situation that did arise, most probably by developing a rule similar to the one found in the US Restatement.

5.38 We therefore conclude that the statutory statement of the rules on formation of contract should not provide a special rule in relation to the application of time limits contained in offers which have been delayed in their transmission to the addressee.

## Acceptance

### *(i) Definition of acceptance*

5.39 The comparator instruments define acceptance as a statement or conduct by an offeree indicating assent to the offer. This is consistent with present Scots law.<sup>29</sup> In the 2012 DP,<sup>30</sup> we proposed that any form of statement or conduct by the offeree should be an acceptance if it indicates assent to the offer.

5.40 Consultees were generally supportive of that proposal. The Senators of the College of Justice thought that a requirement that the assent be “unqualified” should be added, and we agree that this is a useful addition, subject to what is proposed later in this section on modified and late acceptances.

5.41 Dr Black pointed out that the rule by which a notification (such as an acceptance) takes effect only when it reaches the offeror needed to be matched by an equivalent rule for acceptance by conduct. We agree in principle (while bearing in mind our earlier recommendations, to the effect that an uncommunicated act of acceptance by conduct can conclude a contract where the offer itself so provides, or there is a practice or usage to that effect shared by the parties).<sup>31</sup> But it seems inappropriate to talk of conduct reaching the offeror, and we think it better to express the rule for this case in terms of the offeror’s awareness of the offeree’s conduct.<sup>32</sup>

5.42 We therefore recommend that:

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<sup>29</sup> McBryde, *Contract*, paras 6.71 to 6.91. For examples of acceptance of a written offer by the offeree's conduct see *Langstane Housing Association Ltd v Riverside Construction (Aberdeen) Ltd* 2009 SCLR 639 (OH) and *Prosper Properties v Bell*, Dumfries Sheriff Court, 26 March 2008, unreported.

<sup>30</sup> 2012 DP, paras 4.2 to 4.5.

<sup>31</sup> See recommendations 11 and 12 above.

<sup>32</sup> For an example of acceptance by conduct of which the offeror was clearly aware, see *SOS Bureau Ltd v Payne* 1982 SLT (Sh Ct) 33 (Sheriff P I Caplan QC).

- 20. The statutory statement of the law of formation of contract should provide that any form of statement or conduct by the offeree is an acceptance if it indicates unqualified assent to the offer.**

(Draft Bill, section 7(1))

- 21. The statutory statement of the law of formation of contract should provide that acceptance by conduct is effective when the offeror becomes, or ought to have become, aware of the conduct in question.**

(Draft Bill, section 7(2))

### Acceptance by silence

5.43 In the 2012 DP, we also proposed the general principle should be qualified in relation to silence or inactivity by the offeree, with silence or inactivity not normally being sufficient to constitute acceptance. We pointed out that it was not an absolute prohibition, and that it was possible that silence or inactivity might be sufficient in an exceptional case.<sup>33</sup> It might also be added that, in general, an offer cannot stipulate for its acceptance by the offeree's silence, as this is an illegitimate imposition of one party's autonomy upon that of another.<sup>34</sup>

5.44 At least one modern case has considered the circumstances in which, exceptionally, acceptance by silence might be sufficient. In *Shaw v James Scott Builders & Co*,<sup>35</sup> a verbal contract for the construction of a house existed. During construction, a written contract was drawn up in terms which the home owner and the builder had informally agreed. A copy was emailed to both parties, and it specified that any changes would have to be requested within five days. The homeowner responded accepting the terms of the contract, but the builder did not respond. The surveyor then wrote to both parties confirming that the contract had been finalised. The works on the construction of the property continued until disagreements arose and the builder was instructed to stop the work. It was held that the builder had agreed to the contract through his silence. The parties were already in a contractual relationship, there had been discussions on several occasions to agree the text of a formal contractual document to govern their relationship, and the surveyor had sent the email after discussing the proposed terms with the builder. By their conduct, including the builder's silence, the parties fell to be treated as having agreed the terms of the email and the accompanying contractual document.

5.45 We think that the approach proposed in the 2012 DP would be consistent with the way in which *Shaw* was decided. In response to the proposal, the Law Society of Scotland and the Faculty of Advocates differed over the use of the word "normally". The Law Society of Scotland preferred "in itself" (as found in the comparator instruments) and the Faculty a more positive statement that silence could be acceptance "in exceptional circumstances". We are inclined to agree that it would be desirable more closely to mirror the comparator instruments in this case.

5.46 We accordingly recommend:

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<sup>33</sup> 2012 DP, para 4.4. See also McBryde, *Contract*, paras 6.80 to 6.82.

<sup>34</sup> On autonomy in the contractual context, see paras 4.49 to 4.52 above.

<sup>35</sup> [2010] CSOH 68.

- 22. The statutory statement of the law on formation of contract should provide that silence or inactivity by the offeree does not, of itself, constitute acceptance.**

(Draft Bill, section 7(3))

*(ii) Time limits for acceptance*

5.47 The comparator instruments all have rules requiring acceptances to reach the offeror within any time limit stated in the offer or, if there is no express time limit, within a reasonable time. The current postal acceptance rule apart,<sup>36</sup> the general rule in Scots law is to the same effect.<sup>37</sup>

5.48 In the 2012 DP,<sup>38</sup> we asked whether a statutory statement of the law on formation of contract should enable the offeror to fix a time limit for acceptance, with the limit for acceptance otherwise being a reasonable time after the offer was made. Consultees responded affirmatively.

5.49 We accordingly recommend:

- 23. The statutory statement of the law on formation of contract should provide that notification of the acceptance of an offer is effective only if in the case of acceptance by a statement, if the statement reaches the offeror, or in the case of acceptance by conduct, if the offeror is aware or ought to be aware of the conduct, before the expiry of the time limit for a response stipulated in the offer (or if no time limit is specified, within a reasonable time).**

(Draft Bill, section 11(1)(a))

5.50 The DCFR adds a further rule about when an act must be performed to be an unnotified but effective acceptance of an offer. In line with the other rules in this area, it must be performed within any time limit set by the offeror, or within a reasonable time.<sup>39</sup>

5.51 In the 2012 DP, we suggested that if this rule were to be adopted in any statutory statement, it would be a helpful if not necessary elaboration. Consultees were in general support of this proposal. Dr Black and the Faculty of Advocates suggested for reasons of consistency that the rule should explicitly state that the requirement for performance to be within a reasonable time applies only when the offer has stipulated no time limit.

5.52 We accordingly recommend that:

- 24. The statutory statement of the law on formation of contract should provide that, in relation to the conclusion of contract by an unnotified act (where the offer provides, where the parties have established a**

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<sup>36</sup> See paras 4.86 to 4.94 above.

<sup>37</sup> McBryde, *Contract*, paras 6.45 to 6.52.

<sup>38</sup> 2012 DP, paras 4.16 to 4.18.

<sup>39</sup> For an explanation as to when an offer may be accepted by an uncommunicated act, see paras 4.95 to 4.99 above.

**practice to the effect or where there is usage common to those parties, that certain acts by the offeree will conclude the contract), the act must be performed (even without notification of performance or of acceptance to the offeror) within any time limit fixed by the offeror or within a reasonable time after the offer is made.**

(Draft Bill, section 11(1)(b))

### Computation of time limits

5.53 The time limits set for acceptance are not always clearly stated in offers. In the 2012 DP,<sup>40</sup> we asked if it would be useful to have a rule that provided that a period of time stated for an acceptance begins to run from the moment that the offer reaches the offeree, subject to any contrary express statement in the offer or to any other indication to the contrary implicit in the offer, or in the relevant surrounding circumstances. We suggested that adoption of such a default rule would still present little if any difficulty.

5.54 Consultees generally favoured the inclusion of such a rule. But the Senators of the College of Justice and the Law Society of Scotland, while accepting the proposal's consistency with principle, thought that it might encourage litigation in marginal cases. The Law Society of Scotland suggested that the potential for litigation could be reduced by removing the two qualifications to the proposed rule. We agree that if the qualifications were removed then it would remain open to parties to make express contrary provision, or for a different outcome to be implicit from the terms of the offer, given the general principle of party autonomy.

5.55 We therefore recommend that:

- 25. The statutory statement of the law on formation of contract should provide that a period of time stated for an acceptance begins to run from the moment that the offer reaches the offeree.**

(Draft Bill, section 12)

### Late acceptance

5.56 The comparator instruments each contain two further rules under which late acceptances may be effective. The first deals with the acceptance which arrives late with the offeror. Such an acceptance may conclude the contract if without delay the offeror so advises the offeree. The second rule deals with the acceptance which, had transmission processes worked normally, would have arrived on time. Such an acceptance is effective to conclude a contract unless without delay the offeror advises the offeree otherwise. In both cases the offeror's decision must be made and communicated to the offeree without undue delay.<sup>41</sup>

5.57 In the first rule, therefore, there is a contract only if the offeror so decides, because the offeree is not entitled to assume that the acceptance will be effective. The 1993 Report

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<sup>40</sup> 2012 DP, para 4.20.

<sup>41</sup> See Vogenauer, *PICC Commentary*, pp 273 to 274.

noted that this produced "...practically the same result as the existing [Scots] law, under which the late acceptance would be treated as a counter-offer which the offeror could accept."<sup>42</sup>

5.58 With the second rule there is a contract unless the offeror decides otherwise, because the offeree was entitled to assume that its acceptance would be effective.<sup>43</sup> It provides a form of protection for the offeree against failures of the transmission process. The DCFR gives the example of a letter caught in transmission by a postal strike.<sup>44</sup> That protection, at least with regard to postal transmission, was not necessary in Scots law because of the postal acceptance rule. If that rule is abolished, then the protection which it gave the offeree might need to be replaced. The second rule would thus be "a sensible corollary to the change in the postal rule."<sup>45</sup> In the 2012 DP, we also noted that the second rule could perform a useful function in relation to other forms of communication: in particular, widespread power failures might affect electronic communications for unpredictable periods of time.

5.59 In the 2012 DP, we asked whether any statutory statement of the rules of formation of contract should include a provision to the effect that, if an acceptance which arrives late shows that it was sent in such circumstances that if its transmission had been normal it would have reached the offeror in due time, the late acceptance is effective as an acceptance unless, without undue delay, the offeror informs the offeree that the offer has lapsed.

5.60 Only a small minority of consultees favoured such a rule. The Senators of the College of Justice thought it too detailed and complex, and likely to cause confusion and litigation. Mr Price felt that the onus should be on the offeree to ensure effective communication of its acceptance. The Faculty of Advocates and Pinsent Masons suggested that it would be preferable to let the late acceptance be treated as a new offer, with a contract coming into existence only if without undue delay the original offeror accepted it (the current position in Scots law).

5.61 We agree that there is no need to introduce into Scots law a rule which seems to have at the forefront of its thinking transmission of acceptances through the postal system, particularly as the problem can be satisfactorily dealt with given the recommendations we make elsewhere in this Report about offers and counter-offers.

5.62 As a result, we do not need to consider further how to deal with an acceptance that arrives extremely late. In any event, consultees gave a mixed response to our question in the 2012 DP on that matter.

5.63 We accordingly conclude that the statutory statement of the law on formation of contract should not make special provision for late acceptances.

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<sup>42</sup> 1993 Report, para 4.24, citing *Wylie and Lochhead v McElroy* (1873) 1 R 41 (IH) and Gloag, *Contract*, p 37. McBryde, *Contract*, does not appear to deal directly with the problem of a late acceptance.

<sup>43</sup> See DCFR, vol 1, p 322 (Comment C); Vogenauer, *PICC Commentary*, pp 273 to 75.

<sup>44</sup> DCFR, vol 1, p 322 (Illustration 2).

<sup>45</sup> 1993 Report, para 4.25.

(iii) *Modified (or qualified) acceptance*

5.64 The comparator instruments lay down a series of rules on what happens if a purported acceptance is not a simple outright assent to the offer. First, if an offeree replies to an offer with what purports to be an acceptance but which contains terms materially different from those in the offer, the reply is not an acceptance but a rejection of the offer and a new (or counter) offer. The CISG provides a non-exclusive definition of terms that may be material for these purposes but although this might be thought a useful aid towards certainty nothing similar is found in any of the other texts.

5.65 Scots law is to the same basic effect, save that it is not clear how far there is a requirement that the difference between offer and acceptance must be material.<sup>46</sup> It has also been held that although an offer falls as such when met with a qualified acceptance, those parts of the offer with which the qualified acceptance is consistent can be carried forward as part of the counter-offer which is also constituted by the qualified acceptance.<sup>47</sup>

5.66 Since the publication of the 2012 DP, it has been held in the Outer House that a qualified acceptance is sufficient to satisfy a clause in an offer that requires acceptance by a particular time: it need not be a *de plano* acceptance. In any event, as the Lord Ordinary (Kinclaven) noted, a qualified acceptance is a counter-offer open for acceptance by the original offeror.<sup>48</sup> That being the case, the time limit in the original offer, which has fallen, is arguably irrelevant.

5.67 It is less certain how far the second proposition to emerge from the comparator instruments—that non-material additions or alterations made to the offer in what is otherwise an acceptance become part of a contract taken as concluded by that acceptance—is also good Scots law, as we explored in the 2012 DP.<sup>49</sup>

5.68 In the 2012 DP we accordingly thought that the adoption of a rule like that in the comparator instruments would be quite a significant development of the present law. It might create uncertainty in an area where certainty of outcome is highly desirable, by forcing parties to consider whether alterations or additions to an offer made in a purported acceptance were material or not. On the other hand, such a rule could prevent a party escaping what was very substantially an agreement because of some relatively trivial difference between the offer and acceptance.

5.69 In the 2012 DP, we therefore asked whether, in general, when a purported acceptance states different terms from those contained in the offer to which it is a reply it should be treated as a rejection of the offer and as constituting a new or counter-offer. This would not prevent the possibility that agreed terms from the first offer could be incorporated expressly or impliedly in the new or counter-offer.

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<sup>46</sup> *Wolf & Wolf v Forfar Potato Co* 1984 SLT 100 (IH); *Rutterford Ltd v Allied Breweries Ltd* 1990 SLT 249 (OH); *Tenbey v Stolt Comex Seaway Ltd* 2001 SC 638 (OH); *Pinecraven Construction (Guernsey) Ltd v Taddei* [2012] CSOH 18 (OH). See further McBryde, *Contract*, paras 6.92 to 6.94.

<sup>47</sup> *Howgate Shopping Centre Ltd v GLS 164 Ltd* 2002 SLT 820 (OH) at 826 (Lord Macfadyen).

<sup>48</sup> *Pinecraven Construction (Guernsey) Ltd v Taddei* [2012] CSOH 18.

<sup>49</sup> 2012 DP, paras 4.24 to 4.28.

5.70 Most consultees supported this proposal. Pinsent Masons emphasised the importance of being clear that agreed terms of the original offer may be incorporated either expressly or impliedly into the offeree's response.

5.71 We also asked consultees whether they preferred the alternative solution that a purported acceptance should only have the effect of rejecting the offer and becoming a counter-offer if the difference between the two statements was material.

5.72 Most consultees did not favour this alternative, regarding it as introducing too much uncertainty. The Senators of the College of Justice thought that the courts would find difficulty in applying the rules. However, the Law Society of Scotland preferred the alternative because the materiality requirement would minimise the potential for argument over whether a contract had been concluded. While we see some force in this position, in that it tends to facilitate the conclusion of contracts, we have come to the view that the majority view is to be preferred.

5.73 We accordingly recommend that:

**26. The statutory statement of the law of formation of contract should provide that where a purported acceptance states different terms from those contained in the offer to which it is a reply, it should be treated as a rejection of the offer and as a new or counter-offer.**

(Draft Bill, section 8)

*(iv) Withdrawal of acceptance*

5.74 The comparator instruments allow acceptances to be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance. The rule follows logically from the general position that an acceptance takes effect when it reaches the offeror.<sup>50</sup> If there is a period of time while the acceptance is in process of delivery, then that opens up the possibility of an offeree changing its mind and using a speedier mode of communication to inform the offeror of this. A posted letter may be overtaken by a telephone call or email, for example.

5.75 In the 2012 DP, we suggested that if we were to recommend the abolition of the postal acceptance rule then a further rule along the lines of those found in the comparator instruments would be necessary.

5.76 Consultees unanimously supported this proposal. The Senators of the College of Justice thought it should be restricted to a withdrawal made prior to the acceptance becoming effective. We agree, but think there has to be a rule to deal with the situation in *Countess of Dunmore v Alexander*<sup>51</sup> (where acceptance and withdrawal arrived simultaneously with the offeror). The outcome should not depend on which of the statements is read first by the offeror. That would not only create moral hazard for that person, but also

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<sup>50</sup> See Vogenauer, *PICC Commentary*, p 277.

<sup>51</sup> (1830) 9 S 190.

be inconsistent with the objective concept of communication that is at the heart of the reforms we recommend in this Report.

5.77 As we have recommended that the postal acceptance rule be abolished,<sup>52</sup> we go on to recommend that:

27. **The statutory statement of the law on formation of contract should provide that an acceptance may be withdrawn if the withdrawal is communicated to the offeror before or at the same time as the acceptance.**

(Draft Bill, section 10(b))

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<sup>52</sup> See paras 4.86 to 4.90 above.

# Chapter 6 Change of circumstances

## Introduction

6.1 The 1993 Report noted that there were some grounds on which an offer could lapse in Scots law which were not replicated in the CISG. In particular an offer may terminate on a material change of circumstances,<sup>1</sup> or on the supervening death or mental illness of the offeror.<sup>2</sup>

6.2 Such rules did not, however, find their way into any of the other comparator instruments.<sup>3</sup> Perhaps their requirements of good faith would cover the particular case of material change of circumstances during the offer and acceptance process.<sup>4</sup> In Scots law, however, where good faith is generally an underlying principle rather than an active source of entitlements in contract law,<sup>5</sup> specific rules seem to provide a better approach.

6.3 In the 2012 DP, we suggested that if there is to be a statutory statement of the law on formation of contract it should be as complete as possible. We therefore proposed that, if it were desirable to have provisions on changes of circumstances, they should be included in the statement.

6.4 In this Chapter, we outline the general effect that a change of circumstances may have on an offer in Scots law, and address issues of terminology. We then look at death and incapacity in particular, before turning to examine the effect of insolvency on an offer.

## Change of circumstances generally

6.5 The textbooks tend to refer to this topic as “material change of circumstances” and refer to the present rule which was set out by Lord President Inglis:

“when an offer is made without a limit of time being stated within which it must be accepted, it may become inoperative by reason of any important change of circumstances, without any formal withdrawal of the offer being made.”<sup>6</sup>

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<sup>1</sup> See in particular *Macrae v Edinburgh Street Tramways Co* (1885) 13 R 265 (IH); *Bright (Richardson’s Exr) v Low* 1940 SC 280 (IH); *Sommerville v National Coal Board* 1963 SC 666 (IH); *Lawrence v Knight* 1972 SC 26 (OH); McBryde, *Contract*, paras 6.62 to 6.64.

<sup>2</sup> McBryde, *Contract*, paras 6.66 to 6.70. Offers may also be no longer available for acceptance after the lapse of a reasonable time: see paras 5.47 to 5.49 below.

<sup>3</sup> For PICC comments on this, see Vogenauer, *PICC Commentary*, p 260.

<sup>4</sup> The DCFR (III.-1:110) and the proposed CESL (Art 89) do empower a court to vary or terminate an *obligation* the performance of which has become so onerous through an exceptional change of circumstances as to make it manifestly unjust to hold the debtor to the obligation; but there must first be an obligation and the change of circumstances must occur after the obligation has been incurred. Thus this rule is inapplicable to parties in negotiation towards a contract. The same holds good for PICC rules on Hardship (Arts 6.2.1 to 6.2.3).

<sup>5</sup> *R v Immigration Officer at Prague Airport ex parte European Roma Rights Centre* [2005] AC 1, para 60 (per Lord Hope of Craighead).

<sup>6</sup> *Macrae v Edinburgh Street Tramways Co* (1885) 13 R 265 at 269.

6.6 The change of circumstances must however be such as to make the offer “utterly unsuitable and absurd”.<sup>7</sup> McBryde notes several cases, many of them involving the lapsing of tenders in delict claims where either the amount to be awarded by the court had become apparent in some way, or where the pursuer had died.<sup>8</sup> In the 2012 DP, we commented that such cases would continue to be a useful guide as to the scope of material change of circumstances rendering an offer ineffective.

6.7 We also thought that any legislative provision should not go beyond a fairly simple formulation of the principle as stated by Lord President Inglis. We noted that the rule would be a default one and that it would be open to offerors to spell out in their offers the specific circumstances in which they will cease to be available for acceptance. McBryde gives the example of an offer for all the shares of a company which states that it will lapse unless a given percentage of the shareholders accept within a given period of time.

6.8 Most consultees agreed that a statutory statement of the law on formation of contract should include provision on material change of circumstances, and that it should be in substance the same as the present law.

### *Terminology*

6.9 Pinsent Masons did raise a questioning note about use of the word “material”, suggesting that it might imply too low a standard. We note that Lord President Inglis spoke of an “important” change that rendered the offer “utterly unsuitable and absurd”. In relation to remedies for breach of contract,<sup>9</sup> we suggested that the level of breach required to justify the other party in terminating a contract should be “fundamental” or “substantial” rather than “material”.<sup>10</sup> On reflection, we tend to think that “fundamental” more accurately indicates the high standard required by Lord President Inglis. In the remainder of this Chapter, we refer to a “fundamental change of circumstances” rather than the more traditional “material change of circumstances” found in the textbooks, and this is reflected in our draft Bill.

6.10 We therefore recommend that:

**28. The statutory statement of the law on formation of contract should provide that an offer lapses upon a fundamental change of circumstances.**

(Draft Bill, section 6(1))

### **Death or incapacity of any party before formation process complete**

6.11 In this section of the Chapter, we are concerned with the effect of death or supervening mental illness or disorder of any party during a formation process. Such may of course be seen as examples of a fundamental change of circumstance. But it is not firmly settled in Scots law what happens if the offeror is affected in one of these ways after making

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<sup>7</sup> Ibid.

<sup>8</sup> McBryde, *Contract*, paras 6.63 to 6.64.

<sup>9</sup> See Part 4, Chapter 12.

<sup>10</sup> 2017 DP, paras 4.12 to 4.15.

the offer but before it is accepted, or if the offeree is likewise affected after dispatching an acceptance but before it reaches the offeror.

6.12 In some cases, the situation may clearly come within the general “fundamental change of circumstances” test set out above.<sup>11</sup> Where there is *delectus personae* on either side, the death of the person chosen would probably affect either an offer addressed to or an inchoate acceptance made by that person. Gloag however took the wider view that “an offer falls by the death of either party before acceptance”.<sup>12</sup> McBryde is more cautious, but suggests that Scots law adopts a subjective approach toward questions of capacity to contract, and that a person who dies or becomes mentally ill thereby loses the necessary capacity to conclude any contract.<sup>13</sup> The reasoning is equally applicable to offeror and offeree.<sup>14</sup>

6.13 In English law, cases of *delectus personae* apart, offers in at least some circumstances are capable of acceptance after the offeror's death where the acceptor is ignorant of the death at the relevant time.<sup>15</sup> It is also submitted in Chitty that, in the absence of *delectus personae*, the death of the offeree before acceptance leads, not to automatic termination of the offer, but to the question whether:

“on its true construction [it might] be held to have been made to the offeree or to his executors, and that such an offer could be accepted after the death of the original offeree.”<sup>16</sup>

6.14 The 1993 Report argued that the CISG implicitly recognised a rule that an offer cannot be accepted after the death of either party. It argued that a communication could never be said to “reach” a dead addressee, and that it was not possible to conclude a contract if at the moment of conclusion there was only one party in existence. It went on to suggest that, if incapacity at the moment of conclusion would be a ground of invalidity then so too should death be, on the basis that death is “...the ultimate incapacity”.<sup>17</sup> The 1993 Report went on to argue that the CISG also did not preclude reliance on incapacity through mental disorder or illness.<sup>18</sup> Given the parallels between the CISG and the DCFR, it appears to us that the same arguments would apply to the latter.

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<sup>11</sup> As in *Sommerville v National Coal Board* 1963 SC 666 (IH) (where the offeree died prior to accepting a tender).

<sup>12</sup> Gloag, *Contract*, p 37. See also *Gloag and Henderson*, para 5.18, and *Glasgow City Council v Peart* 1999 Hous LR 117, 1999 GWD 29 to 1390 (OH), where an agent's authority to sign an acceptance was held to lapse on the death of its principal.

<sup>13</sup> A problem which the Scottish books do not address is that of the irrevocable offer, which binds the offeror even before acceptance (see paras 5.23 to 5.31 above), and may therefore continue to bind the offeror's estate after death. Cf Chitty, para 2.099, noting that in English law an offer does not fall where a person has validly *contracted* not to revoke it for a fixed period but dies during the period of the offer.

<sup>14</sup> McBryde, *Contract*, paras 6.66 to 6.70. See also paras 26.16 to 26.19, where Professor McBryde discusses the effect of death upon delivery of deeds. It is another question again what happens when death or mental illness of either party intervenes after the contract has been concluded: see the discussion at paras 26.01 to 26.15.

<sup>15</sup> Chitty, para 2.100. The main authorities concern continuing guarantees (eg of bank overdrafts), which are said to be divisible and continuing offers accepted from time to time as the bank makes further loans to its customers. These guarantees clearly survive the guarantor's death with regard to loans made before that event but it is thought that, in Scots law, such guarantees are conditional unilateral obligations in their own right (ie promises to pay upon the default of the borrower) and so bind the estate of the guarantor on that basis.

<sup>16</sup> Chitty, para 2.101.

<sup>17</sup> 1993 Report, para 4.10.

<sup>18</sup> 1993 Report, para 4.12, citing CISG Art 4.

6.15 In the 2012 DP, we agreed that death is the ultimate incapacity. We suggested that a death after an offer is made but before a contract is concluded should have the following effects:

- the death of the offeror should terminate the offer;
- the death of either party should render ineffective any acceptance that has been dispatched but has not been received by the offeror.

6.16 This, like all of our recommendations on formation, is a default rule and so can be varied by the terms in which the offer is made. In essence this is not very different from the English rule, but has the advantage, we think, of providing some baseline certainty in the law. It does not change the rule that contracts and other obligations, as distinct from offers, generally continue to bind the estates of parties to such obligations who happen to die during their currency.<sup>19</sup>

6.17 As we indicated in the 2012 DP, the position where a party is affected by supervening incapacity is potentially more difficult. Defining incapacity solely in terms of mental illness is problematic given the variety of forms that mental illness may take, and the fact that a given condition may not affect capacity to enter into a particular transaction. We also noted that the concept of “incapacity” in the Adults with Incapacity (Scotland) Act 2000 covers not only mental disorder,<sup>20</sup> but also physical disabilities if they render the adult incapable of communicating decisions.

6.18 The granting of powers of attorney, intervention orders by a court, or the appointment of a guardian under the Adults with Incapacity (Scotland) Act 2000 may take care of many of the potential problems in this area.<sup>21</sup> But the common law of incapacity continues to govern the position of a person who has no attorney, intervention order, or guardian in place at the time he or she makes an offer or sends an acceptance.<sup>22</sup> An important rule here is that an incapable person cannot appoint an agent.<sup>23</sup>

6.19 The crucial benefit that the present common law can offer in such circumstances is that what may appear to be a contract binding the incapable person is no such thing: the incapacity during the process of formation means that a contract never was completed. The outstanding problem may be the limits upon what the common law will recognise as incapacity. It is beyond the scope of the present exercise to investigate or propose the extension of the common law of capacity in such circumstances to cover the forms of incapacity recognised in the 2000 Act, although the DP noted McBryde's observation that

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<sup>19</sup> See generally McBryde, *Contract*, Ch 26 Part 1.

<sup>20</sup> Section 87 of the Adults with Incapacity (Scotland) Act 2000 imports the definition of mental disorder found in section 328 of the Mental Health (Care and Treatment) (Scotland) Act 2003 (and so extends beyond mental illness to cover learning disabilities and personality disorders).

<sup>21</sup> A guardianship order renders the adult concerned incapable of entering into any transaction in relation to a matter within the scope of the guardian's authority, unless authorised by the guardian: Adults with Incapacity (Scotland) Act 2000, s 67.

<sup>22</sup> The rules on facility and circumvention and undue influence as grounds of challenge to what appears to be a concluded contract may continue to be of particular relevance in this context. See our joint Consultation Paper with the Law Commission of England and Wales on Consumer Redress for Misleading and Aggressive Practices (Law Com No 199, 2011; Scot Law Com No 149, 2011), esp at Pt 7.

<sup>23</sup> LJ Macgregor, *The Law of Agency in Scotland* (2013) paras 3.12 to 3.13.

some physical problems could be relevant such as the physical trauma that leaves a party in a coma.<sup>24</sup>

6.20 In the 2012 DP, we suggested that it would be helpful for any legislation on the formation of contract to clarify the law in this area. We proposed that while such legislation might refer specifically to the death of either party as a ground upon which an offer or an acceptance might fall or fail, it would be inappropriate for it to use the traditional term of “insanity” as a further ground. Nor would it be appropriate to substitute “mental illness” or “mental disorder”, since that may be at once too expansive and too restrictive. We believed that it would be simpler to adopt the expedient of referring to “death or other loss of capacity” on the basis that this would allow for the further development of the law of capacity to contract in the future, whether by further legislation or by judicial decision.

6.21 Most consultees agreed that it should be provided that an offer should cease to be capable of acceptance as a result of the death or loss of capacity of either party before the conclusion of the contract. Mr Price suggested that the matter could simply be treated as an example of a fundamental change of circumstances and that any more specific rule was unnecessary. We think the topic sufficiently important, however, to warrant a specific provision, although we agree that it is an instance of a fundamental change of circumstances.

6.22 We would therefore recommend that:

**29. The statutory statement of the law on formation of contract should provide that, as an example of a fundamental change of circumstances, an offer ceases to be capable of acceptance as a result of the death or loss of capacity of either party before the conclusion of the contract.**

(Draft Bill, section 6(2))

6.23 Some comment on law firm blogs on the draft Bill provisions published in 2017 was concerned that the position of corporate entities subject to a fundamental change of circumstances was left unclear.<sup>25</sup> In particular Shepherd and Wedderburn made this comment:

“The proposal to codify this rule raises the question of how the rule applies to corporate entities nowadays, for example in the context of a group reorganisation or a merger of banking businesses or building societies.

In such mergers and reorganisations, the ability to manage pipeline business (eg offer letters which have been issued by the institution being merged or reorganised, but which have not yet been accepted by the relevant customers at the point of merger or reorganisation) is an important consideration.

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<sup>24</sup> McBryde, *Contract*, para 6.66, fn 200. The person rendered semi-comatose by a physical trauma may be an even more pertinent example: consider the condition of the plaintiff in *Kaye v Robertson* [1991] FSR 62 (CA).

<sup>25</sup> See CMS, “Contract Formation: So Long, Postal Acceptance?”, 27.09.2017, at <https://goo.gl/mTVDzy>; Gillian Craig (MacRoberts), “Contracting into the 21<sup>st</sup> Century – Contract (Formations) (Scotland) Bill”, 12<sup>th</sup> October 2017, at <https://goo.gl/UZKa44>.

The draft bill would not prejudice a merger or reorganisation being effected using statutory powers, such as a ring-fencing transfer scheme under the Financial Services and Markets Act 2000, due to a carve-out in the draft bill which allows other enactments to apply as intended. Though if the merger or reorganisation takes effect through non-statutory means, by contractual arrangements and conventional conveyances, the interaction of the codified rule under the draft bill with the terms of the relevant offer letters would require more scrutiny.”<sup>26</sup>

6.24 We note first that the perceived problem also arises under the present law. We think that in general the situation described is capable of being seen as a material or fundamental change of circumstances in that the party which made the offer then ceased to exist prior to any acceptance by the offeree. It would fall under the general provision in section 6(1) of the draft Bill. Whether a court would see the change as sufficiently fundamental to make the offer no longer capable of acceptance would depend, we think, on all the circumstances and the practical effects upon the offeree. Further, as Shepherd and Wedderburn observed, section 6(4) continues to provide a “carve out” for relevant statutory schemes. With non-statutory schemes, the prudent offeror can under section 1(1)(a) of the draft Bill make alternative provision in the offer itself. We therefore do not think it necessary to make any more specific provision on this matter in the draft Bill.

## Insolvency

6.25 The insolvency of any party to an ongoing formation process may well be thought to be a fundamental change of circumstances. But the 1993 Report recommended against any change to what it took to be the present law that an offer does not lapse merely because one of the parties becomes insolvent before the contract is concluded.<sup>27</sup> In the 2012 DP, however, we suggested there is some doubt as to whether this is in fact the law. We canvassed a number of conflicting views,<sup>28</sup> but reached the view that the general position was, as McBryde observed, that “[i]nsolvency does not by itself prevent a person entering into contracts.”<sup>29</sup>

6.26 We think on this basis, as well as for the reasons set out in the 1993 Report,<sup>30</sup> that its recommendation continues to be sound. As the 1993 Report pointed out, persons may contract until the date of sequestration, and the trustee has powers to adopt or disclaim contracts previously entered into.<sup>31</sup> It also observed that businesses may continue to trade after insolvency, and may even manage to trade their way out of insolvency, in which case it would be dangerous were offers to lapse on apparent insolvency.

6.27 In the 2012 DP, we therefore proposed that the default rule should be that insolvency of either the offeror or the offeree prior to the completion of the latter's acceptance has no

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<sup>26</sup> See Shepherd & Wedderburn, “Goodbye ‘Postal Acceptance Rule’, Hello ‘Out-of-Office Message’ Rule?”, 05 Sep 2017, at <https://goo.gl/5evhjk>.

<sup>27</sup> 1993 Report, para 4.13.

<sup>28</sup> 2012 DP, paras 3.39 and 3.40.

<sup>29</sup> McBryde, *Contract*, para 26.21 (and see in particular the passage quoted there: Bell, *Commentaries*, I, 265). See also McBryde, *Bankruptcy* (2<sup>nd</sup> edn, 1995), para 1.39.

<sup>30</sup> 1993 Report, para 4.13. In the 2012 DP, we observed that the underlying law had not substantially changed since 1993: 2012 DP, para 3.41 and fn 86.

<sup>31</sup> See now Bankruptcy (Scotland) Act 2016 s 110; D McKenzie Skene, *Bankruptcy* (2018) paras 12.22 to 12.36. We note that sequestration does not generally deprive a person of capacity to contract, although third parties may find it commercially less attractive to contract with an insolvent person.

effect on either offer or acceptance. We noted that parties could safeguard their position by making the continued solvency of the other party an express condition of an offer or acceptance.

6.28 Most consultees supported the suggested clarification of the law, although the Law Society of Scotland commented that we might have “underestimated the clarity of the law on the effect of sequestration, liquidation, administration etc on unaccepted offers (as opposed to concluded contracts).” The Senators of the College of Justice thought that any legislation should be clear that it had no effect upon the application of bankruptcy or insolvency law to the transaction in question. We agree.

6.29 In view of the lack of authority on the question, and the varying views about it found in the standard works on contract law, we think that it would be helpful for the statutory statement of the law on formation to be clear that in general the insolvency of any party to an ongoing formation process is not a fundamental change of circumstance causing an as yet unaccepted offer to lapse. It should also be made clear that this rule does not affect the application of any other enactment or rule of law to the transaction proposed in the offer. We recommend that:

**30. The statutory statement of the law on formation of contract should provide that:**

**(a) the insolvency of either an offeror or an offeree prior to the acceptance of an offer is not in itself a fundamental change of circumstances causing the offer to lapse;**

**(b) this rule is without prejudice to the application of any other enactment or rule of law to the transaction proposed in the offer.**

(Draft Bill, section 6(3) and (5))

## **PART 3**

# **Interpretation of Contract**

# Chapter 7 Interpretation: an introduction

## Background

7.1 The interpretation of contracts is a notoriously difficult area. As disputes will invariably focus on the specific facts before the court and the particular wording of the contract in question, any abstract rules at high levels of generality are difficult to apply. This is almost certainly one reason for the frequency with which questions of interpretation are litigated.

7.2 In 1997 we published a Report on Interpretation in Private Law (the 1997 Report).<sup>1</sup> This was prompted by earlier work which was published as a Report on Three Bad Rules in Contract Law<sup>2</sup> and implemented by the Contract (Scotland) Act 1997. The latter had included the abolition of the parole evidence rule. Questions were thereby raised about other rules by which extrinsic evidence was excluded in the interpretation of contractual and other documents having legal effects (such as wills). The 1997 Report went unimplemented, however, perhaps partly because it appeared that significant developments in judicial thinking on the subject took place in England and Wales the same year. Led by Lord Hoffmann in the House of Lords (and so also being of influence in Scotland), this involved the court in a wider use of “context” to interpret legal documents.<sup>3</sup>

7.3 We returned to the subject in 2011 as the first part of our Eighth Programme project on contract law. This time, the stimulus for work was the uncertainty which the Scottish courts in particular seemed to feel in dealing with the Hoffmann approach. There was also the problem created by Lord Hoffmann himself in his final speech as a Law Lord, delivered in *Chartbrook Ltd v Persimmon Homes Ltd*<sup>4</sup> in 2009, in which he appeared to draw back from some of the logical consequences of his previous reasoning. It thus seemed worthwhile to see whether the uncertainty might be resolved by way of legislation. Our Discussion Paper on the Interpretation of Contract was published in February 2011 (the 2011 DP).

7.4 The law has moved on again since 2011, both in Scotland and England, and appears to have become more settled (along the same lines) in each jurisdiction. We canvass the developments since the publication of the 2011 DP in Chapter 8. In the most recent (2016) edition of his authoritative textbook on the subject, Lord Justice Lewison speaks of a “period ... of consolidation of the principles that govern the interpretation of contracts”, and thinks that this is as true of the Scottish as the English courts.<sup>5</sup> Chitty talks of periods of the courts’ varying emphasis on particular aspects over time, with certainty sometimes highlighted over contextual and purposive approaches, and vice versa:

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<sup>1</sup> Scot Law Com No 160, 1997.

<sup>2</sup> Scot Law Com No 152, 1996.

<sup>3</sup> *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28, [1998] 1 WLR 896.

<sup>4</sup> [2009] UKHL 38; [2009] 1 AC 1101.

<sup>5</sup> Lewison, *Interpretation*, preface; see also p 4.

“The differences, however, appear to be differences of emphasis rather than principle and in all cases the overriding aim of the court is to give effect to the intention of the parties, objectively ascertained, as reflected in the terms of their contract.”<sup>6</sup>

7.5 In the light of these more recent developments, we have determined that now is not an appropriate time to recommend legislative reform of the law of contractual interpretation. This is not to say that we feel complete satisfaction with, or clarity in, the equilibrium that appears to have been achieved; but we would need more reason than that to disturb the equilibrium when our consultation also showed no strong consensus around any alternative model.

7.6 We think, however, that it is worthwhile to explain the state of the law in 2011 to set in context the 2011 DP before going on to discuss the responses that we received to it.

### **Preparation of the 2011 Discussion Paper**

7.7 Our 2011 DP drew heavily upon the DCFR and our previous 1997 Report, which had made use of the PECL and the PICC. It also considered developments in the laws of England and other Commonwealth jurisdictions. From this comparative study, it went on to suggest a tentative roadmap for reform, upon which consultees were invited to comment. A short summary of the DCFR approach may serve to provide a setting for the discussion which follows below.<sup>7</sup>

#### *The DCFR and comparator instruments*

7.8 The DCFR takes what may be termed a “subjective” approach to the interpretation of contracts. The object of the exercise is the determination of the contracting parties’ “common intention even if this differs from the literal meaning of the words”.<sup>8</sup> If one party intended the contract, or a term or expression used in it, to have a particular meaning, and at the time of the conclusion of the contract the other party was aware, or could reasonably be expected to have been aware, of the first party’s intention, the contract is to be interpreted in the way intended by the first party.<sup>9</sup> But if the parties’ common intention cannot be established in this way, then an “objective” approach of interpreting the contract as the reasonable person would be used.<sup>10</sup> In interpreting the contract, regard may be had to relevant matters, including in particular “the circumstances in which it was concluded, including the preliminary negotiations” and “the conduct of the parties, even subsequent to the conclusion of the contract”.<sup>11</sup> Terms and expressions are to be interpreted in the light of the whole contract in which they appear.<sup>12</sup>

7.9 As the national notes to these DCFR articles make clear, the approach is similar to that in most other European systems, but contrasts in a major way with the emphasis in Scots (and English) law on a generally objective approach to the interpretation of contracts,

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<sup>6</sup> Chitty, para 13.046.

<sup>7</sup> The summary is incomplete; we have highlighted here only those rules that are particularly relevant to the discussion in this Report. In addition to the DCFR articles cited below, see DCFR II.–8:101(3)(b), II.–8:102(1) (c) to g), II.–8:103 and 8:104, II.–8:106 and 8:107, and II.–8:201 and 8:202. See further 2011 DP, Chapter 3.

<sup>8</sup> DCFR II.–8:101(1).

<sup>9</sup> DCFR II.–8:101(2).

<sup>10</sup> DCFR II.–8:101(3)(a).

<sup>11</sup> DCFR II.–8:102(1)(a), (b).

<sup>12</sup> DCFR II.–8:105.

and also with a more restrictive approach to what material beyond the contract itself can be considered in determining its meaning.

*Developments in English law: the Hoffmann approach*

7.10 Chapter 4 of the 2011 DP looked at judicial developments in England and the common law world since 1997. This naturally focused on Lord Hoffmann's restatement of the law of interpretation of contract in *ICS*<sup>13</sup> which had, at the time, succeeded in establishing itself as the orthodoxy for the English courts and commentators.<sup>14</sup>

7.11 Under the law in England before *ICS*, where a contract was reduced to writing, a court was not supposed to go outside the document for any further terms or material that would contradict what had been written (the parole evidence rule). Reference to external material was allowed only where the document was ambiguous or unclear.

7.12 But Lord Hoffmann argued that the process of interpretation must involve examining the context in which words are used:

“the background of facts ... plays an indispensable part in the way we interpret what anyone is saying.”<sup>15</sup>

Accordingly, Lord Hoffmann considered admissible surrounding circumstances should always be examined, whether or not at first sight the words appear to be ambiguous.

7.13 To this point, Lord Hoffmann was probably going no further than Lord Wilberforce's declarations more than twenty years earlier that:

“the time has long passed when agreements, even those under seal, were isolated from the matrix of facts in which they were set and interpreted purely on internal linguistic considerations”<sup>16</sup>

and that:

“what the court must do must be to place itself in thought in the same factual matrix as that in which the parties were.”<sup>17</sup>

7.14 For Lord Wilberforce this meant that the court should know “the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating.”<sup>18</sup>

7.15 In *ICS*, however, Lord Hoffmann went on to say that the phrase “matrix of facts” was, “if anything, an understated description of what the background may include.”<sup>19</sup> The surrounding circumstances “include ... absolutely anything which would have affected the

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<sup>13</sup> [1997] UKHL 28, [1998] 1 WLR 896.

<sup>14</sup> 2011 DP, para 4.1.

<sup>15</sup> *ICS*, 912 and 913.

<sup>16</sup> *Prenn v Simmonds* [1971] 1 WLR 1381 (HL) at 1383 and 1384.

<sup>17</sup> *Reardon Smith Line Ltd v Yngvar Hansen-Tangen* [1976] 1 WLR 989 (HL) at 997.

<sup>18</sup> [1976] 1 WLR 989 at 995 and 996.

<sup>19</sup> *ICS*, 912 and 913.

way in which the language of the document would have been understood by a reasonable man.”<sup>20</sup> Indeed, Lord Hoffmann continued:

“the background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax.”<sup>21</sup>

7.16 Thus, in the *ICS* case itself, words placed in brackets with other words in the text under consideration were repositioned outside the bracketed phrase to make the contract say what the court held it must have been meant to say.

7.17 This then, while retaining the objectivity of the reasonable person reading the contract, appeared otherwise to be a genuine shift in approach to contractual interpretation. Ambiguity is not a pre-requisite of an investigation of the factual matrix in which a contract had been concluded. Such an investigation is rather in all cases an indispensable part of the process of understanding what a contract means. This background enables the reader, above all the judge, to determine the intended meaning of the expressions actually used in the contract.

7.18 Even more radically, however, the actual words used do not necessarily govern the meaning to be given to the contract. The background can let the judge decide that the parties used the wrong words, or mis-ordered their words, and these words may then be read in such a way as to give the parties’ expressions the meanings they must have intended, in the light of the background. In the language of the DCFR, a court could find the parties’ common intention was not governed by the literal meaning of the words they used.

7.19 Perhaps the most far-reaching application of this approach by the House of Lords was *The Starsin*,<sup>22</sup> where the court was able not only to read words into a shipping contract where it was “clear both that words have been omitted and what those omitted words were”,<sup>23</sup> but also to ignore other words actually in the contract on the basis that the commercial persons to whom the document was addressed would not have paid any attention to them either.

7.20 In *Chartbrook*, Lord Hoffmann (with whom the other Law Lords agreed) rejected the meaning of a contractual clause “in accordance with ordinary rules of syntax”,<sup>24</sup> on the grounds that it made no commercial sense, and something must have gone wrong with the way in which the contract was expressed. On the ordinary meaning of the words actually used, the licensor of a residential and commercial development would have been entitled to a payment of £4.84 million from the developer licensee as an ‘Additional Residential Payment’ (ARP). A unanimous House of Lords held however that the commercial purpose of the clause was to give the licensor a share, not of the total revenue from residential sales in the development, but of any better-than-expected performance. The interpretation, it was

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<sup>20</sup> *Ibid.*

<sup>21</sup> *Ibid.*

<sup>22</sup> [2003] UKHL 12; [2004] 1 AC 715.

<sup>23</sup> [2003] UKHL 12; [2004] 1 AC 715, para 23 per Lord Bingham.

<sup>24</sup> *Chartbrook*, para 16.

said, better reflected the obviously contingent character of the payment obligation under the ARP clause.

7.21 Giving the leading speech, Lord Hoffmann said:

“When the language used in an instrument gives rise to difficulties of construction, the process of interpretation does not require one to formulate some alternative form of words which approximates as closely as possible to that of the parties. It is to decide what a reasonable person would have understood the parties to have meant by using the language they did.”<sup>25</sup>

7.22 In the 2011 DP, we observed that the full implications of the Hoffmann approach as stated in *ICS* continued to be controversial in England, although in general terms it was widely accepted in the courts<sup>26</sup> and amongst academic lawyers.<sup>27</sup> It was also the starting point of the then-current edition of Lord Justice Lewison’s textbook.<sup>28</sup> We also examined the reception of the Hoffmann approach in other Commonwealth jurisdictions, while noting that it was also the subject of severe and continuing criticism from contract drafters.<sup>29</sup>

7.23 It should be noted, however, that Lord Hoffmann’s seemingly sweeping statements in the *ICS* case were carefully qualified even at the time they were made. They did not adopt a subjective approach to the parties’ intentions: the interpretation was that of the reasonable person. To be relevant, background had to be “reasonably available to the parties”;<sup>30</sup> the parties’ previous negotiations and declarations of subjective intent continued to be excluded from consideration for reasons of practical policy; and “we do not easily accept that people have made linguistic mistakes, particularly in formal documents”.<sup>31</sup> These qualifications were reinforced in subsequent cases. So with regard to the background including “absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man”,<sup>32</sup> Lord Hoffmann later stated that he “meant anything which a reasonable man would have regarded as *relevant*.”<sup>33</sup>

7.24 In *Chartbrook*, Lord Hoffmann accepted that while in principle previous negotiations “may be relevant”,<sup>34</sup> and that evidence about them could be used for purposes other than interpretation, such as establishing that a fact relevant to the background was known to the

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<sup>25</sup> *Chartbrook*, para 21. See also para 25.

<sup>26</sup> See Lord Bingham, “A New Thing Under the Sun? The Interpretation of Contract and the *ICS* Decision” (2008) 12 *Edin LR* 374.

<sup>27</sup> See eg G McMeel, *The Construction of Contracts* (1<sup>st</sup> edn, 2007); C Mitchell, *Interpretation of Contracts: Current Controversies in the Law* (2007); A Burrows and E Peel (eds), *Contract Formation and Parties* (2010), chs 3 to 5. An influential New Zealand proponent of the Hoffmann approach is Professor David McLauchlan: see eg “Contract Interpretation: What Is It About?” (2009) 31 *Sydney LR* 5. Other relevant articles by Professor McLauchlan are cited later in this and the following Chapter.

<sup>28</sup> K Lewison, *The Interpretation of Contracts* (4<sup>th</sup> edn, 2007). See in particular ch 1. The author was at the time a Justice of the High Court of England and Wales. See further para 8.27 below for the approach to be found in his most recent edition.

<sup>29</sup> 2011 DP, para 4.6.

<sup>30</sup> *ICS*, 912.

<sup>31</sup> *ICS*, 913.

<sup>32</sup> *Ibid.*

<sup>33</sup> *BCCI SA v Ali* [2002] 1 AC 251 at 269 (with the emphasis in the original).

<sup>34</sup> *Chartbrook*, para 33.

parties,<sup>35</sup> the general exclusionary rule should be maintained on pragmatic grounds.<sup>36</sup> He spelled out these grounds as follows:

“[35] The first is that the admission of pre-contractual negotiations would create greater uncertainty of outcome in disputes over interpretation and add to the cost of advice, litigation or arbitration. Everyone engaged in the exercise would have to read the correspondence and statements would have to be taken from those who took part in oral negotiations. Not only would this be time-consuming and expensive but the scope for disagreement over whether the material affected the construction of the agreement ... would be considerably increased.

...

[38] ... [P]re-contractual negotiations seem to me capable of raising practical questions different from those created by other forms of background. Whereas the surrounding circumstances are, by definition, objective facts, which will usually be uncontroversial, statements in the course of pre-contractual negotiations will be drenched in subjectivity and may, if oral, be very much in dispute. It is often not easy to distinguish between those statements which (if they were made at all) merely reflect the aspirations of one or other of the parties and those which embody at least a provisional consensus which may throw light on the meaning of the contract which was eventually concluded. But the imprecision of the line between negotiation and provisional agreement is the very reason why in every case of dispute over interpretation, one or other of the parties is likely to require a court or arbitrator to take the course of negotiations into account.”

Thus here for Lord Hoffmann pragmatism clearly wins out over principle and relevancy in determining the admissibility of pre-contractual negotiations. There was no move in the direction of the DCFR on this point.<sup>37</sup>

### *The position in Scotland*

7.25 Chapter 5 of the 2011 DP considered post-1997 developments in Scotland. This noted that the Scottish judges in both *ICS* and *Chartbrook* (Lords Hope and Clyde, and Hope and Rodger respectively) had concurred with Lord Hoffmann, and that his approach had also been referred to with approval in a number of Inner House decisions. This included a categorical statement by the First Division in 2010 that “it is not part of our law of contract that the court can have regard to relevant background circumstances only if there is ambiguity in the words of an agreement.”<sup>38</sup>

7.26 There were however also indications of judicial hostility to the Hoffmann approach in Scotland. In *Multi-Link Leisure Developments v North Lanarkshire Council*,<sup>39</sup> the clause in question involved an option granted by a local authority over land for the purposes of developing a golf course. However, the residential development potential of the land became clear, which raised questions over how the land should be valued. The contract itself did

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<sup>35</sup> *Chartbrook*, para 42.

<sup>36</sup> *Chartbrook*, para 34.

<sup>37</sup> Note here Lord Hoffmann's robust rejection of the approach to pre-contractual negotiations found in Continental systems and in the CISG, PICC and PECL (ie the DCFR'S forerunners) as well as in French law specifically (*Chartbrook*, para 39).

<sup>38</sup> *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 1, 2010 SLT 147, para 38 (Lord Hodge, giving the opinion of the Court).

<sup>39</sup> [2009] CSIH 96; 2010 SC 302.

refer to the “full market value” of the land, but this appeared to conflict with provisions which calculated this as the potential for development as a golf course (or no less than £130,000). An Extra Division rejected the applicability of the Hoffmann approach to leases, expressing its “considerable sympathy” with the severe criticism made of it in the leading Scottish text on contract law.<sup>40</sup> The court held, however, that “full market value” should be given a wide meaning.

7.27 The Supreme Court went on to uphold the decision of the Extra Division, although not endorsing its reasoning.<sup>41</sup> But Lord Hope and Lord Rodger (who gave the leading judgments) also differed between themselves on the basis for the decision. Lord Rodger did not refer to the Hoffmann approach at all, but noted that “something has gone wrong” with the drafting of the contract in question.<sup>42</sup> He considered that one should start with the parts of the contract that are clear, then use these to determine the meaning of the rest.<sup>43</sup> Lord Hope, on the other hand, considered that the words were the ordinary starting point, but that where there was ambiguity the solution could be found “by recognising the poor quality of the drafting and trying to give a sensible meaning to the clause as a whole which takes account of the factual background known to the parties at the time when the lease was entered into.”<sup>44</sup> The divergent approaches taken by Lord Hope, Lord Rodger, and the Extra Division to reach the same result left the position in Scotland somewhat unclear.<sup>45</sup>

7.28 The 2011 DP also noted that the leading modern case on contractual interpretation in Scotland was usually taken to be *Bank of Scotland v Dunedin Property Investment Co Ltd*.<sup>46</sup> There it had been held that the court should start with the words used, while seeking to avoid interpretations that produce an absurd result.<sup>47</sup> There were certainly no recent Scottish cases in which the courts had reworked the words on the same scale seen in *ICS or The Starsin*.<sup>48</sup> Whether the Hoffmann approach had really been adopted at all in Scotland was accordingly unclear.

7.29 The 2011 DP identified several key principles on interpretation seemingly widely accepted by Outer House judges. These were:

- “1. The words used by the parties must generally be given their ordinary meaning.
2. A contractual provision must be construed in the context of the contractual document or documents as a whole.

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<sup>40</sup> [2009] CSIH 96; 2010 SC 302, paras 23 to 25, referring to McBryde, *Contract*, paras 8.25 to 8.27.

<sup>41</sup> *Multi-Link Leisure Developments v North Lanarkshire Council* [2010] UKSC 47, 2011 SC (UKSC) 53.

<sup>42</sup> [2010] UKSC 47, 2011 SC (UKSC) 53 at para 27, per Lord Rodger.

<sup>43</sup> [2010] UKSC 47, 2011 SC (UKSC) 53 at para 28, per Lord Rodger. For a suggestion that Lord Rodger was here using an interpretive technique which he would also have deployed in his Roman law scholarship, see H L MacQueen “Lord Rodger: Jurist then Judge”, (2014) 3 *Cambridge Journal of International and Comparative Law* 11 to 29.

<sup>44</sup> [2010] UKSC 47, 2011 SC (UKSC) 53 at para 19, per Lord Hope.

<sup>45</sup> For further analysis of *Multi-Link*, see D McLauchlan, “A Construction Conundrum” [2011] LMCLQ 428; Lord Grabiner, “The Iterative Approach to Contractual Interpretation” (2012) 128 LQR 41, 52 to 55; C Mitchell, ‘Interpreting Commercial Contracts - The Policing Role of Context in English Law’ in DiMatteo and Hogg (eds) *Comparative Contract Law: British and American Perspectives* (2016), pp 231, 243 and 244.

<sup>46</sup> 1998 SC 657.

<sup>47</sup> 2011 DP, para 5.2.

<sup>48</sup> 2011 DP, para 5.5.

3. In construing a contract drafted by lawyers, the words may be expected to have been chosen with care and to be intended to convey the meaning which the words chosen would convey to a reasonable person.

4. The process of construction is objective, according to the standards of a reasonable third party aware of the commercial context.

5. Regard is to be had to the circumstances in which the contract came to be concluded to discover the facts to which the contract refers and its commercial purposes objectively considered, although this is limited to matters known or reasonably expected to be known by both parties.

6. Where more than one construction is possible, the commercially sensible construction is taken to be what the parties intended.

7. The court must not substitute a different bargain from that made by the parties.<sup>49</sup>

7.30 Having regard to possible tension between numbers 6 and 7 on this list, we took critical note of Lord Diplock's oft-quoted dictum that:

"if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a decision that flouts business commonsense, it must be made to yield to business commonsense."<sup>50</sup>

7.31 We asked about the basis upon which the judge determines business common sense for these purposes, and queried whether counter evidence could be led to show (for example) that the parties had compromised a disagreement around the wording used, or that one of them had simply made a bad bargain.<sup>51</sup>

7.32 We finally noted that the background circumstances on which evidence might be led under number 5 on the list did not, however, include pre-contractual negotiations for the purpose of determining what parties actually meant by the language that they had chosen to use. Also excluded was evidence of how the parties had conducted themselves in performing their contract once concluded as a way of determining what the parties intended by their choice of words. The justification for excluding negotiations was essentially pragmatic, to confine the scope and cost of inquiries into the meaning of a contract; while the elimination of subsequent conduct was said to prevent a contract meaning one thing one day and another the next.

### *Rectification*

7.33 As Lord Hoffmann had also done in *Chartbrook*,<sup>52</sup> the 2011 DP pointed out that the exclusionary rules for interpretation were not paralleled in the law of rectification of documents, whereby the court can re-cast the language of a document so that it reflects accurately the common intention of the parties to it. For that purpose it may refer freely to the parties' pre-contractual negotiations.<sup>53</sup> We noted that in England this had led to parties

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<sup>49</sup> 2011 DP, para 5.13. This list was used by Lord Bannatyne in *Reeves v Yates* [2014] CSOH 47 para 37.

<sup>50</sup> *The Antaios Compania Naviera SA v Salen Rederierna AB* [1985] AC 191, 201.

<sup>51</sup> See 2011 DP, para 5.16.

<sup>52</sup> See 2011 DP paras 4.20 to 4.25.

<sup>53</sup> Law Reform (Miscellaneous Provisions) (Scotland) Act 1985 ss 9 and 10.

bringing alternate cases so that if an argument on interpretation failed, one on rectification might succeed, and that there were instances of this in Scotland too. We also drew attention to the admissibility of evidence about pre-contractual negotiations and post-contract conduct in the DCFR, Continental European jurisdictions, Canada, and the US Restatement, as well as developments in that direction in Australia, New Zealand and South Africa.<sup>54</sup>

### **The 2011 Discussion Paper's suggestions**

7.34 The 2011 DP concluded by tentatively suggesting a reform of the law in light of the DCFR<sup>55</sup> and on the broad lines of para 1(1) of the Schedule to the Draft Bill that accompanied the 1997 Report, but including a reference to the objectively ascertainable common intention of the parties.<sup>56</sup> This would allow the court to take account of: (a) the parties' common intention; (b) the surrounding circumstances; and (c) the nature and purpose of the agreement. The exclusions of pre-contractual negotiations and post-contractual conduct might be relaxed, to obviate the need for parties to adopt the rather cumbersome twin-track approach of interpretation which failing rectification. The point would not be to explore what each party intended during negotiations, but rather to see whether, objectively viewed, they had agreed any meaning for particular words, phrases, or terms.

7.35 The 2011 DP further contemplated that the courts should be encouraged to use their case management powers to ensure that they were not taken on hopeful trawls of the pre- and post-contractual material in a search for evidence to contradict the apparent meaning of a contract. Parties should also be free to use equivalents of entire agreement clauses<sup>57</sup> in order to contract out of the new evidential regime in advance of any dispute about the meaning of the contract arising.

7.36 We also asked consultees whether the general rule of interpretation (that any statement has the meaning that is reasonable, having regard to the surrounding circumstances and the nature and purpose of the juridical act) should be applied *mutatis mutandis* to unilateral juridical acts.

### **Responses to the 2011 Discussion Paper**

7.37 The 2011 DP received 16 responses from a wide range of consultees. These included commercial legal practitioners, academics, professional bodies, one commercial lender and the Senators of the College of Justice. Consultees' views on the proposals mooted were extremely varied, with several attracting split views on their merits. All consultees were, however, agreed that there were at that time uncertainties within the law, and that this was causing difficulties for both clients and advisers.

7.38 In particular, a majority of consultees favoured the proposal for a more liberal approach to admissibility of surrounding circumstances. However, McGrigors and Dundas & Wilson were both strongly against this, citing the increased costs and uncertainties which might result. The Senators, aware of developments in other jurisdictions, noted that the law

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<sup>54</sup> 2011 DP paras 4.14, 4.16, 4.18.

<sup>55</sup> 2011 DP, para 7.1.

<sup>56</sup> 2011 DP, para 7.6.

<sup>57</sup> ie a clause in which parties expressly agree that a particular document embodies their whole contract.

was “currently in a state of flux” and that it would be preferable to allow it to develop incrementally rather than by statute.

7.39 It is also worth noting here the criticism of our scheme for reform which Professor Martin Hogg of the University of Edinburgh published in 2011.<sup>58</sup> He questioned our approach on the basis that it identified a number of factors to be taken into account without prioritising any single one of them. He suggested that such an approach may not be determinative in hard cases and argued that any reforming legislation must disclose a preference between common intention and objective appearance.

7.40 Hogg’s objection can be met by pointing out that the 2011 DP suggested only that the objectively ascertained common intention of the parties should be taken into account. The objective context and the nature and purpose of the contract will of course feature in any determination of objective common intent, so there is in fact no conflict between the factors; rather, they complement one another. It was not suggested that the subjective common intent of the parties should be in any way determinative if it has not been objectively manifested.

7.41 The 2011 DP also addressed the interpretation of unilateral juridical acts and statements, proposing that the general approach to contract interpretation set out in the Discussion Paper should be applied *mutatis mutandis*. The University of Glasgow made an important point in suggesting that given the significance of unilateral statements in contractual dealings, they should be given express provision. It pointed out that the danger of applying the general rule *mutatis mutandis* is that it gives little guidance as to how much variation will be justified. It preferred the approach taken in Article 8(2) of the CISG:

“(1) For the purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was.

(2) If the preceding paragraph is not applicable, statements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.”

7.42 In fact, we now think that this is already the rule in Scots law. In an important (if *obiter*) discussion of the law of unilateral promises, Lord President Gill made the following point:

“[I]n a commercial context, the words of an alleged promise should be interpreted in the same way as any other alleged commercial obligation would be. ... [That is], objectively on the basis of what a reasonable recipient with knowledge of the background would have understood by the documents in question.”<sup>59</sup>

The DCFR also provides that:

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<sup>58</sup> M Hogg, “Fundamental Issues for Reform of the Law of Contractual Interpretation” (2011) 15 Edin LR 406.

<sup>59</sup> *Regus (Maxim) Ltd v Bank of Scotland plc* [2013] CSIH 12, 2013 SC 331, para 38.

“a unilateral juridical act is to be interpreted in the way in which it could reasonably be expected to be understood by the person to whom it is addressed.”<sup>60</sup>

7.43 A relevant difference between promise and contract is that with the latter the court is necessarily seeking the parties’ objective common intention in the wording used, while with a promise the court is determining the intention of the promisor only. That cannot be judged subjectively on either side of the undertaking, but an objective standard can come from the perspective of the reasonable person’s understanding of what the other party intended. The same kind of test applies to any unilateral statement having legal effect, such as offers, acceptances, counter-offers, withdrawals, revocations, and rejections. As Gloag put it in a discussion of formation that was later approved by the House of Lords in an incorporation case:

“The judicial task is not to discover the actual intentions of each party; it is to decide what each was reasonably entitled to conclude from the attitude of the other.”<sup>61</sup>

### **Outcome of consultation**

7.44 In our view, the lack of consensus among consultees in response to our proposals for reform makes it difficult to recommend reform along the lines set out in the 2011 DP. The continuing judicial development of the law, which we consider in Chapter 8, may also render legislative intervention unnecessary. We set out our overall conclusions on the law of interpretation of contract at the end of Chapter 8.<sup>62</sup>

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<sup>60</sup> DCFR II.–8:201(1).

<sup>61</sup> Gloag, *Contract*, p 7; approved in *McCutcheon v MacBrayne* 1964 SC (HL) 28 at 35 per Lord Reid. See also McBryde, *Contract*, paras 8.02 to 8.04. A possible example of this approach to a promise is *Royal Bank of Scotland v Carlyle* [2015] UKSC 13, 2015 SC (UKSC) 93; note also *Fisher v Applied Drilling Technology International Ltd* [2016] CSOH 108.

<sup>62</sup> See paras 8.61 to 8.68 below.

# Chapter 8      Developments since 2011

## Introduction

8.1 As we observed above, the law has continued to develop since the 2011 DP was published.<sup>1</sup> Accordingly, in this Chapter we consider the subsequent developments in the law since the publication of the 2011 DP before setting out our conclusions on the state of the law on interpretation of contract.

## UK Supreme Court: decisions

8.2 Since its inception in 2009 the Supreme Court has been instrumental in the development of the law of contractual interpretation. In the 2011 DP we were able to take account of its decision in *Multi-Link Leisure Developments v North Lanarkshire Council*.<sup>2</sup> It has considered a number of appeals in relation to contractual interpretation since 2011, and the Justices of the Supreme Court have also discussed the topic extrajudicially on several occasions.

### *Rainy Sky SA v Kookmin Bank*

8.3 First for the Supreme Court came *Rainy Sky SA v Kookmin Bank*.<sup>3</sup> Here, under six shipbuilding contracts between the claimant and a shipbuilder, the defendant bank (of whom the shipbuilders were customers) guaranteed a number of advance payment bonds, required by the contracts, which provided for the refund of pre-delivery instalments on a number of triggering events. The shipbuilding contracts listed the insolvency of the shipbuilders as one of the triggering events, but the bonds did not. The interpretation of the bonds fell to be determined by the Supreme Court.

8.4 The problem here was that there was no linguistic ambiguity. The bonds simply did not include the shipbuilder's insolvency as a triggering event. However, this appeared to defeat the commercial purpose of the transaction. The question was whether or not business common sense could be invoked to insert what was effectively an additional clause into the bond. The Court of Appeal applied the literal words, and found for the defendant bank.

8.5 The Supreme Court however, took a different view. Lord Clarke of Stone-cum-Ebony, with whom the other Justices agreed, opined that:

“The language used by the parties will often have more than one potential meaning. ...the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant. If there are two possible

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<sup>1</sup> See paras 7.4 to 7.6 above.

<sup>2</sup> [2009] CSIH 96; 2010 SC 302. See para 7.27 above.

<sup>3</sup> [2011] UKSC 50, [2011] 1 WLR 2900.

constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other.”<sup>4</sup>

8.6 Later in his judgment, Lord Clarke also cited with approval a remark of Lord Mance that:

“[T]he resolution of an issue of interpretation ... is an iterative process, involving ‘checking each of the rival meanings against other provisions of the document and investigating its commercial consequences’.”<sup>5</sup>

8.7 Although Lord Clarke observed that “[w]here the parties have used unambiguous language, the court must apply it”,<sup>6</sup> his adoption of the claimant’s interpretation in this case in fact raises the question of when silence is unambiguous.

8.8 The decision has been criticised. Despite Lord Clarke’s unitary exercise dictum, the judgment appears at least to hint at a requirement of ambiguity in the contract’s wording before a court can begin to take context seriously. This is contrary to the Hoffmann (and indeed the preceding Wilberforce) approach. Mitchell further describes the *Rainy Sky* reasoning as troublesome because:

“it raises the suspicion that judicial use of reasonableness or purposive criteria allows courts to escape from enforcing an unfavourable bargain by providing a common-sense interpretation.”<sup>7</sup>

8.9 *Rainy Sky* is perhaps the clearest example of commercial common sense being used in such a purposive manner as, on a purely linguistic level, there was no ambiguity in the words used. It was only after one considered the purpose of the transaction that the omission of the shipbuilder’s insolvency seemed strange.

#### *Aberdeen City Council v Stewart Milne Group Ltd*

8.10 In late 2011, the Supreme Court decided another Scottish case, *Aberdeen City Council v Stewart Milne Group Ltd*.<sup>8</sup> This concerned an uplift clause in missives which would be triggered if the purchasers sold or leased the land to a third party, or if the purchaser served a specified notice on the seller. Two of these triggers required the parties to ascertain the open market value of the property, and the other used the gross sale proceeds, for the purpose of calculating the uplift. The purchaser sold the property to another company in its group at an undervalue, an event for which the contract did not explicitly provide. It went on to contend that that this triggered the gross sale proceeds method of calculation, and that the resulting uplift was nil.

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<sup>4</sup> *Rainy Sky* at para 21 per Lord Clarke.

<sup>5</sup> *Rainy Sky* at para 28, referring to *Re Sigma Finance Corp* [2009] UKSC 2, [2010] 1 All ER 571, para 12. Lord Mance was himself quoting with approval from para 98 of Lord Neuberger’s preceding dissent in the Court of Appeal; the Supreme Court went on to overturn the majority judgment of the Court of Appeal. For further discussion see Lord Gribner, “The Iterative Approach to Contractual Interpretation” (2012) 128 LQR 41. *Rainy Sky* is dealt with approvingly in a postscript to this article at pp 61-62.

<sup>6</sup> *Rainy Sky* at para 23 per Lord Clarke.

<sup>7</sup> C Mitchell, “Interpreting Commercial Contracts - The Policing Role of Context in English Law” in L DiMatteo and M Hogg (eds) *Comparative Contract Law: British and American Perspectives* (2016), 231, 242.

<sup>8</sup> [2011] UKSC 56, 2012 SC (UKSC) 240.

8.11 The Inner House had held that the method which used the gross sale proceeds required a sale at arm's length, with Lord Clarke appearing to place particular weight on the commercial purpose of the clause.<sup>9</sup>

8.12 The Inner House decision was heavily criticised by Professor Hogg. He objected to the suggestion that courts should take a commercially sensible approach to construction, asking:

“why, if a party has been feckless in allowing a clause susceptible of a commercially disadvantageous sense to form part of the contract ... should [it] be protected from the ill effects of this through a court giving the clause a commercially sensible interpretation rather than allowing that party simply to suffer the results of its commercial fecklessness?”<sup>10</sup>

Hogg went on to characterise the decision of the Inner House as a good example of the court providing “unwarranted assistance”<sup>11</sup> to a party that had made a bad bargain.

8.13 The Supreme Court however agreed with the Inner House (and the Lord Ordinary) but the Justices took diverging approaches to reach that conclusion. Lord Hope thought that the drafting of the contract was “not without its defects”.<sup>12</sup> He, however, felt that the one key feature of the contractual provisions was the fact that “the base figure is to be taken to be the amount which the subjects would fetch in a transaction that was conducted at arm's length in the open market.”<sup>13</sup> He considered that both the other provisions of the contract, and the “context show[ed] that the intention of the parties must be taken to have been that the base figure for calculation of the uplift was to be the open market value of the subjects at the date of the event which triggered the obligation.” Commercial common sense was “simply a makeweight” in his reaching this conclusion.<sup>14</sup>

8.14 Lord Clarke of Stone-cum-Ebony, however, considered that it was not easy to reach this conclusion on the basis of the actual language, but that it was “rather a case in which, notwithstanding the language used, the parties must have intended that, in the event of a sale, the applicants would pay the respondents the appropriate share of the proceeds of sale on the assumption that the sale was at a market price.”<sup>15</sup> This was very similar to the approach taken in the Court of Session.

#### *Lloyds TSB Foundation for Scotland v Lloyds Banking Group Plc*

8.15 Concern about the consequences of a too literal approach to interpretation was reiterated by Lord Mance in another Scottish appeal, *Lloyds TSB Foundation for Scotland v Lloyds Banking Group Plc*.<sup>16</sup> In 1986 B had entered into a deed in favour of the respondent charitable foundation (F). The intention was for F to receive a small percentage of B's pre-tax profits. In 1997 the deed was varied and replaced and B covenanted to pay F the greater of a specified percentage of pre-tax profits and the sum of £38,920. Pre-tax profit and loss

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<sup>9</sup> *Aberdeen City Council v Stewart Milne Group Ltd* [2010] CSIH 81 at para 10 per Lord Clarke.

<sup>10</sup> M Hogg, “Fundamental Issues for Reform of the Law of Contractual Interpretation” (2011) 15 Edin LR 406.

<sup>11</sup> *Ibid.*

<sup>12</sup> [2011] UKSC 56, 2012 SC (UKSC) 240 at para 9 per Lord Hope.

<sup>13</sup> [2011] UKSC 56, 2012 SC (UKSC) 240 at para 16 per Lord Hope.

<sup>14</sup> [2011] UKSC 56, 2012 SC (UKSC) 240 at para 22 per Lord Hope.

<sup>15</sup> [2011] UKSC 56, 2012 SC (UKSC) 240 at para 31 per Lord Clarke.

<sup>16</sup> [2013] UKSC 3, 2013 SC (UKSC) 13.

were defined as the group profit and group loss before taxation shown in the audited accounts. However, in 2008 B acquired a bank (H) which was in difficulties. B was required to enter a figure for the “gain on acquisition” in its group accounts. The figure represented the book value of H’s assets, but it was unlikely that that value would be realised by those assets. B’s accounts showed a loss of £10 billion. When the gain on acquisition was taken into account, the figures showed a profit before tax of £1 billion. F claimed that it was therefore entitled to £3,543,333.

8.16 In disposing of this case Lord Mance was undoubtedly influenced by the unreasonable result perceived to be produced by a literal approach.<sup>17</sup> Instead, he opined that in a case such as this it was necessary to place the contract in the legal and accounting context at the date when it was executed. A striking feature of Lord Hope’s judgment in the case is his confession that his initial approach had been to reach the result suggested by a literal interpretation but that he had been persuaded to a different view by Lord Mance’s arguments.<sup>18</sup>

#### *Arnold v Britton*

8.17 In 2015 the Supreme Court, led by Lord Neuberger, embarked upon yet another restatement of the law of contractual interpretation in *Arnold v Britton*.<sup>19</sup> The case involved the interpretation of service charges in a number of long-leases of holiday chalets on the Gower peninsula in Wales. The clause dealing with the service charge, clause 3(2), varied slightly in each of the leases, but was generally described as a “proportionate part” of the cost of the services, expressed as £90 in the first year, rising by 10% each year thereafter. The tenants’ interpretation was that the lease set the service charge at a proportionate part of the price of providing the services, and therefore the court should disregard the 10% annual rise. The majority, however, declined to construe the lease in this way.

8.18 Lord Neuberger, with whom Lords Sumption and Hughes agreed, stated again that the meaning of a contract has to be assessed in light of:

“(i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party’s intentions.”<sup>20</sup>

8.19 However, building on the comments he had also made extra-judicially, he emphasised several additional factors of which the following are the most important:<sup>21</sup>

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<sup>17</sup> The problem here could have been averted perhaps were there to be a change of circumstance doctrine applying to contracts after as well as before formation, but the former (the existence of which beyond frustration was rejected by Lord Hope) is beyond the scope of this Report. See however Chapter 6 above; also L Macgregor “The Effect of Unexpected Circumstances in Contracts in Scots and Louisiana Law”, in V V Palmer and E C Reid (eds) *Mixed Jurisdictions Compared: Private Law in Louisiana and Scotland* (2009) ch 9.

<sup>18</sup> [2011] UKSC 56, 2012 SC (UKSC) 240 at paras 33 and 34 per Lord Hope.

<sup>19</sup> [2015] UKSC 36, [2015] AC 1619.

<sup>20</sup> *Arnold v Britton* at para 15 per Lord Neuberger.

<sup>21</sup> For the extra-judicial comments see paras 8.31 to 8.34 below. In relation to the facts of the case itself, Lord Neuberger was also “unconvinced” that service charges are subject to any special rule of interpretation (para 23).

- the reliance placed on commercial common sense and surrounding circumstances should not be invoked to undervalue the importance of the language of the provision which is to be construed, because the parties have control over the language they use;<sup>22</sup>
- the less clear the words to be interpreted or the worse their drafting, the more ready the court can properly be to depart from their natural meaning;<sup>23</sup>
- commercial common sense cannot be invoked retrospectively to rescue a party from a bad bargain: it is relevant only to how matters would have been perceived when the contract was made;<sup>24</sup>
- while commercial common sense is a very important factor to take into account, a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed;<sup>25</sup>
- the court may only take into account facts that were known, or reasonably available to both parties, not a fact or circumstance known only to one party;<sup>26</sup>
- sometimes an event will occur that was plainly not intended or contemplated by the parties, judging from the language of their contract. In such a case, if it is clear what the parties would have intended, the court will give effect to that intention.<sup>27</sup>

8.20 Lord Hodge, in *Arnold v Britton*, whilst agreeing with Lord Neuberger’s reasons for dismissing the appeal and not mentioning any requirement of ambiguity before context could be considered, did say that in this case the context “provides little assistance”.<sup>28</sup> But he also reiterated the proposition that the process of interpretation is a unitary exercise which “involves an iterative process by which each of the rival meanings is checked against the provisions of the contract and its commercial consequences are investigated.”<sup>29</sup>

8.21 Lord Carnwath, however, dissented in *Arnold v Britton*. Unlike Lord Neuberger and Lord Hodge, he considered that it was clear that something had “gone wrong with the drafting.”<sup>30</sup> He considered that there were two linguistic problems: firstly, that “there is no grammatical connection to show the relationship between the two descriptions” and secondly that “they are mutually exclusive.”<sup>31</sup> He therefore considered that there was an inherent ambiguity, and it was permissible to prefer one description over the other.

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<sup>22</sup> *Arnold v Britton* at para 17 per Lord Neuberger.

<sup>23</sup> *Arnold v Britton* at para 18 per Lord Neuberger. Lord Neuberger did caution, however, that this would not justify the court in searching for or constructing drafting errors in order to facilitate a departure from the natural meaning of the provision.

<sup>24</sup> *Arnold v Britton* at para 19 per Lord Neuberger.

<sup>25</sup> *Arnold v Britton* at para 20 per Lord Neuberger.

<sup>26</sup> *Arnold v Britton* at para 21 per Lord Neuberger.

<sup>27</sup> *Arnold v Britton* at para 22 per Lord Neuberger. Lord Neuberger cited *Aberdeen City Council v Stewart Milne Group Ltd* as an example of this (see paras 8.10 to 8.14 above). *Lloyds TSB Foundation for Scotland v Lloyds Banking Group Plc* could be added as another (see paras 8.15 and 8.16 above).

<sup>28</sup> *Arnold v Britton* at para 72 per Lord Hodge.

<sup>29</sup> *Arnold v Britton* at paras 76 and 77 per Lord Hodge, citing *Rainy Sky* (see fn 5 above).

<sup>30</sup> *Arnold v Britton* at para 125 per Lord Carnwath.

<sup>31</sup> *Ibid.*

## Reaction to *Arnold v Britton*

8.22 The extent to which Lord Neuberger's approach departs from previous authority, and in particular the *ICS* principles, has been the subject of lively debate. On a first reading, the decision signals a strong move away from the contextual approach to interpretation towards a more literal style of interpretation. Havelock, for example, considers that, as a result of *Arnold v Britton*, the "primary source of meaning" is now the language the parties have used "as opposed to the (wider) context and considerations of 'common sense'".<sup>32</sup> However, on further examination it becomes apparent that the position is more nuanced than that.

8.23 So, for example, Craig Connal QC points out that "*Arnold* may not be as clear a signpost as it at first appears."<sup>33</sup> This is because the leases were entered into in the 1970s, when interest rates were historically high, and a rate of 10% was not unusual. Lord Neuberger certainly took into account the "history of inflation in the United Kingdom"<sup>34</sup> and was not convinced by the commercial argument that "it is inconceivable that a lessee would have agreed to a service charge provision which had the effect for which the respondents contend, at least in the 1970s and much of the 1980s."<sup>35</sup> Therefore, Lord Neuberger took as highly persuasive the context at the time of contracting (in particular the economic circumstances known to both parties at the time the contract was entered into). He even considered whether it would have been a commercially sensible lease for the tenants to accept. However, Connal does conclude that "the way in which the principles were structured in the leading judgment represents a clear shift back towards primary focus on the words used."<sup>36</sup>

8.24 A fair observation, however, is that it was not the examination of the mutually known context to ascertain the objective meaning of a contract (the Lord Hoffmann approach) that Lord Neuberger was cautioning against, more the *ex post facto* invocation of commercial common sense to protect a party from its own "fecklessness".<sup>37</sup> There is apparent a hierarchy of factors with the parties' words in context in the primary position. But the significance given the economic conditions prevailing at the time the leases were entered into shows that context at the time of contracting remains relevant regardless of ambiguity. Indeed Lord Neuberger only mentions ambiguity in his judgment to say that there was none in the contract under consideration.<sup>38</sup>

8.25 As pointed out by Tan, the difference of opinion between Lord Neuberger and Lord Carnwath is particularly striking in light of the earlier case of *Pink Floyd Music Ltd v EMI Records Ltd*.<sup>39</sup> In that case, as members of the Court of Appeal, they each took approaches

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<sup>32</sup> R Havelock "Return to Tradition in Contractual Interpretation" (2016) 27 Kings LJ 188, criticised in D McLauchlan, "Some Fallacies Concerning the Law of Contract Interpretation" [2017] LMCLQ 506. See also D McLauchlan, "The *ICS* Principles: A Failed 'Revolution' in Contract Interpretation?" (2016) 27 NZLR 263; G McMeel, "Foucault's Pendulum: Text, Context, and Good Faith in Contract Law" (2017) 70 Current Legal Problems 365.

<sup>33</sup> C Connal "Has the Rainy Sky Dried Up? *Arnold v Britton* and Commercial Interpretation" (2016) 20 Edin LR 71.

<sup>34</sup> *Arnold v Britton* at para 30 per Lord Neuberger.

<sup>35</sup> *Arnold v Britton* at para 35 per Lord Neuberger.

<sup>36</sup> Connal "Has the Rainy Sky Dried Up?", 76.

<sup>37</sup> M Hogg, "Fundamental Issues for Reform of the Law of Contractual Interpretation" (2011) 15 Edin LR 406, 419.

<sup>38</sup> *Arnold v Britton* at para 27 per Lord Neuberger.

<sup>39</sup> [2010] EWCA Civ 1429; ZX Tan, "Beyond the Real and Paper Deal: the Quest for Contextual Coherence in Contractual Interpretation" (2016) 79 MLR 623, 630 and 631.

seemingly precisely opposite to those they later respectively espoused in *Arnold v Britton*. Neuberger LJ was willing to invoke the commercial purpose of the contract to overcome the text which Carnwath LJ preferred to apply strictly. This suggests that overall something more subtle is at work than a simple and absolute ideological division between individual judges pre-disposed to either formalist literalism or contextualism.

8.26 For Tan, “this dichotomisation cannot fully capture what goes on in the reasoning processes of courts”.<sup>40</sup> He suggests that in each case the court will simply search for “the most coherent rationalisation of text and available content, viz the most contextually coherent construction”.<sup>41</sup> The seemingly reversed positions of Lord Neuberger and Lord Carnwath in *Pink Floyd* and *Arnold v Britton* support this view, and suggest that, as stated at the outset of Chapter 7, disputes about contractual interpretation will often depend a great deal on the facts and text of that particular case.

8.27 Lord Justice Lewison continues to see the five principles enunciated in the *ICS* case by Lord Hoffmann as the starting point for disputes on the subject, but now supplemented by a sixth. For this, he highlights the idea of interpretation as a “unitary exercise” (as stated in *Rainy Sky* and as quoted by Lord Hodge in *Arnold v Britton*). For Lewison, *Arnold v Britton* does no more than re-state this unitary (or iterative) approach. He goes on to say that the six principles “do not represent a new departure”, but are rather “a restatement with differences of emphasis.”<sup>42</sup>

#### *Wood v Capita Insurance Services*

8.28 In its most recent pronouncement on the subject, *Wood v Capita Insurance Services*,<sup>43</sup> the Supreme Court sought to stress the continuity of the law’s approach to the interpretation of contracts both pre- and post-*ICS*.<sup>44</sup> It considered that Lord Hoffmann’s principles had a long pedigree,<sup>45</sup> while noting that “[o]n the approach to contractual interpretation, *Rainy Sky* and *Arnold* were saying the same thing.”<sup>46</sup> Lord Hodge again stressed the iterative or unitary approach to interpretation, and said that it did not matter whether the process began with examination of the factual background or the language of the contract, so long as its balancing nature was understood. In striking the balance the court had to consider the quality of the drafting, the possibility that a party might have agreed something that in the longer term did not serve its interest, and the possibility that the contested term represented a negotiated compromise or was the most the parties could agree. Where there were rival meanings, the court could use its appreciation of business common sense to make a choice between them.

8.29 In a significant passage, Lord Hodge said this:

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<sup>40</sup> Tan, “Beyond the Real and Paper Deal”, 628.

<sup>41</sup> Tan, “Beyond the Real and Paper Deal”, 637.

<sup>42</sup> Lewison, *Interpretation*, p 6. In the first supplement to the sixth edition of his text (published in 2017), Lewison refuses to accept that *Arnold v Britton* heralds a return to a more traditional approach to interpretation.

<sup>43</sup> [2017] UKSC 24, [2017] AC 1173. Lord Hodge gave the unanimous judgment of the Court in which Lords Neuberger, Mance, Clarke and Sumption concurred.

<sup>44</sup> [2017] UKSC 24, [2017] AC 1173, paras 8 to 15. Lords Neuberger, Mance and Clarke had all been prominent in the leading Supreme Court decisions on interpretation preceding *Wood*. See further the comments of D McLauchlan, “Continuity, Not Change, in Contract Interpretation?” (2017) 133 LQR 546.

<sup>45</sup> [2017] UKSC 24, [2017] AC 1173, para 10.

<sup>46</sup> [2017] UKSC 24, [2017] AC 1173, para 14.

“Textualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation. Rather, the lawyer and the judge, when interpreting any contract, can use them as tools to ascertain the objective meaning of the language which the parties have chosen to express their agreement. The extent to which each tool will assist the court in its task will vary according to the circumstances of the particular agreement or agreements. Some agreements may be successfully interpreted principally by textual analysis, for example because of their sophistication and complexity and because they have been negotiated and prepared with the assistance of skilled professionals. The correct interpretation of other contracts may be achieved by a greater emphasis on the factual matrix, for example because of their informality, brevity or the absence of skilled professional assistance. But negotiators of complex formal contracts may often not achieve a logical and coherent text because of, for example, the conflicting aims of the parties, failures of communication, differing drafting practices, or deadlines which require the parties to compromise in order to reach agreement. There may often therefore be provisions in a detailed professionally drawn contract which lack clarity and the lawyer or judge in interpreting such provisions may be particularly helped by considering the factual matrix and the purpose of similar provisions in contracts of the same type. The iterative process ... assists the lawyer or judge to ascertain the objective meaning of disputed provisions.”<sup>47</sup>

8.30 Lord Justice Lewison notes that Lord Hodge speaks of the court’s task as being “to ascertain “the objective meaning of the language the parties have chosen”,<sup>48</sup> whereas in *Arnold v Britton* Lord Neuberger talks of identifying the intention of the parties.<sup>49</sup> Lewison prefers Lord Hodge’s formulation, “which concentrates attention on the meaning of the contract rather than a fictional intention of the parties”.<sup>50</sup>

### **UK Supreme Court: extrajudicial discussions**

#### *Lord Neuberger (2014)*

8.31 In a speech given extra-judicially in 2014, the President of the Supreme Court, Lord Neuberger, pointed out that, in a contract, “the one thing over which the parties have control is the words they have used.”<sup>51</sup> Therefore, “a judge, when asked to determine the parties’ contractual rights and obligations, should never forget how important the wording of the contract is.” He went on to warn against the excessive use of business common sense when interpreting contracts.<sup>52</sup>

8.32 His Lordship was not, however, opposed to the use of context in general as an interpretive tool, stating that “no contractual provision can exist without a context” and that

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<sup>47</sup> [2017] UKSC 24, [2017] AC 1173, para 13.

<sup>48</sup> *Wood v Capita Insurance Services*, para 10.

<sup>49</sup> *Arnold v Britton*, para 15.

<sup>50</sup> Lewison, *Interpretation*, First Supplement to the Sixth Edition (2017), para 1.03. For debate around these issues see Sir George Leggatt, “Making Sense of Contracts: the Rational Choice Theory” (2015) 131 LQR 454; D McLauchlan, “A Better Way of Making Sense of Contracts?” (2016) 132 LQR 577.

<sup>51</sup> Lord Neuberger, “The Impact of Pre- and Post-Contractual Conduct on Commercial Interpretation” (Speech to Banking Services and Finance Law Association Conference, Queenstown, 11 August 2014) <https://goo.gl/BkuLzD>, para 3. Lord Neuberger’s lecture followed his consideration of the issue of interpretation judicially in *Marley v Rawlings* [2014] UKSC 2, [2015] AC 157, a case concerning the interpretation of wills. Lord Neuberger considered that the approach should be the same, whether the court was interpreting contracts or wills (see para 20).

<sup>52</sup> Lord Neuberger, “The Impact of Pre- and Post-Contractual Conduct on Commercial Interpretation”, para 19.

“the particular context inevitably colours what the provision means”. Lord Neuberger identified three potential contexts that may be relevant:

- “(i) the documentary context, namely the other provisions of the contract;
- (ii) the factual context which includes the facts known to both parties;
- (iii) the commercial context, which includes commercial common sense.”<sup>53</sup>

Lord Neuberger’s speech, taken as a whole, suggests that it is only the commercial context to which he thinks courts should not attach too great a weight when interpreting written contracts. He also added, however, that the exclusion from consideration of pre-contractual negotiations and post-formation conduct was “on grounds of established law, practicality and principle”.

8.33 For the law, he noted Lord Hoffmann’s distinction, made in *Carmichael v National Power plc*,<sup>54</sup> between contracts wholly in writing (where the exclusionary rules were at their strongest because juries in the past were often illiterate and it was therefore better to leave interpretation to the judge; further, rectification was available to correct writing that had failed to reflect the parties’ intentions) and those either wholly or partly oral (where the formation and content of the contract was much more a matter of fact). For practicality, the sheer volume of the pre-contractual evidence in any complex written contract was too overwhelming: “[t]he cost in terms of discovery and inspection, preparation for trial, and length of hearing will often be enormous.” The evidence on oral exchanges would be contested and anyway often equivocal. It would all distract attention from the words the parties actually used in their contracts.

*Lord Hodge (2016)*

8.34 In an extra-judicial writing published in 2016 Lord Hodge also warned against an over-literal approach, and observed:

“[T]he apparent experience of the legal draftsmen may mislead the court into too literal an approach to construction. It is necessary to bear in mind that skilled lawyers may have been working against very tight deadlines and may have run out of time or energy after burning the midnight oil for several nights.”<sup>55</sup>

8.35 In the same paper Lord Hodge wrote about “the pragmatic restriction on the consideration of pre-contractual negotiations” as an aspect of controlling the cost of litigation: “In my view it is very important to discourage parties from spending large sums of money trawling through background papers to try to find anything that that would support a strained interpretation of a contract which suits their case.”<sup>56</sup>

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<sup>53</sup> Lord Neuberger, “The Impact of Pre- and Post-Contractual Conduct on Commercial Interpretation”, para 4.

<sup>54</sup> [1999] 1 WLR 2042.

<sup>55</sup> Lord Hodge, “Can Judges Use Business Common Sense in Interpreting Contracts?”, in DiMatteo and Hogg (eds) *Comparative Contract Law: British and American Perspectives* (2016) 272, 277.

<sup>56</sup> Lord Hodge, “Can Judges Use Business Common Sense in Interpreting Contracts?”, 280 and 281.

8.36 In further extra-judicial observations, published in 2017 but written before *Wood v Capita Insurance Services*,<sup>57</sup> Lord Hodge commented:

“I question whether the English courts in *ICS* and *Rainy Sky* really moved far, if at all, from Lord Wilberforce’s formulation 50 years ago when he said that ‘what the court must do must be to place itself in thought in the same factual matrix as that in which the parties were’. At the same time I believe that the majority judgment in *Arnold v Britton* did not impose significant constraints on the contextual approach which allows the court to have regard to business common sense. Since *Rainy Sky*, indeed since Lord Wilberforce 50 years ago, the judicial pendulum has not moved far.”<sup>58</sup>

*Lord Sumption (2016 and 2017)*

8.37 Despite Lord Sumption’s concurrence in the *Wood* judgment, a lecture that he gave to the Centre for Commercial Law in the Edinburgh Law School in November 2016 and the Harris Society in Oxford University in May 2017 showed that he still doubts the legitimacy of the Hoffmann approach.<sup>59</sup> Lord Sumption observed that “the Supreme Court has begun to withdraw from the more advanced positions seized during the Hoffmann offensive, to what I see as a more defensible position.”<sup>60</sup> He went on to comment critically on the Hoffmann speech in *ICS*, saying that the subsequent case law “commonly involve[d] treating the background circumstances as an alternative guide to the parties’ intentions instead of a means of interpreting their language.”<sup>61</sup> While Lord Sumption was clearly not mounting a call for renewal of a purely literal approach to interpretation, nonetheless he also warned (here echoing a theme of Lord Neuberger) that “[t]he parties are the masters of their own agreement, and anything which marginalises the role of words in the process of construction is a direct assault on their autonomy.”<sup>62</sup>

8.38 Lord Sumption also challenged the view that evidence about pre-contractual negotiations is excluded primarily for pragmatic or policy rather than principled reasons:

“... [T]he reason is actually more fundamental than that. The exclusionary rule follows from the objective character of all contractual construction. The course of the negotiations cannot tell us what the contract objectively meant. It can tell us only what one or other or both of the parties subjectively thought or assumed or hoped that it meant. ... Once the courts resort to sources other than the language in order to

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<sup>57</sup> See paras 8.28 to 8.29 above.

<sup>58</sup> Lord Hodge, “Revisiting Old Law: Judicial Development of the Law of Contract” in A J M Steven, R G Anderson and J MacLeod (eds), *Nothing so practical as a good theory: Festschrift for George L Gretton* (2017), p 63. On interpretation, see particularly pp 63 to 66 and 77. In a postscript, Lord Hodge notes that the subsequent Supreme Court decision in *Wood* does support the views set out in the essay.

<sup>59</sup> Lord Sumption, “A Question of Taste: The Supreme Court and the Interpretation of Contracts”, Edinburgh Law School Centre for Commercial Law Miller Lecture, 28 October 2016; Harris Society Annual Lecture, Keble College, Oxford, 8 May 2017, accessible at: <https://goo.gl/tvR1yM>. The severity of Lord Sumption’s criticism of Lord Hoffmann’s *ICS* speech should be read in the light of his personal tribute that forms the foreword to PS Davies and J Pila (eds) *The Jurisprudence of Lord Hoffmann: A Festschrift in Honour of Lord Leonard Hoffmann* (2015). For criticism of Lord Sumption’s views, see McLauchlan, “Some Fallacies”.

<sup>60</sup> Lord Sumption did acknowledge however that “if the Supreme Court has sounded the retreat, it has ... sounded it in rather muffled tones ... It has not actually admitted that earlier decisions went too far. Neither of these cases overruled or even criticised the decisions in *Investors Compensation Scheme* or *Rainy Sky*.” (“A Question of Taste”, p 13). The cases referred to are *Wood v Capita Insurance Services* and *Krys v KBC Partners* [2015] UKPC 46.

<sup>61</sup> Sumption, “A Question of Taste”, p 7.

<sup>62</sup> Sumption, “A Question of Taste”, p 9. Lord Sumption also cited as recent examples of the primacy of words, even when they seem to give rise to a harsh or unreasonable result, *Krys v KBC Partners* and *Wood v Capita Insurance Services*.

identify the object of the transaction, it is difficult to justify the current law about extrinsic evidence. Yet that rule is fundamental to the principle of objective construction ...<sup>63</sup>

8.39 If there is any doubt about the Supreme Court's now distinct line of travel, it is also finally worth noting its clear disapproval of Lord Hoffmann's closely parallel approach to the process of implying terms in contracts,<sup>64</sup> and the reformulation by Lord Neuberger (speaking for the whole Court) of Lord Hoffmann's approach to the interpretation of patent claims (for which his fundamental argument had been that they are to be interpreted in the same way as commercial contracts).<sup>65</sup>

### Developments in other Anglophone jurisdictions

8.40 Positions with regard to contractual interpretation in Anglophone jurisdictions beyond the United Kingdom appear not to have changed significantly in the years since publication of the 2011 DP.<sup>66</sup> In Canada, consideration of the surrounding circumstances is permissible to deepen the court's understanding of parties' mutual and objective intentions, though the Supreme Court has taken care to make it clear that the surrounding circumstances are not to be permitted to overwhelm the words of the contract.<sup>67</sup> In New Zealand, it appears that pre-contractual negotiations may be admissible and considered as part of contractual interpretation, although not to discover the parties' subjective intentions.<sup>68</sup> It appears that the law in South Africa may, if anything, have further developed the contextual approach: the meaning of words is to be considered in the light of all relevant and admissible context in one unitary process,<sup>69</sup> and there is no longer a requirement for ambiguity if it is clear that the words used would lead to a result contrary to parties' intentions.<sup>70</sup>

8.41 However, it should be noted that the position in Australia with regard to the requirement for ambiguity seems to have become less clear as a result of the recent case of *Electricity Generation Corp v Woodside Energy Ltd*.<sup>71</sup> Lord Hoffmann's second principle was not referred to, but the court held that interpretation "will require" consideration of

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<sup>63</sup> Sumption, "A Question of Taste", p 10.

<sup>64</sup> For Lord Hoffmann's approach to the implication of terms see *Attorney General for Belize v Belize Telecom Ltd* [2009] UKPC 10, [2009] 1 WLR 1988 (criticised in Grabiner, "Iterative Approach of Contractual Interpretation", pp 55 to 61), and for the Supreme Court's disapproval see *Marks & Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, [2016] AC 472.

<sup>65</sup> See *Actavis UK Ltd v Eli Lilly & Co* [2017] UKSC 48, reconsidering the approach to patent claims set out by Lord Hoffmann in *Improver Corp v Remington Consumer Products Ltd* [1990] FSR 181 and *Kirin-Amgen Inc v Hoechst Marion Roussel Ltd* [2005] 1 All E.R. 667. The court's approach to Lord Hoffmann's formulations has been described by one commentator as "rather reminiscent of a tutor marking an exam paper": The IP Kat, "An improved Improver? UK Supreme Court moves towards a UK Doctrine of Equivalents in Lilly pemetrexed battle" (2017) at <https://goo.gl/GGdpaQ>. The same commentator also remarks that he "has regarded Lord Hoffmann's judgment in that case as a definitive guide to interpretation and construction and it is a bit of a shock to see his analysis criticised as "wrong in principle" by the Supreme Court": The IP Kat, "An Improved Improver? – Part 2" (2017) at <https://goo.gl/LBcHx3>.

<sup>66</sup> See para 7.22 above. See also G McMeel, *The Construction of Contracts: Interpretation, Implication, and Rectification* (3rd edn, 2017), paras 5.167 to 5.216.

<sup>67</sup> *Sattva Capital Corp v Creston Moly Corp* [2014] SCC 53 at para 57, per Rothstein J.

<sup>68</sup> *Hall v Attorney General* [2012] NZHC 3615 at [77] per Duffy J; *Auckland Waterfront Development Agency Ltd v Mobil Oil New Zealand Ltd* [2014] NZHC 84 at [30] per Katz J. See further F Dawson, "Contract Objectivity and Interpretation in the Supreme Court", in A Stockley and M Littlewood (eds) *The New Zealand Supreme Court: The First Ten Years* (2015) 219.

<sup>69</sup> *Bothma-Batho Transport (Edms) Bpk v S Bothma & Seun Transport (Edms) Bpk* 2014 (2) SA 494 (SCA) at para 12 per Wallis JA.

<sup>70</sup> *V v V (A5021/12)* [2016] ZAGPJHC 311 at para 12 per Spilg J.

<sup>71</sup> [2014] HCA 7.

surrounding circumstances. Subsequent cases have tended to say that the context must be examined in every case, regardless of ambiguity.<sup>72</sup> It has also been suggested that while ambiguity may still be a requirement, the courts in Australia are more likely than the English courts to consider a term to be ambiguous.<sup>73</sup>

## Developments in the Court of Session

8.42 As noted earlier, the pre-2011 position in Scotland was somewhat unclear. There have, however, been significant developments since the publication of our Discussion Paper.

8.43 In *Biffa Waste Services Ltd v Patersons of Greenoakhill Ltd (Biffa Waste)*,<sup>74</sup> Lord Hodge emphasised that “[w]here the parties have used unambiguous language the court must give effect to it” and that the court “is slow to conclude that the parties have made a mistake or used the wrong words”.<sup>75</sup> The use of pre-contractual negotiations and post-contract conduct to aid in determining the parties’ intention was rejected. After considering the admissible evidence, the court held that “the factual background which was available to both parties gives no basis for putting a gloss on the words that the parties used.”<sup>76</sup> The result was relatively harsh for one of the parties, although Lord Hodge believed there was nothing contrary to business common sense in that construction. But Lord Hodge then moved on to allow rectification of the contract. Based on the evidence excluded in the interpretation process, especially the post-formation conduct (which was held to be evidentially relevant in rectification<sup>77</sup>), it was found that the written contract failed to express the parties’ common intention. This meant that the harsh result did not in the end obtain. But interpretation had previously produced a result shown by rectification not to have been what the parties all along intended.

8.44 A possible difference between Lord Hodge’s approach to business common sense and the commercial common sense used in the Inner House appeared to emerge in *Grove Investments Ltd v Cape Building Products (Grove Investments)*, decided in 2014.<sup>78</sup> This case involved a dispute between a commercial landlord and tenant over whether there had been a breach of a lease of an industrial unit. The term in question concerned whether or not the tenant owed an obligation to remedy defects to the property regardless of whether or not these defects had been present at the beginning of the lease. The more natural meaning of the words was that the tenant did owe such an obligation. However, the Inner House allowed the tenant’s appeal, concluding that there were two possible constructions of the lease. Lord Drummond Young stressed that “in any case where a contractual provision is capable of

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<sup>72</sup> *Mainteck Services Pty Ltd v Stein Heurty SA* [2014] NSWCA 184; *Stratton Finance Pty Ltd v Webb* [2014] FCAFC 110; *Newey v Westpac Banking Corp* [2014] NSWCA 319.

<sup>73</sup> Lewison, *Interpretation*, p 9 fn 53. See further the first supplement to this work (published in 2017), p 4.

<sup>74</sup> [2013] CSOH 18, 2013 SLT 729.

<sup>75</sup> [2013] CSOH 18, 2013 SLT 729 at para 16, per Lord Hodge.

<sup>76</sup> [2013] CSOH 18, 2013 SLT 729 at para 28, per Lord Hodge. For further comment see L Richardson “When Interpretation is Not Enough: Rectification of Contracts” (2014) 18 Edin LR 125.

<sup>77</sup> This was a relative innovation on previous practice in rectification cases but seems to be legitimate under section 8(2) of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1985, which allows the admission of “any relevant evidence, written or oral”. Although in rectification the court is concerned with the actual intentions of the parties, these are still assessed objectively: what is relevant is the parties’ intentions as disclosed to each other. See *Shaw v William Grant (Minerals) Ltd* 1989 SLT 121 (note); *Rehman v Ahmad* 1993 SLT 741; *Oliver v Gaughan* 1990 GWD 22-1247; *Angus v Bryden* 1992 SLT 884; *MacDonald Estates plc v Regenesys (2005) Dunfermline Ltd* 2007 SLT 791; *Brown v Rysaffe Trustee Co (CI) Ltd* [2011] CSOH 26.

<sup>78</sup> [2014] CSIH 43, 2014 Housing LR 35.

more than one meaning, the court should adopt the meaning that best accords with commercial common sense.”<sup>79</sup> He also stated that:

“In construing contracts it is also important to bear in mind that a contract is a cooperative enterprise, entered into by parties for their mutual benefit. It is intended to achieve objectives that are common to both parties; that is why a purposive approach to construction must be adopted.”<sup>80</sup>

8.45 However, any uncertainty of approach in Scotland appears now to have been settled by the Inner House in *@SIPP Pension Trustees Limited v Insight Travel Services Ltd.*<sup>81</sup> That case arose from the termination of a lease of commercial premises, with the landlord and tenants in dispute as to the nature and extent of tenants’ obligations to repair, maintain and renew under the lease. Two issues about the interpretation of the lease were canvassed. The first issue was whether, on a proper construction of the relevant clause, the tenants’ obligations at termination were limited to putting the premises in the condition in which they had been received at the beginning of the lease. The second issue was whether the landlord was entitled to payment of a sum representing the cost of putting the premises into the appropriate state of repair regardless of whether the landlord intended to do the work or not. For present purposes, the case is of interest for the light it sheds on the approach of the Court of Session to contractual interpretation, rather than for the impact that the answers given by the Inner House have had on the law of commercial leases.<sup>82</sup>

8.46 At first instance, the Lord Ordinary applied the interpretative approach taken by the Inner House in *Grove Investments* and found for the tenants on both points. The Inner House criticised the approach taken by the Lord Ordinary and reversed his decision on both points, preferring the approach of the Supreme Court in *Arnold v Britton*, particularly in relation to the role of commercial common sense in the interpretative exercise. Lady Smith, delivering the opinion of the court on the first issue, remarked that:

“We accept that the grammar of the clause is not perfect. However, we are satisfied that it is clear that the natural meaning of the language used is not that contended for by the [tenants]. The construction they urged upon the Lord Ordinary (and which was accepted by him) would involve a substantial and unjustified departure from that natural meaning.”<sup>83</sup>

8.47 In addressing the second issue, Lady Smith stated that:

“...the general observations in *Grove Investments* ought not... to be taken as indicating that the considerations of co-operation and mutuality that would be appropriate to, say, partnership or joint venture apply across the board. ...it is not

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<sup>79</sup> [2014] CSIH 43, 2014 Housing LR 35 at para 9, per Lord Drummond Young.

<sup>80</sup> [2014] CSIH 43, 2014 Housing LR 35 at para 11, per Lord Drummond Young.

<sup>81</sup> [2015] CSIH 91, 2016 SC 243.

<sup>82</sup> As noted by L Richardson, “Commercial Common Sense Revisited: Further Developments in Contract Interpretation and Commercial Leasing” (2016) 20 Edin LR 342, the decision on the first point is contrary to what was previously understood to be the position in Scots law, but brings it into line with English law (p 342). Richardson goes on to observe that the rationale of the Inner House is unpersuasive and appears not to take account of earlier Scottish authority on the point (p 347).

<sup>83</sup> *@SIPP Pension Trustees Limited v Insight Travel Services Ltd* [2015] CSIH 91 at para 19, per Lady Smith.

legitimate to re-write the parties' agreement because it was unwise of one party to gamble on future outcomes."<sup>84</sup>

It therefore appears that the decision of the Inner House in *@SIPP Pension Trustees* has brought the position of the Scottish courts on contractual interpretation into line with that in England post-*Arnold v Britton*.

8.48 The approach in *@SIPP Pension Trustees* has been applied (also under direct reference to the approach in *Arnold v Britton*) by the Inner House in *AWG Business Centres Ltd v Regus Caledonia Ltd*,<sup>85</sup> which also concerned a repairing covenant in a lease. The Lord President, delivering the opinion of the court, stated:

"Parties were agreed that commercial common sense was a factor which could be invoked to support either construction and was thus a secondary consideration. The language of exception (c) is significantly clear that, applying commercial common sense, the parties had agreed that, in relation to the Common Parts, only the costs of initial construction should be excluded from the service expenditure recoverable from the tenant by the landlord."<sup>86</sup>

It therefore appears that *@SIPP Pension Trustees* and *Arnold v Britton*, taken together, are being treated as the leading authorities on contractual interpretation in Scots law.<sup>87</sup>

8.49 In February 2017, however, there was an apparent departure from *Arnold v Britton* by the Inner House in *Hoe International v Andersen*.<sup>88</sup> The case concerned a dispute about the validity of a contractual notice. Although primarily focussing on the interpretation of contractual notices the court also considered, at length, the law surrounding contractual interpretation more generally. In an interesting development, the court held that the validity of contractual notices should be determined with reference to commercial common sense, rather than an over-strict, over-literal reliance on black-letter rules.

8.50 As such, the court felt that it was important to consider the purpose of the notice itself and the purpose of any particular requirement not complied with, the idea being that the less significant the consequences of the notice, the less strict an approach to interpretation

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<sup>84</sup> *@SIPP Pension Trustees Limited v Insight Travel Services Ltd* [2015] CSIH 91 at para 44, per Lady Smith.

<sup>85</sup> [2017] CSIH 22 (affirming the Lord Ordinary (Tyre) [2016] CSOH 99).

<sup>86</sup> [2017] CSIH 22, para 22.

<sup>87</sup> For other cases referencing *Arnold v Britton*, see eg *Green v Rangers International Football Club plc* [2017] CSOH 90 (25 November 2015); *Martifer UK Ltd v Lend Lease Construction (EMEA) Ltd* [2016] CSOH 66; *Gyle Shopping Centre General Partners Ltd v Marks and Spencer plc* [2016] CSIH 19, 2017 SCLR 221 (also citing *Rainy Sky*); *Eason v Miller* [2016] CSOH 59 (also citing *Rainy Sky*); *Tait v RGM Solicitors* [2016] CSIH 56, 2017 SCLR 206 (also citing *Rainy Sky*); *Hill v Stewart Milne Group Ltd* [2016] CSIH 35, 2017 SCLR 92 *South Lanarkshire Council v Aviva Insurance Ltd* [2016] CSOH 83; *Kenwright v Stewart Milne Group Ltd* [2016] CSIH 45; *Landvest PCC Ltd v Archdiocese of St Andrews Trustees* [2016] CSOH 109; *Tonsley 2 Trust Trustees v Scottish Enterprise* [2016] CSOH 138 (also referring to *@SIPP Pension Trustees*); *Dem-Master Demolition Ltd v Healthcare Environmental Services Ltd* [2017] CSOH 14 (also referring to *@SIPP Pension Trustees* and *Rainy Sky*); *Gray's Executors v Manson's Executor* [2017] CSOH 25 (also citing *Marley v Rawlings*); *Fife Council v Royal Sun Alliance Insurance plc* [2017] CSOH 28 (also referring to *@SIPP Pension Trustees*); *New Ingliston Ltd v The City of Edinburgh Council* [2017] CSOH 37 (also referring to *@SIPP Pension Trustees*); *Kinloch v Coral Racing Ltd* [2017] CSOH 43, 2017 SLT 856 (also referring to *@SIPP Pension Trustees*); *Midlothian Council v Bracewell Stirling Architects* [2017] CSOH 87 (also citing *Rainy Sky*); *Barnes v Chief Constable of the Police Service of Scotland* [2017] CSOH 92, 2017 SLT 844 (also citing *Luminar Lava*). *Wood v Capita Insurance Services* [2017] UKSC 24, [2017] AC 1173 had been cited by a Scottish court twice at the time of writing (March 2018); by *J H & W Lamont of Heathfield Farm v Chattisham Ltd* [2017] CSOH 119 and *Marin Subsea Ltd v EDS* [2017] CSOH 120.

<sup>88</sup> [2017] CSIH 9.

should be followed. If there has been no prejudice to the other party, the court should be reluctant to hold that failure to comply with a particular requirement renders the notice invalid. In addition, it was held that the courts should be slow to adopt a restrictive approach with regard to the sending of notices. The reason behind this was that a reliance on a formalistic method of interpretation would lead to many notices being invalid as a result of very small errors, which would in turn lead to uncertainty.

8.51 With regard to contractual interpretation more generally, the court, whilst far from rejecting the comments of Lord Neuberger in *Arnold v Britton*, instead applied the commercially sensible approach to contractual interpretation followed in *Rainy Sky*, suggesting that this would reduce transaction costs and lead to greater certainty.

8.52 The decision may perhaps be best reconciled with *Arnold v Britton* as an illustration of the exceptional circumstances where commercial common sense can overcome the ordinary meaning of the words used, thinking primarily of policy concerns about too strict an approach to contractual notices in particular. We certainly do not see it as undermining the apparent consensus around the approach in *Arnold v Britton* properly understood. Indeed, it may simply exemplify Lord Hodge's observation in *Wood v Capita Insurance Services* that, where there are rival meanings, the court can still use its appreciation of business common sense to make a choice between them.

### **Remaining differences between Scottish and English law?**

8.53 There is, however, one area of contractual interpretation on which Scots and English law appear to adopt different positions. This is with regard to what is known as the private dictionary exception: in other words, where parties can be taken to have agreed to attribute a particular meaning to a word other than that it would convey to an objective observer with knowledge of the relevant context (because the parties' pre-contractual statements are excluded from the relevant context under *ICS*).

8.54 The position in England is authoritatively set out in *Chartbrook*. The House of Lords in this case considered in depth the rule excluding pre-contractual negotiations from the context which the court is allowed to take into account. In particular, the court considered the private dictionary rule, which had previously been recognised as an exception to the exclusionary rule. Lord Hoffmann concluded that "evidence may always be adduced that the parties habitually used words in an unconventional sense in order to support an argument that the words in a contract should bear a similar unconventional meaning", but evidence of pre-contractual statements could *not* be adduced where the court is faced with a "choice between two perfectly conventional meanings of the word".<sup>89</sup> This considerably narrows the scope of the private dictionary rule.

8.55 The position under Scots law seems to be that parties can make greater use of pre-contractual statements to demonstrate that a particular word had a meaning which the parties had previously agreed upon. In particular, where one party can be shown to have known that the other used a word or phrase with a specific meaning, and not to have objected to that, the word or phrase will carry that meaning.

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<sup>89</sup> *Chartbrook* at para 45, per Lord Hoffmann.

8.56 This rule can be dated back at least to the House of Lords case of *Houldsworth v Gordon Cumming*.<sup>90</sup> Here, two parties were negotiating the sale of the Dallas estate in Morayshire. The seller sold the land on the basis of a plan they had shown to the purchaser in the course of the negotiations. However, once the sale had concluded, the purchaser attempted to argue that they had in fact purchased the entire legal estate: a larger area than that shown on the plan. However, it was held by the House of Lords that the seller could adduce the plan in evidence as to the intended subject of sale. As put by Lord Loreburn LC, “these negotiations are crucial, and all that passed, either orally or in writing, is admissible in evidence to prove what was in fact the subject of sale; not to alter the contract, but to identify its subject.”<sup>91</sup> The case has not been overruled, and as far as Scotland is concerned, remains authoritative.

8.57 Evidently, there is some conflict between the approach in *Houldsworth* and the approach in *Chartbrook* (where *Houldsworth* was not cited or mentioned). This was considered recently in *Scotia Homes (South) Ltd v McLean*.<sup>92</sup> Here, in similar circumstances to *Houldsworth* itself, sellers of a property showed a plan to the purchasers which indicated that the property would have three bedrooms. However, they were then shown a later plan which indicated that the property would only have two bedrooms. They then tried to withdraw from the purchase and refused to pay the purchase price. The purchasers claimed that the contract was void for uncertainty: only a sustainable proposition if one took into account the original plan which had been shown to the purchasers.

8.58 According to Sheriff Principal Dunlop:

“there is nothing controversial in admitting extrinsic evidence of the circumstances surrounding the contract as part of the process of interpreting its terms. Specifically, I consider that such extrinsic evidence is prima facie admissible to elucidate what the parties meant when they used the expression “Plot 44””<sup>93</sup>.

8.59 He considered this to be consistent with *Houldsworth*, “the facts of which, if not indistinguishable, are very closely analogous to the facts of the present case.”<sup>94</sup> Sheriff Principal Dunlop noted that there may be some conflict with *Chartbrook*, but considered that “for present purposes ... counsel for the respondents was well founded in his submission that [*Houldsworth*] is binding precedent in Scotland.”

8.60 So it would appear that, under the present law, Scotland still takes a more liberal view than England when it comes to the admission of pre-contractual statements to determine the meaning to be attributed to a particular word in the contract. This does not seem to have been altered by *Chartbrook* and was not addressed in *Arnold v Britton* or *@SIPP Pension Trustees*. Lord Hodge, writing extra-judicially, has supported the continuation of the *Houldsworth* rule given the absence of any Scottish equivalent to the English estoppel by convention.<sup>95</sup>

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<sup>90</sup> [1910] AC 537.

<sup>91</sup> [1910] AC 537 at 541 per Lord Loreburn LC.

<sup>92</sup> 2013 SLT (Sh Ct) 68.

<sup>93</sup> 2013 SLT (Sh Ct) 68 at para 31, per Sheriff Principal Dunlop QC.

<sup>94</sup> 2013 SLT (Sh Ct) 68 at para 32, per Sheriff Principal Dunlop QC.

<sup>95</sup> Lord Hodge, ‘Can Judges Use Business Common Sense in Interpreting Contracts?’, 282.

## Conclusion

8.61 In sum, therefore, it is clear that the law of contractual interpretation has again moved on significantly in the period since the publication of our 2011 DP. *Arnold v Britton* now appears to be the leading authority on contractual interpretation north and south of the border. But in *Wood v Capita Insurance Services* the Supreme Court asserted the continuity of its approach in *Arnold*, not only with *Rainy Sky*, but also with that of Lord Hoffmann in the *ICS* case and the earlier guidance on the matrix of fact given by Lord Wilberforce in the 1970s. *Arnold v Britton*, according to the Supreme Court, was not any form of rowing back from *Rainy Sky* to a more literal or textual approach.

8.62 Given the acceptance of *Arnold v Britton* in the Scottish courts, it is important to be clear on what that case holds. While the words used by the parties in their contract are of high importance in determining their intention, it remains legitimate always to consider the factual context known to all the parties to determine what they meant by their chosen words. It is clear that reference may still be made to business common sense, but not to rewrite the contract with the benefit of hindsight even if it seems to entail a harsh result for a party.

8.63 Perhaps most important is the absence of any requirement that words be ambiguous before context can be taken into account.<sup>96</sup> As Moore-Bick LJ has commented: “[D]ifficulty of construction is not the same thing as ambiguity.”<sup>97</sup> There are many reasons why interpretation may be difficult apart from words having more than one possible meaning. Some of them are mentioned in Lord Hodge’s dictum in *Wood v Capita Insurance Services* quoted above: drafting may be rendered problematic by parties’ conflicting aims, communication failures, differing drafting practices, or deadlines which require the parties to compromise in order to reach agreement. *Rainy Sky* points up the difficulties that can be caused by the silence of a contract on a matter which later becomes important. Another difficult case is where circumstances change radically by comparison with the position when the contract was made.<sup>98</sup> From our own observations during this part of the Contract project, a further problem may arise from the not uncommon practice of drawing parts of the text from different, earlier contracts without then editing them to be completely consistent with other parts of the current document or its objectives. For these reasons, we consider that it would be too restrictive to admit context in cases of ambiguity only.

8.64 The tentative views expressed in the 2011 DP were founded on the basis that there was uncertainty and even conflict in the approaches of different courts, but since this seems to have largely settled down there does not appear to us to be the same need for legislation to resolve the differences of view and remove uncertainty.

8.65 Rather, we consider that this is an area that may merit reconsideration in the future, if the position is in fact less firmly settled than we tend to think, or if that approach turns out not

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<sup>96</sup> See McMeel, *Construction of Contracts* (3<sup>rd</sup> edn, 2017), paras 1.114 to 1.115.

<sup>97</sup> *Reilly v National Insurance & Guarantee Corporation Ltd* [2008] EWCA Civ 1460, [2009] 1 All ER (Comm) 1166, para 10. Note also the following dictum of Lord Sumption in *Sans Souci Ltd v VRL Services Ltd* [2012] UKPC 6, para 14: “It is generally unhelpful to look for an ‘ambiguity’, if by that is meant an expression capable of more than one meaning simply as a matter of language. True linguistic ambiguities are comparatively rare. The real issue is whether the meaning of the language is open to question. There are many reasons why it may be open to question, which are not limited to cases of ambiguity.”

<sup>98</sup> As for example in *Lloyds TSB Foundation for Scotland v Lloyds Banking Group Plc* (see paras 8.15 and 8.16 above).

to work well. There is still room for judicial development of the law should appropriate cases arise, especially with regard to the admissibility of pre-contractual negotiations beyond the *Houldsworth* case. To admit evidence from such sources is consistent with the concept of context or the factual matrix known to both parties if it is clear that what is admissible is evidence showing objectively that the parties agreed a meaning to be attributed to language in their final contract. Likewise post-formation conduct can only be relevant if it (again objectively) makes manifest the meaning the parties gave the words of the contract from the very outset of performance.

8.66 Gerard McMeel, a leading commentator on the construction of contracts in English law, has further argued that if the general inadmissibility of pre-contractual negotiations is the result, not of legal principle and the need to follow an objective approach, but of judicial policy related to views about certainty and costs, the rule is weaker,<sup>99</sup> in the sense that it is much more open to a change of judicial view, especially if it becomes apparent that certainty is not promoted and costs not contained by the present approach.

8.67 All this may be taken against Lord Sumption's view that the exclusionary rules are a principled consequence of the objective approach to interpretation and the primacy of the words the parties have chosen to use in their contract. He appears to be alone in that view amongst the Supreme Court Justices who have considered the matter recently.<sup>100</sup> The willingness of parties to seek rectification, the success rate in such actions, and their relative cost, may together provide a useful test of whether the fears on this matter voiced by Lords Hoffmann, Neuberger and Hodge are well-founded.

8.68 To attempt to settle the law by way of legislation one way or another would therefore be at least premature and perhaps unnecessary. Accordingly we make no recommendation for legislative reform of the law on interpretation of contracts.

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<sup>99</sup> G McMeel, *The Construction of Contracts: Interpretation, Implication and Rectification* (2<sup>nd</sup> edn, 2011), vii, viii. There are no precisely similar statements in the 3<sup>rd</sup> edn (published 2017), but see paras 5.162 to 5.166.

<sup>100</sup> Apart from Lord Hoffmann (for whom see paras 7.21 to 7.24 above), see the views of Lord Neuberger (paras 8.31 to 8.33 above), and Lord Hodge (paras 8.34 and 8.35 above).

## **PART 4**

# **Remedies for Breach of Contract**

# Chapter 9 Remedies for breach of contract: an introduction

## Background

9.1 In July 2017, we published a Discussion Paper on Remedies for Breach of Contract (the 2017 DP). It was the fifth paper published in our review of Scots contract law in light of the DCFR. We previously considered remedies for breach of contract in 1999, publishing a Report and draft Bill in December (the 1999 Report). Of the four substantive recommendations made in the 1999 Report, only one has been implemented.<sup>1</sup> We considered each of the unimplemented recommendations in the 2017 DP,<sup>2</sup> and return to them in the following Chapters.

9.2 In addition, the 2017 DP examined the concept of breach of contract and the remedies for it, both in Scots law and under the DCFR. We raised the possibility of a general statutory restatement of the law including but not limited to reform of the present law, but have now decided not to pursue that project any further.<sup>3</sup> The 2017 DP also proposed a number of specific reforms in addition to the unimplemented recommendations of the 1999 Report, and these are further discussed in the following Chapters.

9.3 The 2017 DP indicated our belief that the legal rules on remedies should in general remain default in nature; that is, subject to adjustment by parties in their contracts.<sup>4</sup> Nothing in the consultation responses suggested that this belief was mistaken, and it underpins the recommendations that we make in Chapter 10 in particular.

9.4 In the 2017 DP we also adopted the conveniently neutral terminology of the DCFR, where the contract-breaker against whom a remedy is exercised is usually referred to as the “debtor”, while the other party is the “creditor”. We continue that usage in this Part of the Report. The words are less cumbersome than “party in breach” and “party not in breach”, and less judgmental than “guilty party” and “innocent party”.<sup>5</sup>

9.5 It should be recalled that each of the substantive Chapters in the 2017 DP adopted a structured approach to the topic discussed in it, considering first questions of terminology before comparing the substance of Scots law and the DCFR on the matter and then in the light of that discussion making suggestions as to possible reforms for the consideration of consultees.

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<sup>1</sup> By sections 88 (sheriff court) and 90 (inserting section 47(2A) of the Court of Session Act 1988 of the Courts Reform (Scotland) Act 2014).

<sup>2</sup> 2017 DP, paras 1.27 to 1.31 and Appendix A.

<sup>3</sup> See paras 9.9 to 9.12 below.

<sup>4</sup> See 2017 DP, paras 1.26 and 1.37.

<sup>5</sup> It is also the terminology used by Gloag (Gloag, *Contract*, p 592). In the 1999 DP and 1999 Report we spoke of the party not in breach as the “aggrieved party”, but in reality all parties may be aggrieved even if only one of them is in breach.

## Structure of this Part

9.6 This Part of the Report is divided into nine Chapters. This Chapter provides an introduction to the Part and Chapter 10 sets out our recommendations for reform in three areas. We do not make recommendations for reform in relation to the remaining Chapters in this Part. In these Chapters, we discuss those specific reform proposals made in the 2017 DP upon which this Report makes no recommendation. The principal purpose of including this discussion is to record consultees' views on the various proposals.

9.7 As we do not recommend a general statutory restatement of the law on remedies for breach of contract, we do not discuss in detail proposals from the 2017 DP that would have had the principal effect of restating the present law. Similarly, the decision not to recommend a general statutory restatement of the law means that a systematic reform of its terminology is not possible. But we do cover the responses consultees made to our suggestions, although not in the depth we might otherwise have done.

9.8 Each of the following Chapters is derived from a Chapter in the 2017 DP:

- Chapter 11 Retention and withholding performance
- Chapter 12 Anticipatory or anticipated breach
- Chapter 13 Termination
- Chapter 14 Other self-help remedies
- Chapter 15 Enforcing performance
- Chapter 16 Damages
- Chapter 17 Gain-based damages
- Chapter 18 Transferred loss claims

### **A statutory statement: policy considerations**

9.9 In the 2017 DP, we asked consultees whether they thought that there would be an advantage in having a comprehensive statutory statement of the law on remedies for breach of contract.<sup>6</sup> This was driven by the same policy considerations that led us to seek views on having such a statement on formation of contract.<sup>7</sup>

9.10 Although there was some significant support for the idea (for example, from the Senators of the College of Justice), it met with much more substantial opposition than the proposal for a restatement on formation: in particular, from the Faculty of Advocates, the Society of Solicitor Advocates, the Law Society of Scotland, and a number of commercial law firms. We accept that this level of opposition means that the time is not ripe for such a major innovation in the form of the law of remedies.

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<sup>6</sup> 2017 DP, Ch 11.

<sup>7</sup> See para 3.6 above.

9.11 Further, some of the remedies discussed (notably specific implement) are not limited to breach of contract cases, and a statutory restatement confined to that area might inadvertently create anomalies within the overall system. In any event, whereas we have been able to develop the formation proposal over quite a long period of time (and with the considerable benefit of consultation on an initial draft Bill), the resources needed to produce an equivalent on remedies for breach (above all, time) are simply not available given other priorities within our Tenth Programme of Law Reform.

9.12 For these reasons, we have not recommended that there should be a comprehensive statutory statement of the law on remedies for breach of contract.

# Chapter 10 Recommendations for reform

## Mutuality: effect on party in breach

10.1 The Scots law concept of mutuality of contract has two major consequences:

- if one party does not perform, the other need not perform (that is, it can withhold performance);
- a party which has not performed or is not willing to perform its obligations cannot compel the other to perform.<sup>1</sup>

10.2 The second of these creates significant difficulties.<sup>2</sup> We considered this effect in our 1999 Report,<sup>3</sup> where we noted that some judicial formulations of the rule could be read as saying that a party in breach could not exercise any rights under the contract or sue for damages for its breach by the other party.<sup>4</sup> In our view, however, this was neither what mutuality entailed, nor what it should. Rather, its meaning was that a party against whom the remedies of retention or rescission had been properly exercised could not sue for implement of the obligation being withheld or for damages for its breach (since by definition neither retention nor rescission can be breach of contract where correctly employed).

10.3 In our 1999 Report it appeared to us that this understanding was reinforced by a dictum of Lord Jauncey in *Bank of East Asia v Scottish Enterprise*,<sup>5</sup> where he said:

“I do not consider that the authorities warrant so broad a proposition as that any material breach by one party to a contract necessarily disentitles him from enforcing any and every obligation due by the other party.”<sup>6</sup>

10.4 As such, we thought it unnecessary to recommend corrective legislation in our 1999 Report, given that Lord Jauncey’s statement “...carries the authority of a unanimous decision of the House of Lords”.<sup>7</sup> However, two contrasting decisions of the Inner House in 2010 and 2014 suggest that the effect of this aspect of the mutuality concept may be less clear than we thought in 1999.

10.5 In *Forster v Ferguson & Forster, Macfie & Alexander*,<sup>8</sup> a former partner in a law firm who had been convicted of embezzlement from the firm sued it and the continuing partners for a pension due to him under the partnership agreement upon his leaving the firm. An Extra Division held that he was unable, on the basis of mutuality, to enforce the obligation.

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<sup>1</sup> See McBryde, *Contract*, para 20.47.

<sup>2</sup> 2017 DP, para 2.17.

<sup>3</sup> 1999 Report, paras 7.8 to 7.13.

<sup>4</sup> *Steel v Young* 1907 SC 360 at 366 per Lord Low; *Forrest v Scottish County Investment Co* 1916 SC (HL) 28 at 39 per Lord Wrenbury.

<sup>5</sup> 1997 SLT 1213.

<sup>6</sup> 1997 SLT 1213 at 1216L. See also McBryde, *Contract*, paras 20.48 to 20.52.

<sup>7</sup> 1999 Report, para 7.13.

<sup>8</sup> 2010 SLT 867.

His breach of the duty of utmost good faith incumbent between partners, which went to the root of the whole partnership contract, disabled him from enforcing any of the obligations under the agreement even although the partner had long before ceased to be a member of the firm. The majority view was that:

“no distinction fell to be drawn between a continuing contract and a terminated contract for the purposes of the operation of the principle of mutuality”.<sup>9</sup>

Lord Marnoch, dissenting, thought that:

“the main practical application of the doctrine of mutuality is in relation to retention in the sense of withholding performance in the course of a continuing contract”

and that the only way in which the firm could have escaped the obligation was by rescinding the whole contract on the basis of the partner’s material breach.<sup>10</sup>

10.6 In *McNeill v Aberdeen City Council (No 2)*,<sup>11</sup> on the other hand, another Extra Division appeared to apply the position that we took in our 1999 Report. For reasons that are not clear, however, *Forster* was not cited in *McNeill*. The latter was an employment case involving the parties’ obligations of mutual trust and confidence. The question was whether the employer could withhold performance of that obligation in response to the employee’s breach of other obligations under the contract. An employee resigned during a prolonged investigation of his conduct by the employer, and then brought a claim for unfair constructive dismissal on the basis of the employer’s breach of the trust and confidence obligation. It was established that for some time the employee had in fact been in breach of a kind meriting dismissal. In consequence the Employment Appeal Tribunal held that the doctrine of mutuality disabled the employee from bringing his unfair dismissal claim. This was however overturned by the Extra Division, which held that the employee’s breach did not prevent him making a claim for the employer’s breach of mutual trust and confidence. Otherwise, as Lord Drummond Young put it:

“any breach of contract by the employee of sufficient materiality to permit retention would allow the employer to behave in a wholly outrageous manner, without any redress for the employee.”<sup>12</sup>

10.7 The contrast between the *Forster* and the *McNeill* opinions suggests that the law is less clear and certain than we thought in 1999. The 2017 DP therefore suggested a legislative statement to the effect that a party in breach of contract is not as a result disentitled from exercising any right or pursuing any remedy arising out of the other party’s breach of contract. This does not mean that the first party has complete freedom of manoeuvre. Instead, as we put it in 1999, “[e]verything depends on the terms of the particular contract and on the law of suspension of performance”.<sup>13</sup>

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<sup>9</sup> 2010 SLT 867 at para 15 per Lord Clarke.

<sup>10</sup> 2010 SLT 867 at para 35. Given that rescission is prospective and not a means of avoiding the contract altogether, this latter point may not hold good.

<sup>11</sup> 2014 SC 335.

<sup>12</sup> 2014 SC 335 at para 34.

<sup>13</sup> 1999 Report, para 7.13. For example, in the *Forster* case, as Lord Marnoch suggested, the pension clause on construction could be read as conferring the right upon the partner no matter the circumstances in which he left the firm.

10.8 We do think however that it would be useful to clarify the law on when a party in breach is entitled to make a claim in respect of another party's breach of their contract would be useful. There was close to unanimous agreement from consultees in relation to the proposition that party A, who is in breach of a contract with party B, is nevertheless entitled to exercise any right or to pursue any remedy arising out of party B's breach, where B's breach occurs before party B terminates the contract for A's breach. As such, and given the comment from the Faculty of Advocates that if the contrary was the case this would result in unnecessary practical complication, we believe that providing for this reform in legislation would be useful and a welcome clarification of the law in this area. We would add now that A is not entitled to sue for performance of an obligation lawfully withheld or retained by B in response to A's breach.

10.9 Morton Fraser however thought that the introduction of "a bold legislative statement" on the subject could be problematic and that in general terms, the answer to this question must depend on the nature of the breaches. They gave the following examples: (a) if B has the option to terminate because of the materiality of A's breach but has chosen to continue to perform it then there is no obvious reason why a breach by B should not be actionable by A, and (b) if A is in breach, then B will have had the option to refuse to perform or terminate and should have taken one of these options to avoid any difficulties arising.

10.10 In relation to Morton Fraser's case (a), where B has chosen to continue to perform despite the materiality of A's breach, we think this is dealt with by the rule because in it B has not terminated the contract. Further, while we agree with their view of case (b), in which if A is in breach, then B has the option to refuse to perform or terminate and should take one of these options to avoid any problems, we do not think it causes any difficulty for the proposed rule. If justified by A's breach, B can retain its own performance or terminate the contract without incurring any liability to A.

10.11 We think that the law can be made clear by a concise statutory provision to the effect that a party in breach of contract may nonetheless exercise any right, or pursue any remedy arising out of the other party's breach provided that the latter breach occurred before the second party rescinded the contract for the first breach. The first party may not seek performance of any obligation of the second party that would have been due in the period following the rescission. The first party also may not seek performance of an obligation that is being lawfully retained or withheld by the second party. In line with the general policy set out in Chapter 9,<sup>14</sup> this rule should be default in nature (that is, subject to the contrary agreement of the parties). We therefore recommend that:

- 31. It should be provided that a party in breach of contract may nonetheless exercise any right, or pursue any remedy arising out of the other party's breach provided that the latter breach occurred before the second party rescinded the contract for the first breach. The first party should not be able to seek performance of any obligation of the second party that would have been due in the period following the rescission; or of an obligation that is being lawfully retained or withheld by the second party**

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<sup>14</sup> See above, para 9.3.

**in response to the first party's breach. These rules should be subject to the contrary agreement of the parties.**

(Draft Bill, sections 16(1), 17)

### **Restitution after rescission**

10.12 The 2017 DP noted that despite the basically prospective nature of termination under the DCFR (in other words it affects only future obligations of performance), it also provides more generally for rights of restitution on termination of any benefit from the other party's performance of obligations under the terminated contract (or terminated part thereof).<sup>15</sup> Restitution is not required, however, to the extent that conforming performance by one party has been met by conforming performance by the other, or where the contract was gratuitous.<sup>16</sup> The remedy arises, therefore, only where at the point of termination for non-performance by the debtor, some performance has been rendered by one party but not met at all, or not fully met, by the reciprocal performance of the other party.<sup>17</sup> The remedy's aim is the redress of economic imbalances resulting from the termination.

10.13 Under the DCFR restitution of an unreciprocated performance may be applied for by any party to the contract. Both the terminating creditor and the debtor may have rendered performances before the termination. The terminating party may elect to treat performance received as non-conforming if what was received is rendered of no, or of fundamentally reduced, value to that party by virtue of the non-performance by the other party giving rise to the termination.<sup>18</sup> This is however to view matters from the creditor's perspective only. There may still be something—money, property, the benefit of a service—in the hands of the creditor which the debtor would not have handed over unless it was to receive the creditor's full performance in return. Each party may therefore be required to make restitution. An illustration of the situation may be the sale of a faulty vehicle. The buyer is entitled to terminate and reclaim the price, but must also return the vehicle to the seller.

10.14 If the relevant performance was a payment of money, the amount received is to be returned. If a non-money benefit (such as the vehicle in the example just given) remains transferable, it is to be returned unless the transfer would cause unreasonable effort or expense, in which case its value is to be paid instead. If the benefit is non-transferable, its value is to be paid.<sup>19</sup> The obligation to return a benefit extends to its natural or legal fruits.

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<sup>15</sup> DCFR III.–3:510. The DCFR's restitution regime also applies to "excused non-performance" (ie frustration: see the 2017 DP, para 1.18) but we consider the matter here only in the context of termination for breach. For arguments that "there are, in principle, no fundamental differences between void, avoided, terminated and frustrated contracts regarding restitution, as long as the preliminary question that restitution should be granted is answered positively", and that "the way forward may be to separate restitution after failed contracts from the traditional categories of contract and unjustified enrichment in favour of an independent area of law", see S Meier, "Unwinding Failed Contracts: New European Developments" (2017) 21 Edin LR 1 (quotations at pp 28 and 29 respectively). We do not address such questions here, although we note that the proposed scheme may well be capable of extension into situations other than termination for breach.

<sup>16</sup> DCFR III.–3:511.

<sup>17</sup> For the concept of reciprocity of obligations within a contract in the DCFR, see para 2.7 of the 2017 DP.

<sup>18</sup> DCFR III.–3:511(2).

<sup>19</sup> For rules on valuing a benefit see DCFR III.–3:512. For liabilities arising after the time when return was due, see DCFR III.–3:514.

10.15 The initial recipient of the benefit is however obliged to pay a reasonable amount for any use made of it,<sup>20</sup> while also being entitled to payment of the value of any improvements made to the benefit which the other party can readily obtain by dealing with it.<sup>21</sup> The entitlement to payment for improvements flies off, however, if (a) the improvement was a non-performance of an obligation which the recipient owed to the other party; or (b) the recipient made the improvement knowing, or could reasonably be expected to know, that the benefit would have to be returned. The recipient of the benefit must also pay recompense (in the sense of compensation) for any reduction in its value through a change in its condition between the time of receipt and the re-transfer to the other party. The liability is reduced if the recipient's conduct causing the change was made in the reasonable but mistaken belief that the other party's performance conformed with the contract.

10.16 The 1999 Report considered this issue and concluded that the redressing of economic imbalances caused by rescission of a partly performed contract should be left to the law on unjustified enrichment rather than be regulated by a general statute on remedies for breach of contract.<sup>22</sup> In 2007, however, McBryde noted that there had been a considerable amount of writing on the subject of unjustified enrichment and breach of contract and that "[t]here is not unanimity either as to what the law is, or as to what the law should be."<sup>23</sup>

10.17 In the most recent judicial consideration of the question, Lord Tyre held that a party to a contract who has made payment in anticipation of a counterpart performance which never occurs has a remedy of restitution in Scots law. He also noted the absence of consensus amongst commentators as to the legal basis for this remedy, observing that in his view it did not depend upon the law of unjustified enrichment (in particular, upon the *condictio causa data causa non secuta*).<sup>24</sup>

10.18 In the 2017 DP we thought it clear in principle that where parties have rendered performances under a contract but not received the reciprocal counter-performances, and the contract is then terminated, there should be restitution of the performances in question. This remedy should be reciprocal, that is available if appropriate to both the creditor and the debtor in the other breach obligations. We accordingly asked consultees if they agreed that where parties have rendered conforming performances under a contract but not received the reciprocal counter-performances, there should be reciprocal restitution of the uncompleted performances after termination for breach. If they agreed, we asked if the system of rules set out on this matter in the DCFR provided a satisfactory approach to the issue. Finally we asked if alternatively consultees considered that the law in this area should be left to develop by way of court decisions.

10.19 The Senators of the College of Justice, the Faculty of Advocates, the Society of Solicitor Advocates, the Law Society of Scotland and Morton Fraser all agreed that there

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<sup>20</sup> DCFR III.-3:513(1).

<sup>21</sup> DCFR III.-3:513(2).

<sup>22</sup> 1999 Report, para 7.23.

<sup>23</sup> McBryde, *Contract*, para 20.132. To the works he cites should be added S Miller, "Unjustified Enrichment and Failed Contracts", in R Zimmermann, D Visser and K Reid (eds), *Mixed Legal Systems in Comparative Perspective: Property and Obligations in Scotland and South Africa* (2004), ch 15; R Evans-Jones, *Unjustified Enrichment Volume 1: Enrichment by Deliberate Conferral: Condictio* (2003), paras 6.97 to 6.123.

<sup>24</sup> *Stork Technical Services (RBG) Ltd v Ross's Executor* [2015] CSOH 10A, 2015 SLT 160, paras 33, 34.

should be reciprocal restitution of uncompleted performances after termination for breach in the circumstances outlined. Pinsent Masons did not agree or disagree but acknowledged that there was some logic to the proposal.

10.20 There was also majority agreement amongst those consultees who responded that the system of rules set out on the matter in the DCFR was in general a satisfactory approach to the issue. The Faculty commented that while reformulation in accordance with the DCFR rules was preferable to waiting on the development of case law, they felt that some expressions used in the DCFR could be improved upon. But in substance they represented the best solution. The Law Society considered that while the DCFR was a reasonable starting point, the drafting of the PICC should also be considered, in particular Article 7.3.6.<sup>25</sup>

10.21 Considering this level of consultee support, and given the present lack of clarity of the law in this area, we recommend providing for this reform in legislation. It should be noted that the DCFR sets out detailed provision as to how reciprocal restitution would work in practice.<sup>26</sup> In our view, this is indicative of the fact that the DCFR is a model law that attempts to be all-encompassing. The lesser level of detail in the PICC reflects its status as a system of principles rather than rules.

10.22 We have come to the conclusion that the detailed provision in the DCFR should be substantially replicated in our draft Bill, albeit re-phrased for greater clarity in the context of Scots law. A new remedy is being provided, and the legislation should make clear its nature and scope. We have however taken on board the comments from the Faculty of Advocates and the Law Society of Scotland that the DCFR rules could be improved upon and we have therefore deviated from the DCFR approach in our draft Bill where we thought it appropriate.

10.23 Thus under the Bill parties to a contract lawfully rescinded for breach must make mutual return of unreciprocated performances made before the termination occurred. If the relevant performance was a payment of money, the amount received is to be repaid. If a non-money benefit (for example, goods supplied) remains transferable, it is to be returned unless to do so would be unreasonable or impracticable, in which case its value is to be paid instead. If the benefit is non-transferable, again its value is to be paid. There are detailed rules on how in either case the value is to be determined. If the recipient has disposed of the benefit for an amount greater than its value, that greater amount is to be paid to the other party. The obligation to return a benefit extends to its natural or legal fruits.

10.24 The recipient of the benefit must pay a reasonable amount for any use made of it,<sup>27</sup> and must also pay compensation for any reduction in its value through a change in its condition between the time of receipt and the re-transfer to the other party. The liability to pay compensation is reduced if the change in condition was through a non-performance of

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<sup>25</sup> Unidroit PICC article 7.3.6 reads as follows: "(1) On termination of a contract to be performed at one time either party may claim restitution of whatever it has supplied under the contract, provided that such party concurrently makes restitution of whatever it has received under the contract. (2) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable. (3) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party. (4) Compensation may be claimed for expenses reasonably required to preserve or maintain the performance received."

<sup>26</sup> See paras 10.13 to 10.15 above.

<sup>27</sup> Cf the Consumer Rights Act 2015, s 24(8) to (11), which allows a limited deduction from refund of the price to take account of a consumer's use of rejected goods.

an obligation which the other party owed to the recipient, or the recipient's conduct causing the change was made in the reasonable but mistaken belief that the other party's performance conformed with the contract.

10.25 The recipient is also entitled to payment of the value of any improvements made to the benefit which the other party can readily obtain by dealing with it.<sup>28</sup> This entitlement does not exist, however, if either the improvement was itself a breach of the contract, or the recipient made the improvement knowing, or when it ought to have known, that the benefit would have to be returned.

10.26 In line with the general policy set out in Chapter 9,<sup>29</sup> all these rules should be default in nature (that is, subject in whole or in part to the contrary agreement of the parties). We therefore recommend that:

- 32. Subject to the power of the parties to agree otherwise, where a contract is rescinded for breach and parties have previously rendered conforming performances under the contract but not received the reciprocal counter-performances, there should be reciprocal restitution of the benefits received through the unreciprocated performances.**
- 33. Again subject to the power of the parties to agree otherwise, there should also be detailed rules on the valuation of non-money benefits, and provisions on (i) compensation for any reduction in the value of a returned benefit and (ii) payment for use or improvement of the benefit by the recipient.**

(Draft Bill, sections 16(1), 18 to 21)

10.27 It is important to note that, in line with the general principles of Scots law on remedies for breach of contract, this new remedy may be cumulated with other remedies so long as their exercise together is compatible one with another.<sup>30</sup> Thus for example the rescinding party may obtain restitution under the Bill provisions while also seeking damages for other losses caused by the breach. This is one important effect of section 24(a)(iii) of the draft Bill, which lays down that the Bill is without prejudice to any enactment or rule of law regulating any question related to remedies for breach not provided for in the legislation.

### **Contributory negligence**

10.28 The availability of contributory negligence as a defence to claims for damages based on breach of contract has been an open question for some time.<sup>31</sup> At common law, contributory negligence was generally thought not to be part of contract law; issues about a pursuer's contribution to its own loss were generally dealt with by way of causation and mitigation rules.<sup>32</sup> Further, "culpable carelessness is not usually to be ascribed to the plaintiff

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<sup>28</sup> DCFR III.-3:513(2).

<sup>29</sup> See above, para 9.3.

<sup>30</sup> See 2017 DP, paras 11.9 to 11.11.

<sup>31</sup> 1988 Report, para 4.11; 1999 Report, para 4.1; McBryde, *Contract*, paras 22.34 to 22.36; MacQueen and Thomson, *Contract*, paras 6.43 to 6.46.

<sup>32</sup> MacQueen and Thomson, *Contract*, para 6.46. But note the argument in Glanville Williams, *Joint Torts*, pp 214 to 222, that there was no conclusive authority to this general effect in England and Wales before 1945 and that in

merely because he has omitted to take precautions against breach.<sup>33</sup> In delict, however, contributory negligence, if established, operated as a complete defence to a claim for damages.<sup>34</sup> The severity of this rule was mitigated however by the Law Reform (Contributory Negligence) Act 1945 (the 1945 Act), which allows for apportionment of responsibility between the parties. The general principle is that where a party suffers damage partly through its own “fault” and partly through the “fault” of another, its damages are to be reduced “to such extent as the court thinks just and equitable having regard to the claimant’s share in the responsibility for the damage”.<sup>35</sup> The 1945 Act was undoubtedly intended to apply in delictual claims for negligence; but its wording could be read as also covering contractual claims likewise based on negligence.<sup>36</sup>

10.29 The 2017 DP marked the third occasion on which the availability of contributory negligence as a defence to claims based on breach of contract had been considered by this Commission, with previous examinations of the topic in 1988<sup>37</sup> and again in 1999.<sup>38</sup> It was also considered by the Law Commission for England and Wales in 1993.<sup>39</sup> We summarised the earlier unimplemented recommendations in the 2017 DP.<sup>40</sup> None of the recommendations made by either Commission on the subject has been implemented.

10.30 There have been few developments in the case law since 1999. As we explained in the 2017 DP, the publication of the DCFR provided an opportunity to revisit the issue and to reassess our previous recommendations. In the 2017 DP, we therefore examined the rules dealing with concurrent fault under the DCFR and the current state of the law on contributory negligence as a defence to breach of contract in Scotland. We then briefly summarised the recommendations made in our earlier Reports, before setting out possible options for reform.

10.31 The DCFR rule on this subject embraces two possible scenarios: first, where the “creditor’s conduct was a partial cause of the non-performance”, and secondly where the creditor’s conduct, “though not in any way responsible for the non-performance itself, exacerbated its loss-producing effects”.<sup>41</sup> The second scenario raises questions of reduction or mitigation of loss,<sup>42</sup> but it appears that the DCFR does not sharply distinguish between mitigation of loss and contributory negligence of the creditor, perhaps because European legal systems diverge as to whether these concepts are treated differently or alike.<sup>43</sup>

10.32 We concluded however that the DCFR provisions have the dual benefits of flexibility and conceptual clarity. In particular they allow for the apportionment of liability between the creditor and debtor based on relative fault. The artificiality that can flow from the all or

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substance (if not in terminology) contributory negligence could be a complete defence in any case of unintentional breach of contract (and not just negligent breach).

<sup>33</sup> Glanville Williams, *Joint Torts*, p 214.

<sup>34</sup> *McNaughton v Caledonian Railway Co* (1858) 21 D 160. See further H L MacQueen and W D H Sellar, “Negligence” in K Reid and R Zimmermann (eds), *A History of Private Law in Scotland* (2000), vol 2, p 536.

<sup>35</sup> 1945 Act, s 1(1).

<sup>36</sup> Chitty, para 26.077; McBryde, *Contract*, para 23.33.

<sup>37</sup> 1988 Report, Part IV.

<sup>38</sup> 1999 Report, Part 4.

<sup>39</sup> Contributory Negligence as a Defence in Contract (Law Com No 219, 1993).

<sup>40</sup> 2017 DP, paras 10.44 to 10.49.

<sup>41</sup> DCFR III.–3:704 Commentary A.

<sup>42</sup> Which is dealt with in DCFR III.–3:705.

<sup>43</sup> DCFR III.–3:705 Notes 1(a) and (b).

nothing nature of causation is avoided as a result.<sup>44</sup> We accepted, however, that they might provide less certainty to parties who wished to settle a claim between themselves without resorting to litigation. As relative fault will ultimately be a question for the court, involving an exercise in apportioning responsibility, we thought that parties might be less inclined to settle disputes in the hope that they could achieve a more favourable outcome in court.

10.33 The debate as to whether the 1945 Act extends the operation of contributory negligence as a defence to damages claims for breach of contract arises as a result of the way in which the 1945 Act defines “fault”.<sup>45</sup> In England and Wales, where “‘fault’ means negligence, breach of statutory duty or other act or omission which gives rise to a liability in tort or would, apart from this Act, give rise to the defence of contributory negligence”, the Court of Appeal has held that the 1945 Act can apply as a defence to claims of damages for breach of contract in certain circumstances.<sup>46</sup> The leading English case is *Forsikringsaktieselskapet Vesta v Butcher*,<sup>47</sup> where the Court of Appeal adopted a proposed classification of contractual claims set out at first instance by Hobhouse J. These were:

“(1) Where the defendant's liability arises from some contractual provision which does not depend on negligence on the part of the defendant.

(2) Where the defendant's liability arises from a contractual obligation which is expressed in terms of taking care (or its equivalent) but does not correspond to a common law duty to take care which would exist in the given case independently of contract.

(3) Where the defendant's liability in contract is the same as his liability in the tort of negligence independently of the existence of any contract.”<sup>48</sup>

The Court of Appeal held that the 1945 Act only applied to claims for damages for breach of contract if they were category (3) cases.

10.34 In 2017 Professor James Goudkamp of Oxford University put forward the argument that *Vesta* has been impliedly over-ruled by two subsequent decisions of high authority.<sup>49</sup> In *Standard Chartered Bank v Pakistan National Shipping Corp (Nos 2 and 4)* the House of Lords held that the 1945 Act did not apply to proceedings in the tort of deceit.<sup>50</sup> In *Co-operative Group (CWS) Ltd v Pritchard* the Court of Appeal held that contributory negligence

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<sup>44</sup> See paras 10.39 to 10.41 below.

<sup>45</sup> 1945 Act, ss 4 (England and Wales), 5 (Scotland). The issue was first addressed in Glanville Williams, *Joint Torts*, pp 328 to 332, arguing that the 1945 Act applied to negligence claims whether arising in tort or from breach of contract. By contrast with his approach to the common law (above n 32), he did not address the question of strict liability claims under the legislation. But he did point out that “the original form of the Contributory Negligence Bill provided that it should not apply to any claim arising under a contract. This was deleted and replaced by the present paragraph (b) of s.1(1), which is different in its effect. It was evidently felt that the early draft was a mistake” (p 331).

<sup>46</sup> *Forsikringsaktieselskapet Vesta v Butcher* [1988] 3 WLR 565. See further the 2017 DP, paras 10.17 to 10.21; Kramer, *Contract Damages*, paras 15.114 to 15.134.

<sup>47</sup> [1988] 3 WLR 565. Although subsequently appealed to the House of Lords ([1989] AC 852), the question of contributory negligence was not addressed in the House of Lords, and the judgment of the Court of Appeal was affirmed on other grounds.

<sup>48</sup> [1986] 2 All ER 488 at 508, per Hobhouse J.

<sup>49</sup> J Goudkamp, “The Contributory Negligence Doctrine: Four Commercial Law Problems” [2017] LMCLQ 213, 218 to 221.

<sup>50</sup> *Standard Chartered Bank v Pakistan National Shipping Corporation* [2002] UKHL 43, [2003] 1 AC 959.

was not a defence in the tort of battery.<sup>51</sup> In each case the foundation of the court's approach was that the 1945 Act did not apply to those cases in which contributory negligence was not a defence at common law. On parity of reasoning, it follows that the 1945 Act cannot apply at all in breach of contract cases.<sup>52</sup> Professor Goudkamp also argued that the threefold classification in *Vesta* bore no relation to anything actually said in the 1945 Act.<sup>53</sup>

10.35 In Scotland, where under the 1945 Act "fault" means wrongful act, breach of statutory duty or negligent act or omission which gives rise to liability in damages, or would apart from this Act, give rise to the defence of contributory negligence", the issue has arisen on a number of occasions in the Outer House of the Court of Session.<sup>54</sup> It appears that broadly the approach in *Vesta* has been followed, but an authoritative resolution is awaited from the Inner House.<sup>55</sup> It has also been argued that the Scots definition of "fault" in the 1945 Act is wider than its English counterpart, essentially because the English definition refers to "liability in tort" whereas the Scots definition refers to "liability in damages". The argument is then that any breach of contract is a wrongful act capable of sounding in damages, and so the defence of contributory negligence is universally available.<sup>56</sup> An argument of this sort was advanced by the defender in *Stewart and Stewart v Pure Ltd*,<sup>57</sup> but it was rejected by Lord Glennie (noting as he did so that the non-application of contributory negligence to breach of contract cases at common law in Scotland made it unlikely that the 1945 Act altered that position only by implication).<sup>58</sup>

10.36 In summary, as the law has been thought to stand since the *Vesta* case, it appears that contributory negligence is available to debtors in a breach of contract claim if their contractual obligation is concurrent with a delictual obligation, or an obligation that would give rise to a breach of statutory duty. This is the case regardless of whether the creditor chooses to frame its action solely in terms of breach of contract.<sup>59</sup> It therefore appears that there is a somewhat arbitrary division in the Scots law of contributory negligence. But, as remarked in the 1999 Report, "it is not justifiable to draw a distinction between contracts involving the exercise of care and skill and other contracts".<sup>60</sup>

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<sup>51</sup> *Co-operative Group (CWS) Ltd v Pritchard* [2011] EWCA Civ 329, [2012] QB 320. On contributory negligence in battery and deceit (plea excluded in both as intentional torts), see further Glanville Williams, *Joint Torts*, p 198 (where he also drily notes: "There is a tale of counsel who drafted a plea of contributory negligence to a charge of seduction; but this is probably apocryphal.")

<sup>52</sup> The High Court of Australia concluded that the equivalent Australian legislation, based on the 1945 Act, did not apply where the claim was for breach of contract: *Astley v Austrust Ltd* [1999] HCA 6; 197 CLR 1. See also D Logan, "Contributory Fault in Contract – a Step Back?", 2000 SLT (News) 81. The decision was quickly reversed by legislation in all Australian jurisdictions: J W Carter, *Contract Law in Australia* (6<sup>th</sup> edn, 2013) paras 35.29-35.32. The general position now is by specific statutory provision that "if a plaintiff claims damages for the 'breach of a contractual duty of care', and that duty is 'concurrent and co-extensive with a duty of care in tort', the plaintiff's claim must be reduced 'to such extent as the court thinks just and equitable' having regard to the plaintiff's 'share in the responsibility for the damage'" (Carter, *Contract Law*, para 35.30).

<sup>53</sup> Goudkamp, "Contributory Negligence Doctrine", pp 221 to 222.

<sup>54</sup> *Lancashire Textiles (Jersey) Ltd v Thomson Shepherd & Co Ltd* 1985 SC 135; *Concrete Products (Kirkcaldy) Ltd v Anderson and Menzies* 1996 SLT 587; *Scottish and Southern Energy plc v Lerwick Engineering and Fabrication Ltd* [2008] CSOH 41, 2008 SCLR 317; *Stewart and Stewart v Pure Ltd* [2008] CSOH 49.

<sup>55</sup> We examined the cases in detail in the 2017 DP: see paras 10.22 to 10.32.

<sup>56</sup> MacQueen and Thomson, *Contract*, para 6.45.

<sup>57</sup> [2008] CSOH 49.

<sup>58</sup> 2017 DP, paras 10.29 to 10.31.

<sup>59</sup> See McBryde, *Contract*, para 22.36.

<sup>60</sup> 1999 Report, para 4.11.

10.37 While the supposed position may be more certain than that under the DCFR, we commented in the 2017 DP that it was not obvious to us that it leads to just results in all, or even many, cases. Professor Goudkamp's arguments on whether the 1945 Act applies at all to breach of contract serve to deepen doubt. As he also observes, the 1945 Act was designed to *augment* rather than *curtail* the circumstances in which damages are recoverable.<sup>61</sup> Use for the latter purpose in contract cases is thus somewhat contradictory of the Act's basic policy.

10.38 In the 2017 DP, we commented that contributory negligence is not the only doctrine by which Scots (and English) law take account of a creditor's contribution to losses arising from breach of contract. Contributory negligence overlaps with causation and mitigation. There are cases in which the creditor's conduct might equally be dealt with under either causation or mitigation principles.<sup>62</sup>

10.39 We noted, however, that these other concepts have their limitations. Causation will normally oblige courts to reach an all or nothing conclusion by finding that the creditor was the cause of its own loss, and hence receives nothing, or that the debtor was the cause of the loss, and therefore must pay full damages. This is likely to produce unreasonable results where each party is partly to blame for the loss.<sup>63</sup> Similarly, we observed that mitigation is limited by the fact that it only operates after the breach, and therefore will not cover situations in which the creditor behaved unreasonably prior to or contemporaneously with the breach of contract.<sup>64</sup> Further in relation to mitigation, "[i]t has never been suggested that the courts should make an apportionment as between claimant and defendant in respect of this loss so as to allow the claimant a partial recovery in respect of it."<sup>65</sup>

10.40 In the 2017 DP, we suggested that one solution to the all or nothing problem would be to adopt a more flexible approach to causation and make an apportionment between the parties based on the causative potency of each party's conduct. This was the approach taken in the 1999 Report's recommendation on this topic. Where loss was caused partly by a breach of contract and partly by the conduct of the breach victim, that party's damages should be reduced to take account of the conduct's contribution to the loss.

10.41 A potential example in the English case law is *Tennant Radiant Heat Ltd v Warrington Development Corporation*,<sup>66</sup> a dispute between tenant (suing in tort on grounds of nuisance or negligence) and landlord (counterclaiming on the basis of breach of the tenants' repairing covenants). Questions of contributory negligence and causation arose. The Court of Appeal held that the claim was in contract and could not be formulated in tort. Accordingly, the case was a category (1) case as set out in *Vesta*, and the 1945 Act did not apply. But the court went on to use causation principles in ordering the landlord to pay 90% of the damages due to the tenants on the claim, and ordering the tenants to pay 10% of the

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<sup>61</sup> Goudkamp, "Contributory Negligence Doctrine", p 223.

<sup>62</sup> Chitty, para 26.078.

<sup>63</sup> See the cases cited in the 2017 DP, para 10.34 and fn 57, for a discussion of this point.

<sup>64</sup> McBryde, *Contract*, para 22.37 and fn 115, citing a number of circumstances in which mitigation cannot operate.

<sup>65</sup> *McGregor on Damages*, para 6.018.

<sup>66</sup> [1988] 1 EGLR 41.

damages due to the landlord in the counterclaim. However, *Tennant Radiant* has been described as an unusual case,<sup>67</sup> and does not appear to have been followed in England.<sup>68</sup>

10.42 The 2017 DP proffered three possible options:

- to make no positive recommendation for reform, and leave the courts to develop the law in light of *Vesta*;
- to return to our 1988 recommendations, and introduce contributory negligence as a defence in purely contractual claims, but only where the debtor owed a duty of reasonable skill and care; or
- to restate our 1999 recommendation, and introduce contributory negligence of the creditor as a means of limiting all contractual claims for damages.

10.43 We also commented on the policy implications of each of these options. We noted that option 1 would represent a departure from the Commission's previous recommendations, would do nothing to address the perceived deficiencies in the current law (not least whether the position in Scotland and England is actually aligned) and would be inconsistent with the DCFR. We acknowledged that option 2 represented the 1988 recommendations, while noting the reasons given in the 1999 Report for departing from them.<sup>69</sup> We further commented that, in our view, the reasons advanced in support of option 3 in the 1999 Report had not in any way been diminished in the intervening years. Considerations of basic fairness suggest that a debtor should not be wholly liable for a loss partly attributable to the creditor. Equally the creditor should not be deprived of its damages claim by its merely partial contribution to its own loss. Option 3 would put Scots law in a position similar to the DCFR. Finally, we observed that Ireland, another jurisdiction with very close ties to England and Wales, had introduced a similar scheme in 1961.<sup>70</sup>

10.44 As a result, we asked consultees for their views on adopting option 3 and again recommending, as we did in 1999, the introduction of contributory negligence of the creditor as a means of limiting all contractual claims for damages. Our proposed reform was supported by the Senators of the College of Justice, the Law Society of Scotland, the Society of Solicitor Advocates and Morton Fraser. Pinsent Masons supported reform, but favoured reverting to option 2 (the 1988 recommendation to introduce contributory negligence as a defence in purely contractual claims, but only where the debtor owed a duty of reasonable skill and care).

10.45 The Faculty of Advocates however explained that it considered that a defence of contributory negligence should not generally be available in claims for damages for breach of contract. It went on to say that *Vesta* is, in its experience, followed, and that it expected the Inner House to take the same approach if called upon to consider the question. On a point of principle, the Faculty also indicated that extending contributory negligence to *Vesta*

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<sup>67</sup> *Chitty*, para 26.78 and fn 402. The Court of Appeal itself appeared sceptical of *Tennant Radiant* in *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd* [1990] 1 QB 818 at 904, but the point was not considered in the House of Lords.

<sup>68</sup> Contributory Negligence as a Defence in Contract (Law Com No 219, 1993), para 3.13.

<sup>69</sup> 1999 Report, paras 4.6 to 4.12.

<sup>70</sup> Civil Liability Act 1961, ss 34 to 42.

category (1) cases (where there was no duty of care) would amount to the court rewriting parties' contracts and that parties were best placed to allocate risk. The Faculty accepted that the difference between *Vesta* category (2) and (3) cases was driven by the wording of the 1945 Act and that, free from the constraints of the Act, there might be room for extending the concept to category (2) cases. However, it favoured that result being achieved as a matter of construction of individual contracts rather than as a rule of law. Taking all of this into account, we think that the Faculty's position most closely approximates to option 1 (no positive recommendation for reform).

10.46 In the light of the support from a majority of consultees for our proposed approach of introducing contributory negligence of the creditor as a means of limiting all contractual claims for damages, we see no reason to depart in general terms from the recommendation made in the 1999 Report. We do not see that it involves re-writing contracts (especially if, as we recommend below, parties are free to exclude the defence in their contract). Rather it is about remedies and defences in actions of damages for breach. Neither do we see how the option 2 result could be achieved by way of construction of particular contracts. Further, the present law's dependence on the nature of the breach before the creditor's contribution to its own loss can be taken into account also leads to strange anomalies. The debtor must argue that the breach constituted negligence while the creditor must claim that it did not. In the words of one commentator quoted in the 2017 DP:

“it brings the law into disrepute if [defenders] are left to argue that they were negligent, whilst [pursuers] deny this.”<sup>71</sup>

10.47 The issue to be addressed is at bottom one of loss with concurrent causes. The debtor's breach must cause loss to the creditor before the latter can recover damages; but the breach need not be the only cause for the debtor to be liable for the loss (so long as it is a “but for” cause).<sup>72</sup> The creditor's conduct may be a separate but concurrent cause of the loss.

10.48 Given however that the law of contributory negligence is based on considerations of fairness between the parties, a further question beyond causation is the nature of the creditor's conduct. It has never been necessary for contributory negligence to be conduct which, had it caused loss to a third party rather than the creditor, would have given rise to liability of the creditor to that third party in law.<sup>73</sup> The well-established test under the 1945 Act

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<sup>71</sup> R Stevens, “Should Contributory Fault be Analogue or Digital?” in A Dyson, J Goudkamp and F Wilmot-Smith (eds) *Defences in Tort* (2015), p 247; found quoted in J O'Sullivan, “Contributory Negligence and Strict Contractual Obligations Revisited”, in A Dyson, J Goudkamp and F Wilmot-Smith (eds) *Defences in Contract* (2017), p 237 (also arguing that permitting contributory negligence defences in cases of breach of strict contractual obligations “is to be preferred”). Goudkamp, “Contributory Negligence Doctrine”, 224, argues that this criticism is over-stated. The general recognition of the defence continues to be advocated in *McGregor on Damages*, para 7.015.

<sup>72</sup> See eg *A/B Karlshamns Oljefabriker v Monarch Steamship Co Ltd* 1949 SC (HL) 1; and further McBryde, *Contract*, paras 22.16 to 22.25; *McGregor on Damages*, para 7.009 (“fault not causally contributing to the damage cannot be taken into account in the first place”).

<sup>73</sup> It has been said in the House of Lords that the definition of “fault” in section 4 (and by implication in section 5) must be divided into two parts: the first (“negligence, breach of statutory duty or other act or omission which gives rise to a liability in tort”/“wrongful act, breach of statutory duty or negligent act or omission which gives rise to liability in damages”) relating to the defendant's conduct; the second (“or would, apart from this Act, give rise to the defence of contributory negligence”/“or would apart from this Act, give rise to the defence of contributory negligence”) to the claimant's. See *Reeves v Commissioner of Police of the Metropolis* [2000] 1 AC 360, 382D to

is rather one of the relative blameworthiness of the parties. As is explained in *McGregor on Damages*, “that blame is the basis [for apportionment] is shown primarily by the use of the word ‘responsibility’ in s.1(1) [of the 1945 Act], and also by the use there of the term ‘just and equitable’”.<sup>74</sup>

10.49 The draft Bill that accompanied the 1999 Report provided that where loss or harm is caused to a contracting party (a) partly by breach of the contract by another party to it and (b) partly by an act or omission of the first contracting party, the damages recoverable in respect of the breach may be reduced proportionately to the extent that the loss or harm was caused by that act or omission.

10.50 The Bill also provided that in considering whether to reduce damages under its provisions a court was to have regard to the whole circumstances of the case, including the conduct of both or all persons concerned. This was intended to prevent an entirely mechanistic causal approach and to allow account to be taken of the nature of each party’s conduct, in line with the approach under the 1945 Act. Accidental or blameless conduct by the creditor should not have the effect of reducing its damages for the other party’s breach of contract. Rather, to be relevant the creditor’s conduct would have to be unreasonable, foolish or blameworthy.<sup>75</sup> But it was not necessary that the creditor’s conduct be such as to give rise to civil liability had it caused loss to some other person than the creditor itself (for example, as a delict or breach of contract).

10.51 We have decided to recommend proceeding by way of addition to the 1945 Act making clear that the defence of contributory negligence under the Act applies to all claims of damages for breach of contract. We think this best achieved by making the definition of “fault” in section 5 of the 1945 Act subject to a new provision, which has the effect of extending the definition to include “breach of contract”. This approach has the benefit of leaving in place all the other relevant jurisprudence under the 1945 Act as well as making clear the intent not to open up a completely new kind of defence for breach of contract separate and distinct from contributory negligence as it has been previously understood. Thus the defence will arise under section 1(1) of the 1945 Act where the pursuer in a claim of damages for breach of contract suffers loss partly through its own fault (which may or may not be a breach of contract or other legal wrong), and partly through the breach of contract by the other party. The damages recoverable in respect of the breach will be reduced to the extent the court considers just and equitable having regard to the pursuer’s share in the responsibility for the loss. It is also necessary to make the new definition applicable to section 1(2), (5), and (6) of the 1945 Act (each of which refers to fault and applies in cases where section 1(1) applies), and we so recommend below.<sup>76</sup>

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E (Lord Hope of Craighead); *Standard Chartered Bank v Pakistan National Shipping Corporation* [2002] UKHL 43, [2003] 1 AC 959, para 11 (Lord Hoffmann).

<sup>74</sup> *McGregor on Damages*, para 7.009. See also *SME, Obligations*, paras 409, 929; *Gloag and Henderson*, para 25.36; J M Thomson (ed), *Delict* (2007, with updates), paras 8.14, 8.17 (B J Rodger). For England and Wales see *Charlesworth and Percy on Negligence* (13<sup>th</sup> edn, 2017), chapter 4.

<sup>75</sup> 1999 Report, para 4.10. See also Discussion Paper No 109 on Remedies for Breach of Contract (April 1999), paras 10.4 and 10.6.

<sup>76</sup> The subsections read as follows: “(2) Where damages are recoverable by virtue of the foregoing subsection subject to such reduction as is therein mentioned, the court shall find and record the total damages which would have been recoverable if the claimant had not been at fault. ... (5) Where, in any case to which subsection (1) of this section applies, one of the persons at fault avoids liability to any other such person or his personal

10.52 An example may assist in understanding what this entails. Suppose C purchases a new car from D (a reputable dealer), stipulating that the vehicle is to be supplied with winter tyres. It arrives without them, but C does not notice this. Shortly thereafter C has a catastrophic accident in the car due to losing traction on black ice. C's damages from D for breach of contract may be reduced by the omission to check that the right tyres had been fitted before driving that day, even though neither a breach of contract nor negligence by C (the tyres were roadworthy in normal conditions and there was no reason to suspect black ice). The question of by how much C's damages should be reduced would depend on the court's assessment of the relative weight of C's contribution to his own misfortune. There might be no reduction at all if the court decided that in all the circumstances C's behaviour was not unreasonable and that accordingly D should be fully liable. The negligence or otherwise of D's breach is irrelevant.<sup>77</sup>

10.53 The draft Bill of 1999 also provided for the application of its provision to contributory negligence by the intended beneficiary of a unilateral voluntary obligation. This appears to have been more for reasons of overall coherence than because any specific issue had been identified with unilateral voluntary obligations. We have certainly identified no such issue. Adding provision for it to the 1945 Act creates additional complexity without any obviously commensurate benefit. We have therefore decided not to follow that lead in the present recommendation.

10.54 We accordingly recommend:

- 34. The definition of "fault" in section 5 of the Law Reform (Contributory Negligence) Act 1945 should be extended so that the reference in section 1(1), (2), (5) and (6) of the Act to the fault of either party includes a reference to a breach of contract by either party.**

(Draft Bill, section 22)

10.55 The other recommendations which we make in this Chapter will, if implemented, all be subject to the power of the parties to contract out.<sup>78</sup> It is not clear, however, whether it is possible to contract out of the application of the 1945 Act. Long ago Glanville Williams said of the common law position that "[i]t need hardly be doubted that the defence of contributory negligence cannot be set up if it was the intention of the contract to exclude it."<sup>79</sup> He made no similar observation, however, about the position under the 1945 Act, and we have found no

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representative by pleading the Limitation Act, 1939, or any other enactment limiting the time within which proceedings may be taken, he shall not be entitled to recover any damages from that other person or representative by virtue of the said subsection. (6) Where any case to which subsection (1) of this section applies is tried with a jury, the jury shall determine the total damages which would have been recoverable if the claimant had not been at fault and the extent to which those damages are to be reduced."

<sup>77</sup> The creditor's conduct may of course amount to a wrong for which it is civilly liable to third parties injured as a result of its conduct. In the complex tort case of *Lambert v Lewis* [1982] AC 225, what was found in effect to be the vehicle owner's negligence in keeping check on his tow-hitch absolved the seller thereof from its liability to him for breach of the implied warranty of quality. A trailer had separated from the owner's vehicle thanks to the defective tow-hitch, leading to a crash with another vehicle whose occupants were all killed or seriously injured. The owner was found liable to the victims to the extent of 25%, the tow-hitch manufacturer being liable for the remaining 75%.

<sup>78</sup> See paras 9.3, 10.11 and 10.26 above, along with s 16(1) of our draft Bill.

<sup>79</sup> Glanville Williams, *Joint Torts*, p 222.

commentary or judicial decision on the point. But the proviso to section 1 of the 1945 Act is worth noting for its possible significance in this connection:

“Provided that—(a) this subsection shall not operate to defeat any defence arising under a contract; (b) where any contract or enactment providing for the limitation of liability is applicable to the claim, the amount of damages recoverable by the claimant by virtue of this subsection shall not exceed the maximum limit so applicable.”<sup>80</sup>

10.56 We have however decided to avoid any doubt and to make a recommendation in line with the general policy for the reforms proposed in this Chapter. The recommendation is to the effect that the new contributory negligence rule for breach of contract should be subject to contrary provision in parties’ contracts. We are of course in no position to make a recommendation going further to affect the whole operation of the 1945 Act in the law of delict as well as in breach of contract. It may be that in the interval between publication of this Report and implementation of its recommendations the general position under the 1945 Act will be made clearer by judicial or juristic exegesis. Meantime, however, we recommend:

**35. The new contributory negligence rule for breach of contract should be subject to contrary provision in parties’ contracts.**

(Draft Bill, section 16(2))

*Exclusion of any remedy for party causing other party’s non-performance*

10.57 We noted in the 2017 DP that in addition to its rule on the reduction of damages as a result of the creditor’s contribution to its own loss, the DCFR also contains a general rule that a party may not exercise any of the remedies for non-performance to the extent that it caused the other party’s non-performance.<sup>81</sup> The commentary indicates that the rule is based on considerations of good faith and fair dealing, it being contrary to those principles for the creditor to have a remedy for non-performance for which it is responsible.<sup>82</sup> In the 2017 DP, we commented on the fact that the rule was one of broad application, particularly as the creditor did not have to be at fault or intend to cause the non-performance. We also observed that it might act as a total or a partial bar on the exercise of remedies, depending on the extent to which the creditor’s conduct had caused the non-performance.<sup>83</sup> The DCFR here separates out the issue of conduct on behalf of the creditor that contributes to the breach from that already considered, namely the extent to which the creditor’s conduct contributes to its loss from the breach.

10.58 This general DCFR rule has no precise parallel in the modern Scots law of contract. A number of other rules do however give rise to similar effects in restricting a party’s right to a remedy in response to breach on the other side.<sup>84</sup> In the light of the apparent consistency

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<sup>80</sup> Glanville Williams, *Joint Torts*, p 332, comments of the proviso to s 1 of the 1945 Act: “The general apportionment rule ... is subject to a precautionary proviso which declares that it does not defeat any defence arising under a contract (eg a contractual consent to run the risk of harm), and that the damages awarded must not exceed any maximum fixed by contract or enactment (e.g a maximum sum fixed in a workman’s railway ticket, or the maximum provided in [various statutes] ...).” Note also Glanville Williams’ observation on s 1(1)(b), cited at n 45 above.

<sup>81</sup> DCFR III.–3:101(3).

<sup>82</sup> DCFR III.–3:101 Commentary A.

<sup>83</sup> See the 2017 DP, para 10.4.

<sup>84</sup> 2017 DP, paras 10.39 to 10.41.

of Scots law with the DCFR principle, we asked consultees whether it should be incorporated into Scots law if a general statutory restatement were pursued.<sup>85</sup> Consultees (including those opposed to having a restatement at all) agreed that any restatement should provide that a party may not exercise any of the remedies for non-performance to the extent that it caused the other party's non-performance. The Faculty of Advocates did observe that it did not consider the circumstances envisaged in our question would amount to a breach of contract entitling the other party to exercise remedies for non-performance, but otherwise had no particular difficulty with the proposal. The Law Society of Scotland was also in favour, but thought that non-performance remedies and obligations of indemnity should be clearly distinguished (with the latter unaffected by the general rule).

10.59 For the reasons given in Chapter 9,<sup>86</sup> we are not recommending a restatement of the law of remedies for breach of contract. In the light of that decision, and also recognising that present Scots law probably already gives effect to the principle articulated in the DCFR, we have also decided not to make any recommendation for a generally stated rule that a party may not exercise any of the remedies for non-performance to the extent that it caused the other party's non-performance.

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<sup>85</sup> 2017 DP para 10.42 and question 70.

<sup>86</sup> See paras 9.9 to 9.12 above.

# Chapter 11 Retention and withholding performance

## Introduction

11.1 Retention is one of the remedies (sometimes characterised as defensive or self-help remedies) that may be exercised without first raising a court action. These may be contrasted with judicial remedies where the intervention of the courts is necessary for their exercise. The DCFR recognises a similar remedy which it terms “withholding performance”.

## Comparison of the DCFR and Scots law

### *Reciprocal obligations and the concept of mutuality*

11.2 The 2017 DP compared the DCFR concept of reciprocal obligations with the Scots law concept of mutuality. The DCFR regards the existence of reciprocal obligations in a contract as a factor of significance in the availability of withholding performance as a remedy for non-performance. It states that an obligation is reciprocal in relation to another obligation if:

- “(a) performance of the obligation is due in exchange for performance of the other obligation;
- (b) it is an obligation to facilitate or accept performance of the other obligation; or
- (c) it is so clearly connected to the other obligation or its subject matter that performance of the one can reasonably be regarded as dependent on performance of the other.”<sup>1</sup>

11.3 This concept can be compared with Scots law’s broader concept of mutuality of contract,<sup>2</sup> which plays an important role in relation to retention. Where both parties have rights and duties under the contract, these rights and duties are interdependent or reciprocal and the enforceability of one party’s rights is conditional upon the same party performing its own duties. This underpins the retention remedy: if one party does not perform, the other need not perform, ie it can retain or withhold its own performance.

11.4 As the 2017 DP noted, before these effects of mutuality come into play, it must be shown that the obligations in question are indeed interdependent or “the causes of one another”<sup>3</sup> and the test to be applied in resolving this question has been the subject of debate for many years. In the most authoritative recent decision, *Inveresk plc v Tullis Russell Papermakers Ltd*,<sup>4</sup> there is said to be a presumption that a contract is to be regarded as a

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<sup>1</sup> DCFR III – 1.102(4).

<sup>2</sup> This is sometimes described as the interdependence or unity of contract.

<sup>3</sup> See McBryde, *Contract*, paras 20.53 to 20.56, quoting Erskine, *Institute* III, 3, 86.

<sup>4</sup> [2010] UKSC 19; 2010 SC (UKSC) 106, para 42 (per Lord Hope of Craighead).

whole and that all the stipulations on either side are interdependent for the purposes of mutuality.

11.5 Other decisions have however expressed a different approach. In *Bank of East Asia v Scottish Enterprise*,<sup>5</sup> for example, it was held necessary to analyse whether or not the withheld performance was directly reciprocal (or “contemporaneous”) to the specific obligation breached by the other party. This meant that payment due for a particular phase of work in a major construction contract could only be withheld for breaches in that phase and not for others in the next one. The Lord President (Rodger) also adopted that approach in *Macari v Celtic Football and Athletic Co Ltd*,<sup>6</sup> where he stated that:

“the law does not regard each and every obligation by one party as being necessarily and invariably the counterpart of every obligation by the other.”<sup>7</sup>

So the court held that a football club manager’s duty to obey his employer’s lawful instructions as to where to live was not counterpart to the employer’s duty of trust and confidence, especially when the manager was otherwise carrying out his duties and drawing his salary.

11.6 In the 2017 DP, we noted that none of these views is necessarily irreconcilable, as arguably *Macari* and *Bank of East Asia* are simply exceptions to the general rule stated in *Inveresk*. Difficulty has, however, arisen from the lack of certainty as to whether the general rule or the exception applies from contract to contract and case to case.

11.7 A new approach to the determination of interdependence was suggested, however, by Lord Drummond Young in 2013 in *McNeill v Aberdeen City Council (No 2)*.<sup>8</sup> He avoided any reference to presumptions and spoke instead of withholding or temporary non-performance of the “substantive obligations under the contract” pending performance of its obligations by the other party:

“By the expression ‘substantive’ obligations, I mean the fundamental obligations that define what the contract is intended to achieve; in a contract of sale of goods these would be the supply of goods and the payment of the price, and in a contract of employment they are the performance of services by the employee and the provision of work and the payment of salary or wages by the employer.”<sup>9</sup>

11.8 The significance of this approach is that not every obligation on a party in a contract is counterpart to the other party’s obligations. The difficulty it involves may be the need to work out what the substantive obligations of any given contract are which is not a straightforward task for a non-lawyer. Therefore it is probably not a suitable test to apply in the context of remedies meant to be available to contracting parties on a self-help basis without the assistance of a court.

11.9 As such, it appeared to us that there is some significant uncertainty in Scots law about the meaning and scope of mutuality. We suggested in the 2017 DP that there were

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<sup>5</sup> 1997 SLT 1213.

<sup>6</sup> 1999 SC 628.

<sup>7</sup> 1999 SC 628 at 640.

<sup>8</sup> 2014 SC 335.

<sup>9</sup> 2014 SC 335 at para 27.

three possible options: acceptance of the traditional approach, as most recently set out in *Inveresk* (a presumption of general interdependence capable of being displaced in particular cases); moving to Lord Drummond Young’s “substantive obligations” test, as set out in *McNeill*; or departing from the principle of mutuality entirely and replacing it with the DCFR equivalent of reciprocal obligations. We therefore asked consultees whether in view of the present uncertainty about the meaning and scope of mutuality in the law on breach of contract, they considered that adoption of the DCFR’s formulation of its equivalent concept of reciprocal obligations would provide a useful and workable clarification of the position. We also asked if there were other approaches canvassed in recent judicial decisions which they preferred.

11.10 In the present law, mutuality typically applies within the confines of a single contract. There is an important contrast with compensation (or “set-off”) where liquid claims (that is, ones fixed in amount and presently payable, as distinct from illiquid ones not yet quantified or due) may extinguish each other even if they arise from different contracts or other obligations.<sup>10</sup> But the Supreme Court in *Inveresk* affirmed that mutuality justifying retention may arise where two or more contracts form part of a single transaction between the parties, with the obligations in each being interrelated as a result.<sup>11</sup> This is clearly wider than anything envisaged under the DCFR concept of reciprocity, and it blurs the distinction between mutuality and compensation. The 2017 DP therefore asked consultees, if mutuality is redefined, whether it should nonetheless remain capable of stretching across more than one contract, the inter-relationship of which arises from their both being part of a single transaction between the parties.

#### *Retention and withholding performance*

11.11 The DCFR provides two model rules about withholding performance, depending on whether the obligations are to be performed simultaneously or sequentially. In the first situation, neither has to perform until the other party has tendered performance, much as in the Scots law of mutuality.<sup>12</sup> In the second situation, the party who is to perform first may withhold performance if it reasonably believes that the other party will not perform when the latter’s performance falls due. That right is lost if the other party gives an adequate assurance of performance.<sup>13</sup>

11.12 In *McNeill*, Lord Drummond Young observed that retention is “a right to withhold performance of substantive obligations under the contract pending performance by the other party of its obligations.”<sup>14</sup> In his view the right went no further, and he added that “the principle of retention cannot generally be invoked in respect of a breach of contract that has occurred in the past and is unlikely to be repeated.”<sup>15</sup> Thus, if retention is security for counter-performance, the claims must be outstanding at the time the debtor’s performance is due. But it has been argued on the basis of the *Inveresk* case that retention is not so limited, and that retention can be used as a defence to an action for performance, by which a party in breach may secure the performance due to it or damages for continued non-performance

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<sup>10</sup> See McBryde, *Contract*, para 20.62 to 20.65.

<sup>11</sup> 2010 SC (UKSC) 106 at paras 34 to 38 per Lord Hope of Craighead.

<sup>12</sup> DCFR III.-3:401(1).

<sup>13</sup> DCFR III.-3:401(2).

<sup>14</sup> 2014 SC 335 at para 28.

<sup>15</sup> 2014 SC 335 at para 29.

by the other party.<sup>16</sup> In *Inveresk*, for example, the creditor was held able to retain payment of a sum due to the debtor pending the outcome of a separate damages action for breach of contract which the creditor had already raised against the debtor.

11.13 Finally, in Scots law the claim retained need not be liquid, nor for money. In this respect, therefore, Scots law appears to be wider than the DCFR, under which the respective performances must be due for one party to withhold, or the party withholding must reasonably anticipate the other party's non-performance when it falls due.

#### Controls on use of the remedies

11.14 In the 2017 DP, we pointed out that the DCFR does not require that non-performance be in some sense material or fundamental before performance may be withheld.<sup>17</sup> For Scots law, it has been said that the breach giving rise to a right to retain must be material in the same way that it is for rescission.<sup>18</sup> But we noted in the 2017 DP that this has been doubted by a number of writers, including Gloag and McBryde, on the basis that merely withholding or suspending performance is a very different thing from terminating the contract altogether.<sup>19</sup> While a breach ought indeed to be very serious in order to justify the creditor in releasing itself and the debtor from future performance of the contract by rescinding, merely suspending performance with the intent of pressing the debtor to perform does not seem to call for quite the same level of breach. Indeed, that might render the remedy much less useful than it would otherwise be.

11.15 The 2017 DP noted that the concern about possible abuse of a right to withhold performance<sup>20</sup> is probably met in the DCFR by the concept of good faith and fair dealing in deploying a remedy for non-performance.<sup>21</sup> In Scots law there is a relatively undeveloped notion that retention is subject to the equitable control of the court. It seems to be for the party against whom retention is being exercised to show that the remedy is being used inequitably. In *McNeill*, Lord Drummond Young stressed the court's equitable power to prevent retention becoming an "instrument of abuse",<sup>22</sup> which might occur when it was used otherwise than to secure future performance by the debtor. But this does not imply that the performance withheld should bear a close relationship in value to the non-performance on the other side, or to the adverse effects actually suffered by the creditor as a result of the non-performance.<sup>23</sup>

11.16 In the 2017 DP it was suggested that some additional light might be thrown on the equitable control of retention by the equitable control of the closely parallel right of lien.<sup>24</sup> We suggested that it may be possible to apply the thinking seen in the lien cases to other cases of retention, and cease to apply a test of materiality of breach as a way of controlling unfair

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<sup>16</sup> L Richardson, "Set-off – a concept divided by a common language?" [2017] LMCLQ 238; Gloag, *Contract*, pp 623 to 624, 626 to 627.

<sup>17</sup> DCFR III.–3:401 Commentary B.

<sup>18</sup> MacQueen and Thomson, *Contract*, para 5.21.

<sup>19</sup> Gloag, *Contract*, p 623; McBryde, *Contract*, paras 20.60, 20.88.

<sup>20</sup> For example, where the debtor's non-performance is trivial, but the performance withheld by the creditor is significant.

<sup>21</sup> See the 2017 DP, paras 11.14 to 11.22. It is also possible that some Continental systems might deal with the issue by way of the concept of abuse of right.

<sup>22</sup> 2014 SC 335 at para 30.

<sup>23</sup> MacQueen and Thomson, *Contract*, para 5.21.

<sup>24</sup> See 2017 DP paras 2.32 to 2.34 for detailed discussion.

and oppressive use of the remedy. We pointed out that the lien approach has the attraction of enabling a balance to be held between the interests of the respective parties.

*“Special retention” and set-off*

11.17 The 2017 DP noted that a point upon which practitioners were pressing for clarification is the interaction between the law of retention and the law of compensation (sometimes described as “set-off”). Their concerns flow in particular from the decision in the *Inveresk* case.<sup>25</sup> The judgment of Lord Rodger of Earlsferry in that case showed in detail that in Scotland the court has an equitable power to allow a party to retain a liquid debt on the basis of an illiquid claim that will shortly become liquid in order for set-off—or, in the traditional language of Scots law, compensation—to extinguish the two debts to the amount of whichever is the lesser. The rule is found but not elaborated to the same extent in a number of modern works.<sup>26</sup> It tempers the strictness of the rules under the Compensation Act 1592, by which extinctive compensation takes place only between two liquid claims (not necessarily arising from the same source of obligation). The classic example of an illiquid claim is an action of damages for breach of contract, the claim becoming liquid upon the court’s decree quantifying the amount to be paid.

11.18 The rule expounded by Lord Rodger has been dubbed “special retention”, to contrast it with the “mutuality retention” just discussed.<sup>27</sup> We adopted that terminology in the 2017 DP. The essential point is that while the withholding or suspension of performance in mutuality retention tends to look to the eventual performance of the contract (or a substitute therefor), special retention is a step on the road to the extinction of its obligations by compensation.<sup>28</sup> *Inveresk*, in which the retaining creditor’s damages action against the debtor was well under way, may have been a case where the latter concept should have been applied, rather than extending the principle of mutuality across two different contracts.<sup>29</sup>

11.19 We concluded in the 2017 DP that there is no doubt as to the existence of special retention in Scots law. There can also be no doubt that its existence is supported by the relevant provisions of the DCFR, which we examined in detail. But we note that in the DCFR the relevant rules are classified as part of set-off, dissociated from the law of remedies on breach of contract. Similar rules operate in the major Continental legal systems.<sup>30</sup>

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<sup>25</sup> *Inveresk plc v Tullis Russell Papermakers Ltd* 2010 SC (UKSC) 106. The key passage in Lord Rodger’s judgment is found at paras 57 to 107. It is technically *obiter*.

<sup>26</sup> See eg Gloag, *Contract*, p 646; *Gloag and Henderson*, paras 3.31, 10.15; Wilson, *Debt*, para 13.5; McBryde, *Contract*, paras 25.46, 25.57 to 25.58.

<sup>27</sup> L Richardson, “Examining ‘Equitable’ Retention” (2016) 20 Edin LR 18.

<sup>28</sup> See McBryde, *Contract*, para 20.64. Richardson, “Set-off”, further argues that “mutuality retention” can function in Scots law in the same way as “equitable set-off” in English law: that is, it can be applied by a creditor in respect of a breach that has already occurred in the past and for which the debtor is liable either to cure or to pay damages. Compensation, on the other hand, functions in much the same way as “independent set-off” in English law. In our Advisory Group Ms Richardson indicated that she had not identified an equivalent to special retention in the English law of set-off. Equitable set-off requires a close connection between the claims, where special retention does not. A stay of execution under CPR 87.3(4) may be the nearest equivalent.

<sup>29</sup> See para 11.10 above. As pointed out in our Advisory Group, however, special retention is not available as of right, unlike mutuality retention. Instead, the defender in *Inveresk* would have to show the equity of allowing retention, without having any exhaustive list of factors going to the equities to which to refer.

<sup>30</sup> See the national notes to DCFR III.–6:103. See also R Zimmermann, *Comparative Foundations of a European Law of Set-Off and Prescription* (2002 (2010 reprint)) pp 51 to 56; P Pichonnaz and L Gullifer, *Set-off in Arbitration and Commercial Transactions* (2014).

11.20 It is not part of the present law reform exercise to propose legislation on set-off in Scots law, desirable though it may be to update a statute passed over 400 years ago. It is however useful to make clear here that special retention is not based on mutuality of contract. The respective claims may be unconnected in the sense of not being reciprocal or interdependent or, indeed, because they arise from distinct sources of obligation. The court's allowing special retention is based upon it being equitable to do so in all the circumstances, whereas mutuality retention is a generally available right which may be prevented on equitable grounds (but rarely seems to be so). Further, while special retention allows a party to withhold its liquid performance where the other party has not performed another illiquid obligation between them, it is not compensation, in that it does not give rise directly to the extinction of obligations.

### **Summary of consultation responses**

11.21 A majority of consultees were against replacing the term "retention", largely because they were against pursuing a general statutory restatement of the law of remedies. However most consultees preferred the term "suspension" as opposed to the term "withholding" if such a change was to be pursued.

11.22 The Senators of the College of Justice agreed that there was a need to update the terminology in this area of law and Burness Paull commented that they were generally in favour of user-friendly and accessible definitions of the terms which are regularly used in this area of the law. Pinsent Masons and the Faculty of Advocates acknowledged that there was some scope for confusion on the law relating to retention and withholding performance but they did not consider that renaming the concepts would increase clarity. The Law Society of Scotland and Morton Fraser did not consider the language of "retention" to have given rise to practical difficulties that necessitated reform.

11.23 A majority of the consultees were also against adopting the DCFR's formulation of its equivalent concept of reciprocal obligations in order to clarify the meaning and scope of mutuality. Views were also split as to whether alternative approaches as canvassed in the recent judicial decisions of *Inveresk* and *McNeill* were preferable.

11.24 The Law Society of Scotland was uncertain whether the DCFR's formulation should be adopted, although they did agree that it presents a workable approach which could replace the current uncertainty if a statutory restatement was pursued. However the Faculty of Advocates and Pinsent Masons did not think that the formulation would make the meaning and scope of mutuality any clearer than it is already.

11.25 The Faculty considered *McNeill* to have been decided in the particular context of employment law and did not think that it introduces doubt on the nature of the general concept of mutuality. The Senators of the College of Justice were against adopting the DCFR's concept of reciprocal obligations and preferred the approach in *McNeill*.

11.26 Those who responded on the point were unanimous that mutuality should remain capable of stretching across more than one contract. The Law Society commented that it was quite common for contracts to exist within a "framework" and that mutuality should be regarded as

“arising in relation to obligations that are inter-related, regardless of whether that is documented in a single contract or multiple contracts.”

11.27 Consultees gave mixed responses on whether or not the debtor’s non-performance had to be material before the creditor can exercise the remedy of retention or withholding performance. However a majority of the consultees who responded agreed that the courts should have a power to deal with abusive or oppressive use of the remedy.

11.28 Some consultees agreed that the debtor’s non-performance must be material before the creditor can exercise the remedy of retention or withholding performance. However Mr Christie expressed doubt as to whether the term “materiality” made the law any clearer. Similarly the Law Society were concerned with the potential for confusion if the language of “materiality” was retained. The Faculty of Advocates also thought that the term “material” was ambiguous and its use could make the law more uncertain.

11.29 Pinsent Masons disagreed with the proposition that the courts should have power to deal with abusive or oppressive use of the remedy of retention, commenting that the law of contract “is not in principle concerned with fairness but starts from a proposition of freedom to contract”. They were concerned that such a provision interfered with that freedom in an unacceptable way, creating uncertainty.

11.30 A majority of consultees agreed that any legislation on mutuality and retention should provide for its non-application to special retention. Pinsent Masons argued, however, that the law in relation to special retention can cause difficulties, and did not see the logic in excluding it from this exercise, particularly given that practitioners have specifically identified it as being ripe for clarification.

## **Conclusions**

11.31 We indicated in the 2017 DP our belief that the remedy of retention is generally functioning reasonably well and that clarification of certain issues was required more than reform.<sup>31</sup> The consultation response may have shown that this view is reasonably widely shared, although the extent of clarification required is not. Some clarification may indeed be provided by the analysis which we offered in the 2017 DP and have reiterated in this Chapter.

11.32 Given our decision not to recommend a general statutory restatement of the law of remedies for breach of contract, we have thought it best to leave further clarification of the law of mutuality and retention to the courts and to practitioners. Accordingly we make no other recommendation for legislative reform on these matters.

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<sup>31</sup> 2017 DP, para 2.29.

# Chapter 12 Anticipatory or anticipated breach

## Introduction

12.1 In Chapter 3 of the 2017 DP, we considered the concept of anticipatory breach; examined the unimplemented recommendation in our 1999 Report that the rule which allows a party unreasonably to proceed with unwanted performance and claim payment for it should be reformed; and developments in Scots law since then. The Chapter then discussed whether the law in this area ought to be reformed.

12.2 Chapter 3 began with a brief discussion of potential terminological issues in this area. Anticipatory breach is the concept that a contracting party may be entitled to exercise breach remedies in anticipation of a breach by the other party which, although threatened, has not yet occurred.<sup>1</sup>

12.3 This concept is most commonly encountered where a party repudiates a contract or contractual obligation by indicating that when the time comes it will not perform. This gives the other party an option (which, however, it need not exercise) to accept this, terminate the contract and claim damages immediately without waiting for the date when performance would have been due. In effect the repudiation, once accepted, is treated as if it were an actual breach.

12.4 Although there are some conceptual difficulties in the notion of anticipatory breach, the power of a creditor to take measures before a breach occurs clearly serves a number of useful purposes, particularly in the commercial world.<sup>2</sup> There is no general requirement that a decision to affirm the contract rather than accept a repudiation be reasonable. In *White & Carter v McGregor*<sup>3</sup> a contract to place advertisements of the business of a Clydebank garage was repudiated by the customer but the advertising company affirmed the contract, placed the unwanted advertisements and sued for payment. The House of Lords held<sup>4</sup> that, despite the unwanted and wasteful nature of the performance, the creditor was entitled to be paid. The aim of the recommendation in the 1999 Report was primarily to moderate the rigour of this decision.

## Terminology

### *Anticipated breach*

12.5 In Chapter 3 of the 2017 DP, we used the term “anticipated breach” rather than “anticipatory breach” to describe conduct by a debtor that will justify the creditor in beginning to exercise its breach remedies even though the time for the debtor’s performance has not yet arrived. We thought that it was more accurate to characterise the situation as one of

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<sup>1</sup> Like the ULIS (arts 48, 75) and the CISG (art 72).

<sup>2</sup> For a full discussion see Liu, *Anticipatory Breach*. Note also McBryde, *Contract*, para 20.23.

<sup>3</sup> 1962 SC (HL) 1.

<sup>4</sup> By a majority of three to two.

anticipated breach, rather than one of anticipatory breach. The Oxford English Dictionary defines the two adjectives as follows:

anticipatory, *adj.*

Of or pertaining to an anticipator; of the nature of anticipation.

anticipated, *adj.*

1. Taken or occurring in advance or beforehand.
2. Used beforehand, as money.
3. Apprehended beforehand, looked for, expected.

12.6 The 2017 DP suggested that the definition of “anticipatory” is not particularly helpful, noting that at best it might be taken to signify a breach which has been anticipated, but if so it might be simpler just to use “anticipated”. It was our view that it is the third sense of “anticipated” which most accurately describes the situation: the creditor apprehends that the debtor will be in breach when the time for performance comes, and it is this that justifies the exercise of the creditor’s remedies for breach.

#### *Repudiation*

12.7 The 2017 DP also discussed the term “repudiation”, noting that its use in Scots law is apt to cause confusion. It is sometimes used to describe anticipated breach, but a party actually in material breach can be said to have repudiated the contract too.<sup>5</sup> The requirements and timing of anticipated breach and material breach are different and so are the options available to the innocent party when faced with either circumstance.<sup>6</sup>

#### *Repudiation in the sense of anticipated breach*

12.8 The 2017 DP noted the case of *Edinburgh Grain Ltd (in liquidation) v Marshall Food Group Ltd*,<sup>7</sup> in which Lord Hamilton said that repudiation of the contract could be shown by:

“conduct demonstrative of an intention not to perform fundamental contractual obligations as and when they fall due.”

He added:

“That intention may have its origin in a choice by the obligant not to fulfil his contract or in an inability on his part to do so.”<sup>8</sup>

If that view is correct, then “repudiation” becomes even less apt as a term of art with which to describe the trigger for remedies for anticipated breach.

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<sup>5</sup> McBryde, *Contract*, para 20.03.

<sup>6</sup> *Ibid.*

<sup>7</sup> 1999 SLT 15.

<sup>8</sup> 1999 SLT 15 at 22.

### *Repudiation in the sense of material breach*

12.9 In assessing whether the debtor's conduct constitutes a breach of contract, an unjustified refusal to perform when performance is due is likely to be seen as a "material" or "fundamental" or "substantial" breach justifying termination.<sup>9</sup> This is especially so where time is either expressly or impliedly of the essence.<sup>10</sup>

12.10 It is difficult to see what the adjective "repudiatory" adds to the exercise of determining whether the breach is sufficiently fundamental or material or substantial to justify termination. The present law on the termination remedy seems to be that the creditor must notify the debtor of its termination, and we suggested in the 2017 DP that this should continue to be the law.<sup>11</sup> If that is correct, it is difficult to see what, if anything, the requirement that a repudiation be accepted by the creditor can add to the law. "Repudiation" in this context would become a redundant piece of terminology, or at least not one with any technical connotations.

12.11 It is difficult to propose that a word be abolished as a legal term of art. We thought a better approach would simply be to make the concept of repudiation redundant through the changes that we suggested making to the law elsewhere in chapter 3 of the 2017 DP. Therefore we asked consultees whether they agreed that there should be a clear distinction between the concepts of anticipated breach and material breach and that applying the term "repudiation" to both of them is undesirable.

### **Comparison of the DCFR and Scots law**

12.12 The DCFR identifies three scenarios that may be characterised as "anticipated breach":

- anticipated breach of a monetary obligation;
- withholding performance where the creditor reasonably believes that the debtor will not perform when performance of a subsequent obligation falls due; and
- termination for anticipated non-performance of the debtor's obligation.

### *Anticipated breach of a monetary obligation*

12.13 The first scenario contemplated by the DCFR arises where the debtor is due to make a payment in return for the creditor's performance of a reciprocal obligation.<sup>12</sup> If the creditor has yet to perform its reciprocal obligation and it is clear that the debtor will be unwilling to receive the creditor's performance, the creditor is entitled to proceed with performance and may recover payment.

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<sup>9</sup> A refusal to perform may of course be justified as a retention based on breach by the other party.

<sup>10</sup> See 2017 DP, para 3.10 for further discussion.

<sup>11</sup> See 2017 DP, Questions 11 and 12.

<sup>12</sup> DCFR III.-3:301.

12.14 The DCFR is therefore broadly in accordance with the Scots law rule as set out in *White & Carter*, but the qualifications in the DCFR mean that the rigour of the decision is mitigated.

*Withholding performance in response to an anticipated breach*

12.15 The second scenario contemplated by the DCFR occurs where a creditor is to perform a reciprocal obligation *before* the debtor performs, and the creditor reasonably believes that there will be non-performance by the debtor when the debtor's performance becomes due. The creditor may withhold performance of the reciprocal obligation for as long as the reasonable belief continues.<sup>13</sup> The creditor must give the debtor notice as soon as reasonably practicable, and is liable for any loss caused to the debtor by a breach of this duty.<sup>14</sup> The right to withhold performance in this manner is lost if the debtor gives an adequate assurance of due performance.<sup>15</sup>

12.16 The 2017 DP noted that an important difference between the first and second scenario is whereas in the first it has to be clear that the debtor is unwilling to receive performance,<sup>16</sup> in the second the question is only one of the creditor's reasonable belief that the debtor will not perform.<sup>17</sup> In our 1999 Report we decided against a need to legislate for the second scenario in Scots law. This was on the basis that the courts were likely to recognise the possibility of anticipated breach in cases not necessarily involving outright express refusals of performance by the debtor. The 2017 DP discussed whether subsequent developments make reform of Scots law in this area desirable.

*Termination for anticipated non-performance*

12.17 The third scenario contemplated by the DCFR is that the creditor may terminate before performance of a non-monetary contractual obligation is due if the debtor has declared that there will be a non-performance of the obligation, or it is otherwise clear that there will be such a non-performance.<sup>18</sup> It is also a requirement that the non-performance would have been fundamental.

12.18 In effect, this is equivalent to the Scots law concept of termination after anticipatory repudiation of the contract by the debtor, but in the DCFR there is no need for the creditor to accept the repudiation before it can exercise its remedies.<sup>19</sup> The purpose of requiring acceptance in Scots law appears to be in making it clear that the creditor has terminated the contract and wishes to exercise its other available remedies, rather than performing the contract itself or compelling the debtor's performance. However, in the DCFR approach to termination the creditor is required to notify the debtor of its actions.<sup>20</sup> This appears to us to

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<sup>13</sup> DCFR III.–3.401(1).

<sup>14</sup> DCFR III.–3.401(3). For "notice" generally see DCFR I.–1:109 and see III.–3:106 for notices relating to non-performance in particular.

<sup>15</sup> DCFR III.–3:401(2).

<sup>16</sup> As in *White & Carter* itself, where the debtor told the creditor unequivocally that he no longer wanted performance, stating: "Please cancel the contract."

<sup>17</sup> For example, because it acquires reliable information that the debtor is not performing other, similar contracts, or lacks the resources to do so.

<sup>18</sup> DCFR III.–3:504.

<sup>19</sup> For the present requirements of an acceptance of a repudiation see McBryde, *Contract*, para 20.33.

<sup>20</sup> See further para 13.15 below.

serve the same function as acceptance does in Scots law, and so it does not appear that present Scots law differs greatly from the DCFR in this scenario.

12.19 As a result, we did not think that any reform was required in relation to this aspect of the law on anticipated breach.

### **Potential reforms: anticipated breach of a monetary obligation**

#### *Basis for reform*

12.20 As already noted, *White & Carter* continues to be followed in Scots law.<sup>21</sup> This is despite trenchant criticism of the decision in England,<sup>22</sup> where it is the subject of two important qualifications. First, the creditor cannot compel the debtor to cooperate. As Lord Reid remarked in *White & Carter*:

“Of course, if it had been necessary for the debtor to do or accept anything before the contract could be completed by the creditors, the creditors could not and the court would not have compelled the debtor to act, the contract would not have been completed and the creditors' only remedy would have been damages.”<sup>23</sup>

The effect is that the creditor will be compelled to accept the breach if it cannot continue with performance without the cooperation of the debtor.<sup>24</sup> The relatively limited availability of the specific performance remedy in English law may be particularly significant here; but specific implement has a wider ambit in Scots law.<sup>25</sup> This may mean that co-operation could be enforced in at least some cases in Scotland where it would not be in England.

12.21 The second qualification of *White & Carter* is also derived from the speech of Lord Reid when he stated:

“It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. ... But if [the party] had no such interest then that might be regarded as a proper case for the exercise of the general equitable jurisdiction of the court.”<sup>26</sup>

12.22 Whilst Lord Reid's view was not expressly shared by the other members of the majority (Lords Tucker and Hodson), this reasoning has been utilised in subsequent cases as a means of limiting the *White & Carter* principle when it has appeared that full

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<sup>21</sup> *Salaried Staff London Loan Company Limited v Swears and Wells Limited* 1985 SC 189.

<sup>22</sup> See, for example, P M Nienaber, “The Effect of Anticipatory Repudiation: Principle and Policy” 1962 CLJ 213; Liu, *Anticipatory Breach*, pp 193 to 217; M P Furmston, *Cheshire, Fifoot and Furmston's Law of Contract* (16<sup>th</sup> edn, 2012), pp 782 to 783.

<sup>23</sup> 1962 SC (HL) 1 at 13.

<sup>24</sup> *Hounslow London Borough Council v Twickenham Garden Developments Ltd* [1971] Ch 233; *Attica Sea Carriers Corp v Ferrostaal Poseidon Bulk Reederei GmbH (The Puerto Buitrago)* [1976] 1 Lloyd's Rep 250; *Isabella Shipowner SA v Shagang Shipping Co Ltd* [2012] 2 All ER (Comm) 461, paras 37 to 41. But note that the decision of the majority in *Société Générale, London Branch v Geys* [2012] UKSC 63, [2013] 1 AC 523 is consistent with the decision in *White & Carter*. Lord Sumption's powerful dissent is, however, based in part on Lord Reid's co-operation qualification to the decision in *White & Carter* as well as the wrongfully dismissed employee's inability to obtain an order for specific performance against the employer.

<sup>25</sup> See the 2017 DP, para 6.18.

<sup>26</sup> 1962 SC (HL) 1 at 14.

performance of the contract is wasteful.<sup>27</sup> In England there appears to be judicial consensus that a commercial party always has a legitimate interest in performing the contract except in cases of absolute unreasonableness.<sup>28</sup>

12.23 *White & Carter* was followed in Scotland in *Salaried Staff London Loan Company v Swears and Wells Limited*,<sup>29</sup> where the Lord President (Emslie) appeared to accept as a relevant control mechanism the “legitimate interest” test articulated by Lord Reid.<sup>30</sup>

12.24 In the 1999 Report, we noted two competing principles and assumptions: the first, that contracts should be performed; the second, that one party should not be permitted, by wasteful or unreasonable conduct, to increase the burden on the other party.<sup>31</sup> There was disagreement amongst judges and commentators about which should prevail.<sup>32</sup> The uncertainty created by this divergence of opinion and lack of clarity regarding the extent of the rule was the basis for our previous recommendation that there should be legislation to the effect that a party to a contract who has been told that performance under the contract is no longer wanted but who, being in a position to give performance without the co-operation of the other party, has proceeded to perform, is not entitled to recover payment for performance occurring after intimation that further performance is unwanted if (a) that party could have entered into a reasonable substitute transaction without unreasonable effort or expense or (b) it was unreasonable for that party to proceed with that performance.<sup>33</sup>

#### *Subsequent developments in Scots law*

12.25 The leading case on anticipated breach in Scots law since 1999 is *AMA (New Town) Ltd v Law*.<sup>34</sup> In that case,<sup>35</sup> the purchasers had entered into missives to buy off-plan flats in a housing development being undertaken by AMA. The missives provided for a purchase price consisting of a deposit on reservation of the plot and a further deposit on conclusion of missives, with the balance payable at the date of entry. The missives provided a mechanism for determining the date of entry, and it was a matter of agreement that this clause triggered a date of entry at 23 September 2009. Entry and vacant possession were to be given and the keys released to the purchasers only on payment of the full purchase price (including any extras) and any interest due.

12.26 At the date of entry, payment in terms of the missives was not made and the purchasers’ agents advised AMA’s agents that their clients were not in a position to proceed. A formal demand for payment was made but no payment was forthcoming. In these

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<sup>27</sup> For a full (and critical) review of the English cases, see J O’Sullivan, “Repudiation: Keeping the Contract Alive”, in Virgo and Worthington, *Commercial Remedies*, ch 3.

<sup>28</sup> O’Sullivan, “Repudiation”, 53. See also J W Carter, “*White and Carter v McGregor* – How Unreasonable?” (2012) 128 LQR 490; N Andrews, “Breach of Contract: A Plea for Clarity and Discipline” (2018) 134 LQR 117, 122 to 124.

<sup>29</sup> 1985 SC 189.

<sup>30</sup> 1985 SC 189 at 194.

<sup>31</sup> 1999 DP, para 5.11.

<sup>32</sup> 1999 DP, para 5.11 fnn 21 and 22.

<sup>33</sup> 1999 Report, para 2.10 and recommendation 1.

<sup>34</sup> [2013] CSIH 61; 2013 SC 608; 2013 SLT 959.

<sup>35</sup> There were three appeals which were heard together. The defenders and respondents were respectively Mr Law, his wife and a company in which he had an interest. Mr Law’s case was treated as the primary case: see para 8.

circumstances, AMA sued for payment of the balance of the purchase price, averring (which was admitted) that it was ready and willing to implement its obligations under the missives.

12.27 On appeal to the Inner House, AMA was successful. An Extra Division held that the innocent party could accept the repudiation of the contract and seek damages, or refuse to accept it and seek implement—but the choice was that of the innocent party, and the party in default could not compel the innocent party to accept damages.<sup>36</sup> Lady Dorrian, giving the leading judgment, indicated that the creditor’s choice was not restricted except where circumstances rendered implement impossible or, in exceptional circumstances, wholly unjust.<sup>37</sup> Impossibility appears to encompass the notion of cooperation which is used to qualify the *White & Carter* principle in England.

12.28 As noted in the 2017 DP the meaning of cooperation is not free from controversy, although its practical significance is evident: the debtor can prevent a claim for the contract price by simply withholding its cooperation, at least so far as it cannot be enforced by way of specific implement. So long as the debtor’s cooperation is necessary for the creditor to perform in conformity with the terms of the contract, this is sufficient to prevent the creditor from affirming the contract and insisting upon performance.

12.29 In English law, the cooperation qualification has no application where the creditor’s continuing performance is not a condition precedent to the payment of the contract price. A similar approach is apparent in *AMA*. As Lady Dorrian observed, “[t]he terms of the contract are clear: payment was triggered by the date of entry and nothing else.”<sup>38</sup> While Scots law does not use the concept of conditions precedent (or subsequent), the obligation to pay the final instalment in *AMA* was read as an independent obligation for which the debtor’s cooperation was not required. The parties were contracting on builders’ missives. These do not accord with the usual practice in residential conveyancing<sup>39</sup> where the obligations would tend to be inter-dependent (ie to pay the price *in exchange for* a good and marketable title, a validly executed disposition and so on).<sup>40</sup> The direct significance of *AMA* may therefore be limited to contracts for the sale of new build properties, with inter-dependent obligations being more frequently encountered in practice elsewhere.<sup>41</sup>

12.30 We also concluded that *AMA* has adhered to the general *White & Carter* principle,<sup>42</sup> and that its main advance is in setting out more clearly the extent to which Lord Reid’s cooperation qualification has a role in Scots law. It thus goes some way to clarify the circumstances in which a decree for payment for unwanted performance may be refused.

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<sup>36</sup> 2013 SC 608, para 46 per Lady Dorrian. See also para 1 per Lord Menzies.

<sup>37</sup> 2013 SC 608, para 48.

<sup>38</sup> 2013 SC 608, para 47. See also the English case of *Ministry of Sound (Ireland) Ltd v World Online Ltd* [2003] EWHC 2178 (Ch), paras 33 and 45.

<sup>39</sup> 2013 SC 608 at para 50 per Lady Dorrian “Usual practice” was the basis for the support given to the sheriff principal’s decision in *AMA (New Town) Ltd v McKenna* 2011 SLT (Sh Ct) 73 by W W McBryde and G L Gretton, “Sale of Heritable Property and Failure to Pay” 2012 SLT (News) 17.

<sup>40</sup> See the Scottish Standard Clauses (Edition 2), clause 18.1, available at: <https://goo.gl/ZPAxtj>

<sup>41</sup> Although Professors Reid and Gretton had not had sight of the missives, they came to the conclusion that there was nothing to suggest that the missives were not in standard form. See K G C Reid and G L Gretton, *Conveyancing 2013* (2013), pp 124 to 131. However, we understand that the parties contracted using builders’ missives rather than the Combined Standard Clauses in force at the time.

<sup>42</sup> 2013 SC 608, paras 1 to 3 per Lord Menzies.

## Options for reform

12.31 The 2017 DP set out two possible options for reform in relation to the *White & Carter* rule. The first was to do nothing, allowing the decision in *AMA* as far as it develops the cooperation exception to bed in further. The courts would be left to develop the present law and possibly create further exceptions to the rule in favour of payment for unwanted performance. The 2017 DP noted however that a potential disadvantage of this option is that there would remain a great deal of uncertainty in the interim, and there is no guarantee that the issue will be raised in the near future.

12.32 Alternatively, we proposed reiteration of our 1999 recommendation on this matter.<sup>43</sup> This would have the effect of aligning Scots law with the DCFR on the point. We thought there to be merit in such an approach, and that the decision in *AMA* has not significantly altered the circumstances.

12.33 A number of other options were considered in the 2017 DP, including the restoration of the law to the position it was in before *White & Carter*,<sup>44</sup> the adoption of the American model (where the creditor may continue to perform, subject to a duty to mitigate loss)<sup>45</sup> or the conferral on the court of a general discretion to refuse to grant a decree for payment for unwanted performance where it believes this would be unreasonable. We concluded that, for the reasons we gave in relation to these options in the 1999 Report, they are not attractive.

12.34 In our 1999 Report, we considered it un-necessary to legislate for withholding performance in response to anticipated breach, on the basis that the courts would likely recognise such a possibility should it arise. We also noted however that we were not aware of any decision of the Scottish courts on a creditor withholding its own performance in response to anticipated breach. Given the continuing lack of such a decision in nearly 20 years since the 1999 Report was prepared, we concluded in the 2017 DP that legislative clarification could be useful. It would be possible not only to recognise that a creditor may withhold its performance in response to anticipated breach, but to enable a creditor to seek clarification of the debtor's position where the creditor has reasonable doubts about the debtor's intention to perform.

12.35 Enabling a creditor to act in the ways mentioned might also mean that the debtor can retract what might otherwise amount to anticipated breach. Termination will only be possible if the debtor fails to respond to a request for an assurance of performance. We therefore asked whether legislation should provide that a creditor may respond to indications of the

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<sup>43</sup> See para 12.24 above.

<sup>44</sup> 1999 DP, para 5.14.

<sup>45</sup> 1999 DP, para 5.15. For a comparative discussion of US law preferring the approach in *White & Carter* provided that the creditor must show a legitimate interest in not accepting the debtor's repudiation, see M P Gergen, "The Right to Perform after Repudiation and Recover the Contract Price in Anglo-American Law", in L A DiMatteo and M Hogg (eds), *Comparative Contract Law: British and American Perspectives* (2015) ch 16. David Campbell provides a response to Gergen's analysis, questioning the result in *White & Carter* itself on the basis of the 'legitimate interest' test (at pp 338 to 341). Note that O'Sullivan, "Repudiation: Keeping the Contract Alive", criticises the "legitimate interest" limitation, many of the decisions referring to it being justifiable, in her view, by a policy-based power of the courts to break stalemates and prevent perpetual obligations: "outside such a situation ... there is no justification for any restriction on the claimant's unfettered right, following a repudiation, to elect to keep the contract alive, perform and claim the price from the defendant" (p 74). Andrews, "Breach of Contract", 124, argues that *White & Carter* should no longer apply in cases of entirely executory contracts, ie ones where performance has not begun at the time of the other party's repudiation.

debtor's unwillingness or inability to perform its obligations as and when they fall due under the contract by either (a) notifying the debtor of its concerns and that it is going to withhold performance of its own obligations, while empowering the debtor to end the withholding by sending the creditor an adequate assurance that it will perform its obligation when the time comes; or (b) seeking an adequate assurance directly from the debtor, being thereby entitled to withhold its performance until such assurance is received, and becoming entitled to terminate the contract if one is not received within a reasonable time.

### **Summary of consultation responses**

12.36 A small majority of the consultees who responded were in favour of changing the terminology used to describe the situation in which a creditor may begin to exercise remedies for breach even although the time for the relevant performance by the debtor has not yet arrived, to "anticipated breach". There was also some but not majority support for making a distinction between the concepts of anticipated breach and material breach. Pinsent Masons thought there was already a clear distinction between the concepts and agreed with McBryde that it is better to use "anticipatory breach" or "material breach" as appropriate, as these terms are more precise than "repudiation". The latter should probably not be used as a term of art, given its meaning varies with the context. But the Faculty of Advocates, while agreeing the importance of distinguishing between the concepts of anticipated breach and material breach, did not agree that describing the consequences of both types of breach as "repudiation" was misleading.

12.37 A majority of consultees agreed that the law should provide that the creditor may terminate before performance of a contractual obligation is due if (a) the debtor has declared that there will be a non-performance of the obligation, or it is otherwise clear that there will be such non-performance; and (b) that non-performance would have been fundamental. However Pinsent Masons were concerned that introducing a concept of "fundamental" would create uncertainty.

12.38 There were mixed views in relation to the other questions. The Senators of the College of Justice and the Society of Solicitor Advocates agreed that the 1999 recommendation for reform should now be promoted. The Faculty of Advocates maintained that they did not see any issue with the law as it currently stands. The Law Society of Scotland acknowledged that the unmitigated application of the *White & Carter* principle could have absurd results but they did not think the scenario of a party pressing on with unwanted performance, regardless of the debtor being unwilling to receive that performance, commonly arises. They further commented that in practice:

"The principle forms a valuable part of an overall framework that encourages certainty regarding performance of contractual obligations and that the proposed reform tips the balance too far away from contractual certainty and risks encouraging non-performance."

They concluded that if reform was pursued, a higher threshold for intervention was required, approaching the matter from the perspective of the creditor's legitimate interest.

12.39 Dentons also considered the *White v Carter* principle to form

“a valuable backdrop in maintaining a position of certainty that contractual obligations will be enforced by the courts wherever possible to do so.”

This they considered attractive to commercial clients and as encouraging performance without recourse to court action. They also noted that the proposed reform was not likely to be workable in the arena of complex contracts where the procurement process is generally lengthy and complex, and significant effort and expense would likely be needed to secure a substitute transaction.

12.40 Several law firms argued that reform of the law was not necessary at this stage as well. The Law Society of Scotland did not think that reform of the law in this area was required by its lack of clarity, commenting that the current common law framework is described by Lady Dorrian in *AMA* in giving the leading judgment. It was therefore their view that the issue was whether reform was desirable in order to bring about change to the current common law framework.

12.41 There were also mixed views as to whether the law should provide that a creditor may respond to indications of the debtor’s unwillingness or inability to perform its obligations as and when they fall due under the contract by either: (a) notifying the debtor of its concerns and that it is going to withhold performance of its own obligations, while empowering the debtor to end the withholding by sending the creditor an adequate assurance that it will perform its obligation when the time comes; or (b) seeking an adequate assurance directly from the debtor, being thereby entitled to withhold its performance until such assurance is received, and becoming entitled to terminate the contract if one is not received within a reasonable time.

12.42 The Senators of the College of Justice were in favour because they considered that the lack of cases on this point in the last 20 years made it apt to be addressed by way of the proposed reforms. Morton Fraser were also in favour if a statutory restatement was pursued but had concerns about the language proposed, which they thought could undermine contractual uncertainty by permitting withholding of performance in response to very low-level activity. The Faculty did not agree with the proposal, commenting that they were not convinced that there was an issue with the current law, and that in fact the introduction of concepts such as “indications of the debtor’s unwillingness...to perform” could add unnecessary complexity and ambiguity to the law. Pinsent Masons also disagreed with the proposal, saying that making such provision would introduce unnecessary complexity and uncertainty.

12.43 Mr Christie commented that he thought the proposed reform could be a useful tool to attempt to maintain parties’ contract, since it allows a further step to be taken and “is less zero-sum than repudiation or termination”. He commented that of the options discussed in the 2017 DP, the first seemed closer to the ultimatum procedure discussed elsewhere in the 2017 DP,<sup>46</sup> in that it served to highlight the potential for further action but provided the debtor with an opportunity to perform “before there is a full stop to parties’ mutual performance”.

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<sup>46</sup> See paras 13.21 and 13.22 below, and also the 2017 DP, paras 4.24 to 4.26.

## Conclusions

12.44 There was a general consensus among consultees that the present law on anticipated breach served a useful purpose. There were however mixed views as to whether to reform the law to clarify the circumstances in which a decree for payment for unwanted performance may be refused as recommended in our 1999 Report, or whether reform should be left to see how the *AMA* decision developed. Only a slight majority of consultees were in favour of proceeding with reform. There were also mixed views as to whether the law should provide that a creditor may either give the debtor notice of retention until given an assurance of performance, or seek such an assurance, being entitled at least to retain until the assurance is received or to rescind if it is not given within a reasonable time.

12.45 In the light of an apparent lack of strong pressure for reform of this area of law at present, and the mixed views even amongst those who do advocate reform, we have decided to make no recommendations on the topic now. Further, the seeming difficulties with *White & Carter* which we first identified in our 1999 Report may conceivably be resolved in future by greater judicial focus on whether the creditor's continued performance involves forcing active cooperation upon an unwilling debtor, or about whether the creditor has a legitimate interest in continuing to perform its obligations despite the debtor's anticipated breach. The *AMA* case does not rule either of these possibilities out in any way. Finally, the present law is not against creditors seeking assurances of future performance when in doubt as to whether it is going to happen, and it is not impossible for a system recognising the concept of anticipated breach to allow creditors to retain their own performances at least until reasonably certain that the debtor will perform.

12.46 Accordingly we make no recommendation for legislative reform of the law relating to anticipated breach.

# Chapter 13 Termination

## Introduction

13.1 Chapter 4 of the 2017 DP focused on rescission for material breach of contract, the second generally available self-help remedy for breach of contract in Scots law. Termination is the DCFR's equivalent remedy. The Chapter began as usual with questions of terminology, before comparing the twin concepts of rescission and termination. It also considered the relationship between the use of ultimatums in Scots law and the DCFR provisions allowing a creditor to fix an additional period for performance before termination. It concluded by examining the potentially difficult issues with restitution after a contract is terminated, which has already been discussed in Chapter 10 of this Report and will not be referred to again here.

## Terminology

### *Rescission, resiling and termination*

13.2 In Scots law, “rescission” is a remedy used to bring a contract to an end. The concept involves a party declaring that it is no longer bound under a contract, so that it may lawfully refuse to carry out its obligations under the contract.<sup>1</sup> The difficulty that arises in relation to this term is that it applies in more than one situation. The most commonly encountered sense is that of a party wishing to rescind a contract due to a material breach on the part of another party to that contract.<sup>2</sup> However, there is another closely related, but different, situation: rescission *ab initio*, which involves unwinding a contract as if it had never existed. Here, the self-help remedy may be used when a party wishes to escape a contract which is voidable, typically as a result of misrepresentation (innocent or fraudulent) by the other party.<sup>3</sup> If necessary, the remedy is obtained by raising an action of reduction, but then *restitutio in integrum* must be possible before reduction is granted.<sup>4</sup> There is accordingly scope for confusion between the two forms of rescission.

13.3 As observed in the 2017 DP, it is not conducive to coherent and accessible law to have the same name for remedies operating in distinct contexts with different effects. In any event “rescission” is not a word in widespread contemporary use and we thought its meaning was likely to be obscure to lay persons.

13.4 Another word commonly used to denote parties bringing a contract to an end is “resile”. Again, this is not a word in widespread current use except by Scots lawyers. It

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<sup>1</sup> *SME, Remedies* para 94.

<sup>2</sup> *SME, Remedies* para 95.

<sup>3</sup> See eg *Macleod v Kerr* 1965 SC 253. This case involved the sale of a car to a person who misrepresented himself and was in fact an imposter. By the time the cheque used to pay for the car was dishonoured, the imposter had sold the car to a good faith third party. The seller sought to rescind, but it was held that contacting the police did not amount to rescission *ab initio*. Contrast the near contemporaneous English decision, *Car & Universal Finance Co v Caldwell* [1965] 1 QB 525, on which see also W A Wilson, “Dial 999 for Rescission”, (1964) 27 MLR 472.

<sup>4</sup> McBryde, *Contract*, para 20.05.

denotes withdrawal from an obligation which has been improperly constituted, or is a catch-all expression to signify lawful withdrawal from a contract which is not in response to breach or anticipated breach.<sup>5</sup>

13.5 In the 2017 DP, we sought views on replacing this terminology with alternatives we thought were more intelligible and more likely to be understood by the general public.<sup>6</sup> We therefore asked if “rescission” should be replaced with “termination” and “resile” should be replaced with “withdraw”.

#### Summary of consultation responses

13.6 Consultees’ views were mixed on both proposals. The Senators of the College of Justice agreed with both of the proposed alternative terms, considering them more intelligible than the existing terminology. Morton Fraser had no concerns with replacing “resile”, but were against replacing it with “termination”, commenting that while it is not common in practice to use the term rescission for situations other than material breach, “termination” is used colloquially as well as in the legal sense, which could lead to confusion. The Law Society of Scotland were equivocal in relation to both proposals, conceding that the suggested changes in terminology could result in “marginal improvement”, but that they were not aware of particular problems caused by the existing terms. The Faculty of Advocates commented that they considered “termination” too vague and that there was nothing to gain from replacing the word “rescission”. Pinsent Masons considered that the proposed changes were neither necessary nor desirable.

13.7 We accordingly concluded that support was not strong for these proposed terminological reforms.

#### *Breach: material, fundamental or substantial?*

13.8 While contracting parties can of course provide expressly for when a contract may be terminated for breach (or indeed otherwise), the default position in Scots law is that a breach must be “material” before the remedy of rescission is available. Under the DCFR the non-performance must be “fundamental”. The adjectives “material” and “fundamental” are intended to denote a situation in which the debtor’s activity (or inactivity) undermines the basic purpose of the contract to such an extent as to justify bringing the contract to an end. However, McBryde takes the view that “[t]he phrase ‘material breach’ is unfortunate, in that no breach of contract is immaterial.”<sup>7</sup> He thinks that the phrase has a meaning “nearer to substantial breach”,<sup>8</sup> although it may equally be questioned whether any breach of contract can be said to be insubstantial. Performance even one minute late could justify termination where time is of the essence.

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<sup>5</sup> McBryde, *Contract*, para 20.04.

<sup>6</sup> See the 2017 DP, Question 17.

<sup>7</sup> McBryde, *Contract*, para 20.91.

<sup>8</sup> McBryde, *Contract*, para 20.91.

13.9 The DCFR says that a non-performance is “fundamental” if:

“(a) it substantially deprives the creditor of what the creditor was entitled to expect under the contract, as applied to the whole or the relevant part of the performance, unless at the time of conclusion of the contract the debtor did not foresee and could not reasonably be expected to have foreseen that result; or

(b) it is intentional or reckless and gives the creditor reason to believe that the debtor’s future performance cannot be relied on.”<sup>9</sup>

13.10 We concluded in the 2017 DP that the method for determining whether a breach is material in Scots law is similar to that of determining whether something falls under the heading of fundamental non-performance for (a) above in the DCFR. “Fundamental non-performance” and “substantial breach” are also arguably more meaningful descriptions than “material breach”. In particular, “fundamental” might be seen as a term more clearly indicating the gravity of breach required before the other party can terminate the contract.

13.11 We acknowledged in the 2017 DP that whatever adjective is used the courts will most likely approach the question by asking whether or not the breach in question justifies termination. But language can be important in giving persons without legal advice guidance on exercise of the self-help remedy of termination. We therefore asked whether the term “fundamental breach” or “substantial breach” should be adopted in place of “material breach” as the term for the kind of breach which justifies termination of a contract.

#### Summary of consultation responses

13.12 A small majority of the consultees who responded were in favour of adopting “fundamental breach” or “substantial breach” in place of “material breach” as the term for the kind of breach which justifies termination of a contract. The Faculty of Advocates were not opposed to change if there was to be a statutory restatement and commented that both terms were equally appropriate. However several law firms were opposed to making any change, either because they did not consider there to be any benefit in replacing the term “material breach” or because they thought the suggested alternatives would create uncertainty.

#### **Comparison of the DCFR and Scots law**

13.13 As we note above, under the DCFR termination is available as a remedy if the debtor’s non-performance is fundamental. In Scots law, rescission for breach is possible only if the breach is material. The DCFR further provides that where the debtor’s obligations under the contract are not divisible the creditor may only terminate the contractual relationship as a whole.<sup>10</sup> It also provides for partial termination where a contract is to be performed in several parts or is otherwise divisible. If there is fundamental non-performance in relation to a part to which the counter-performance can be apportioned, the aggrieved party can terminate in relation to that part.<sup>11</sup>

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<sup>9</sup> DCFR III.–3:502(2). Fundamental non-performance is defined in substantially similar terms in PECL art 8:103 and PICC art 7.3.1(2). The McGregor Code (para 306) allows termination for “substantial” breach, which is total non-performance or such other failure as to make unreasonable the innocent party’s continuation of performance.

<sup>10</sup> DCFR III.–3:506(1).

<sup>11</sup> DCFR III.–3:506(2).

13.14 The 2017 DP noted that Scots law does not seem to have developed any rule equivalent to this partial termination of a divisible (or separable) contract, although we understand that this may occasionally be provided for by bespoke drafting in the contract.<sup>12</sup> We therefore asked consultees if a general statutory restatement is pursued, whether it should provide for a right of partial termination where the obligations under a contract are separable.

13.15 Under the DCFR, the right to terminate must be exercised by notice to the other party.<sup>13</sup> No court action by the aggrieved party is required to terminate the contract, nor is there any period of grace. This is consistent with Scots law.<sup>14</sup>

13.16 Notice under the DCFR should be given within a reasonable time after a late tender of performance or a tender that otherwise does not conform to the contract of which the creditor has become, or could reasonably be expected to have become, aware; otherwise the creditor loses the right to terminate.<sup>15</sup> Likewise in Scots law a right to rescind which is not exercised within a reasonable time will be lost.<sup>16</sup> We therefore asked consultees whether there should be provision for a creditor to terminate the contract within a reasonable time after material (or substantial or fundamental) non-performance by the debtor.

13.17 The DCFR provides that on termination, the outstanding obligations or the relevant part of the outstanding obligations of the parties under the contract come to an end.<sup>17</sup> This is consistent with Scots law.<sup>18</sup> Termination does not, however, affect any provision of the contract for the settlement of disputes or other provision which is to operate even after termination; this is again consistent with Scots law.<sup>19</sup> Termination is thus basically prospective rather than retroactive.<sup>20</sup> The terminating creditor also retains existing rights to damages or stipulated payments for non-performance.<sup>21</sup> There seems nothing inconsistent with Scots law principles in these rules. In the 2017 DP we therefore invited comment from consultees on (a) a requirement that the creditor notify termination to the debtor; and (b) the need for the law to specify the prospective effects of termination.

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<sup>12</sup> Note that partial reduction of a contract is well recognised: see the treatments of this subject cited in Report on Third Party Rights in Contract (Scot Law Com No 245, 2016) para 2.46 note 84.

<sup>13</sup> DCFR III.–3:507. See also PECL art 9:303; PICC art 7.3.2.

<sup>14</sup> McBryde, *Contract*, para 20.107 notes that “[i]n principle, intimation of some kind is necessary for rescission and rescission cannot take effect until it is intimated.”

<sup>15</sup> DCFR III.–3:508(1).

<sup>16</sup> McBryde, *Contract*, para 20.121 and cases cited in fn 418.

<sup>17</sup> DCFR III.–3:509(1); PECL art 9:305; PICC art 7.3.5.

<sup>18</sup> McBryde, *Contract*, para 20.109.

<sup>19</sup> McBryde, *Contract*, paras 20.108 (liquidate damages clauses), 20.110 to 20.115 (arbitration clauses). See also now Arbitration (Scotland) Act 2010 s 5.

<sup>20</sup> The DCFR avoids the unfortunate use of the word “avoidance” which obscures the nature of the remedy of termination under both ULIS and the CISG, at least in their English-language versions. It also leaves it unclear whether the consequence is automatic or requires the innocent party to take steps. The McGregor Code (para 307), in an echo of the 1960s doctrine of “fundamental breach” in English law, provides for automatic termination.

<sup>21</sup> McBryde, *Contract*, para 20.119. In addition under the DCFR III.–3:509(3) the creditor has the same right to damages or a stipulated payment (ie a penalty) for non-performance as it would have had if there had been non-performance of the debtor’s now extinguished obligations. With regard to these extinguished obligations the creditor is not to be regarded as having caused or contributed to the loss suffered merely by exercising the right to terminate. Commentary E to the article explains this provision, with hypothetical illustrative examples. The comparative notes do not point to any other system in which such rules are recognised, however, and our Advisory Group harboured doubts about them. We therefore do not consult upon them. The losses referred to in the provision might be recoverable as consequential upon the breach leading to termination. Any penalty clause would be subject to whatever system of rules applies to such clauses: see our Discussion Paper No 162 (2016 DP).

## Potential reforms

### *Persistent non-material breaches*

13.18 In our Advisory Group reference was made to the problem of “persistent non-material breaches”, none of which individually justifies rescission. While solutions to this problem are often the subject of express contractual provision allowing for termination, or provided by use of the ultimatum procedure discussed below,<sup>22</sup> we thought that it might be helpful to have some default rule on the subject. We therefore asked whether persistent non-material breaches should be treated as a breach justifying termination.

### *Notice fixing additional period for performance*

13.19 As a balance to the debtor’s right of cure,<sup>23</sup> the DCFR allows the creditor to give notice to the non-performing debtor of an additional period of time for performance.<sup>24</sup> During the additional period notified by the creditor, the creditor may withhold performance of its reciprocal obligations and claim damages for any loss incurred, but may not resort to any other remedy. If the creditor is notified by the debtor that it will not perform during that period, or if upon expiry of the period due performance has not been made, the creditor may resort to any available remedy.<sup>25</sup>

13.20 The 2017 DP noted that in particular, a creditor may terminate in a case of delay in performance of a contractual obligation which is not in itself fundamental if the notice fixes an additional period of time of reasonable length and the debtor does not perform within that period.<sup>26</sup> The procedure lets the issuer withhold performance and then, when there is still non-performance at the end of the ultimatum period, terminate.

13.21 Scots law recognises an ultimatum procedure by which a breach which initially does not justify termination may be made to do so by the expiry of a period of time notified to the debtor by the creditor.<sup>27</sup> The ultimatum procedure is in common use in conveyancing transactions with respect to failures to pay the price, and our Advisory Group told us that it is also usual for commercial contracts to make some provision on the matter. It has not been confined to breaches of payment obligations and is sometimes linked to giving the debtor an opportunity to remedy defective performance.<sup>28</sup>

13.22 The 2017 DP concluded that an ultimatum procedure by which termination of the contract may be justified is obviously useful in practice. The DCFR adds some detail by comparison with present Scots law. We therefore asked whether there should be provision for an ultimatum procedure by which a non-material breach of contract could lead to termination of the contract by the creditor who had previously notified the debtor of a

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<sup>22</sup> See paras 13.21 and 13.22 below.

<sup>23</sup> See paras 14.7 to 14.10 below. For further information see the 2017 DP, paras 5.8 to 5.13.

<sup>24</sup> DCFR III.–3:103(1).

<sup>25</sup> DCFR III.–3:103(2). See also PICC art 7.1.5; PECL art 8:106. For antecedents see ULIS arts 27, 31, 44, 62; CISG arts 47, 63.

<sup>26</sup> DCFR III.–3:503(1).

<sup>27</sup> See paragraph 4.24 of the 2017 DP for the leading case, *Rodger Builders v Fawdry* 1950 SC 483. Compare the Scottish Standard Clauses (which are used for the purchase and sale of residential property). Cls 12 and 13. Where the breach is clearly material, no ultimatum need be used: see for example *Persimmon Homes v Bellway Homes* [2011] CSOH 149, [2012] CSOH 60, para 18 (Lord Drummond Young).

<sup>28</sup> See eg *McLennan v Warner & Co* 1996 SLT 1349; McBryde, *Contract*, paras 20.128 to 20.131.

reasonable period of time within which the latter must perform the obligation in question. We also asked that if it should, whether it should also provide that:

- (a) during the period of the notice the creditor is entitled to withhold its performance and may claim damages for the period of delay;
- (b) the notice may provide for automatic termination by non-performance at the end of the notified period; and
- (c) if the notice period is unreasonably short, termination (whether automatic or requiring further notice to the debtor) can take place only at the end of a reasonable period of time.

### **Summary of consultation responses**

13.23 A majority of consultees were opposed to the proposal for a right of partial termination where the obligations under a contract are separable. The Society of Solicitor Advocates were opposed to the proposal as they considered that parties should not be compelled to remain in a contractual relationship if one party wishes to end the relationship. The Faculty of Advocates considered that the proposal would require the court to recast the contract to which the parties had agreed, and having to do so by reference to considerations which the parties themselves may or may not have regarded as significant. Several law firms considered that if partial termination was something that parties wanted, then they could accommodate this in their contract.

13.24 The Law Society of Scotland considered that a case could be made for allowing termination of particular parts if there is evidence of significant demand for it. However

“there should be a (rebuttable) presumption of contractual unity with respect because there could be a risk of a bit of cherry picking...”.

13.25 There was however majority agreement among those consultees who responded to the proposal, that there should be provision for a creditor to terminate the contract within a reasonable time after material non-performance by the debtor.

13.26 There was further near consensus from the consultees responding on the point that there should also be provision requiring the creditor to notify the debtor of termination. The Senators of the College of Justice noted however that care should be taken to ensure that this does not introduce unnecessary formalism or lead to arguments about an asserted failure to notify termination or about the deficiencies of any notification.

13.27 Views were more mixed as to whether the law should also specify the prospective effects of termination. While the Senators agreed with this, the Faculty of Advocates commented that while in principle they had nothing against such a proposal, in practice they would require to know what those effects would be specified as being, before being able to comment more meaningfully. The Society of Solicitor Advocates also had concerns, noting that specification of the prospective effects of termination appeared to them to be unwise given the multitude of contractual obligations. Morton Fraser considered that it was already clear that in Scots law, termination had prospective effect.

### *Persistent non-material breaches*

13.28 A majority of the consultees who responded were against persistent non-material breaches being treated as a breach justifying termination. The Faculty of Advocates considered that the current law already allows for:

“the recognition of an overarching repudiatory breach where one party to a contract consistently commits non-material breaches which objectively viewed, do manifest an intention not to perform the contract according to its terms.”

13.29 The Senators of the College of Justice were also opposed, commenting that the ultimatum procedure should provide an adequate remedy, and that the proposals might result in opportunistic rescissions. Mr Christie considered that the “classification” of the contract in question is significant, and stated that the cumulative effect of non-material breaches could be considered differently in what would otherwise be one-off transactions compared with longer-term contracts. Like the Senators, he considered that an ultimatum procedure before termination would give parties an opportunity to rectify the situation. He also noted that if parties wish to allow termination for cumulative non-material breaches, then they can agree this in their contracts.

13.30 While the Law Society of Scotland acknowledged that a series of non-material breaches could be sufficiently serious when taken as a whole to constitute a material breach which would therefore justify termination, they considered that:

“the downside risk of persistent non-material breaches *per se* resulting in a termination where people could not work out how to exclude this possibility appears to be greater than the advantage of allowing someone to escape who has not thought to provide that persistent breach of certain terms would allow termination.”

13.31 Again several law firms were not persuaded that the suggested change would be helpful. Morton Fraser were concerned that allowing for persistent non-material breaches to be treated as a breach justifying termination could be open to abuse, and while they felt that allowing persistent non-material breaches to be treated as a breach justifying termination could be beneficial, they thought that safeguards to avoid the potential for abuse would be helpful.

### *Notice fixing additional period for performance*

13.32 A small majority of consultees were in favour of the proposal that there should be provision for an ultimatum procedure by which a non-material breach of contract could lead to termination of the contract by the creditor who had previously notified the debtor of a reasonable period of time within which the latter must perform the obligation in question. Views were more mixed as to whether there should also be provision that (a) during the period of notice the creditor is entitled to withhold its performance and may claim damages for the period of delay; (b) the notice may provide for automatic termination by non-performance at the end of the notified period; and (c) if the notice period is unreasonably short, termination (whether automatic or requiring further notice to the debtor) can take place only at the end of a reasonable period of time.

13.33 The Faculty of Advocates, the Society of Solicitor Advocates and Morton Fraser agreed that if a general statutory restatement was pursued, it should include the proposals in (a) to (c) referred to above. Other consultees supported only some of the proposals. The Law Society of Scotland agreed with (a) and (b), but considered that in the case of (c), a creditor should be required to issue a second notice. Mr Christie suggested that in the case of (b) the creditor should be required to issue a second notice, commenting that two notices would create two clear points at which a creditor would be accountable for its decision making and required to communicate with the debtor. He also thought that in the case of (c), a reasonable time should be fixed.

## Conclusions

13.34 A majority of the consultees who responded were opposed to the proposal that there should be provision for a right of partial termination where the obligations under a contract are separable. There was majority support from those consultees who responded that there should be provision for (a) a creditor to terminate the contract within a reasonable time after material non-performance by the debtor and (b) the creditor to be required to notify termination to the debtor. However, all this was in the context of a possible general statutory restatement (and in relation to the latter proposal, the difficulties that might arise from a general statement that termination is prospective).

13.35 A majority of the consultees who responded were opposed to the proposal that persistent non-material breaches should be treated as a breach justifying termination. There was majority support from those consultees who responded, that if a general statutory restatement was pursued it should provide for an ultimatum procedure (which it should be said, is the current law). There was more mixed support for such a provision including the proposals referred to in (a) to (c),<sup>29</sup> although none were rejected outright and in their own right each acquired its own majority support.

13.36 The conclusion which we draw from the consultation summarised above is that in general the Scots law of rescission for breach is thought to work well as it stands and not to be in need of the relatively minor adjustments that might be suggested by comparison with the DCFR. The problems identified may in any event be resolved by appropriate contract drafting and fact-sensitive judicial decisions. Issues about the somewhat antiquated and obscure terminology with which the law is expressed are recognised (and to some extent at least dealt with in modern contract drafting), but are not thought to prevent the law functioning as it should. While there may be problems with the application of the law for those outwith the circles of the higher judiciary, the bar, and solicitors in commercial practice, these are not so great as to produce widespread calls for reform.<sup>30</sup> In these circumstances we cannot recommend such clarifying reform except in the context of a general statutory restatement, the time for which we have decided is not ripe.

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<sup>29</sup> See para 13.33 above.

<sup>30</sup> See however for parallel problems in English law N Andrews, "Breach of Contract: a Plea for Clarity and Discipline" (2018) 134 LQR 117, 125-129.

# Chapter 14 Other self-help remedies

## Introduction

14.1 Following consideration of the two generally available self-help remedies in Scots law already discussed (retention, and rescission for material breach) and the DCFR's equivalents, Chapter 5 of the 2017 DP considered further DCFR remedies (price reduction and cure). It discussed the extent to which they are recognised in Scots law, and some potential reforms that might be considered.

14.2 Scots law recognises self-help remedies for breach other than retention, and rescission for material breach, but only in limited contexts such as consumer contracts. The DCFR also recognises other self-help remedies, though unlike Scots law it does not confine them to the consumer context. These remedies are price reduction and cure. The latter exists in two different forms: the debtor's right to cure non-performance, and the creditor's right to have non-conforming performance remedied.

## Price reduction

### *Comparison of the DCFR and Scots law*

14.3 The 2017 DP noted that the DCFR allows a remedy of price reduction for non-performance, distinguishing it from damages.<sup>1</sup> Scots law once knew a remedy of this kind in the law of sale, terming it the *actio quanti minoris*.<sup>2</sup> A purchaser who received defective property from the seller could, while retaining the goods, seek reduction of the price to the property's actual value as it stood rather than damages reflecting the difference in value. However this remedy was rejected in the nineteenth century.<sup>3</sup> Properly understood as a remedy where the property as sold did not conform to contract, the outcome might have been different, but the rule against the *actio quanti minoris* remained part of Scots contract law until it was abolished by section 3 of the Contract (Scotland) Act 1997. The difficulty, at least so far as self-help remedies are concerned, is that section 3 appears to relate to the application of the rule to judicial remedies, abolishing it only so far as it prevents the purchaser obtaining damages for breach of contract.

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<sup>1</sup> DCFR III.–3:601. See also ULIS arts 41, 44 and 46; CISG art 50; PECL art 9:401.

<sup>2</sup> See generally SLC Discussion Paper No 97 *Contract Law: Extrinsic Evidence, Supersession, and the Actio Quanti Minoris* (1994), Part V; R Evans-Jones, "The History of the Actio Quanti Minoris in Scotland" 1991 JR 190; A L Stewart, "The Actio Quanti Minoris" (1966) 11 JLSS 124. Evans-Jones points out that Scots law embraced two distinct claims under the name *actio quanti minoris*: one the price reduction remedy discussed in the text, the other the right of the buyer of defective property to retain the object and claim damages for the defect. It was probably as a result of consequent confusion that in the nineteenth century the *actio* was rejected by the courts, thereby denying the purchaser both the price reduction remedy and damages unless the contract was rescinded. This "monstrous" rule was abolished by the Contract (Scotland) Act 1997 s 3, implementing our Report on Three Bad Rules in Contract Law (Scot Law Com No 152, 1996) Part IV.

<sup>3</sup> See *McCormick v Rittyer* (1869) 7 M 854 at 848, per the Lord President (Inglis). The likeliest reason for the rejection of the remedy was because it was misunderstood as providing a remedy wherever property sold was said not to be worth the price paid or to be paid for it (*laesio enormis*).

14.4 Price reduction is, however, now a consumer remedy available under the Consumer Rights Act 2015 (the 2015 Act).<sup>4</sup> It was introduced in 2003, implementing an EU Directive.<sup>5</sup> As with the DCFR, it is available only if the goods, digital content or services (as the case may be) do not conform to the contract. The remedy is an alternative to the final right to reject. It arises only if (a) in the case of goods, the supplier has made one unsuccessful effort to cure the non-performance; or (b) the consumer cannot require cure; or (c) cure has not been effected within a reasonable time or without significant inconvenience to the consumer. There seems to have been as yet no significant judicial discussion of the remedy in the United Kingdom or the Court of Justice of the European Union.

#### *Potential reform*

14.5 We concluded in the 2017 DP that the main advantage in a price reduction remedy (distinct from damages) is the self-help possibility of deducting sums from payments due, a remedy often explicitly provided for in commercial contracts. It provides a practical alternative to suing when either there is no right to terminate because the non-performance is not fundamental, or when the right to terminate has been lost through lapse of time.<sup>6</sup>

14.6 The question for Scots law therefore is whether what is presently a consumer remedy should be extended to contracts in general and not restricted to ones for the supply of goods, digital content and services to consumers. On one view, there is as yet insufficient knowledge of how the consumer remedy operates in practice to justify its wider extension.<sup>7</sup> We therefore asked consultees whether a price reduction remedy along the lines of that provided in sections 24, 44 and 56 of the Consumer Rights Act 2015 should also be provided for non-consumer contracts in general. We also asked if consultees had any information or data about the use of this remedy in a consumer context.

### **Debtor's right to cure non-performance**

#### *Comparison of the DCFR and Scots law*

14.7 Under the DCFR, a debtor may cure an initially non-conforming performance in certain circumstances.<sup>8</sup> The simplest form is (if it can be done within the time allowed for performance) for the debtor to make a new and conforming tender.<sup>9</sup> Alternatively, if it is not possible to make a new and conforming tender within the time allowed for performance, the debtor may offer to cure it within a reasonable time and at its own expense.<sup>10</sup> The offer must

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<sup>4</sup> 2015 Act ss 24 (supply of goods), 44 (digital content), 56 (services). An earlier price reduction remedy can be found in Council Directive (EEC) 90/314 (as replaced by European Parliament and Council Directive 2015/2302), implemented in the UK by the Package Travel, Package Holidays and Package Tours Regulations (SI 1992/3288) reg 11 (implementing recital 34 and Article 14(1) of the Directive).

<sup>5</sup> See section 48C of the Sale of Goods Act 1979 (as inserted by the Sale and Supply of Goods to Consumers Regulations 2002). Section 48C implemented Article 3 of Directive 1999/44/EC of the European Parliament and of the Council of 25th May 1999 on certain aspects of the sale of consumer goods and associated guarantees (OJ No. L171 7.7.99, p 12).

<sup>6</sup> See para 5.6 of the 2017 DP.

<sup>7</sup> The Advisory Group thought that the remedy had not yet been often invoked.

<sup>8</sup> The right to cure has antecedents in ULIS (art 44) and the CISG (arts 46(3), 48). Both PECL (art 8:104) and PICC (art 7.1.4) recognise the possibility that a non-performing party may tender a cure, but have rather different versions of the right. The debtor cannot seek to cure a total non-performance.

<sup>9</sup> DCFR III.–3:202(1).

<sup>10</sup> For the corresponding ability of the creditor to fix an additional time for performance under the DCFR see paras 13.19 and 13.20 above; for the ultimatum procedure found in Scots law see paras 13.21 and 13.22 above.

be made promptly after being notified of the lack of conformity. Even if the cure is successful, the creditor retains the right to damages for any loss caused by the debtor's initial or subsequent non-performance or by the process of effecting cure.<sup>11</sup>

14.8 Scots law seems on the whole not to recognise a concept akin to a debtor's right of cure, other than in relation to irritancy in leases<sup>12</sup> or to remediable defaults under a standard security.<sup>13</sup> However there have been judicial suggestions at first instance that the creditor may not always be able to rescind without giving the debtor a second chance to perform.<sup>14</sup>

#### *Potential reform*

14.9 The 2017 DP noted that in our 1999 Report we took the view that even the limited debtor's right to proffer cure and forestall the creditor's right to terminate (as now found in the DCFR) shifted the balance of power too much against the creditor.<sup>15</sup> This was because we placed a high value on the creditor's right to reject, especially in consumer cases. That also informed our joint recommendations with the Law Commission for England and Wales in 2009 that consumers should have a short-term but immediate right to reject defective performances by suppliers of goods, which could be exercised regardless of the existence of repair and replacement remedies as well. This has now been implemented by sections 20 and 22 of the 2015 Act.

14.10 In the 2017 DP we remained inclined to think that in general the debtor should not be empowered to insist on attempting cure of a defective performance, although the creditor is of course entitled to accept a proffer of such cure should it be made. We noted that under the DCFR it is only if the breach is non-fundamental that the debtor may so insist, while the offer may be refused by the creditor who has reason to believe that the debtor's previous non-performance was made knowingly, or that the proffered cure cannot be made within a reasonable time, or without substantial inconvenience or prejudice to the creditor, or is inappropriate in the circumstances. While these are substantial limitations upon the debtor's right, they still leave much ground for difficult disputes between the parties. We also note the possibility that, if high English authority in sale of goods law is followed, the debtor who has made an early but defective tender of performance which is rejected by the creditor does already have the power to try again within the time limit provided by the contract.<sup>16</sup> We therefore asked consultees the following questions:

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<sup>11</sup> DCFR III.–3:204(3).

<sup>12</sup> A tenant may be able to remedy its material breach to prevent the invocation of a conventional irritancy in accordance with s 5 of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1985, or to purge a legal irritancy at common law. On irritancy generally, see our (unimplemented) Report on Irritancy in Leases of Land (Scot Law Com No 191, 2003), Part 1.

<sup>13</sup> Conveyancing and Feudal Reform (Scotland) Act 1970, ss. 21 and 23.

<sup>14</sup> *Lindley Catering Investments v Hibernian FC* 1975 SLT (Notes) 56; *Strathclyde Regional Council v Border Engineering Contractors Ltd* 1998 SLT 175. See further 2017 DP, para 5.11, for the most recent cases in this area.

<sup>15</sup> 1999 Report, para 7.21.

<sup>16</sup> *Borrowman Phillips & Co v Free and Hollis* (1878) 4 QBD 500 (CA); *Motor Oil Hellas (Corinth) Refineries SA v Shipping Corp of India (The Kanchenjunga)* [1990] 1 Lloyd's Rep 391 (HL). See also Benjamin's Sale of Goods, (9<sup>th</sup> edn, 2014), para 12.032; *Atiyah and Adams' Sale of Goods*, (13<sup>th</sup> edn, 2016) p 441; Goode, *Commercial Law* (5<sup>th</sup> edn, 2016), paras 12.19 to 12.27.

(1) Should the debtor have a right to carry out a cure (repair or replace or repeat performance) of a prior non-performance notified to it by the creditor if: (a) performance is still possible within any relevant time limit imposed by the contract; or (b) the debtor offers a cure at its own expense, to be carried out within a reasonable time?

(2) Should this right exist only if the non-performance is not so fundamental as to entitle the creditor to terminate the contract?

(3) If consultees consider that debtors should have such a right, do they agree that while the cure is carried out the creditor may not terminate the contract, but that it may withhold its own performance and that it retains the right to claim damages for the initial non-performance if appropriate?

(4) Do consultees also agree that the debtor has the obligation to take back the replaced item at its own expense, while the creditor need not pay for any use made of that item?

(5) Do consultees further agree that if the cure is not carried out within a reasonable time the creditor may terminate the contract and exercise any other remedy available to it in respect of the breach of contract?

(6) Do consultees finally agree the creditor should not be obliged to accept an offer of cure if: (a) it has reason to believe that the debtor's initial performance was made with knowledge of its non-conformity and was not in accordance with good faith and fair dealing; (b) it has reason to believe that the debtor will be unable to effect the cure within a reasonable time and without significant inconvenience to the creditor or other prejudice to the creditor's legitimate interests; or (c) cure would be inappropriate in the circumstances?

## **Creditor's right to have non-conforming performance remedied**

### *Comparison of the DCFR and Scots law*

14.11 Finally, the 2017 DP compared the DCFR and Scots law in relation to the creditor's right to have non-conforming performance remedied. We noted that specific performance under the DCFR includes the remedying free of charge of a performance not in conformity with the terms of the relevant obligation, ie repair or replacement of the non-conforming performance.<sup>17</sup> In Scots law, however, Professor McBryde writes that "[s]pecific implement seeks implement of the contract, not an undoing of what has been done in breach of contract for which the remedy is damages".<sup>18</sup> It accordingly appears to us that in this respect the DCFR concept of specific performance of a non-monetary obligation is rather broader than specific implement.

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<sup>17</sup> DCFR III.-3.302(2).

<sup>18</sup> McBryde, *Contract*, para 23.14.

14.12 However, we note that such a creditor's right does exist to a limited extent in Scots law, in the context of consumer contracts for the supply of goods, or digital content, or services. The consumer has the right under the 2015 Act to demand repair or replacement of defective supplies at the supplier's expense and within a reasonable time.<sup>19</sup> The choice between repair or replacement is the consumer's.<sup>20</sup>

14.13 There has been almost no case law in any of the United Kingdom jurisdictions about the consumer's repair or replacement remedy.<sup>21</sup> In *Douglas v Glenvarigill Co Ltd*<sup>22</sup> it was argued for a consumer buyer (in submissions that were apparently "not detailed"<sup>23</sup>) that he had a right to reject a defective car almost two years after purchase following failed attempts at repair. The judge noted that where repair or replacement were sought, rejection could follow where they were unsuccessful after a reasonable period of time. However in this case, it was held that the consumer was not entitled to reject so long after the initial sale of the car.

#### *Potential reform*

14.14 The law of consumer protection is based on the idea of putting the consumer on a more equal footing with the seller, so that the consumer has full autonomy at the time of contracting, in accordance with the classic principles of freedom of contract. For example, in a contract for sale of goods, the consumer is protected if the goods are not as they were originally described.<sup>24</sup> We therefore asked why this remedy should not extend to classical or commercial contract law. The one possible answer is that the 2015 Act exists to regulate consumer contracts and protect vulnerable groups, and that the traditional idea of commercial contracts involves parties who are (relatively) equal.

14.15 However, this is often not the case, especially where there is a service element to the contract. We noted that even when incorporated, small businesses are often in a vulnerable position, without the necessary funds for litigation. The inherent difficulties in seeking a decree for specific implement mean that court action can be a long and expensive process. A right to repair or replacement might better meet this sort of case. We therefore asked for consultees' thoughts on the possibility of extending to all contracts a creditor's right to have non-compliant performance remedied by the debtor and whether any creditor should have a right to seek cure from the debtor in line with the specific remedy of repair or replacement (or repeat performance of a service) now afforded to consumers under the Consumer Rights Act 2015.

#### **Summary of consultation responses**

14.16 A majority of consultees were not in support of reforming the law so that a price reduction remedy along the lines of that provided in sections 24, 44 and 56 of the Consumer Rights Act 2015 also be provided for non-consumer contracts in general. The Faculty of Advocates were against such a reform and noted that price reduction was something that

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<sup>19</sup> 2015 Act ss 23, 43 and 55. For services the remedy is known as "repeat performance".

<sup>20</sup> 2015 Act ss 23(2) (goods); 43(2) (digital content). There is no need to exercise choice of this kind with "repeat performance" of services.

<sup>21</sup> See *Lowe v W Machell Joinery Ltd* [2011] EWCA Civ 794, [2012] 1 All ER (Comm) 153; *Richford v Parks of Hamilton (Townhead Garage) Ltd* 2012 GWD 24-505 (Hamilton Sheriff Court, 10 January 2012).

<sup>22</sup> [2010] CSOH 14, 2010 SLT 634.

<sup>23</sup> 2010 SLT 634 at para 37 per Lord Drummond Young.

<sup>24</sup> 2015 Act, s 11.

parties can provide for themselves if they wish. The Senators of the College of Justice were not convinced that the case for a price reduction remedy in non-consumer contracts was made, commenting that in this context, the interests of commercial certainty outweigh the advantage of such a remedy. The Law Society of Scotland considered that while price reduction is available in many other systems and it is difficult to see why consumers have much more need of it than other contracting parties, the choice between price reduction and damages:

“undermines the purity of contract law’s focus on the expectation interest and it can be difficult to police the boundary between termination and very extreme price reduction.”

On balance therefore, they thought this remedy was not desirable as a default rule for non-consumer cases. No consultees provided any information or data about the use of this remedy in the consumer context.

14.17 There was also limited support amongst consultees who responded for the proposal that the debtor should have a right to carry out a cure (repair or replace or repeat performance) of a prior non-performance notified to it by the creditor if: (a) performance is still possible within any relevant time limit imposed by the contract; or (b) the debtor offers a cure at its own expense, to be carried out within a reasonable time. While the Society of Solicitor Advocates agreed with the proposal, the Senators of the College of Justice considered that in general, a debtor should not have the right to insist on attempting cure of a defective performance. However the latter commented that if such a right was to be recognised it would be easier to justify in the circumstances described in (a) rather than (b).

14.18 In relation to (a), the Faculty of Advocates considered a debtor to be normally entitled to have a failure in performance cured, where performance is still possible within any relevant time limit imposed by the contract, provided that the creditor has not already terminated the contract. They therefore could not see how there could be “non-performance” unless:

“there had been an unequivocal indication of an intention not to perform, which would amount to a repudiatory breach.”

They were however not in favour of the debtor having a cure in either of the circumstances in (a) or (b), which was also the view of the Law Society of Scotland and Morton Fraser.

14.19 While most consultees were against a right to cure non-performance, in general they agreed that if there is to be such a right, it should only exist if the non-performance is not so fundamental as to entitle the creditor to terminate the contract. Similarly, consultees generally agreed that if there is to be such a right, the creditor may not terminate the contract while the cure is carried out, but it may withhold its own performance and retain the right to claim damages for the initial non-performance if appropriate. They also agreed that if there is to be such a right, the debtor has the obligation to take back the replaced item at its own expense, while the creditor need not pay for any use made of that item. The Faculty of Advocates commented however that the question posed was too general and that consideration should be given as to whether this could give rise to disproportionate prejudice or advantage to one or other party to the contract.

14.20 Once again, if there is to be a right to cure, most consultees agreed that if it is not carried out within a reasonable time, the creditor should be allowed to terminate the contract and exercise any other remedy available to it in respect of the breach of contract and that a creditor should not be obliged to accept an offer of cure. The Faculty commented that there would be no other course open to the creditor in the circumstances envisaged, and that the question highlighted the scope for disputes under the proposed rule. They also commented in relation to proposal (6)<sup>25</sup> that the terms used in (a) were too vague (“reason to believe”, “in accordance with good faith and fair dealing”) and could not sensibly form the basis of any new rule. In respect of (c), the Faculty considered that no creditor should be obliged to accept cure if it would in some meaningful sense be inappropriate to do so.

14.21 As to whether any creditor should have a right to seek cure from the debtor in line with the specific remedy of repair and replacement (or repeat performance of a service) now afforded to consumers under the Consumer Rights Act 2015, a small majority of consultees were against this proposal. While the Society of Solicitor Advocates agreed with the proposal, the Faculty of Advocates and the Senators of the College of Justice disagreed, both noting that consumer contracts are often very different to non-consumer contracts. The latter considered that the protection given to consumers in consumer contracts would risk unduly favouring creditors in ordinary commercial contracts. Pinsent Masons also disagreed, stating that they did not think reform at this stage would be desirable. Mr Christie responded equivocally, pointing out that:

“relational contracts are more likely to have detailed terms of agreement, and in consumer contracts, where there is less likely to be a detailed agreement, there is less of a long term relationship – and the right to seek a cure is likely to be less disruptive.”

14.22 The Law Society of Scotland considered that while it would be preferable to clarify that a court can order a party in breach to cure its defective performance as part of specific implement, there could be a case for preventing termination for a reasonable time after a request for cure has been made because that request raises the reasonable expectation that the debtor will have a chance to fulfil it.

## **Conclusions**

14.23 There was a general lack of support from consultees who responded to the proposal that a price reduction remedy along the lines of that provided in the Consumer Rights Act 2015 should also be provided for non-consumer contracts in general.

14.24 There was also a general lack of support from the consultees who responded to the proposal that a debtor should have a right to carry out a cure (repair or replace or repeat performance) of a prior non-performance notified to it. However if there was to be such a right to cure, consultees seemed to support it where performance was still possible within any relevant time limit imposed by the contract. Consultees similarly agreed that if there was to be such a right to cure, it should exist only if the non-performance is not so fundamental as to entitle the creditor to terminate the contract, and that the creditor may not terminate the

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<sup>25</sup> See para 14.10 above.

contract while the cure is carried out (but it may withhold its performance and retain the right to claim damages for the initial non-performance if appropriate).

14.25 Consultees also agreed that if there was to be such a right to cure, the debtor should have the obligation to take back the replaced item at its own expense, while the creditor need not pay for any use made of that item. Further, if the cure is not carried out within a reasonable time the creditor may terminate the contract and exercise any other remedy available to it in respect of the breach of contract. Finally, they agreed, that if there was to be such a right, the creditor should not be obliged to accept an offer of cure if (a) it has reason to believe that the debtor's initial performance was made with knowledge of its non-conformity and was not in accordance with good faith and fair dealing; (b) it has reason to believe that the debtor will be unable to effect the cure within a reasonable time and without significant inconvenience to the creditor or other prejudice to the creditor's legitimate interests; or (c) cure would be inappropriate in the circumstances.

14.26 There was also limited support for the final proposal that a creditor should have a right to seek cure from the debtor in line with the specific remedy of repair or replacement (or repeat performance of a service) now afforded to consumers under the Consumer Rights Act 2015.

14.27 Overall, it seems that our consultation has shown no appetite at present for the possible reforms discussed in this Chapter. Accordingly we make no recommendation for legislative reform (a) to provide for a price reduction remedy for non-consumer contracts in general; (b) allow a debtor to carry out a cure (repair or replace or repeat performance) of a prior non-performance notified to it by the creditor; or (c) to give a creditor a general right to seek repair or replacement of the debtor's defective performance of its contractual obligations.

# Chapter 15 Enforcing performance

## Introduction

15.1 The DCFR recognises two separate rights of the creditor to enforce performance: a right to recover payment of money which is due,<sup>1</sup> and one to enforce specific performance of an obligation other than one to pay money.<sup>2</sup> These correspond to the Scots law remedies of the action for payment and specific implement respectively.

15.2 In the 2017 DP, we examined how the DCFR and Scots law approach rights to enforce performance, before going on to look at possible reforms. Those that we identified focused to an extent on the mechanisms for enforcing a decree of specific implement in Scotland, which is properly speaking an aspect of the law of diligence, and hence outwith the scope of the DCFR. However, we pointed out that the availability or otherwise of a remedy in Scots law only takes us so far: a question remains as to whether that remedy can be made effective. We also raised for discussion the possibility that reform might best be achieved by moving away from specific implement and creating a bespoke remedy to enforce performance of contract.

## Terminology: specific implement and specific performance

15.3 As we do not recommend a general statutory restatement of the law on remedies for breach of contract, it is not possible at this time to recommend that the terminological reforms be taken forward alone.<sup>3</sup> However, we think that there is value in summarising briefly the issues and the views expressed by consultees about specific implement and special performance.

15.4 Scots law uses the remedy known as specific implement in order to compel performance by a contract debtor of its obligations *ad factum praestandum* (non-monetary obligations) under the contract. However, the term “specific performance” is encountered in other contexts, principally in statute.<sup>4</sup> In the 2017 DP, we provisionally expressed the view that “specific implement” was, in the strict sense, applicable to contractual situations and that other orders for enforcement were more correctly described as specific performance. We noted that practice appeared, to an extent, to have diverged from the position in law.

15.5 We also observed that while the term used in the DCFR is “specific performance”, it applies to monetary and non-monetary obligations,<sup>5</sup> and to obligations not to do something as in the same way as obligations to perform. We commented that specific performance in the DCFR context is accordingly far broader than specific performance or specific implement in Scots law.

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<sup>1</sup> DCFR III.–3:301.

<sup>2</sup> DCFR III.–3:302.

<sup>3</sup> See further paras 9.9 to 9.12 above.

<sup>4</sup> See the 2017 DP, paras 6.4 to 6.6.

<sup>5</sup> DCFR III.–3:301 and 3:302.

15.6 We therefore suggested that reform of the terminology would be desirable, although we proposed that something more fundamental than simply adopting the DCFR terminology was required.<sup>6</sup> Having canvassed a number of options, we provisionally suggested that the remedy used to enforce performance of an obligation might simply be called a performance order, and asked for consultees' views.

#### *Summary of consultation responses*

15.7 Consultees were divided on the initial question of whether the terminology used to describe the remedy used to enforce performance of an obligation could usefully be clarified. The Faculty of Advocates took the position that the terminology did not cause any difficulty in practice for those likely to be discussing the subject, and the Law Society of Scotland, the Society of Solicitor Advocates, Morton Fraser and Pinsent Masons did not think that the present position was problematic or that reform was required.

15.8 Burness Paull, by contrast, agreed with the general position adopted in the 2017 DP, saying that it was "indisputable" that the terminology is not readily comprehensible to non-lawyers, and that it was difficult to clearly define and explain to a client various concepts such as specific implement. Dr Rowan also suggested that "specific implement" was less than clear, and that other formulations would more accurately reflect the essence of the remedy. The Senators of the College of Justice indicated that the case for reform set out in the 2017 DP was, in their view, persuasive.

15.9 Views were also mixed among consultees as to the proposed term "performance order", with the Faculty and the Senators supporting it. Dr Rowan considered that it was insufficiently precise, and that it would be preferable to include "compelled" or "enforced". Morton Fraser did not think the term appropriate, and the Law Society thought that the real issue was the term "*ad factum praestandum*", not "specific implement".

### **Comparison of the DCFR and Scots law**

#### *Payment of money*

15.10 In the 2017 DP, we reviewed the remedy of action for payment in light of the DCFR and expressed the view that there were no pressing issues that required reform.<sup>7</sup> Consultees concurred in that view and did not bring any new issues to our attention. Accordingly, we take the view that there is no need for us to make any recommendations about actions for payment.

#### *Performance of non-monetary obligations*

15.11 We went on to compare the DCFR remedy of specific performance of an obligation other than one to pay money with the Scots law remedy of specific implement, noting that in both cases the remedies were generally available as of right, subject to limited exceptions.<sup>8</sup>

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<sup>6</sup> 2017 DP, para 6.9.

<sup>7</sup> 2017 DP, paras 6.11 to 6.14.

<sup>8</sup> 2017 DP, paras 6.15 to 6.17.

We contrasted this with the position in England and Wales, where specific performance is an equitable remedy available only where damages would be inadequate.<sup>9</sup>

15.12 We also identified that negative enforcement of contractual remedies (an obligation not to do something) was an aspect of specific performance under the DCFR, whereas in Scotland recourse is had to the separate remedy of interdict. We outlined the key ways in which interdict and specific implement differ, at least in relation to breach of contract, and queried why they should operate differently.<sup>10</sup>

15.13 Finally, we noted that the DCFR concept of specific performance was rather broader than specific implement, in that it includes the remedying free of charge of a performance not in conformity with the terms of the relevant obligation, that is, repair or replacement of the non-conforming performance.<sup>11</sup> We noted that such a right existed only in Scots law in relation to consumer contracts for the supply of goods, or digital content, or services.<sup>12</sup>

15.14 As a result of this analysis, we invited consultees to give their views on introducing a unified remedy for performance of non-monetary obligations in Scots law.<sup>13</sup>

### **Enforcement of performance of non-monetary obligations**

15.15 In our 1999 Report, we noted that consultees had suggested a need for further work in relation to civil imprisonment as it applies to a decree for specific implement. We took the view that further research and consultation would be required on the subject and so made no recommendations at that time. We decided that it would be desirable to revisit this topic in the 2017 DP, particularly as interest had been aroused by a recently-reported sheriff court judgment about the use of civil imprisonment to enforce decrees *ad factum praestandum*.<sup>14</sup>

15.16 As we noted in the 2017 DP, the availability of civil imprisonment as an enforcement mechanism is a key difference between the specific implement and payment remedies.<sup>15</sup> While civil imprisonment for debt was largely abolished by the Debtors (Scotland) Act 1880, civil imprisonment to enforce decrees *ad factum praestandum* remains generally available, and is regulated by the Law Reform (Miscellaneous Provisions) (Scotland) Act 1940.

15.17 Despite this, resort to civil imprisonment to enforce decrees *ad factum praestandum* appears to be rare: between April 2011 and April 2015 nobody was civilly imprisoned for that reason. While we suggested that this meant that the primary means of correcting a wilful failure to comply with a decree *ad factum praestandum* was not being put into effect, members of our Advisory Group counselled that its effectiveness lay in the *threat* of imprisonment because very few people would, ultimately, defy a court order where the consequence might be imprisonment.

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<sup>9</sup> 2017 DP, para 6.18.

<sup>10</sup> 2017 DP, paras 6.19 and 6.20.

<sup>11</sup> DCFR III.-3:302(2).

<sup>12</sup> See paras 14.11 to 14.15 above for discussion about whether that consumer remedy should be extended more generally.

<sup>13</sup> See paras 15.22 and 15.23 below.

<sup>14</sup> *Moneybarn No. 1 Ltd v Bell* 2016 SLT (Sh Ct) 419.

<sup>15</sup> 2017 DP, paras 6.24 and 6.25.

15.18 Despite this, we thought that it would be appropriate to invite consultees to consider the abolition of civil imprisonment and its replacement with alternative enforcement mechanisms.

## Potential reforms

### *Abolition of civil imprisonment*

15.19 In the 2017 DP, we summarised a number of difficulties with civil imprisonment, notably the expense involved for the creditor,<sup>16</sup> seeming judicial reluctance to grant warrant to imprison,<sup>17</sup> and the impossibility of imprisoning a corporate body or an individual who is outwith the jurisdiction.<sup>18</sup> We suggested that imprisonment as the primary sanction for failure to comply with an order for specific implement did not lend itself well to the needs of modern business, or economic efficiency.

15.20 We went on to comment that outright abolition of civil imprisonment for non-compliance with an order *ad factum praestandum* might be a step too far, in the light of its availability in other remedial contexts for the enforcement of contracts (notably interdict), and its utility in upholding the authority of court orders and motivating defaulters to comply with them.

15.21 Accordingly, in addition to asking consultees whether civil imprisonment to enforce decrees *ad factum praestandum* should be abolished, we also asked for their views on a number of potential reforms to the current model, focusing on a clarification of the court's powers to make alternative orders to imprisonment, and on whether it would be desirable to empower the court to order that a penalty for non-performance be payable.

### *A unified remedy for performance of non-monetary obligations?*

15.22 As we commented in the 2017 DP, the DCFR recognises a single remedy for enforcement of non-monetary obligations. In Scots law, it is necessary to look both to specific implement and to interdict as well as (in the consumer context) the creditor's right to repair or replacement to cover the same ground. We also highlighted some of the inconsistencies as to when implement and interdict are available.<sup>19</sup> This in turn reminded us that in the mid-1990s some discussion arose about the extent to which specific implement and interdict do (or do not) dovetail.<sup>20</sup> We also observed that cases have turned on whether the correct remedy is being sought, and that is to some extent driven by the different criteria for obtaining the respective remedies, and what may be done to enforce them.

15.23 Rather than try to reconcile the differences that exist among the current remedies, we invited consultees to consider a rather more radical approach to potential reform of the law on remedies for breach of contract. We suggested a new remedy which would, at the highest level of generality, involve two steps: first, for the matter to be submitted to the court for a

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<sup>16</sup> 2017 DP, para 6.33.

<sup>17</sup> 2017 DP, paras 6.34 and 6.35. We do note however that our Judicial Advisory Group thought imprisonment "a valuable last resort", pointing to its recent use in a breach of interdict case (*Mackenzie Hall Ltd and PRA UK Holding Pty Ltd v Mackenzie*, 8 January 2015).

<sup>18</sup> 2017 DP, para 6.36.

<sup>19</sup> See the 2017 DP, para 6.20.

<sup>20</sup> See eg *Church Commissioners for England v Abbey National plc* 1994 SC 651.

decision on whether the creditor is entitled to enforce performance of an obligation, and secondly for the court to make an order which is intended to secure the enforcement of the contract. We asked consultees for their views on creating a single bespoke remedy that encompassed both positive and negative non-monetary obligations, and on whether the courts should have broad powers to make orders intended to secure performance. We also asked consultees whether they would prefer to confer discretion on the courts (as is more commonly encountered in the United Kingdom) or to have a rules-based approach to determining the most appropriate order (as the DCFR does). Finally we asked if it would be helpful to give examples of the sort of order that might be made.

## **Summary of consultation responses**

### *Abolition of civil imprisonment*

15.24 Consultees were generally of the view that civil imprisonment should be retained as the ultimate sanction for wilful refusal to comply with a decree *ad factum praestandum*. The Senators of the College of Justice commented that its availability was ultimately a policy question for the legislature, but observed that its current availability does cause a party in breach to think very hard about the consequences of continued wilful refusal. Other consultees also pointed to the deterrent effect of the sanction, even if it was rarely sought.

15.25 Consultees also agreed that the periods for which civil imprisonment may be ordered for wilful refusal to comply with a decree *ad factum praestandum* and for breach of interdict should be aligned in length.<sup>21</sup>

15.26 A majority of consultees favoured empowering the courts to make such orders as may be just and equitable in all the circumstances as an alternative to civil imprisonment as a means of enforcing a decree *ad factum praestandum*. A number of consultees did comment that they thought the court could already do so in appropriate cases. It was also observed that this might be a more effective means of having the contract performed.

15.27 Views were also mixed among those consultees who addressed the question of whether those alternative orders should be available with the initial decree. The Faculty of Advocates and Pinsent Masons made the point that this would offer the debtor alternatives to performance, which would cut across the policy aim of ensuring that contracts are performed. The Faculty did suggest that it might, however, be useful if the debtor had made clear its refusal to perform even in the face of a court order. The Senators of the College of Justice thought that early availability of the alternative order would be useful in appropriate cases, and Morton Fraser and the Society of Solicitor Advocates both supported the proposal.

15.28 A majority of consultees agreed that it should be open to the court to specify a penalty which is to be paid if a party fails to comply with a decree *ad factum praestandum*. The Faculty of Advocates took issue with specifying the penalty in advance, commenting that in effect it might be perceived as pricing non-compliance, and that the appropriate penalty for wilful failure to obey an order of court should depend on the precise circumstances of the failure which were unlikely to be known at that time. The first of those

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<sup>21</sup> This would resolve the anomaly identified in the 2017 DP, para 6.32.

issues would be addressed by a comment made by Mr Christie, who noted that the sum payable would have to be penal in nature precisely to avoid the debtor making an economic calculation about non-compliance. We do, however, see some force in the Faculty's second objection.

15.29 Consultees' views as to whom a penalty should be payable were finely balanced. Some argued that the penalty was in lieu of performance, and so should be payable to the creditor having regard to its legitimate interests. It was also noted that the creditor would bear the expenses of bringing the proceedings, and so it would seem unfair for the penalty to be taken by the state. Others thought that the penalty was properly levied in order to uphold the authority of the court and the judicial system, and so it should fall to the state. As Dr Rowan pointed out, this is a controversial issue in jurisdictions that do operate penalty regimes of this nature. She commented that in France, where the penalty is paid to the creditor, there have been objections that this results in the creditor's unjustified enrichment – but queried whether the state was any more deserving a recipient. Mr McLean noted that in French law, a public contract or concession can be ended, subject to an indemnity, if the public interest is considered by the public authority to be no longer served by it.<sup>22</sup>

*A unified remedy for performance of non-monetary obligations?*

15.30 Consultees' views on the introduction of a unified remedy to enforce non-monetary obligations were mixed. The Faculty of Advocates, Pinsent Masons, Dentons and the Society of Solicitor Advocates were opposed, with the first three considering, broadly, that the current law was adequate and thus that reform was undesirable. The Senators of the College of Justice thought the proposal radical, but saw merit in it for the reasons outlined in the 2017 DP. Dr Rowan also supported the proposal for those reasons, and it was further supported by Mr Christie, Morton Fraser and the Law Society of Scotland (which repeated its observation that it would be better addressed as part of a wider project on civil procedure).

15.31 Consultees broadly agreed that the courts should have broad powers to make orders that were intended to secure performance of the obligation in question. However, they were divided on whether a general discretion ought to be conferred, or whether a rules-based approach would be preferable. Indeed, the Faculty of Advocates proposed that a combined approach would be desirable, with restricted judicial discretion constrained by the guiding principle of ensuring performance of the obligation. Dr Rowan suggested that certainty would be better served by giving examples of the orders that could be made and setting out the criteria that would apply to determine which was most appropriate. Morton Fraser commented that the terms of the contract itself would have to be taken into account, and the Senators of the College of Justice preferred a rules-based approach in the interests of certainty.

15.32 Finally, consultees broadly agreed that it might be desirable to give examples of the type of order that might be made, although the Faculty of Advocates commented that this should be purely illustrative and not exhaustive. Similarly, Morton Fraser again pointed to the need to take into account the terms of the contract in determining the appropriate order.

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<sup>22</sup> See <https://goo.gl/d6mrBp>.

## Conclusions

15.33 Although we have been able to identify a consensus for certain reforms of civil imprisonment for wilful failure to comply with a decree *ad factum praestandum*, we have considered very carefully a point made by the Law Society of Scotland: the question of how to enforce compliance with court orders goes far beyond the contractual context. Were we to propose reforms, the effect (if they were implemented) would be to create a divergence between remedies for breach of contract on one hand and the general law of remedies on the other. We entirely agree with the Law Society's comment that "[t]here is great merit in an integrated system of private law, where general issues are regulated at a general level in terms of clarity and simplicity." The Law Society suggested that it would be desirable for the Commission to undertake a civil procedure project on court orders and enforcement instead. We note that suggestion.

15.34 Accordingly, we do not propose to make recommendations for reform of civil imprisonment as it relates to breach of contract. We do however note consultees' views, and think that they provide a useful starting point should this issue be considered further in future.

15.35 Given the mixed views expressed by consultees, we are not minded to recommend replacing specific implement and interdict in the contractual context at this time. As with the previous potential reform, however, we think that there is considerable force in the Law Society of Scotland's view that this proposal would be better explored in further detail as part of a wider review of the law on remedies and enforcement.

15.36 Accordingly we make no recommendation for legislative reform to the remedies for enforcement of non-monetary obligations.

# Chapter 16 Damages

## Introduction

16.1 In the 2017 DP, we examined how the DCFR and Scots law approach damages as a remedy, with a view to its inclusion in a general statutory restatement of the law on remedies for breach of contract. We then went on to examine potential reforms, focusing on whether the position on non-patrimonial losses could be put on a more stable footing in Scots law, as recommended in our 1999 Report.<sup>1</sup>

## Comparison of the DCFR and Scots law

16.2 In the 2017 DP, we compared the DCFR and Scots law approach to damages as a remedy. We observed a number of common features, such as the remedy existing to recover the loss caused by non-performance or breach without any requirement for fault.<sup>2</sup> We noted that both the DCFR and Scots law took the same basic approach to the measure of damages, commenting that the approach could be characterised as protecting the creditor's expectation (or performance) interest.<sup>3</sup> We also noted that the DCFR and Scots law rules on mitigation of loss<sup>4</sup> and on the appropriate currency for an award of damages<sup>5</sup> were broadly aligned.

16.3 On the other hand, we noted a number of areas where the DCFR and Scots law took different approaches in relation to damages. For example, the DCFR makes particular provision for damages recovery following termination of contract, measured by the cost of procuring a substitute performance or by the difference between the contract price and the price of performance at the time of termination, as well as any further loss. Scots law does not have an equivalent, and in our 1999 Report we took the view that legislative provision of this kind was unnecessary, given the general principle that damages are for the recovery of losses.<sup>6</sup>

16.4 The DCFR also takes a different approach to liability. It is limited by reasonable foreseeability of the loss as "a likely result of the non-performance" at the time of conclusion of the contract, but this restriction does not apply if the non-performance was intentional, reckless, or grossly negligent.<sup>7</sup> In our 1999 Report we observed that "hardly any consultees" thought that there should be an exception of the latter kind to the general rule of

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<sup>1</sup> 1999 Report, Part 3 and recommendation 2.

<sup>2</sup> 2017 DP, paras 7.2 and 7.3.

<sup>3</sup> 2017 DP, paras 7.4 and 7.5. We also remarked that the Scots law approach was probably flexible enough to protect the creditor's reliance interest: see paras 7.5 to 7.7.

<sup>4</sup> 2017 DP, para 7.11.

<sup>5</sup> 2017 DP, para 7.12.

<sup>6</sup> 2017 DP, para 7.8.

<sup>7</sup> DCFR III.–3:703. See also PECL art 9:503; PICC art 7.4.4.

remoteness,<sup>8</sup> and the courts have continued to apply the “two-limb” approach formulated in *Hadley v Baxendale*.<sup>9</sup>

16.5 We also observed that the DCFR does not appear to have any express equivalent to the possibility found in English law that, while in general loss is assessed as at the date of breach, account may exceptionally be taken of events occurring after that date.<sup>10</sup>

16.6 Having concluded our comparison of the DCFR and Scots law, we did not propose any reform of Scots law. We did, however, suggest that the law could usefully be clarified by including it in any general statutory restatement. We set out five propositions that should form the basis of a restatement of the remedy of damages,<sup>11</sup> and also asked about when damages should be assessed (and any exceptions to that).<sup>12</sup> For the reasons given in Chapter 9,<sup>13</sup> we are not recommending a restatement of the law of remedies for breach of contract. We do, however, summarise briefly the consultation responses that we received.

#### *Summary of consultation responses*

16.7 As we note above, consultees were generally not in favour of a statutory restatement. However, the six consultees who addressed the five propositions that we set out largely agreed that they should be included in any restatement. The Law Society of Scotland did suggest that the first and fifth propositions were simply elaborations of the second, and so questioned the utility of including them. Had we been proceeding with a restatement, we would have revisited that point.

16.8 We also proposed that in general loss should be assessed at the date of breach, but that exceptions should be permitted, and asked for views on potential exceptions. Consultees’ views on this point were mixed, with the Faculty of Advocates and Pinsent Masons both suggesting that there were already so many exceptions to this rule in English law that it was doubtful whether it could be called a rule at all. By contrast, the Senators of the College of Justice were content with the general rule so long as it was made clear that it could be departed from to give effect to the compensatory principle, while Morton Fraser agreed with the rule but thought it unclear what any exceptions might be or why it would be helpful to allow for them. In the circumstances, we simply note from consultees’ differing views that the utility of a rule about when loss should be assessed is perhaps unclear.

#### **Potential reform: damages for non-patrimonial loss**

16.9 Non-patrimonial loss is the loss of something other than money or property. For example, distress caused by a breach of contract does not generally sound in damages for breach of contract. The decision of the House of Lords in *Addis v Gramophone Co Ltd* is the longstanding authority for this proposition.<sup>14</sup> However, not all non-patrimonial claims are disallowed: Scots law recognises damages for non-patrimonial loss in certain situations.<sup>15</sup>

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<sup>8</sup> 1999 Report, para 7.32.

<sup>9</sup> See the 2017 DP, para 7.9 and fn 30 for further detail on subsequent developments in domestic law.

<sup>10</sup> 2017 DP, para 7.10.

<sup>11</sup> 2017 DP, Question 50.

<sup>12</sup> 2017 DP, Questions 51 and 52.

<sup>13</sup> See paras 9.9 to 9.12 above.

<sup>14</sup> *Addis v Gramophone Co Ltd* [1909] AC 488. See also Gloag, *Contract*, p 686.

<sup>15</sup> See the 2017 DP, paras 7.16 to 7.18.

The basic position is that physical loss or harm caused by a breach of contract will attract damages but other types of loss or harm, such as mental distress, will not.<sup>16</sup> But some non-physical loss or harm has become recoverable as a free-standing claim in damages, as a result of a series of cases from the 1970s onward, though the class of contract to which this applies is narrowly confined.<sup>17</sup> Put colloquially, the test has been whether the sole or a significant objective of the contract is to provide the creditor with pleasure or to prevent the same party from suffering distress.

16.10 In the 2017 DP, we included a diagram that summarised the current law on the recoverability of loss following breach of contract.<sup>18</sup> We pointed out that this illustrates the significance of the exceptions to the principle that non-patrimonial loss is irrecoverable.

16.11 We then went on to summarise recent developments in relation to the recovery of non-patrimonial loss, focusing on two cases involving surveyors.<sup>19</sup> From those developments, we identified a number of preliminary conclusions:

- the law is unclear;<sup>20</sup>
- it is developing, but in a piecemeal and patchwork fashion;
- there is some anecdotal evidence that the lower courts are currently awarding damages in suitable cases for non-patrimonial loss;<sup>21</sup>
- this means that decisions about awards of damages are dependent not simply on the exercise of what is, in essence, judicial discretion but also on the judge's understanding of what the proper test is, which leads not to legitimate variation of outcome but to inherent injustice;
- accordingly, there would be value in a principled reform embodied in a clear and universally applicable statutory rule.<sup>22</sup>

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<sup>16</sup> The simplicity of this distinction may turn out to be more apparent than real. In *Farley v Skinner* [2001] UKHL 49; [2002] 2 AC 732, Lord Scott essays, at para [85], an explanation of what is meant by "physical inconvenience and discomfort" (and what the substitution of "non-physical" would produce).

<sup>17</sup> See the 2017 DP, paras 7.20 and 7.21; McBryde, *Contract*, paras 22.101 to 22.105.

<sup>18</sup> 2017 DP, Appendix B.

<sup>19</sup> 2017 DP, paras 7.22 to 7.27. The cases are *Watts v Morrow* [1991] 4 All ER 937, [1991] 1 WLR 1421 and *Farley v Skinner* [2001] UKHL 49; [2002] 2 AC 732. Further on English cases in this area see Kramer, *Contract Damages*, ch 19.

<sup>20</sup> See the leading case of *Farley v Skinner* [2001] UKHL 49, [2002] 2 AC 732, para [28] per Lord Steyn and para [110] per Lord Scott. But despite this a feature of the case is four separate and detailed speeches, each giving subtly differing reasons for the result. The fifth, Lord Browne-Wilkinson, agrees with two of the others. An example of the difficulties to which this gives rise is that the test tentatively set out at para [54] for use in future cases is contained in Lord Hutton's speech, but he is not one of those with whom Lord Browne-Wilkinson agrees. It has been said that "[a] close examination of all four speeches in *Farley* can make your head spin": A Bowen, "Watts v Morrow and the consumer surplus", 2003 SLT (News) 1 at 6. Thus the law remains unclear despite Lord Scott saying (at para [74]) that it was highly desirable that the court should resolve the present angst on this subject, the angst is arguably still present.

<sup>21</sup> See, eg, Lord Steyn's comment in *Farley v Skinner* at para [20]: "I am satisfied that in the real life of our lower courts non-pecuniary damages are regularly awarded on the basis that the defendant's breach of contract deprived the plaintiff of the very object of the contract, viz pleasure, relaxation, and peace of mind." This is quoted in a Scottish context without demur: A Bowen, "Watts v Morrow and the consumer surplus", 2003 SLT (News) 1, at 5 and 6.

<sup>22</sup> There have been calls from the bench to this effect, with Staughton LJ inviting the House of Lords or the Law Commission to supply it in *Hayes v James & Charles Dodd (A Firm)* [1990] 2 All ER 815 at 822.

16.12 We also reviewed the issue of quantification of non-patrimonial loss, observing that such an award of damages is compensatory in nature and that awards (at least in England) are modest.<sup>23</sup>

### *Proposals for reform*

16.13 In addressing this topic in the 2017 DP, we were revisiting a topic that had last been considered in our 1999 Report, where we criticised the current law and recommended that all forms of loss or harm should be recoverable, whether or not patrimonial in nature, subject only to the normal rules as to causation, mitigation and remoteness.<sup>24</sup> Almost all consultees supported this, and the one dissenting view was to the effect that the common law should be allowed to continue to evolve and develop incrementally.

16.14 Given the time that had elapsed since the publication of the 1999 Report, we were particularly interested to hear consultees' views on whether it was now the time to proceed with a statutory reform, the aim of which would be to state clearly that awards of damages as compensation for non-patrimonial loss or harm are competent. We also acknowledged the likely contrary arguments: the risk of opening the floodgates to new claims,<sup>25</sup> and the assimilation of contractual and delictual damages for non-patrimonial loss without good reason.<sup>26</sup>

16.15 We went on to suggest that there were principled reasons for supporting reform: first, a growing trend to reducing the scope of irrecoverable loss in breach of contract<sup>27</sup>, and secondly the Scots approach of focusing on the relevant remedy to right wrongs rather than formalistic insistence on identifying the correct form of action.<sup>28</sup>

16.16 Accordingly, we asked consultees: subject to the normal remoteness and other rules, should damages recoverable for breach of contract include non-patrimonial loss or harm of any kind; and, in particular, should loss of the satisfaction of obtaining a contractual benefit, and harm in the form of pain, suffering or mental distress be included?<sup>29</sup>

### **Summary of consultation responses**

16.17 Consultees broadly agreed that it should be possible, in principle, to recover damages for non-patrimonial loss. The Senators of the College of Justice pointed out that policy justification for refusing to allow recovery was far from clear, and suggested that the floodgates argument was manageable given the need to prove the head of loss and the likelihood that awards would be at a modest level. Morton Fraser disagreed, however, on both of these points, saying that permitting the recovery of damages for non-patrimonial loss would lead to a proliferation of small and vexatious claims and cause significant uncertainty due to difficulties in quantifying the loss.

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<sup>23</sup> 2017 DP, para 7.29 (highlighting in particular *Farley v Skinner* and *Milner v Carnival plc (t/a Cunard)* [2010] EWCA Civ 389, [2010] 3 All ER 701). See further Kramer, *Contract Damages*, paras 19.56 to 19.72.

<sup>24</sup> 1999 Report, paras 3.5 to 3.8.

<sup>25</sup> 2017 DP, para 7.32.

<sup>26</sup> 2017 DP, para 7.33.

<sup>27</sup> 2017 DP, para 7.34.

<sup>28</sup> 2017 DP, para 7.35.

<sup>29</sup> 2017 DP, questions 53 and 54.

16.18 The Faculty of Advocates, while agreeing that damages for non-patrimonial loss should be recoverable, did not consider that legislation was needed to achieve that outcome. Indeed, the Faculty argued that “inconvenience” was routinely discussed as a head of claim in sheriff court actions for damages for breach of contract, and that awards were made relatively frequently. It therefore adhered to the position it had taken in 1999, saying that the law was evolving and developing and that there was no compelling reason for statutory intervention at this time.

16.19 In relation to the proposed heads of claim that we mentioned, the Faculty of Advocates expressed some concern in relation to “loss of the satisfaction of obtaining a contractual benefit”, cautioning that proof of loss would be required. It did, however, agree that the heads should be included if they amounted to genuine loss or harm. The Senators of the College of Justice similarly remarked that the loss claimed would have to be proved to the court’s satisfaction. The Law Society of Scotland agreed that the heads should be included, although it questioned whether explicit provision would be required.

## Conclusions

16.20 The proposed reform to the recoverability of damages for non-patrimonial loss derives directly from our 1999 Report, where we recommended that:

“It should be made clear that, subject to the normal remoteness rule, the loss or harm for which damages may be recovered for breach of contract includes non-patrimonial loss or harm of any kind, and in particular includes loss of the satisfaction of obtaining what was contracted for and harm in the form of pain, suffering or mental distress.”<sup>30</sup>

16.21 It appears to us that consultees show less enthusiasm for legislating on this subject now than did those who responded 19 years ago. In particular, we acknowledge that the Faculty of Advocates continues to think that the law should be left to develop on a case-by-case basis. In 1999, we took the contrary view and recommended legislation.

16.22 However, there is some force in the argument put forward by the Faculty of Advocates that damages of this sort are now available in appropriate cases in Scots law and that legislative intervention is not required. The cases are non-commercial ones in which personal, social and family interests predominate. We observe that this development of the law has, according to the Faculty, largely taken place at Sheriff Court level and so it has perhaps not received the attention that it deserves. Our own researches have led us to the under-noted dictum in the Outer House which is not reported, or cited in the standard works on contract.<sup>31</sup> English law appears to be moving in a similar direction, and there is undoubted

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<sup>30</sup> 1999 Report, para 3.8 and recommendation 2.

<sup>31</sup> D Brodie, *The Contract of Employment* (2008), para 20.13, draws attention to an unreported dictum of Lord Gill in the Outer House, finding relevant a claim for non-patrimonial loss arising from the sale of a building plot to a married couple: “[T]he purpose of this contract was the purchase by the pursuer and her husband of a dwelling house for their own occupation, it would be open to her to argue that this was not a purely commercial contract ... but was one which affected the purchasers’ personal, social and family interests” (*Brennan v Robertson*, unreported, 21 April 1995, OH). Lord Gill’s dismissal of the action on other grounds was reversed by the Second Division in *Brennan v Robertson* 1997 SC 36, with however the court noting that “The Lord Ordinary determined certain matters relating to relevancy on which he was addressed which do not now arise, either because his determination on these matters is not challenged or because the pleadings have been amended” (p 39). These appear to have included the question of non-patrimonial loss.

benefit in the two systems continuing to develop together in this area rather than moving apart, perhaps significantly.<sup>32</sup>

16.23 Under the present law it is reasonably clear from decisions at the highest judicial level that when awards of damages are made for non-patrimonial loss the level of award should not be high.<sup>33</sup> This is however a matter more of judicial policy than a rule, born of a desire to ensure that such damages do not become punitive rather than compensatory. It is however not easy to frame this as a statutory rule capable of general application. The recommendation in our joint Report with the Law Commission for England and Wales on Consumer Redress for Misleading and Aggressive Practices that damages for distress and inconvenience should be awarded against traders who used the prohibited practices against consumers was carried into the resulting legislation, but without the provision which we had also recommended that such damages should be “restrained and modest”.<sup>34</sup> But such a rule might have to be formulated if there was a general lifting of the rule against recovery of non-patrimonial loss.

16.24 Another policy concern which has waxed stronger in our thinking since publishing the 2017 DP is employment contracts.<sup>35</sup> Although prior to the *Addis* case Scots law perhaps allowed claims for the wrongfully dismissed employee’s non-patrimonial loss,<sup>36</sup> the general exclusion of recovery for such loss since then has probably been at its most significant in such contracts despite their non-commercial character. It is true that the rule has been subject to significant constriction in some modern House of Lords decisions,<sup>37</sup> while the continuing limitation of recovery in employment cases has been criticised by academic commentators in England as well as Scotland.<sup>38</sup> But we think that the position in employment contracts should not be changed without further research on the subject.

16.25 In part this is because in statutory unfair dismissal cases it has been authoritatively laid down that the “loss” which the unfairly dismissed employee may recover as damages from the employer does not include the former’s non-patrimonial loss.<sup>39</sup> There could be a risk of undermining that statutory position if the general law allowed such losses to be recoverable, in the sense that dismissed employees might be encouraged to seek remedies

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<sup>32</sup> See *McGregor on Damages*, paras 5.015 to 5.035; Kramer, *Contract Damages*, ch 19.

<sup>33</sup> See para 16.12 above.

<sup>34</sup> See Consumer Protection from Unfair Trading Regulations 2008, reg 27J(1)(b) (added by Consumer Protection (Amendment) Regulations 2014, reg 3); and Joint Report on Consumer Redress for Misleading and aggressive Practices (Law Com No 322, Scot Law Com No 226, 2012), recommendation 44.

<sup>35</sup> See 2017 DP, para 7.17.

<sup>36</sup> Brodie, *Contract of Employment*, paras 20.12 to 20.13.

<sup>37</sup> Notably in *Eastwood v Magnox Electric*; *McCabe v Cornwall County Council* [2005] 1 AC 503 (financial loss resulting from psychiatric or other illness caused to wrongfully dismissed employee by pre-dismissal unfair treatment recoverable); and *Malik and Mahmud v Bank of Commerce and Credit International* [1998] AC 20 (damages for financial loss awarded to ex-employee for ex-employer’s breach of contract because the “stigma” or loss of reputation through having once worked for a publicly disgraced employer prevented the ex-employee gaining new employment within the relevant sector).

<sup>38</sup> Brodie, *Contract of Employment*, para 20.13; D Cabrelli, *Employment Law in Context* (2<sup>nd</sup> edn, 2016) para 15.3.1; M Freedland, *The Contract of Employment* (2016) p 540.

<sup>39</sup> See the Employment Rights Act 1996 s 123; *Dunnachie v Kingston Upon Hull City Council* [2004] UKHL 36, [2005] 1 AC 226 (over-turning a contrary decision in the Court of Appeal below purporting to over-rule the initial decision on the subject under the Industrial Relations Act 1971, s 116, *Norton Tool Co Ltd v Tewson* [1973] 1 WLR 45 (National Industrial Relations Court)). *Norton* is not referred to in *Dunnachie*, however.

in the courts as well as in employment tribunals.<sup>40</sup> It would also be undesirable for Scots law to move out of step with English law in this area in particular.

16.26 We have therefore come to the view that we should make no recommendation with regard to damages for non-patrimonial loss, and instead continue to leave the matter to the courts and further academic research on the reach and implications of the present limitations and their possible removal.

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<sup>40</sup> See discussion in *Johnson v Unisys Ltd* [2001] UKHL 13, [2003] 1 AC 518.

# Chapter 17 Gain-based damages

## Introduction

17.1 The 2017 DP examined the concept of gain-based damages, which are best described as awards that reflect the gain made by the debtor from its breach of contract, rather than compensating the creditor for the loss it has suffered.

17.2 The concept appears to have originated in England and Wales, where the courts have made a number of awards of damages which can best be characterised in this way. The concept has also spread to other common law jurisdictions, although its reception has not been uniform. Such damages have so far received little attention in Scotland as a potential remedy for breach of contract, perhaps in light of House of Lords authority that they are not available.<sup>1</sup>

17.3 In the 2017 DP, we considered the extent to which the DCFR and Scots law recognise the existence of gain-based damages. We then reviewed the development of the concept in England and Wales, and other common law jurisdictions, before discussing whether the non-recognition of this type of award in Scots law should be revisited.

17.4 In this Chapter, we summarise briefly the discussion set out in the 2017 DP and then address consultees' views on whether gain-based damages for breach of contract should be recognised in Scots law.

## Comparison of the DCFR and Scots law

17.5 The DCFR contains no provision about gain-based damages, with damages for breach of contract being recoverable only in respect of the creditor's loss. This appears to be intentional, given that only a few of the legal systems involved in the DCFR recognise the concept.<sup>2</sup>

17.6 Similarly, we observed that in Scots law, damages for breach of contract are purely compensatory: if the debtor makes a profit in breaching the contract, that is regarded as irrelevant to any calculation of the creditor's damages.<sup>3</sup>

17.7 That said, Scots law recognises that a debtor may be called to account for its profits in certain circumstances. It appears, however, that this arises only where there has been a breach of fiduciary obligations, the underlying policy being to deter parties in fiduciary positions from committing breach of duty. Not all fiduciary relationships involve a contract, although partnership and agency typically do.<sup>4</sup>

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<sup>1</sup> See para 17.6 below.

<sup>2</sup> See the 2017 DP, paras 8.4 and 8.5.

<sup>3</sup> See the 2017 DP, paras 8.6 to 8.9 where we cited McBryde, *Contract*, para 22.94 and *Teacher v Calder* (1898). 25 R 661 (Inner House); (1899) 1 F (HL) 39 (House of Lords).

<sup>4</sup> See further L J Macgregor, *The Law of Agency in Scotland* (2013) ch 6.

## Development of the concept of gain-based damages

17.8 As we set out in the 2017 DP, the concept of gain-based damages is primarily one drawn from English law. Its availability in English law, and apparent non-availability in Scots law, indicates a clear divergence in the law in relation to damages for breach of contract.

17.9 We therefore examined the origin of gain-based remedies in English law, noting that they were first found in the law of tort before the House of Lords held that they also applied to breaches of contract in *Attorney General v Blake*.<sup>5</sup>

17.10 We noted that academic views as to the nature of gain-based remedies varied, with James Edelman arguing that they fall into two distinct categories: accounts of profits (or disgorgement awards), and reasonable fee awards,<sup>6</sup> whereas Dr Rowan suggests that reasonable fee awards achieve, in effect, partial disgorgement and that there is a “sliding scale” of damages with an account of all profits representing total disgorgement.<sup>7</sup> In the 2017 DP, we adhered to Edelman’s approach which appeared to us to be in line with the approach taken by the Court of Appeal in recent cases.

17.11 Disgorgement awards are intended to represent the totality of the debtor’s profits from committing the breach of contract. The rationale underpinning this award is generally understood to be deterrence of breach. In depriving the debtor of the benefits of breaching the contract, any incentive to do so is removed.<sup>8</sup> The concept is known elsewhere in English law, most notably in relation to fiduciary obligations.<sup>9</sup>

17.12 By contrast, reasonable fee awards do not deprive the debtor of the entirety of the profits made in committing the breach, but require the debtor to pay the creditor a hypothetical “reasonable fee” for the waiver of the contractual right in question. The rationale behind such an award is controversial. While such an award may be considered restitutionary or gain-based because it is the amount the debtor has saved in not having to

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<sup>5</sup> [2001] 1 AC 268 at 284 per Lord Nicholls of Birkenhead. For more detail, see the 2017 DP, para 8.10.

<sup>6</sup> Edelman, *Gain-Based Damages* Ch 3. The author is now a Justice of the High Court of Australia and editor of *McGregor on Damages*: see its chs 14 (“Restitutionary Damages”) and 15 (“Disgorgement Damages (Account of Profits)”). See also Winterton, *Money Awards*, pp 47 to 51, 60 to 68; Kramer, *Contract Damages*, chs 21 and 22; G Virgo, “Gain-Based Remedies”, in Virgo and Worthington, *Commercial Remedies*, ch 13.

<sup>7</sup> Rowan, *Remedies for Breach of Contract*, p 160 and fn 343.

<sup>8</sup> Rowan, *Remedies for Breach of Contract*, p 155 and fn 314; G Black, “A New Experience in Contract Damages? Reflections on *Experience Hendrix v PPX Enterprises*” 2005 JR 31; K Barnett, “Deterrence and Disgorging Profits for Breach of Contract,” (2009) 17 RLR 79; R Cunnington, “The Measure and Availability of Gain-Based Damages for Breach of Contract”, in D Saidov and R Cunnington (eds), *Contract Damages: Domestic and International Perspectives* (2008), p 207; R Cunnington, “The Assessment of Gain-Based Damages for Breach of Contract” (2008) 71 MLR 559.

<sup>9</sup> *Boardman v Phipps* [1967] 2 AC 46. See also P Birks, “The Content of Fiduciary Obligation” [2000] Israeli LR 3; I Samet, “Guarding the Fiduciary’s Conscience – a Justification of a Stringent Profit-Stripping Rule” (2008) 28 OJLS 763.

pay such a fee to the creditor,<sup>10</sup> others consider it to be compensatory and based on the creditor's lost opportunity to bargain with the debtor.<sup>11</sup>

### *Reasonable fee awards*

17.13 We traced the history of reasonable fee awards (which are sometimes called *Wrotham Park* damages),<sup>12</sup> observing that many of the previous restrictions on their use had fallen away<sup>13</sup> and that the Court of Appeal had held that the only question the court should ask itself when considering whether to grant a reasonable fee award is "what remedy is required to avoid injustice in the particular case."<sup>14</sup>

17.14 The question of whether traditional damages would leave the creditor undercompensated appears to be key, with the essential comparison being whether the debtor's gain exceeds the creditor's loss by a significant amount.<sup>15</sup> The assessment of a reasonable fee is a hypothetical exercise carried out on the basis of a negotiation between a willing buyer (the debtor) and a willing seller (the creditor), the subject-matter of which is the release of the relevant contractual obligation.<sup>16</sup> The court will normally assess a reasonable fee award at the date of the breach, but may depart from this rule where justice requires it to do so.<sup>17</sup>

### *Accounts of profits*

17.15 The House of Lords first awarded an account of profits as a remedy for a breach of contract in *Attorney General v Blake*,<sup>18</sup> a highly unusual case involving an attempt by the Attorney General to prevent a former member of the Secret Intelligence Service profiting further from the publication of his memoirs which dealt with his conviction for offences under the Official Secrets Act 1911 and subsequent escape to the USSR.

17.16 The Attorney General formulated his case differently at each stage, eventually succeeding before the House of Lords on an argument that Blake was in breach of contract and that, given the exceptional circumstances, the Attorney General was entitled to an account of the profits made by Blake from that breach.<sup>19</sup> The decision has been the subject

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<sup>10</sup> Edelman, *Gain-Based Damages* Ch 3; *Experience Hendrix LLC v PPX Enterprises Inc* [2003] EWCA Civ 323, [2003] EMLR 25. See further A Burrows, "Are 'Damages on the *Wrotham Park* Basis' Compensatory, Restitutory or Neither?" in D Saidov and R Cunnington, *Contract Damages: Domestic and International Perspectives* (2008), p 165; C Rotherham, "'*Wrotham Park* Damages' and Accounts of Profits: Compensation or Restitution?" [2008] LMCLQ 25.

<sup>11</sup> *WWF World Wide Fund for Nature (formerly World Wildlife Fund) v World Wrestling Federation Entertainment Inc* [2007] EWCA Civ 286, [2008] 1 WLR 445; *Pell Frischmann Engineering Ltd v Bow Valley Iran Ltd* [2009] UKPC 45, [2011] 1 WLR 2370.

<sup>12</sup> After the case in which they were first granted: *Wrotham Park Estate Co Ltd v Parkside Homes Ltd* [1974] 1 WLR 798.

<sup>13</sup> 2017 DP, para 8.16.

<sup>14</sup> *Morris-Garner v One Step (Support) Ltd* [2016] EWCA Civ 180, para 120 per Christopher Clarke LJ. It disapproved the suggestion in *Abbar v (SEDCO) Real Estate Ltd* [2013] EWHC 1414 that the creditor must be unable to establish any financial loss assessed on the usual basis.

<sup>15</sup> 2017 DP, para 8.17.

<sup>16</sup> 2017 DP, para 8.18.

<sup>17</sup> *Morris-Garner v One Step (Support) Ltd* [2016] EWCA Civ 180, [2017] QB 1, para 132 per Christopher Clarke LJ.

<sup>18</sup> [2001] 1 AC 268; note further A W B Simpson, "A Decision Per Incuriam?" (2009) 125 LQR 433.

<sup>19</sup> See further the 2017 DP, paras 8.21 to 8.25.

of academic criticism, not least for failing to address the earlier House of Lords decision in *Teacher v Calder*. It has also been doubted whether any contract in fact existed.<sup>20</sup>

17.17 An account of profits for breach of contract was subsequently awarded in *Esso Petroleum Ltd v Niad*,<sup>21</sup> a commercial case about the sale of fuel where the debtor's breach of an agreement to sell the creditor's products at prices set by the creditor led to the creditor raising proceedings. The court pointed to a number of factors that, in its view, made an account of profits the appropriate remedy, although again the decision has been subject to academic criticism.<sup>22</sup>

17.18 Although an account of profits has not been awarded for a breach of contract in any other case in England and Wales, it has been discussed in a small number of subsequent cases, all of which stress the requirement of exceptionality as a pre-requisite. A great deal of the academic commentary in England supports the proposition that the purpose of an account of profits, at common law or in equity, is to deter the debtor from breaching its obligations.<sup>23</sup> This is generally agreed to be necessary in fiduciary relationships, as the fiduciary is uniquely placed to take advantage of the person to whom the obligations are owed. However this can also happen, exceptionally, in the contractual context.<sup>24</sup>

17.19 We went on to review the reception of the concept of an account of profits for breach of contract, stemming from *Blake* and *Esso* in English law, in other jurisdictions. We found that the reception of this remedy has been mixed. We have identified jurisdictions where the position appears similar (Canada<sup>25</sup>), where the remedy is more readily available (Israel<sup>26</sup>), where the possibility of the remedy is accepted but has never been applied (Ireland<sup>27</sup>), and where the remedy has been rejected (Australia<sup>28</sup>).

### **Potential reform: reasonable fee awards**

17.20 In the 2017 DP, we invited consultees to consider whether Scots law would benefit from the introduction of gain-based remedies for breach of contract. As the present view appears to be that a reasonable fee award and an account of profits are remedies of a very different nature, we asked consultees for their views on each remedy separately.

17.21 We pointed out that it is currently unclear whether reasonable fee awards are available under the Scots law of contract.<sup>29</sup> We suggested that there were broadly two options: to leave the law as it stands, in the hope that a suitable case might come before the courts to clarify the point, or to recommend legislating for the introduction of reasonable fee awards.

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<sup>20</sup> 2017 DP, para 8.26.

<sup>21</sup> [2001] EWHC Ch 458.

<sup>22</sup> 2017 DP, paras 8.27 to 8.29.

<sup>23</sup> M Conaglen, "The Nature and Function of Fiduciary Loyalty" (2005) 121 LQR 452; Edelman, *Gain-Based Damages*, Ch 3; Barnett, "Deterrence and Disgorging Profits for Breach of Contract", (2009) 17 RLR 79.

<sup>24</sup> 2017 DP, paras 8.30 and 8.31.

<sup>25</sup> 2017 DP, paras 8.33 to 8.35.

<sup>26</sup> 2017 DP, paras 8.36 to 8.38.

<sup>27</sup> 2017 DP, para 8.39.

<sup>28</sup> 2017 DP, para 8.40.

<sup>29</sup> 2017 DP, para 8.42

17.22 If consultees favoured legislation, we also sought their views on the circumstances in which reasonable fee awards should be available, and on how they ought to be calculated.<sup>30</sup> We observed that, although there was some divergence in the cases, the English approach to these questions appeared reasonably clear (and might provide some guidance).

#### *Summary of consultation responses*

17.23 The consultees who addressed these questions on the whole agreed that reasonable fee awards should be available in Scots law where a creditor could not otherwise be compensated adequately for a breach of contract. However, a number of consultees, including the Faculty of Advocates and Morton Fraser, observed that in their view there was nothing to say that such an award could not presently be made in Scots law. The Senators of the College of Justice also observed that in their view there was nothing in Scots law to exclude a reasonable fee award in an appropriate case. The Senators went on to comment, however, that they did not think the time was right for statutory intervention to put the matter beyond doubt. They pointed to the fact that the law in England and Wales was still in a state of development, and suggested that while the test in *Morris-Garner*<sup>31</sup> was nebulous it was an honest description of the court's approach – albeit one that was not appropriate to attempt to set out in statute. Morton Fraser also favoured allowing the law to develop incrementally.

17.24 In relation to the circumstances in which reasonable fee awards should be available, and how they ought to be calculated, views among consultees were mixed. The Faculty of Advocates and Pinsent Masons broadly favoured convergence with the English position. Morton Fraser thought that no easy or obvious rule could be formulated, and that it would be for the court to assess the commercial considerations for each party and, having regard to proportionality, assess the correct level of damages. In a similar vein, the Senators of the College of Justice thought it would be inappropriate to be prescriptive as to circumstances where such an award might be available, saying that it should be a decision for the court, in the circumstances of a particular case.

#### *Conclusions*

17.25 In light of consultees' responses, we have concluded that while there is general support for the availability of reasonable fee awards for breach of contract in Scots law, there is no significant support for recommending legislation on this point. Indeed, consultees tended to take the view that such an award could already be made if an appropriate case arose, or that in any event the law was capable of being developed by the courts to achieve that outcome.

17.26 We also acknowledge the differing views among consultees as to the circumstances in which a reasonable fee award should be available, and on how it should be calculated. As consultees do not favour legislating on this matter, it is not necessary for present purposes to attempt to reconcile those differing views.

17.27 For these reasons we make no recommendation for legislative reform of the availability of reasonable fee awards for breach of contract.

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<sup>30</sup> 2017 DP, question 56.

<sup>31</sup> See the 2017 DP, para 8.17, and also para 8.43 where we suggested excluding that test as too nebulous.

## Potential reform: accounts of profits

17.28 In the 2017 DP, we took the view that Scots law does not allow a creditor to require a debtor to disgorge profits made as a result of a breach of contract.<sup>32</sup> We suggested that if a case like *Blake* were to reach the Scottish courts, the consequence might be that the debtor could profit from flagrant breaches of contract and the creditor would not have an effective remedy. We went on to propose that such a difficulty could be avoided if the concept of a disgorgement award (or account of profits) as a remedy for breach of contract were introduced, and sought consultees' views on doing so.<sup>33</sup>

17.29 We observed that the availability of such a remedy varies significantly in the different jurisdictions that recognise it, and summarised those differing approaches.<sup>34</sup> Having analysed the position, we tentatively identified the principles (mainly arising from the English cases) that we thought would most appropriately regulate the availability of an account of profits,<sup>35</sup> and invited consultees' views on them.<sup>36</sup>

### *Summary of consultation responses*

17.30 Consultees' views on our proposal that a disgorgement award (or account of profits) should be introduced as a remedy for breach of contract were mixed. The Faculty of Advocates and the Law Society of Scotland were in favour, although both emphasised that it should only be available in exceptional circumstances. The Society of Solicitor Advocates was opposed and Morton Fraser wondered whether such a remedy was necessary. Pinsent Masons suggested that the law in this area was developing, at least in fiduciary cases, and should be left alone to develop. The Senators of the College of Justice asserted that the courts "clearly" had power to order a debtor to account to a creditor for profits and that intervention was unnecessary.<sup>37</sup> Dr Rowan was perhaps most supportive of the proposal, stating that its introduction would reinforce the existing protection of performance in Scots law by giving the courts an additional weapon, and so it was to be welcomed.

17.31 Consultees were agreed, however, that if the remedy were introduced then it should be available only in exceptional circumstances where specific conditions were met. Their views again varied as to the appropriateness of the conditions we had provisionally identified in question 59. For example, the Faculty of Advocates thought that the first condition<sup>38</sup> was essentially meaningless, whereas every other consultee that addressed it thought it appropriate. The Faculty also thought that the second condition that we proposed<sup>39</sup> was key to the availability of the remedy, whereas the Law Society of Scotland thought it to be too open and potentially lacking in legal certainty. Consultees expressed concern that making

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<sup>32</sup> Leaving aside the interaction between the law of contract and fiduciary obligations mentioned in para 17.7 above.

<sup>33</sup> 2017 DP, question 57.

<sup>34</sup> 2017 DP, paras 8.46 to 8.57.

<sup>35</sup> 2017 DP, paras 8.51 and 8.52.

<sup>36</sup> 2017 DP, questions 58 to 60.

<sup>37</sup> We have been unable to find examples outwith the fiduciary context discussed above, despite what the Senators say. Nor can we necessarily reconcile their position with *Teacher v Calder* (1899) 1 F (HL) 39.

<sup>38</sup> 2017 DP, question 59(a): "that specific implement or interdict would have been available to the creditor before the breach occurred".

<sup>39</sup> 2017 DP, question 59(b): "the breach having occurred, that ordinary damages would be inadequate as they would leave the creditor undercompensated as the debtor's gain from the breach would be out of proportion to the creditor's loss".

available such a remedy would interfere with the compensatory nature of damages in Scots law, whereas Dr Rowan argued that such a remedy had nothing to do with compensation, and was entirely directed at deterring profitable breach. Morton Fraser suggested that in patent infringement cases the innocent party could choose between damages and an account of profits, and commented that this might be adaptable for contractual claims – a significantly more liberal approach than we had originally outlined.

### *Conclusions*

17.32 We think that there is no clear consensus in favour of legislative introduction of a disgorgement award, or account of profits, as a remedy for breach of contract in Scots law. There is even less consensus on the form that such a remedy should take if it were introduced. Significant work would be needed to reconcile the differing approaches taken by consultees, and in the circumstances we think that it would be more appropriate to adopt the approach proposed by Pinsent Masons, and await further developments in the courts.

17.33 For these reasons we make no recommendation for legislative reform of the availability of a disgorgement award (or account of profits) for breach of contract.

# Chapter 18 Transferred loss claims

## Introduction

18.1 The 2017 DP considered the issue of transferred loss,<sup>1</sup> which arises where a breach of contract occurs and loss results, but that loss is sustained by a person who is not party to the contract. The contract-breaker is the debtor (D) and the other contracting party is the creditor (C). We refer to the person who suffers the loss as the third party (T).

18.2 A conventional analysis of this scenario produces a problematic result. T suffers a loss but is not a party to the contract and so does not have title to sue for breach of contract. C, by contrast, has title to sue but has suffered no loss. Given the compensatory nature of damages in Scots law, C is not entitled to damages. D has broken the contract but does not incur liability to anyone for doing so, with the loss falling on T.<sup>2</sup>

18.3 In the 2017 DP, we noted that parties might make express provision in the contract to protect T, or that they might rely on collateral warranties. We then noted that, when the Contract (Third Party Rights) (Scotland) Bill was enacted and brought into force,<sup>3</sup> it might be easier for parties to include express provision in favour of T. The discussion in the 2017 DP focused, however, on what happens when parties have not made any express arrangements to deal with a transferred loss situation.

18.4 The 2017 DP considered briefly the extent to which the concept of transferred loss is recognised in the DCFR, then traced its development in Scots and English law. It then set out possible options for reform in this area.

## Comparison of the DCFR and Scots law

### *The DCFR*

18.5 We observed that, although the DCFR provides for third-party rights in contract,<sup>4</sup> it does so by recognising their existence where parties have created them in the contract itself, rather than providing for their existence as a matter of law if certain requirements are fulfilled. The DCFR does not appear to contain any provisions which explicitly address the issue of transferred loss, and unless the parties have expressly provided in their contract to protect T's position in the event of a transferred loss situation,<sup>5</sup> the DCFR does not appear to offer a solution. This is despite the problem being known in other European legal systems,

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<sup>1</sup> Also known as the damages "black hole": see *GUS Property Management Ltd v Littlewoods Mail Order Stores Ltd* 1982 SLT 50 at 54, per Lord Stewart; 1982 SC (HL) 157 at 177, per Lord Keith of Kinkell; *McLaren Murdoch & Hamilton Ltd v Abercromby Motor Group Ltd* 2003 SCLR 323 at para 33, per Lord Drummond Young. Reservations about this terminology were expressed in *Marquess of Aberdeen and Temair v Turcan Connell* [2008] CSOH 183 at para 45, per Lady Smith.

<sup>2</sup> For the difficulties that arise in trying to plead a relevant case in these circumstances, see McBryde, *Contract*, para 22.30.

<sup>3</sup> Now the Contract (Third Party Rights) (Scotland) Act 2017, which came into force on 26 February 2018.

<sup>4</sup> DCFR II.–9:301 to 9:303.

<sup>5</sup> See para 18.3 above.

notably Germany.<sup>6</sup> We therefore concluded that the DCFR did not offer a yardstick against which Scots law can be compared in relation to transferred loss.

#### *Overview of the concept of transferred loss*

18.6 Although its roots lie much deeper, the concept of transferred loss as an aspect of general contract law has come to prominence in several reported cases in the United Kingdom over the last twenty years. The courts have generally been sympathetic to the view that D should be liable in a transferred loss situation, although a definitive approach to achieve that result has never been entirely settled. In Scotland, all of the cases have been decided at first instance, and none of them has turned on a question of transferred loss. In England, despite a number of cases reaching the highest levels of the court system, there is still no settled view of the law.

18.7 In general terms, the answer given has been to make D liable to C for T's loss, but only in limited circumstances. C's claim is based upon its contractual relationship with D: the remedy arises as a matter of the law of contract. It has not been made clear, however, how C may be made accountable to T for what C recovers from D.

18.8 In some circumstances, it is also possible that T may have a direct claim against D under another branch of the law, such as delict or unjustified enrichment. The 2017 DP did not examine this possibility in detail, although it was taken into account where relevant.

#### *Origins of transferred loss claims*

18.9 The English and Scots courts have attempted to remedy the issue of transferred loss and impose liability on D since at least the nineteenth century, but only in limited circumstances. This was achieved by exceptions to the general rule that C might not recover damages because it had not suffered the loss. The principal exception was thought to apply only in relation to shipping law until the 1990s. Its origins are to be found in *Dunlop v Lambert*,<sup>7</sup> a Scottish appeal to the House of Lords which was reconsidered and critically analysed in 1977 by the House of Lords in *The Albazero*.<sup>8</sup> In that case, Lord Diplock attempted to rationalise and explain the rule.

18.10 In the 2017 DP, we commented that it appeared that the *Albazero* exception, as reformulated by Lord Diplock:

- is based on the intention of the parties rather than any freestanding legal principle;
- only applies to contracts concerning goods;
- entitles C to recover by way of damages rather than T.

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<sup>6</sup> See H Unberath, *Transferred Loss: Claiming Third Party Loss in Contract Law* (2003). In the systems influenced by the Code Civil and its article 1792, the concept of decennial liability may cover some cases of transferred loss in the construction context. See a useful comparative note on the subject published by Eversheds-Sutherland: "Decennial Liability in Construction Projects" (2015) at <https://goo.gl/B5PX63>.

<sup>7</sup> (1839) 7 ER 824; (1839) 6 CI & F 600.

<sup>8</sup> [1977] AC 774. Useful analyses of the subsequent development of English law include M Furmston and G J Tolhurst, *Privity of Contract* (2015) paras 6.39 to 6.159; Kramer, *Contract Damages*, ch 21. Recent critical discussions include Winterton, *Money Awards*, pp 55 to 59, 273 to 276; C Webb, "Performance Damages" in Virgo and Worthington, *Commercial Remedies*, ch 9. See further the 2017 DP, paras 9.13 to 9.15.

Lord Diplock's reformulation would, however, go on to be revisited in subsequent cases.<sup>9</sup>

#### *Development and expansion of transferred loss*

18.11 In the construction case of *Linden Gardens v Lenesta Sludge Disposals Ltd*,<sup>10</sup> the House of Lords expanded the *Albazero* exception from carriage of goods cases to contracts generally.<sup>11</sup> It reached that conclusion on two distinct grounds, which would come to be known as the "narrower ground" (favoured by the majority), and the "broader ground" favoured by Lord Griffiths. The proponents of the narrower ground did not, however, reject the broader ground approach<sup>12</sup> and so the preferred approach has been much debated in the subsequent cases.<sup>13</sup>

18.12 The basis of the narrower ground is that C can recover T's loss arising from breach of a contract dealing with property where it was contemplated that the property would be transferred to, or the loss would otherwise be suffered by, T, and if T could not acquire a right to hold D liable for the breach.<sup>14</sup> It shares features with the *Albazero* exception from which it derives, not least the need for a property-related link among the parties and the fact that it is C, rather than T, who has the right of action.

18.13 On the broader ground, by contrast, C could recover because the loss was suffered by C who "did not receive the bargain for which he had contracted,"<sup>15</sup> and the measure of damage should be the cost of curing the damage caused by the breach.<sup>16</sup> This approach of course leaves open the question of whether or not there is any obligation on C to pay the damages recovered to T.

18.14 The House of Lords returned to the issue in a further construction case, *Alfred McAlpine Construction Ltd v Panatown Ltd*.<sup>17</sup> It is notable, not so much for its outcome or for any extension of the principle, as for the detailed examination of transferred loss undertaken by each of the judges. Lord Clyde (in the majority) in particular analysed the derivation of the rule in *Dunlop v Lambert* and its subsequent development in *The Albazero*.<sup>18</sup> In addition, he rejected the contention that the operation of the *Albazero* principle hinges upon the intention of the contracting parties, saying that it is better seen as a solution imposed by law.<sup>19</sup>

18.15 By contrast, the minority would have applied the broader ground from *Linden Gardens*. They were willing to hold that, in cases such as the present, C ought to be able to recover for the loss as its own loss.<sup>20</sup>

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<sup>9</sup> It should also be noted that the facts in *The Albazero* did not satisfy the requirements of the exception, and so the exception was not applied in the case which gives it its name.

<sup>10</sup> [1994] 1 AC 85.

<sup>11</sup> Chitty, para 18.057.

<sup>12</sup> [1994] 1 AC 85 at 95, per Lord Keith of Kinkel; at 96, per Lord Bridge of Harwich.

<sup>13</sup> See para 18.6 above.

<sup>14</sup> [1994] 1 AC 85 at 115, per Lord Browne-Wilkinson.

<sup>15</sup> [1994] 1 AC 85 at 97, per Lord Griffiths.

<sup>16</sup> Further on the measure of damages in transferred loss cases see S Rowan "Cost of Cure Damages and the Relevance of the Injured Promisee's Intention to Cure", [2017] CLJ 616.

<sup>17</sup> [2001] 1 AC 518.

<sup>18</sup> [2001] 1 AC 518 at 522 to 531, per Lord Clyde.

<sup>19</sup> [2001] 1 AC 518 at 530, per Lord Clyde. He also pointed to certain difficulties in applying the broader ground (at 534).

<sup>20</sup> [2001] 1 AC 518 at 546, per Lord Goff.

18.16 The status of the broader ground after *Panatown* remained unclear. Lord Browne-Wilkinson decided *Panatown* on the basis of the narrower ground, but he recalled that in *Linden Gardens* he had expressed sympathy with the broader ground.<sup>21</sup> He was prepared to assume that the broader ground was sound in law, although not applicable in the case at hand.<sup>22</sup>

18.17 The UK Supreme Court then in April 2017 considered issues of transferred loss in *Lowick Rose LLP (in liquidation) v Swynson Ltd*.<sup>23</sup> The Court was clear that no transferred loss claim arose on the facts, which concerned the professional negligence liability of accountants. The significance of the judgments lies in the continued lack of clarification on whether the narrower ground or the broader ground should be preferred. The Justices noted that a number of questions about transferred loss claims remained open, not least the correctness of the broader ground approach, but took the view that it was not the case in which to resolve those issues.<sup>24</sup>

#### *Transferred loss claims in Scotland*

18.18 Despite the remaining questions about the applicability of the broader ground, in Scotland it is clear that it is the narrower ground which has been adopted. To date, the Scottish cases have all been decided at first instance, principally in the Outer House.<sup>25</sup>

18.19 Following *Panatown*, Lord Drummond Young considered the principle of transferred loss in Scots law in the construction case of *McLaren Murdoch & Hamilton Ltd v Abercromby Motor Group Ltd*.<sup>26</sup> In the event, Lord Drummond Young held that the loss in question had been sustained whilst C was still the owner of the property (before its transfer to T), so there was no black hole.<sup>27</sup> He went on to consider (*obiter*) what the position would be if that conclusion were incorrect.<sup>28</sup>

18.20 Drawing heavily upon Lord Clyde's judgment in *Panatown*, Lord Drummond Young indicated that Scots law should recognise the principle of transferred loss and adopt the narrower ground approach.<sup>29</sup> He also rejected the broader ground as being inconsistent with the underlying principles of Scots contract law.<sup>30</sup> Finally, he cited with apparent approval

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<sup>21</sup> [2001] 1 AC 518 at 577, per Lord Browne-Wilkinson.

<sup>22</sup> *Panatown* was criticised by Judge Richard Seymour QC in *Rolls-Royce Power Engineering Plc v Ricardo Consulting Engineers Ltd* [2004] 2 All ER (Comm) 129 at paras 128 and 130 for muddying the waters for practitioners with regard to claims for transferred loss.

<sup>23</sup> [2017] UKSC 32; [2017] 2 WLR 1161.

<sup>24</sup> See further the 2017 DP, paras 9.28 to 9.32, where the views of Lords Sumption, Mance and Neuberger are summarised.

<sup>25</sup> The matter was also briefly but carefully considered by Sheriff Taylor (as he then was) in *Clark Contracts Ltd v The Burrell Company Construction Management Ltd (No 2)* 2002 SLT (Sh Ct) 73. As it was common ground that a *ius quaesitum tertio* existed, however, there was no black hole to fill and no need to apply *Panatown*: see paras 23 to 42.

<sup>26</sup> 2003 SCLR 323. See further the 2017 DP, paras 9.34 to 9.37.

<sup>27</sup> 2003 SCLR 323 at para 34, per Lord Drummond Young.

<sup>28</sup> 2003 SCLR 323 at paras 35 to 43, per Lord Drummond Young.

<sup>29</sup> 2003 SCLR 323 at para 42, per Lord Drummond Young, citing *Alfred McAlpine Construction Ltd v Panatown Ltd* [2001] 1 AC 518 at 535, per Lord Clyde.

<sup>30</sup> 2003 SCLR 323 at paras 40 and 41, per Lord Drummond Young.

Lord Clyde's view that the *Albazero* exception is better regarded as a rule of law than as depending on the intention of the parties.<sup>31</sup>

18.21 In *Marquess of Aberdeen and Temair v Turcan Connell*,<sup>32</sup> a case on the negligence liability of solicitors, Lady Smith referred to Lord Clyde's approach in *Panatown*, and agreed with Lord Drummond Young in *McLaren Murdoch* that the application of the rule did not depend upon identifying the intention of the parties, but rather applied as a matter of law.<sup>33</sup>

18.22 A related issue was considered by Lord Doherty in *Axon Well Intention Products Holdings AS v Craig*,<sup>34</sup> which was concerned with breach of a restrictive covenant in a shareholders agreement and the liability of the covenantor (D) to the covenantee company (C) and an affiliate company of the latter (T). D argued that C could not make a *Panatown* claim, as T could be put in a position where it potentially had direct remedies against D, albeit non-contractual ones, meaning that there was no black hole.<sup>35</sup>

18.23 Lord Doherty considered (*obiter*) whether the availability to T of a non-contractual remedy claim against D would affect C's ability to bring a *Panatown* claim, commenting that in some circumstances it might. He suggested that the relevant test was whether the alternative remedy would provide equivalent means of redress and equivalent prospects of success to an action for damages for breach of contract.

18.24 In the 2017 DP, we questioned whether this was a desirable approach, noting that it was difficult to see how that test could readily be applied. We remarked that it seemed almost to invite satellite litigation, and that the feasibility of D satisfying the test was perhaps debatable.

18.25 The 2017 DP concluded that the Scottish courts appear to recognise the principle of transferred loss on the narrower ground proposed in *Linden Gardens* and restated by Lord Clyde in *Panatown*. We did observe, however, that none of the cases discussed was decided on the basis of transferred loss and that accordingly an authoritative statement of Scots law in this area, as with English law, is still awaited.<sup>36</sup>

## Potential reforms

18.26 As Lord Neuberger observed in *Lowick Rose*,<sup>37</sup> *Panatown* left open a number of points in a difficult area of law. Several recurring issues have not been resolved, and these formed the basis for the potential reforms that we proposed in the 2017 DP. They are:

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<sup>31</sup> 2003 SCLR 323 at paras 35 and 36, per Lord Drummond Young citing *Alfred McAlpine Construction Ltd v Panatown Ltd* [2001] 1 AC 518 at 530, per Lord Clyde.

<sup>32</sup> [2008] CSOH 183; 2009 SCLR 336.

<sup>33</sup> [2008] CSOH 183 at paras 45 and 46, per Lady Smith. See further the 2017 DP, paras 9.38 and 9.39.

<sup>34</sup> *Axon Well Intention Products Holdings AS v Craig* [2015] CSOH 4. For comment on *Axon Well*, see L MacFarlane, "Black Holes and Revelations on the Transferred Loss Doctrine" (2015) 19 Edin LR 388. See also the 2017 DP, paras 9.40 to 9.43.

<sup>35</sup> [2015] CSOH 4 at paras 11 to 16.

<sup>36</sup> Transferred loss may also have arisen as an issue in *Harbro Group Ltd v MHA Auchlochlan* [2014] CSIH 14, but it was decided on other grounds. In *Upton Park Homes Ltd v MacDonalds, Solicitors* [2009] CSOH 159 the pursuer's claim for loss referred to a third party's loss also flowing from the breach of contract but their pleadings did not do enough to show that they were claiming that loss on behalf of the third party, and to that extent the claim was held irrelevant.

<sup>37</sup> [2017] UKSC 32 at para 106.

- should a transferred loss claim be permitted?<sup>38</sup>
- should T have a direct claim against D?<sup>39</sup>
- what is the proper basis of a transferred loss claim?<sup>40</sup>
- should the availability of other remedies to T (contractual or non-contractual) bar a transferred loss claim?<sup>41</sup>
- should remedies other than damages be available to T?<sup>42</sup>

*Should a transferred loss claim be permitted?*

18.27 The 2017 DP was concerned only with issues of transferred loss arising from breach of contract. The policy concern addressed by the principle of transferred loss is preventing losses caused by breach of contract from falling irrecoverably into a legal black hole.

18.28 We indicated that we considered the policy behind the principle of transferred loss to be a sound and rational one. As Lord Drummond Young put it in *McLaren Murdoch*, "...in a well-regulated legal universe black holes should not exist."<sup>43</sup> The principle is one that may only be invoked when driven by legal necessity: it is an exception to the general rule and one which is unavailable if there is another route by which the black hole might be avoided.<sup>44</sup> There is no other obvious mechanism by which the policy concern might be addressed.

18.29 For these reasons, we provisionally suggested that transferred loss claims should be permitted, broadly along the lines that have so far been recognised by the courts and we asked consultees for their views on the general principle that a party who breaches a contract should be liable in damages for the loss caused by that breach, even if the loss was suffered by someone other than the other party to the contract.

Summary of consultation responses

18.30 Consultees narrowly supported this proposal, with the Senators of the College of Justice, the Law Society of Scotland, the Society of Solicitor Advocates, Mr Christie, and Burness Paull in favour. Burness Paull indicated that the principle should apply, but only in clearly defined and limited circumstances, noting that the interests of D have to be protected as well as those of T.

18.31 By contrast, this proposal was opposed by the Faculty of Advocates and three law firms (Morton Fraser, Pinsent Masons and Dentons). In general, they considered that any provision for the protection of T was a matter for the contracting parties, and that it should be left to the parties to write it into the contract if they thought it appropriate. It was also observed that the Contract (Third Party Rights) (Scotland) Bill then before the Scottish

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<sup>38</sup> 2017 DP, paras 9.46 to 9.48 and question 61.

<sup>39</sup> 2017 DP, paras 9.49 to 9.60 and questions 62 and 63.

<sup>40</sup> 2017 DP, paras 9.61 and 9.62 and questions 64 and 65.

<sup>41</sup> 2017 DP, paras 9.63 to 9.66 and questions 66 and 67.

<sup>42</sup> 2017 DP, paras 9.67 and 9.68 and questions 68 and 69.

<sup>43</sup> 2003 SCLR 323 at para 33, per Lord Drummond Young.

<sup>44</sup> *Lowick Rose LLP (in liquidation) v Swynson Ltd* [2017] UKSC 32 at para 16, per Lord Sumption.

Parliament would make this easier, and so further intervention should be avoided at this time.

*Should T have a direct claim against D?*

18.32 At present, a substantial area of potential difficulty in relation to transferred loss claims is the relationship between C and T. To date, the courts have permitted C to recover T's loss and account to T for the damages received. The alternative would have been to permit T to raise proceedings, deriving title to sue from C's title, but we are not aware of any case where this has occurred.

18.33 As matters stand, then, only C may bring proceedings in order to recover damages for T's loss. This raises two significant difficulties:

- whether T can compel C to raise proceedings in the first place;
- if damages are recovered, whether, when and how C must account to T.

18.34 In the 2017 DP, we concluded that the proposition that T may compel C to raise proceedings against D is untenable. We suggested that the adverse consequences were entirely out of proportion to the mischief which the proposition attempts to cure. Accordingly, we did not propose it as a potential reform.<sup>45</sup>

18.35 We also observed that while it seems to be accepted that C must account to T,<sup>46</sup> it is rather less clear when this must take place, or what the enforcement mechanism might be, and that this added to the uncertainty around transferred loss claims.<sup>47</sup>

18.36 Instead, we proposed that these difficulties could be avoided if T were instead permitted to claim directly against D, and sought consultees' views.

18.37 We accepted, however, that creating a statutory direct right of action for T against D would not be without its own problems, and that it would have to be quite precisely circumscribed so as not to expose D to a host of third-party claims whenever D perpetrates a breach of contract. We therefore invited consultees' views on three proposals that were intended to keep the proposed statutory remedy within tightly drawn bounds.

Summary of consultation responses

18.38 Consultees were generally agreed that, if transferred loss claims were to be permitted, then it would be preferable for T to have a direct claim against D rather than relying on (or attempting to compel) C to bring proceedings. Indeed, Burness Paull submitted that reliance on C was unworkable in practice, save in limited circumstances.<sup>48</sup> The Senators

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<sup>45</sup> See further the 2017 DP, paras 9.52 to 9.56.

<sup>46</sup> *The Albazero* [1977] AC 774 at 844, per Lord Diplock; *Alfred McAlpine Construction Ltd v Panatown Ltd* [2001] 1 AC 518 at 535, per Lord Clyde; *McLaren Murdoch and Hamilton Ltd v Abercromby Motor Group Ltd* 2003 SCLR 323 at para 42, per Lord Drummond Young; *Marquess of Aberdeen and Temair v Turcan Connell* [2008] CSOH 183 at para 45, per Lady Smith.

<sup>47</sup> See the 2017 DP, para 9.51.

<sup>48</sup> They gave as examples group companies, and contracts that contained a mechanism to allow eg a sub-contractor to bring proceedings by way of "name borrowing" provisions.

of the College of Justice and the Law Society of Scotland both agreed with the reasoning given in the 2017 DP.

18.39 Our first proposal in relation to that direct claim was that T should only be able to claim damages against D if it was reasonably foreseeable to D that a person in T's position might suffer loss. Consultees' views on this proposal were mixed. While the Society of Solicitor Advocates, the Law Society of Scotland and Burness Paull agreed with the proposed reasonable foreseeability test, the Faculty of Advocates and the Senators of the College of Justices thought it too low a test, and favoured respectively a test of actual knowledge at the time of contracting of the prospect of loss being suffered by T and a test more akin to the voluntary assumption of responsibility test found in delict.

18.40 Consultees did, however, agree with our second proposal that T and C should only be able to recover their own losses arising from D's breach.

18.41 With the exception of the Faculty of Advocates, consultees also agreed with our third proposal that it should be left to the courts to ensure that double recovery is not permitted. The Faculty indicated that it would prefer to see it clearly stated as a rule of law that double recovery is not permitted.

#### *What is the proper basis of a transferred loss claim?*

18.42 In the 2017 DP, we observed that the proper basis of a transferred loss claim has been the subject of judicial and academic discussion since the emergence of the narrower ground and the broader ground in *Linden Gardens*,<sup>49</sup> and noted that availability of the broader ground is by no means settled in Scotland or in England.

18.43 We went on to comment that there can be little doubt that the narrower ground approach is accepted in both Scotland and England. Accordingly, we asked consultees whether the narrower ground was now sufficiently settled that it might usefully be restated in statutory form for the third party claim now to be introduced, identifying three conditions that would form the basis for the rule:

- that the contract in question was one to carry out work upon, or provide services in relation to, property belonging to the creditor;
- that the property was subsequently transferred to a third party; and
- that the third party's loss could have been reasonably foreseen by the debtor at the time of contracting.

18.44 We also asked consultees whether it should remain open to the courts to develop the broader ground approach to transferred loss if a suitable case arose.

#### Summary of consultation responses

18.45 With the exception of the Faculty of Advocates, consultees generally agreed with our proposed restatement of the narrower ground. The Faculty, by contrast, said that any

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<sup>49</sup> See para 18.11 ff above.

statutory recognition of transferred loss claims should from the outset apply to a wider category of cases than merely property transfer claims. It observed that there was no reason in principle for such a restriction.

18.46 The Senators of the College of Justice commented that there would be no need for the property to be subsequently transferred if their preferred test of voluntary assumption of responsibility were adopted.<sup>50</sup> If that were done, then they suggested that there would be no need to leave open the broader ground. If not, they thought it should be left open to the courts. The Law Society of Scotland and Mr Christie both supported leaving it open given the unanswered questions in this area which might conceivably give rise to another black hole.

*Should the availability of other remedies to T bar a transferred loss claim?*

18.47 In the 2017 DP, we suggested that transferred loss claims should not be available where an alternative contractual remedy exists.<sup>51</sup> However, we did not think that the prospect of non-contractual remedies should be taken into account.<sup>52</sup> Nor did we think that the prospect of C assigning its rights to T should bar the availability of a transferred loss claim.<sup>53</sup> We asked consultees for their views on each of these points.

#### Summary of consultation responses

18.48 With one exception, consultees agreed with each of our proposals. The Faculty of Advocates commented that if there were to be statutory recognition of transferred loss claims, then such a remedy should take precedence over, and exclude, non-contractual remedies. No other consultee supported that view.

*Should remedies other than damages be available to T?*

18.49 We commented that the transferred loss cases to date have all been concerned with the remedy of damages only. We asked consultees whether they thought that T should only be allowed to claim damages, or if other remedies should be possible.

18.50 In particular, we were interested in consultees' views about whether the remedy of cure should be available (we noted that it was unclear whether specific implement would assist T, as it would only secure performance between C and D, not D and T). This has been overtaken as a result of the conclusions set out in Chapter 14, but we record consultees' views below.

#### Summary of consultation responses

18.51 Consultees generally agreed with our provisional view that T would have to be confined to secondary remedies (damages). The Faculty of Advocates thought that allowing T to seek other remedies would call into question what a contract actually is in Scots law. Other consultees, such as the Senators of the College of Justice and the Law Society of

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<sup>50</sup> They indicated that this would accord with Lord Neuberger's observations in *Lowick Rose*, as set out in the 2017 DP, para 9.31.

<sup>51</sup> See the 2017 DP, para 9.63.

<sup>52</sup> See the 2017 DP, para 9.64.

<sup>53</sup> See the 2017 DP, para 9.65.

Scotland, agreed with our assessment that specific implement was unlikely to be of benefit to T.

18.52 The Senators did point out that ancillary remedies, such as interdict, might well be available in appropriate cases. However, no other consultee suggested that any remedy other than damages would be appropriate.

## Conclusions

18.53 As we note above, a narrow majority of consultees agreed with our proposal as a general principle that a party who breaches a contract (D) should be liable in damages for the loss caused by that breach, even if the loss was suffered by someone (T) other than the other party to the contract (C).<sup>54</sup> As we went on to observe, that principle appears to have been accepted in Scots law.<sup>55</sup> Accordingly, what we proposed in the 2017 DP was to recognise the principle in statute, and to attempt to clarify and improve the existing law by giving T a title as well as an interest to sue.

18.54 The recognition of the principle in this fashion was not however to be across the board. T's claim would arise only in cases where the contract between C and D was for the latter to carry out work upon, or provide services in relation to, property belonging to C, and the property is subsequently transferred to T. The limitation reflected Lord Neuberger's formulation of the present rule in *Lowick Rose*, and was intended to confine within definite bounds to whom D's liability can arise. It also reflected the predominance of carriage and construction cases in the jurisprudence on transferred loss.

18.55 This restricted approach would however mean that cases such as *Lowick Rose* itself, *Marquess of Aberdeen and Temair*, and *Axon Well* were definitely excluded from the scope of the reform. For cases of these kinds (two involving claims of professional negligence, the other breach of a shareholder covenant), it would still be necessary for action to be taken by C rather than T. Assuming that the recognition of the relevance of a transferred loss claim in the two latter cases in particular is correct, the result of a limited reform such as was suggested in the 2017 DP would be the creation of a somewhat arbitrary division in the law, lacking much or any foundation in principle.

18.56 We have come to think that we cannot provide a satisfactory solution to the difficulties raised by T's present inability to recover transferred loss directly without much further investigation of the various commercial and other contexts in which the issue may arise. The limited time and resources at our disposal given other priorities within the Tenth Programme of Law Reform mean that such an investigation is not possible at present.

18.57 In reaching this view, we take some comfort from having learned from one very experienced practitioner that "[t]here are not that many black hole cases", and the ones that do arise do so "because somebody has not thought the matter through".<sup>56</sup> Burness Paull

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<sup>54</sup> See para 18.30 above.

<sup>55</sup> See paras 18.18 to 18.25 above. Indeed, as we note in para 18.9 above, the origins of transferred loss claims are to be found in the Scottish case of *Dunlop v Lambert*.

<sup>56</sup> Craig Connal QC (Pinsent Masons) giving oral evidence on the Contract (Third Party Rights) (Scotland) Bill 2017 to the Delegated Powers and Law Reform Committee of the Scottish Parliament (Official Report, 28 March 2017, col 29). In an earlier evidence session Dr Ross Anderson from the Faculty of Advocates said: "There will be situations in which the parties have not envisaged something that will happen subsequently. The classic

observed that parties to the contractual matrix are usually well aware of the need to address liability for and recovery of third party losses by way of express contractual provision.<sup>57</sup> Further, the problem of T's inability to compel C to act or to account has not yet arisen in the reported case law. While the present legal position is, in our view, uncertain and capable of creating significant practical difficulties, its resolution cannot be seen as an urgent matter in relation to other current law reform issues.

18.58 Further, a substantial minority of the consultees responding to the 2017 DP disagreed with the initial proposal for a statutory statement of the principle of transferred loss. On a closer reading of their responses, it appears that they think that the law on transferred loss as it currently stands is wrong, and that the correct approach – far from restating the present position in statute with some modifications – would be to change the law so that transferred loss claims could arise only where the parties to a contract had expressly provided for that eventuality.

18.59 As will be apparent from the 2017 DP, abolition of the recoverability of transferred loss outside contractual provision for its recovery is not a course of action that had commended itself to us. It would certainly make Scots law on this matter significantly different from English law. The clear need for further investigations (for which however there is insufficient time and resource within our Tenth Programme) and the divided counsels of consultees on the matter have left us unable to identify a generally acceptable solution to the transferred loss problem. Accordingly we make no recommendations to that end at this time.

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example is where one of the parties—a bank, for example—is restructured, whether voluntarily or involuntarily, and the contract, when it was concluded in year 1, may not have made provision for that particular eventuality in which a completely different party comes to hold the contractual rights” (Official Report, 21 March 2017, col 11).

<sup>57</sup> Burness Paull added, however: “... as corporate structures become more extensive and contractual matrices become more complicated, so the risk of unintended gaps increases. In such circumstances it would be commercially attractive for a third party to be able to have recourse to clearly defined law on transferred loss.”

**PART 5**

**Penalty Clauses**

# Chapter 19 Penalty clauses: an introduction

## Background

19.1 As a general rule, the victim of a breach of contract may recover damages representing compensation for its loss from the perpetrator of the breach.<sup>1</sup> The law on contract damages is however default in nature, in that contracts can provide their own scheme for payment of a sum or other sanction by the perpetrator of a breach of contract. The advantages of doing so for the contracting parties are the facilitation of contingency planning, the avoidance of disputes and litigation, and the consequent reduction of uncertainty about the outcomes of breach. But the possibility that this freedom may be abused by a party at the expense of the other means that it has never been left unfettered by the law.<sup>2</sup>

19.2 The decision of the UK Supreme Court in November 2015 in the conjoined cases of *Cavendish Square Holding BV v Talal El Makdessi* and *ParkingEye Limited v Beavis*<sup>3</sup> marked a significant development in what had previously been thought a settled area of the law.<sup>4</sup> Under Scots and English law between the end of the nineteenth century and 2015, a distinction was made between clauses which genuinely pre-estimated the damages payable on a breach of contract, and clauses which did not. Clauses which attempted to provide for the recovery of a genuine pre-estimate of loss were referred to as liquidated damages and were enforceable. Clauses which provided for a payment to be made instead of damages, but did not base this upon any attempt to pre-estimate loss, were referred to as penalty clauses, and were unenforceable.<sup>5</sup> The leading statement of these rules was made in 1914 by the Scottish judge Lord Dunedin in the English House of Lords case, *Dunlop Pneumatic Tyre Co Ltd v New Garage Motor Co Ltd*.<sup>6</sup>

19.3 Two main issues with this approach were identified by this Commission in a Discussion Paper on Penalty Clauses published in 1997 (the 1997 DP). First, some contractual provisions, while in no way oppressive or unreasonable, were liable to be struck down as unenforceable penalty clauses because, not being pre-estimates of damage, they fell on the wrong side of the line drawn between penalty clauses and liquidated damages. Second, some contractual provisions of an oppressive and unreasonable nature could escape judicial control because they were drafted in such a way as not to arise on a breach of contract, or as not involving the post-breach payment of a sum of money by the contract-breaker. Thus, for example, a clause which on its face became enforceable upon a party's insolvency rather than breach could be extravagant and without any justification, yet escape judicial control, despite the prejudice this could cause to other creditors in the insolvency.

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<sup>1</sup> See Chapter 16. For further information see the 2017 DP, paras 7.2 to 7.13.

<sup>2</sup> On the history of Scots law on this topic see McBryde, *Contract*, paras 22.148 to 22.152; *Cavendish/ParkingEye*, paras 250 to 253, per Lord Hodge.

<sup>3</sup> [2015] UKSC 67, [2016] AC 1172.

<sup>4</sup> See paras 19.7 and 19.8 below. For a detailed analysis of the decision's impact on English law by Hugh Beale, see Chitty on Contracts Second Cumulative Supplement to the Thirty-Second Edition (2017), pp 206 to 253.

<sup>5</sup> See generally McBryde, *Contract*, Ch 22 Part 8; SME, *Obligations*, paras 783 to 801.

<sup>6</sup> [1915] AC 79, 86 to 88.

19.4 Following consultation, we proposed a new legislative statement of the law on penalty clauses in a Report published in 1999 (the 1999 Penalties Report).<sup>7</sup> The comparative materials considered included the Council of Europe’s Resolution on Penal Clauses in Civil Law 1978,<sup>8</sup> the UNCITRAL Uniform Rules on Liquidated Damages and Penalty Clauses,<sup>9</sup> the PICC, and the PECL. In short summary, the 1999 Penalties Report recommended replacing the “genuine pre-estimate of loss” test with one of “manifest excess”; extending controls to clauses providing for penalties otherwise than upon breach of contract; and covering not only obligations to pay money but also transfers of property and forfeitures. This would have brought Scots law closer to the systems elsewhere in Europe apart from England and Wales.

19.5 The recommendations made in the 1999 Penalties Report were not implemented, however, after the Scottish Government conducted a public consultation about it in 2010.<sup>10</sup> Instead the Scottish Government invited us to reconsider the matter as part of the review of contract law in the light of the DCFR that was included in our Eighth Programme of law reform.<sup>11</sup>

19.6 The DCFR, it may be noted, deals with penalties in a way not dissimilar to the PICC and the PECL.<sup>12</sup> It provides that terms in an obligation requiring the debtor who fails to perform the obligation to pay a specified sum to the creditor for such non-performance are enforceable by the creditor irrespective of the actual loss. There is, however, judicial control where the specified sum is “grossly excessive”. This falls to be determined in relation to the actual loss suffered and the other circumstances. The control does not take the form of striking the provisions down; instead the judge is empowered to reduce the specified sum to a reasonable amount. This judicial power cannot be evaded by a contrary contractual provision.<sup>13</sup> There is sufficient difference from the PICC and the PECL, however, to mean that a new review might reach results different from the 1999 Penalties Report.

## Developments in the law

19.7 As our work on the review went forward, the conjoined cases of *Cavendish Square Holdings BV v Makdessi* and *ParkingEye Ltd v Beavis* came before the UK Supreme Court. The conjunction was prompted by the issues raised in the courts below, which suggested much dissatisfaction with the law’s dependency on the liquidated damages/penalty dichotomy. A larger bench than usual—seven rather than five Justices—was convened, making clear the court’s readiness to undertake a major review of the law. In addition, the antecedent *Andrews* case in Australia in 2012 had held that a penalty did not have to result from a breach of contract to be subject to regulation, so that this question too was before the

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<sup>7</sup>1999 Penalties Report.

<sup>8</sup> Text accessible at <https://goo.gl/YDG6n3>.

<sup>9</sup> Text accessible at <https://goo.gl/PSf1Nv>. See also DP No 103 (the 1997 DP), para 4.19.

<sup>10</sup> The consultation document is available [here](#) and the Scottish Government’s summary analysis report is available [here](#).

<sup>11</sup> See <https://goo.gl/dc1JW2>.

<sup>12</sup> On the Continental systems see the 2016 DP, paras 2.31 to 2.39. The ‘mixed’ systems of South Africa, Louisiana, Quebec and Israel are also discussed at paras 2.40 to 2.45.

<sup>13</sup> DCFR III.–3:712.

Supreme Court.<sup>14</sup> There was also an audacious argument in the *Cavendish* case that the penalties rule should simply be abolished altogether.<sup>15</sup>

19.8 The UK Supreme Court judgments in *Cavendish/ParkingEye* were issued in November 2015. The Court resisted the call for abolition of the penalties rule on the footing that the Law Commissions had made no such recommendation when considering the subject previously,<sup>16</sup> and that equivalent rules subsisted in other legal systems with which English law should remain broadly in step.<sup>17</sup> Lord Hodge added a further reason against abolition:

“[T]here remain significant imbalances in negotiating power in the commercial world. Small businesses often contract with large commercial entities and have little say as to the terms of their contracts. Examples such as the relationship between a main contractor and a sub-contractor in the construction industry and that between a large retail chain and a small supplier spring to mind.”<sup>18</sup>

19.9 But, as we explained in great detail in the 2016 DP, the Supreme Court nonetheless made radical adjustments to the law in England and Wales, and (it seems to be generally accepted) in Scotland as well.<sup>19</sup> The new approach can be summarised as follows. While as a matter of public policy the law sets its face against the imposition of a punishment of one contracting party (the debtor) by another (the creditor) by way of a penalty clause, it is no longer a general pre-condition of a clause’s enforceability that it be a pre-estimate of the financial loss which the creditor will suffer as a result of the conduct for which the penalty is incurred. While a clause of that character remains generally enforceable, the substantive question is whether the clause offers protection for a legitimate interest of the creditor that is not extravagant, exorbitant or unconscionable.

19.10 Further, the Supreme Court ruled that actual performance of the contract is a legitimate interest for these purposes, so that the penalty may seek to deter non-performance or to reward performance (or particular ways of performing) by the penalty-debtor. The conduct falling to be penalised must be a breach of contract, but the penalty-creditor’s protectable interests can go beyond what would ordinarily be recoverable as damages flowing from that breach. These protectable interests will generally be of a commercial character. Thus, for example, there can be incentivisation for the penalty-debtor

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<sup>14</sup> *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205 (summarised in the 2016 DP, paras 3.3 to 3.7). See also *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 90 ALJR 835 (summarised in the 2016 DP, paras 3.54 to 3.59). Both cases emerged from a single class action in relation to bank charges: see S Harder, “The Scope of the Rule against Contractual Penalties: A New Divergence”, in A Robertson and M Tilbury (eds) *Divergences in Private Law* (2016) 135, 137 to 8. For an argument that the English and Australian approaches are convergent, see S Worthington “The Death of Penalties in Two Legal Cultures?” (2016) 7 *UK Supreme Court Yearbook* 129.

<sup>15</sup> On why the argument can be seen as audacious, see the 2016 DP, para 3.15 and note 20.

<sup>16</sup> In addition to our 1999 Penalties Report, the court referred to a Law Commission (for England and Wales) Working Paper No 61, *Penalty Clauses and Forfeiture of Moneys Paid* (1975). Our colleagues in England and Wales never proceeded to a Report on the subject. See further *Cavendish/ParkingEye* paras 38 (Lords Neuberger and Sumption), 163 to 164 (Lord Mance), 263 (Lord Hodge), and 292 (Lord Toulson).

<sup>17</sup> *Cavendish/ParkingEye* paras 36 to 39 (Lords Neuberger and Sumption, with whom Lord Clarke and Carnwath agreed), 162 to 168 (Lord Mance), 216 to 218, 256 to 267 (Lord Hodge). Lord Toulson agreed rather with Lord Mance and Lord Hodge.

<sup>18</sup> *Cavendish/ParkingEye* para 262. See also Lords Neuberger and Sumption at para 38; Lord Mance at paras 162, 167 (all more *en passant* on this point).

<sup>19</sup> The judgments of the Court are subjected to detailed analysis in the 2016 DP, paras 3.8 to 3.45, to which reference should be made for detailed citations.

to perform so that for the penalty-creditor valuable trading goodwill is not lost altogether, efficient business operations are maintained, and profit margins are achieved. It no longer matters that the penalty could apply to a variety of kinds of breach without seeking to differentiate between them.

19.11 Under the Supreme Court's approach, the penalty is unenforceable if it is extravagant, exorbitant or unconscionable in relation to these legitimate interests. Where the creditor's interests do not go beyond those ordinarily recoverable via the law of damages, that is, they are confined to compensation, a clause going beyond the pre-estimation of loss is perhaps more likely to be seen as penal. But the pre-estimation can validly be of the highest level of damages that could possibly arise from the breach. Where the creditor's losses are of a kind not lending themselves to pre-estimation, the sanction provided for is less likely to be seen as excessively penal so long as it can be related to the creditor's legitimate interests.

19.12 The law on penalty clauses was also held by the Supreme Court to apply to clauses where the penalty is other than payment of a sum of money *after* breach. It can apply to the forfeiture of sums of money and other property handed over *before* the breach, as well as to clauses entitling the second party post-breach to withhold payments and other property transfers it was due to make to the contract-breaker. But the amount of a forfeitable deposit must, it seems, be reasonable, and market norms may be used to determine what is reasonable in this context.

19.13 The Supreme Court rejected any idea of a judicial power to modify a penalty clause in English law. A clause is either enforceable or it is not. If the latter, the penalty-creditor is left to whatever other remedy may be available to it under the general law. In Scots law, however, as Lord Hodge noted, a judicial modifying power already exists at common law and by statute, and is unaffected by the *Cavendish/ParkingEye* decision.<sup>20</sup> The scope of the statutory power is definitely limited to penalties in support of a primary obligation to pay money,<sup>21</sup> but the common law power, little used in over a century, may have a wider ambit.<sup>22</sup>

19.14 While application on breach remains an essential feature of a clause before it can be treated as a penalty (whether or not enforceable), the Supreme Court also introduced into the analysis the concepts of primary and secondary obligations as a way of explaining when the penalty rules do or do not apply. A primary obligation is one of the obligations of performance in accordance with the contract, while a secondary obligation is one which arises upon breach of contract, such as the obligation to pay damages in compensation for the loss caused to the other party by the breach. Secondary obligations arising upon breach may be set out in the contract or in the general law. Penalty clauses would typically be characterised as secondary obligations.<sup>23</sup>

19.15 The complication to which the joint judgment of Lords Neuberger and Sumption in particular gives rise, however, is that in some cases where a clause appears to become

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<sup>20</sup> *Cavendish/ParkingEye* paras 251 to 252, 283.

<sup>21</sup> Debts Securities (Scotland) Act 1856 s 5 (summarised in the 2016 DP, para 2.17).

<sup>22</sup> See most recently *Wirral Borough Council v Currys Group plc* 1998 SLT 463 per Lord Hamilton at 466 to 467; 2016 DP, para 3.34.

<sup>23</sup> We explored the concept of primary and secondary obligations in greater detail in the 2016 DP: see paras 3.19 to 3.22 and in particular fn 30.

operative only after breach (and so on the face of things be a secondary obligation in their terms), it may actually be a “conditional primary obligation”—that is, really an obligation of performance which arises on the occurrence of certain conditions that can include breach. The penalties rule does not apply to conditional primary obligations, according to Lords Neuberger and Sumption. A yet further complication, however, is that the penalties rule may after all be applied if the conditional primary obligation is in substance a penalty.

19.16 The effects of the change are apparent from the facts and decisions in the cases before the Supreme Court. In the *Cavendish* case M had sold his business to C subject to a non-competition clause. If he broke this he would forfeit further payments of \$44 million due to be made to him under the contract and be required to sell to C his remaining shares in the company at a price disregarding goodwill, costing him some 23% of the shares’ market value. The Justices were divided as to whether these clauses were primary obligations, contingent on circumstances and enabling adjustments to the final contract price payable to M if certain events occurred, or secondary obligations arising from breach of the primary obligation not to compete. But those who thought the obligations secondary did not think that the clauses failed the penalty test. C had legitimate interests to protect itself against competition from M.

19.17 In the *ParkingEye* case, on the other hand, B had parked his car in a car park where the first two hours’ parking was free and charges were then made by P: in B’s case, a charge of £85 for staying for an hour over the free time. The Justices held that the charge was a secondary obligation arising on breach of contract by B, but that the amount was not exorbitant, given that P had legitimate interests in the efficient management of the car park to enable all customers to find parking spaces and in an income stream that would cover its costs and permit a profit to be made.

19.18 The results of the two cases show how the idea of a reasonable pre-estimate of the loss likely to be suffered by the innocent party is no longer the litmus test for an enforceable penalty. They also demonstrate the difficulty under the new tests of deciding whether or not a clause is of the kind that operates only on breach of contract and is thus subject to the penalty test.

### **The 2016 Discussion Paper**

19.19 In November 2016 we published a Discussion Paper on Penalty Clauses.<sup>24</sup> We noted that, quite apart from the uncertainty in *Cavendish* itself as to the application of the primary/secondary obligation distinction, this had also been manifested in subsequent cases in England and Wales, and in Scotland. *Gray and others v Braid Group Holdings Ltd*<sup>25</sup> was a Scottish case concerning a ‘bad leaver’ clause in a company’s Articles of Association. By this clause a shareholder who had participated in bribery offences in relation to the company’s business was required to sell his shares (with a market value of some £20.6 million) back to the company at their subscription or par value (£2.44 million). While an Extra Division was unanimous in holding that the clause in question was not a primary or a conditional primary obligation, only by a majority was it not struck down as a penalty.

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<sup>24</sup> The 2016 DP.

<sup>25</sup> [2016] CSIH 68, 2016 SLT 1003 (discussed in the 2016 DP, paras 3.46 to 3.51). Leave to appeal to the UK Supreme Court was refused.

19.20 By contrast, in the English bad leaver case of *Richards and Purvis v IP Solutions Group*,<sup>26</sup> May J held that, despite the clause before the court applying on breach of contract by a shareholder-employee, it was “more akin to a primary obligation agreed between parties for distinct commercial reasons to do with a shareholder leaving the Company.” A price of £1 for the aggregate shareholding of the Bad Leaver was simply an agreed price on transfer.

19.21 There had also been criticism of *Cavendish/ParkingEye* from both commercial law practitioners and academic lawyers, with some regretting that an opportunity to abolish the penalties rule had not been taken, while others pointed to the difficulties posed by the primary/secondary obligation distinction. In the 2016 DP we briefly summarised the history of the distinction between primary and secondary obligations in English law.<sup>27</sup> We also noted Dr Carmine Conte’s argument that the primary/secondary obligation distinction as made by the Supreme Court is mistaken and unworkable. In his view (consistent with the historical analysis of the subject we had previously offered), an obligation is primary if it arises from parties’ consent, secondary if it arises from the general law. In relation to penalty clauses, therefore, it would be better to distinguish between ‘original’ and ‘collateral’ primary obligations, with penalty clauses being in the latter category.<sup>28</sup> Finally, we drew attention to James Fisher’s criticism of the policy view that contract clauses defining secondary obligations are more open to judicial control than primary ones: “[p]rima facie, whatever norms justify the principle of freedom of contract apply with equal force to primary and secondary obligations.”<sup>29</sup>

19.22 Commentators were also concerned by the “legitimate interests” test for penalty, the scope of which was seen to be uncertain even in relation to liquidated damages clauses (that is, ones based on a genuine pre-estimate of loss). Finally, some anxiety had been expressed that, while the penalties rule had not been abolished, the effect of *Cavendish/ParkingEye* was such that there was a good chance of its never again being successfully invoked.<sup>30</sup>

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<sup>26</sup> [2016] EWHC 1835 (QB).

<sup>27</sup> 2016 DP, para 3.19 and fn 30.

<sup>28</sup> 2016 DP, para 4.9, referring to C Conte ‘The Penalty Rule Revisited’ (2016) 132 LQR 382.

<sup>29</sup> 2016 DP, para 4.10, referring to J Fisher ‘Rearticulating the Rule against Penalty Clauses’ [2016] LMCLQ 169 (quotation at 171).

<sup>30</sup> See 2016 DP, paras 4.1 to 4.11. For further academic and comparative comment on the case, see (1) a special series of comparative case notes in (2017) 25(1) *European Review of Private Law* 169 to 271 (comments from Belgium, Germany, the Netherlands, France, Italy, Sweden, and Poland, suggesting that English law has come closer to the Continental pattern but remains exceptional in not considering the actual effects of the penalty clause and not recognising judicial modification as a remedy); (2) A Summers “Unresolved Issues in the Law on Penalties” [2017] *Lloyds Maritime and Commercial Law Quarterly* 95 to 121 (focussing on the application of substance over form; conditional primary obligations, on which he supports the criticisms by Conte and Fisher; retention clauses; scope of legitimate interests; boundary of punishment; weight of procedural considerations); (3) M Cheung “Shylock’s Construction Law: The Brave New Life of Liquidated Damages” (2017) 33(3) *Construction LJ* 173 to 87 (suggesting that parties should refrain from inflating the amount of liquidated damages in the name of “legitimate business interests”); (4) S Worthington “Penalty Clauses” in Virgo and Worthington, *Commercial Remedies*, ch 16 (criticising the Court’s failure to abolish the penalty doctrine or to articulate a convincing rationale in support of the doctrine, and suggesting that the primary/secondary distinction is unworkable: “Whatever the judges say about how obvious these distinctions are, and absent a complete descent to arid formalism, there is—I suggest—no legal or practical substantive distinction in play at all” (p 377); and favouring instead “an approach that relies on procedural unfairness, rather than substantive unfairness” as “both easier to implement and easier to justify” (p 388)); (5) *McGregor on Damages*, ch 16.

19.23 The last point seemed to gain some support from the two bad leaver cases mentioned above. In *Richards*, May J had opined that even if the clause in question was a secondary obligation there was “nothing unconscionable in an arrangement arrived at between parties dealing at arms’ length with the benefit of extensive expert advice”.<sup>31</sup> Further, in *Edgeworth Capital (Luxembourg) Sarl v Ramblas Investments BV*<sup>32</sup> the Court of Appeal found that an upside fee agreement was not a penalty because the fee was payable on the occurrence of an event—early repayment of a loan—not upon a breach of contract.

19.24 We accordingly began our questions for consultees with three high-level options:

- leaving the courts to develop the law further, allowing the true effects of *Cavendish/ParkingEye* to emerge, with further reform then to be considered if perceived to be necessary;
- abolition of the penalties rule, either outright, in its application to business contracts, or in its application to consumer contracts;
- replacement of the present law with a new scheme for the regulation of penalty clauses.

With regard to the third option, we set out a tentative new approach in some detail and invited comments. We indicated that our final view would be strongly guided by consultees’ responses to our questions.<sup>33</sup>

### Summary of Consultation Responses

19.25 In response to the 2016 DP, a clear majority of consultees favoured the first option. None at all favoured either outright or partial abolition of the penalties rule. We deal first with the responses to these two options, before moving on to summarise the responses to the third option (replacement of the present law) in the following Chapter.

#### *Leave the law to develop*

19.26 The arguments for taking the first option of doing nothing for the time being were particularly strongly expressed by commercial law firms and the professional bodies. Morton Fraser said that the difficulties arising in practice after *Cavendish/ParkingEye* had been over-estimated. The Law Society of Scotland remarked:

“[C]ommercial advice has been given on the appropriate framing of contracts. In light of those decisions, it is now fairly regular for commercial contracts to set out the commercial/social justification for any clause which may be impugned as a penalty eg to ensure prompt payment for goods/services. It is also now common to frame the clause as a conditional primary obligation rather than a purely secondary obligation, for example, payment on specified event.”

19.27 Burness Paull, while noting that the primary/secondary obligation did cause difficulties for practitioners and was capable of abuse by attempts to convert a secondary

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<sup>31</sup> [2016] EWHC 1835 (QB) at para 85.

<sup>32</sup> [2016] EWCA Civ 412.

<sup>33</sup> 2016 DP, para 1.12.

obligation into a primary obligation with a view to evading the consequences of the penalty rule, added that flexibility in the assessment of recoverable loss has been well received in a wide variety of sectors (specifying in particular construction, public sector, and dispute resolution). They continued:

“The current law may not be ideal but it is not, as yet, causing substantial difficulties in practice and any disadvantages will hopefully be clarified by subsequent case law.”

The Faculty of Advocates agreed that the *Cavendish/ParkingEye* decision should be allowed to bed in, although it considered that developments ought to be kept under active review for a reasonable period of time.

19.28 Academic consultees made similar comments. Dr Turner observed that it “often occurs that any court decision on a point of commercial interest is treated with apprehension by practising lawyers”, and thought it would be wise to wait and see what the effects of *Cavendish/ParkingEye* actually were before making any move to reform the law. Dr Rowan thought that in general *Cavendish/ParkingEye* was to be welcomed, and the criticism of the uncertainties created by the decision should not cause undue concern. She commented:

“Short term uncertainty is to be expected and tolerated following any new development in the law ... [and] will quickly be replaced by a corpus of jurisprudence providing guidance to aid the application of the new test of validity.”

19.29 A further argument for doing nothing at this stage was that Scots law would be left substantially in line with its English counterpart. The Law Society of Scotland said that it would be hesitant to create a difference of approach between Scotland and England and Wales at this point. Burness Paull observed that it would be an attractive option from their clients’ point of view for Scots law to remain aligned with English law. Mr Connal (who did not favour leaving the law as it stands after *Cavendish/Parking Eye*) nevertheless emphasised that his support for reform was dependent on it being carried out at a UK level. He did not consider that a proposal to reform Scots law alone would justify support.

19.30 Finally, the Law Society of Scotland drew our attention to the case of *First Personnel Services Limited v Halfords Limited*,<sup>34</sup> suggesting that fears that the penalty rule was practically dead post-*Cavendish/ParkingEye* were perhaps overstated. The dispute concerned the fees payable in relation to temporary workers supplied to the defender by a recruitment company. The contract contained the following clause:

"Charges which represent wages paid are invoiced weekly and are payable within seven days of the date of FPS's invoice. Any invoice outstanding over seven days from the date of payment shall carry interest on the balance at the rate of 2% per month or part thereof until payment."

The rate of interest provided in the clause was in excess of the rate of interest generally awarded in respect of commercial debts at that time. The recruitment company argued that the rate was not out of all proportion to its legitimate interest in enforcing punctual payment of the invoice and having regard to their own liability to pay employees. The court, however, held that the interest provision was penal and unenforceable on the basis that the rate was

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<sup>34</sup> [2016] EWHC 3220 (Ch).

far above the statutory rate prescribed under section 6 of the Late Payment of Commercial Debts (Interest) Act 1998.<sup>35</sup> Accordingly, the clause was not supported by the legitimate interest identified.

### *Outright or partial abolition?*

19.31 Outright or partial abolition of the penalties rule was however opposed by all consultees, who supported the position adopted by the Supreme Court in *Cavendish/ParkingEye*. Consultees' main reason for taking this position was the protection the rule gave to weaker parties such as employees and small and medium-sized enterprises in negotiating contracts and settlements of disputes with stronger parties. The Law Society of Scotland also argued that "it must be the case that it is a legitimate power of the Court to regulate and refuse to implement unconscionable bargains." Burness Paull commented that "No regulation at all is not an attractive option."

19.32 Outside our consultation, Professor Sarah Worthington has argued strongly that the penalties rule should be abolished.<sup>36</sup> In her view the Supreme Court in *Cavendish/ParkingEye* failed to articulate a convincing rationale in support of the rule, and that while the apparent expansion of the interests that a penal clause may protect is a move in the right direction, the law "is now far more uncertain than it was in 2015".<sup>37</sup> The basis for control in the primary/secondary obligation test is "fatally flawed",<sup>38</sup> because it means that whenever a contract makes alternative provisions for performance, the subsidiary option is open to review as a penalty. "This has the potential to swallow whole areas of contract law which were previously safe under the old formulaic rule."<sup>39</sup>

19.33 The Supreme Court view against abolition was however supported by our consultees. Whatever the courts did with the rule when it was invoked before them, more important was its expression of a public policy rule against the infliction of punishment by contract. Outside the court room, the rule gives parties in weaker bargaining positions in contract negotiations a platform from which to bargain over the extent of a penal term. For example, Dr Turner commented:

"Even if few stipulations are struck down as penal, there is value ... in the possession of a rule which threatens to invalidate penal stipulations: the message that punishment by contract is unlawful is readily understood."

## **Conclusions**

19.34 We are therefore clear that the penalty rule should not simply be abolished, in whole or in part, and have also come to the view urged upon us by the majority of consultees, that we should not recommend legislative reform of the rule ahead of seeing how the law develops after the *Cavendish/ParkingEye* decision. We would not particularly wish to justify our present conclusion on the basis that Scots law must necessarily be tied to English law in

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<sup>35</sup> 8% per annum over the official dealing rate: see SSI 2002/336, art 4.

<sup>36</sup> See S Worthington "The Death of Penalties in Two Legal Cultures?" (2016) 7 *UK Supreme Court Yearbook* 129; Worthington "Penalty Clauses" in Virgo and Worthington, *Commercial Remedies*, ch 16.

<sup>37</sup> Worthington "Penalty Clauses", 388.

<sup>38</sup> *Ibid.*

<sup>39</sup> *Ibid.*

this area. The law is already different (for example, on judicial modification) without notable ill effects.<sup>40</sup>

19.35 Our primary reasons for not recommending further legislative reform at this stage are:

- the consistent evidence already cited that so far the decision is not creating major difficulties in legal practice;
- that the judicially reformulated rule is still capable of being used to strike down clauses seen as excessively penal in their effects; and
- that the Supreme Court has pointed the law in what seems to us to be the right general direction, while still leaving it open for further refinement in the future.

19.36 Our own continuing researches have revealed at least one further post-*Cavendish/Parking Eye* decision striking down a penalty clause.<sup>41</sup> In *Vivienne Westwood Ltd v Conduit Street Development Ltd*,<sup>42</sup> a side letter to a commercial lease stipulated that the landlord would accept a lower rate of rent from the tenant, increasing gradually from £90,000 for the first year to £100,000 in the fifth year. If a higher open market rent was determined upon the first rent review then this would be capped at £125,000 per annum for the following five. If the tenant broke any of the conditions in the side letter or lease then the rent would revert to the higher rate payable under the lease agreement. The terms of the side letter were to apply retrospectively. As a result, the tenant would be liable to pay additional rent for all of the preceding years. In June 2015 the tenant failed to pay the rent resulting in the landlord claiming that the side letter had been terminated and that the open market rent was payable. The tenant's primary obligation under the lease was to pay rent. The terms of the side letter were that the landlord could increase the rent upon any breach by the tenant no matter how material or immaterial, and regardless of the impact of the breach. This amounted to a change to a primary obligation. In terms of whether the landlord had a legitimate interest in enforcing the conditional right to increase the rent, the court found that the reduced rent had been a key factor in the agreement and therefore the landlord could not be said to have a legitimate interest in increasing the rent. The provision was held to be penal in nature and was struck down.

19.37 Further, as indicated in the analysis of the UK Supreme Court judgments in the 2016 DP,<sup>43</sup> *Cavendish/ParkingEye* is a significant movement of the law in the general direction seen as desirable in our 1999 Report. It is also closer to the position generally in the rest of Europe and as set out in the DCFR.<sup>44</sup> The test for penalty has been narrowed so that it will apply only in exceptional cases, but the range of clauses to which the test can be applied

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<sup>40</sup> As Dr Rowan also remarked, "[i]t is not clear whether there would be much difference in practice between the prohibition against penalty clauses in England (which now accepts agreed sums that have a deterrent effect but which are not extravagant) and the general enforceability of penalty clauses as proposed in the Discussion Paper (which would also recognise that agreed sums that exceed the actual loss suffered and are deterrent are permissible unless extravagant or manifestly excessive ... )."

<sup>41</sup> A further Scottish case on parking charges in which *ParkingEye* was applied is *Indigo Park Services UK Ltd v Watson*, Sheriff Court of Tayside, Central and Fife at Dundee, 6 September 2017 (Sheriff L A Drummond QC).

<sup>42</sup> [2017] EWHC 350 (Ch).

<sup>43</sup> See Chapter 3 of the 2016 DP.

<sup>44</sup> See the special series of comparative case notes in (2017) 25(1) *European Review of Private Law* 169 to 271.

has been extended. A penalty can be challenged whatever its form, whether it is an obligation to pay money or transfer property, or a forfeiture of money or property, or a power to withhold money or other property due to the debtor. Finally, the position of the Supreme Court against a judicial power to modify a penalty reflects only the existing law of England and Wales, and leaves unaffected the existing powers of the Scottish courts under both statute and common law.

19.38 While the Supreme Court's decision to retain the requirement that to be a controllable penalty the clause has to be triggered by a breach is inconsistent with our previous recommendation, it does provide a (possibly rather blunt) means by which not every clause in a contract requiring one of the parties to do something becomes potentially reviewable as a penalty. Such a possibility was of serious concern to consultees commenting in the 2010 consultation on our 1999 Report and draft Bill. That was a question which we ourselves sought to address in the 2016 DP. Whether it will be met by the court's holding that a conditional primary obligation can be challenged if in substance it is a penalty is one of the major issues on which developments will continue to be watched.

19.39 It may also still be open to the Scottish courts to revisit the question of whether the penalty rule can only apply on breach in the light of this comment made to us by Dr Turner:

“[I]t would appear that Scots law had no requirement of breach until that was copied from England during the twentieth century: see Heydon, Leeming and Turner, *Meagher, Gummow and Lehane's Equity: Doctrines and Remedies*, 5th ed (2015), [18-040]-[18-050], esp. [18-050] fn 79 (on the derivation of the English requirement and its translation to Scotland, noting *inter alia* that the detection by the court in *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296 of a breach requirement in *Bell Brothers (HP) Ltd v Aitken* 1939 SC 577 requires some “interpretation” of the earlier case in light of English legal developments which were only to come later) and, on other constraints on relief from penalties in English law absent a requirement of a breach of a promissory term, at [18-055], [18-155]-[18-160], [18-175].”

19.40 For these reasons, we do not recommend legislative reform or abolition of the law on contractual penalties at this time.

# Chapter 20 Proposed reforms: analysis of responses

## Introduction

20.1 In the previous Chapter, we concluded that the majority of consultees supported leaving the law to develop in light of *Cavendish/ParkingEye* while keeping those developments under review, and we recommended that approach be taken. It would be possible to leave matters there, but that would not do justice to the responses which we received on the third option in our 2016 DP, the scheme for possible replacement of the present law.

20.2 The view that the law in Scotland needs to be reformed after *Cavendish/ParkingEye* was supported in particular and in detail by the Senators of the College of Justice, Mr Cotton, and Mr Styles. As noted in the preceding Chapter, Mr Connal shared that view but thought that reform should only be carried out on a UK-wide basis.

20.3 Further, many consultees who favoured allowing the law to develop without intervention at this time did nonetheless comment in helpful detail on many of the suggestions made for reform in the 2016 DP, identifying areas of doubt or difficulty in either the present law or the possible reform. The Law Society of Scotland acknowledged that this might perhaps be an area which could benefit from reform, while Morton Fraser and Burness Paull expressed specific concerns about the operation of penalties in employment contracts. Although Burness Paull was clear that the reform option was not its preferred one, it also indicated that it would not object to reform based on further consultation:

“...to ensure well established structures are not at risk eg corporate deal structures currently used in connection with breach of covenants; or liquidated damages provisions in construction contracts.”

20.4 We also received submissions from the Competition and Markets Authority (CMA) and the British Parking Association (BPA). The CMA was concerned that a reform based on the general enforceability of penalty clauses unless excessive in their penal effects might adversely affect the understanding of the consumer protection measures against penalties. The BPA pointed out that contract law did not work well for the purposes of managing parking on private land, favouring instead a regulatory approach like the one that exists for parking on public land.

20.5 Finally, Mr Cameron gave us a view of penalty clauses in operation, based upon his experience in the telecommunications industry. He suggested that penalty clauses are used to highlight obligations that parties regard as of importance and also as a starting point for negotiations should problems arise. He also commented that it is not unknown for primary obligations to be impossible to perform because negotiators had not understood the technology to be deployed under the contract. In his view, penalty clauses:

“form an integral element in the way in which corporate bodies negotiate their way through ongoing relationships.”

20.6 Mr Connal provided another example:<sup>1</sup>

“[O]ur client had engaged an employment agency to supply a temporary (though skilled) worker. By a roundabout route a formerly supplied temporary worker had ultimately been engaged as a permanent worker. That was said to be contrary to a prohibition in the contract with the employment agency. They sought payment of a large sum from the Company. The regular payment arrangements were effectively to add a mark-up to the rate received by the individual, so if the individual's rate was £100 the agency charged the Company £120. On the face of it, therefore, any loss through being deprived of the opportunity to provide agency workers could at best be represented by the mark-up. The term, nevertheless, provided for payment of the full invoiceable amount, ie both base rate and mark-up. The claim was challenged as a penalty. The response was that it was a principal obligation and in any event not dependent on breach. A contrary argument was run. The case then settled.”

20.7 In light of these helpful responses, we think it useful to add a summary of the responses to the reform scheme outlined in the 2016 DP, adding our comments on them where appropriate. This may be helpful in monitoring and contributing to post-*Cavendish/ParkingEye* developments in practice and in the courts.

#### *Alternative approach: reinstatement of the former law*

20.8 Mr Styles expressed disappointment that we had not considered going back to the pre-*Cavendish/ParkingEye* law as one of the options in our 2016 DP. Given that we have consistently criticised that law since 1997, we suggest that our failure to propose it as a reform option is perhaps understandable. We did, however, quote Professor Francis Dawson of the University of Auckland, who favoured what he called a “bright line test” which involved a comparison *ex post facto* between the contractually agreed sum and the amount that would ordinarily be awarded for the breach.<sup>2</sup> The difference from the old law is the *ex post facto* comparison. But this was not favoured by any of our consultees. In her response Dr Rowan remarked that “[t]he invalidation of all over-compensatory damages clauses was a crude and inexact solution.” We agree, and for these reasons have not considered further the possibility of reinstating the former law.

### **Summary of responses**

#### *Enforceability as starting point*

20.9 In the 2016 DP, we suggested that the starting point should be a legislative statement that the common law rule against penalties is abolished. This would have the effect that penalties would no longer be unenforceable or void: they would be valid and enforceable. Liquidated damages clauses would remain enforceable according to their terms. The statutory protection against penalties for consumers under the unfair terms legislation would be unaffected,<sup>3</sup> as also other statutory provisions on penalties.<sup>4</sup> We thought

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<sup>1</sup> It bears some similarities to the *First Personnel Services* case mentioned in para 19.30 above.

<sup>2</sup> 2016 DP, para 4.10.

<sup>3</sup> Consumer Rights Act 2015, Sch 2, Part 1, para 6.

<sup>4</sup> For these see 2016 DP para 5.19.

that a starting point of enforceability would be less uncertain while recognising that a new regime of control would have to be a well-targeted one, tailored to meet the requirements of public policy, modern business and greater legal certainty.

20.10 Consultees favouring reform generally agreed that this would be a useful approach. The Senators and Mr Cotton believed that the right way forward was to replace the common law rule with a regime directed at specified contract terms. The Law Society of Scotland also agreed that this approach would be appropriate. The Faculty of Advocates thought that any reform legislation “would have to be drafted on the basis that the contract, and its terms, were generally enforceable”. Burness Paull and Dr Turner saw the approach as appealing in principle, but the former warned that it might prove complex in practice. Dr Rowan however thought it “odd and unclear” to create a new rule by referring to another rule, which is intended no longer to apply, because it would become necessary to answer questions about the new rule by reference to the old rule. She commented:

“If the starting point is the enforceability of certain types of contract term (however the Commission chooses to define these terms) unless they are penal and oppressive (or whatever phrase is ultimately preferred), then this should be stated clearly.”

20.11 We take from this (and Mr Cameron’s submission) that the approach to any future reform should be driven by the general enforceability of contracts. It is not necessary here for us to say whether that could best be achieved by an abolition of the existing common law on penalties, from which the enforceability of penalties could be inferred, or by a declaration that clauses hitherto regarded as penalties are henceforth to be regarded as enforceable.

20.12 A related point arose from our questions about exempting from our suggested controls penalties specifically provided for in other enactments or rules of law, and also conventional irritancies. We provided a number of examples of the former in the 2016 DP.<sup>5</sup> We should also have mentioned the provision about penalties in the unfair terms legislation.<sup>6</sup> Consultees generally agreed with the suggested exclusions, although Dr Turner suggested they could be left to statutory construction. We are inclined to think that the certainty of specific provision on the matter would be helpful, and might meet the concerns expressed by the CMA. There is much to be said for keeping the general law in this area out of consumer protection so that the latter can develop its own, suitably bespoke approach.

#### *Terms to which a new penalty rule should apply*

20.13 The 2016 DP asked whether the control of penalty should apply only when the penalty was brought into operation by a breach of contract (as in the present law), while a further question asked whether the scope of control should be extended to cover terms: (a) providing for early termination of the contract or (b) giving a party options between different ways of performing its obligations under the contract when the choice of one has relatively adverse consequences for the party compared to the other.<sup>7</sup>

20.14 Only the Law Society of Scotland was unequivocal in answering the first of these questions negatively, supporting its position with the contention that giving Scots law wider

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<sup>5</sup> 2016 DP, para 5.19.

<sup>6</sup> Consumer Rights Act 2015, Sch 2, Part 1, para 6.

<sup>7</sup> 2016 DP, questions 5 and 6.

scope than English could lead to different results in identical cases depending on whether they arose north or south of the border. However, the clear majority of consultees did not favour confining the operation of a new penalties rule to situations of breach. Morton Fraser, generally opposed to reform, nonetheless felt that the existing law is not as clear as it could be in its application to conditional primary obligations that are really disguised penalties. They gave an example of a voluntarily departing employee contractually obliged to repay training fees previously met by the employer, and agreed that the second question above gave the “best possible extension” to the breach rule. The Senators and Mr Cotton also supported the formulation in the second question.

20.15 The detail of the second question (as distinct from the policy) was however cogently criticised by other consultees. Mr Connal pointed out that clauses are rarely explicit in saying whether or not they become operational on breach of contract. He drew attention to his example of the employment agency already referred to,<sup>8</sup> and suggested that the essence of what should be covered is where the creditor’s loss would in some way be recoverable at common law but the contract imposes a payment with no connection to that loss (being thus a windfall for the creditor). Dr Turner thought that the penalty rule should only apply where the debtor defaults (which concept was not to be equated with breach) or fails in some contractual responsibility without having promised to carry it out.

20.16 We recognise with Dr Turner that the formulation proposed in the second question’s (b) part was particularly difficult, and Mr Connal’s comments might be read as at least not endorsing it. It is possible that a preferable approach can be drawn instead from consultees’ general support for the ideas that controls should apply whatever form the penalty takes. This would include the withholding or retention of performance by the creditor under an express term of the contract as well as transfer or forfeiture of money or property by debtor to creditor,<sup>9</sup> and that the courts should be encouraged to look for substance rather than form.<sup>10</sup>

20.17 Taking all of this into account, we think that there might be support for the following formulation:

A term in a contract should be potentially subject to regulation as an exorbitant penalty<sup>11</sup> if it obliges a party (the debtor) to transfer or forfeit money or property to another party to the contract (the creditor); or if the latter may withhold a performance otherwise due to the debtor, where in either case the debtor’s obligation or the creditor’s power arises - (a) upon breach of any other term in the contract by the debtor; or (b) upon the occurrence of an event for which the debtor is responsible although not under any obligation to bring it about or to prevent it.

20.18 A term falling within the proposed formula would be enforceable unless it fails the penalty test. The terms about departing employees repaying training fees and charges when

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<sup>8</sup> See para 20.6 above.

<sup>9</sup> Based on Question 7 of the 2016 DP. The Faculty of Advocates was against making contractual withholding clauses subject to the penalty rule, but the difficulty then arising is that while the common law remedy of retention is subject to equitable control by the court (see our 2017 DP, paras 2.31 to 2.33; above, paras 11.15 to 11.16), there is no control at all of an express contractual provision.

<sup>10</sup> This is based on Question 8 of the 2016 DP.

<sup>11</sup> For our preference for using “exorbitant” (in the sense of “out of all proportion”) to characterise the penalty that is subject to regulation see para 20.19 below.

temporary workers became permanent ones with an employer as distinct from the employment agency would seem to be covered, as also bad leavers in general, whether or not their leaving was in breach of contract. This might meet some of the difficulties in employment contracts mentioned by Morton Fraser and Burness Paull.

### *Defining penalty*

20.19 In the 2016 DP, we asked consultees what word or phrase might best be used to indicate the excessively penal effect of a term. No one word or phrase emerged as clearly ahead of the other possibilities in the responses to this question. It may be that “exorbitant” or “out of all proportion” (but not “disproportionate”) would best capture what is looked for. That would be, as we elaborate below, essentially a comparison between the harm suffered by the creditor in relation to its legitimate interests and what is required of the debtor under the term impugned. “Grossly excessive”, “unconscionable” and “extravagant” all carry a slight air of moral or value-laden disapproval which may not be suitable for objective judicial regulation. In the remainder of this Chapter we use “exorbitant” or “exorbitance” to characterise the effect of a term falling to be regulated as a penalty. This is consistent with *Cavendish/ParkingEye*.

### *Legitimate interests*

20.20 Following *Cavendish/ParkingEye*, terms which have penal effects are valid and enforceable if they protect a legitimate interest or interests of the creditor. In response to questions posed in of the 2016 DP,<sup>12</sup> consultees felt that the interests that should be recognised as legitimate included:

- actual performance by the debtor of all its obligations;
- encouragement of prompt or early performance of obligations by the debtor;
- avoidance of litigation;
- other commercial interests of the creditor *of which the debtor knew or ought to have known* (the words in italic are added at the suggestion of the Senators).

20.21 The legitimate interest in protecting third parties from loss through the debtor’s breach or other performance-related act provided the third party has no means of recovering its loss, suggested by the 2016 DP,<sup>13</sup> rested on the present position of the courts in transferred loss cases whereby the creditor sues the debtor for breach and recovers the third party’s loss.<sup>14</sup> As we do not recommend reform of the law to give the third party a direct right of action against the debtor,<sup>15</sup> it seems right still to keep this particular interest of the creditor amongst the list of legitimate ones that may be protected by a penalty term provided that the third party has no other means of recovering its loss. Most responses to this question gave it an affirmative answer. Those in the negative were the Law Society of Scotland and Mr Styles, both on the grounds that the net was being too widely cast at this point.

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<sup>12</sup> 2016 DP, questions 14 to 19.

<sup>13</sup> 2016 DP, question 15(a).

<sup>14</sup> See Chapter 18 above.

<sup>15</sup> See paras 18.53 to 18.59 above.

20.22 The 2016 DP asked whether a number of other factors, based on matters canvassed by the Justices of the Supreme Court in *Cavendish/ParkingEye*, would be useful guidelines:

- whether the penalty clause had been negotiated between the parties at arms' length;
- the availability of independent legal advice to the debtor under the penalty clause at the time of contracting;
- where the penalty clause was unnegotiated, the steps taken by the creditor to bring the penalty clause to the debtor's attention at the time of contracting, or the extent to which the debtor was aware of the existence and effect of the clause;
- the actual or anticipated resources of the debtor as known to or reasonably anticipated by the creditor at the time of contracting.<sup>16</sup>

20.23 The question was answered in the negative by consultees, slightly to our initial surprise. But the various reasons put forward on the matter came to seem sound to us. The matters mentioned are not "legitimate interests" of the creditor. Nor do they say anything about the exorbitance of a penalty. They are rather factors going more to questions about incorporation of the clause in the parties' contract and procedural fairness in contract formation. In a context where the starting point is the general enforceability of contractual penalties, and the question to be answered is about the excessiveness or otherwise of the penalty in relation to the creditor's protectable interests, the factors explored in the question are neither here nor there. The general law on contract formation already deals with the matters it mentions so far as it is necessary to do so.

20.24 Consultees also showed no enthusiasm for requiring or even encouraging (so far as it is possible to do that by statute) parties to list in their contract what they regarded as the creditor's legitimate interests protected by the penalty term, as we suggested in another question.<sup>17</sup> It appears from the responses that this is already happening in practice: it remains to be seen what the judges will make of these lists when they come before the courts. The creditor's "wider societal goals" (referred to in a previous question<sup>18</sup>) may also emerge through such lists and be treated as legitimate interests, but consultees rightly saw no value in mentioning such matters in statute.

20.25 Likewise consultees were unenthusiastic by expressly mentioning trivial breach,<sup>19</sup> on the basis that if relevant such matters could best be taken into account in assessing penalty, unenforceability and possible judicial modification of the term. It is not a matter of anyone's legitimate interests.

20.26 Finally, consultees did not think it appropriate to try to identify interests that could never be protected.<sup>20</sup> We agree that this is too difficult. We noted, however, suggestions from Mr Cotton and the Faculty of Advocates that, since the law on penalties is founded on public policy, it might be helpful to bear in mind what other issues are regarded as against public

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<sup>16</sup> 2016 DP, question 17.

<sup>17</sup> 2016 DP, question 16.

<sup>18</sup> 2016 DP, question 15(b).

<sup>19</sup> 2016 DP, question 19.

<sup>20</sup> As suggested in 2016 DP, question 16, second sentence.

policy by contract law (for example contracts that are illegal at common law, such as restrictive covenants).<sup>21</sup>

### *Testing exorbitance*

20.27 There was reasonably widespread support for the proposal that there should be statutory guidelines on the tests for exorbitance justifying judicially imposed sanctions (whether of unenforceability or modification) amongst the responses to the 2016 DP. Dr Rowan contributed a comparative comment:

“It would be helpful for statutory guidelines to spell out what factors should be taken into account when determining whether an agreed term is excessively penal. This can only benefit transactional certainty. In France, the courts have had the power to modify ‘manifestly excessive’ agreed sums downwards since a reform of the law in 1975. No guidelines were provided at the time. The resulting uncertainty was criticised by practitioners and commentators alike. Many argued that statutory guidelines would have helped, at least in the short to medium term.

Relevant factors that have emerged over time in the French case law resemble many of the guidelines that are considered in the Discussion Paper. They include the intention of the parties at the time they entered into the contract and in particular whether the stipulated sum was clearly intended to have a deterrent effect; the nature of the contract; existing professional usages; the bargaining position of the parties; and perhaps most obviously the disproportion between the actual loss suffered and the amount of the stipulated sum.”

20.28 The factors which garnered support in our consultation were the following:<sup>22</sup>

- the actual effect of the term in question on the debtor compared with the effect of the breach or the event on the identified legitimate interests of the creditor;
- the reasonable contemplations of the parties at the time of concluding the contract;
- custom and practice (if any) in relevant markets;<sup>23</sup>
- any other relevant circumstance.

20.29 The first suggested guideline (that account is to be taken of the actual or harmful effect inflicted on the debtor by the term, considered however in the light of what the parties could reasonably assess on these matters at the time of contracting and all other relevant circumstances) attracted the broad support of most consultees apart from the Senators.

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<sup>21</sup> On public policy in contract see McBryde, *Contract*, Chapter 19. Of particular interest are the interests recognised as protectable by restrictive covenants.

<sup>22</sup> Gleaned from those asked about in the 2016 DP, questions 13 and 18.

<sup>23</sup> Were we to have made a specific recommendation for reform in this area we might have added the following words to what appeared in the 2016 DP: “and (without prejudice to the relevance of that factor on its own) to any protests against such custom and practice made by the debtor before entering the contract containing the penalty term.” The addition is suggested by our recalling the decision in *Strathlorne Steamship Co v Baird & Sons* 1916 SC (HL) 134, in which it was held that a custom on how to discharge grain at the Port of Leith was not implied into a charterparty even though it provided for discharge of the ship’s cargo ‘according to the custom of the port of discharge’. This was because, while there was a relevant custom in Leith, shipowners regularly protested against it, since it existed mainly for the convenience of the receivers of grain. There may be some analogy here with the use of penal clauses in certain markets today.

They invoked the interest of certainty for parties in arguing that the test for exorbitance should be applied as at the time of contracting.

20.30 The problem with this is that it means that a term which is actually highly penal in effect may pass muster, while one which is less penal may nonetheless be struck down—exactly as has been found problematic with the pre-*Cavendish/ParkingEye* law. If it is argued that such results would in practice not be allowed to happen, then it can only be with the benefit of knowledge that the actual effects of the term either are or are not penal.

20.31 Mr Connal, who was also concerned about the uncertainty of taking actual harm into account, nonetheless eventually favoured the formulation in Question 13, because the process envisaged also involved taking into account what the parties could reasonably assess about the potential harm at the time of contracting. He agreed with us that the bad leaver case of *Gray and others v Braid Group Holdings Ltd*<sup>24</sup> was a good illustration of how the approach might work:

“It must at least be arguable that it would have been within the contemplation of the parties when they entered into their arrangement for bad leaver clauses that the fortunes of the Company could fluctuate and that if the Company prospered, a transfer at par could be regarded as a severe penalty. Nevertheless, that is the deal they reach.”

20.32 With regard to the question of custom and practice in the relevant market, most consultees seemed also to say that such a guideline would be useful. It may be helpful to be clear that we did not intend this guideline to suggest that established market custom and practice should be decisive in favour of upholding a term. Rather it is something to which a court could have regard in determining penalty, with it being possible to say the established practice was exorbitant.<sup>25</sup>

*What should the legal effects of exorbitance be?*

20.33 Under the present law, even after the *Cavendish/ParkingEye* decision, the effect of a finding of penalty is that the clause is unenforceable, and the creditor is sent to its common law remedies (whatever they may be). What precisely otherwise is meant by “unenforceability” is not completely clear: even in *Cavendish/ParkingEye*, the Justices mention voidness and invalidity alongside unenforceability.<sup>26</sup> Unenforceability does however fit with the idea that exorbitant penalty clauses are contrary to public policy.

20.34 Further, in Scotland the relationship between unenforceability and judicial powers to modify penalties at common law or under statute is untested. There is a view that the power is limited to penal obligations arising from non-payment of money.<sup>27</sup>

20.35 If however the common law power applies to performance as well as payment obligations, either the law is (i) that the penalty is unenforceable and the creditor must claim

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<sup>24</sup> [2016] CSIH 68, 2016 SLT 1003.

<sup>25</sup> See too the comments of Christopher Clarke J in *BNP Paribas v Wockhardt EU Operations (Swiss) AG* [2009] EWHC 3116 (Comm) para 23, and of Lords Neuberger and Sumption in *Cavendish/ParkingEye* para 100; quoted at 2016 DP, para 5.60.

<sup>26</sup> *Cavendish/ParkingEye* at para 88, per Lords Neuberger and Sumption.

<sup>27</sup> See 2016 DP, para 3.33.

instead common law damages (even if these turn out to be greater in amount than the sum imposed by the penalty),<sup>28</sup> or (ii) that the court modifies the penalty to the amount of the loss for which damages could be claimed.<sup>29</sup> The power seems therefore to be one to modify the penalty to the amount of the *actual loss suffered* through the antecedent breach of contract. The statutory power is likewise to reduce the penalty “so as not to exceed the real and necessary expenses incurred in making the debt effectual”.<sup>30</sup>

20.36 In the 2016 DP, we asked consultees whether they thought that it should cease to be possible for a court to declare a clause unenforceable for exorbitance (apart from consumer cases), confining the available sanction to modification of the clause in question.<sup>31</sup> Only the Senators favoured this. The majority of those who responded said that the court’s powers should not be so limited, although for different reasons. For Morton Fraser, it came down to a question of clarity:

“We think that the law should be clear that a penalty clause is either enforceable or not. Parties to contracts (particularly commercial ones) should be able to draft enforceable clauses. If they cannot do so, then the clause should be unenforceable. It seems to us that legal certainty almost demands that the result is one or the other.”

20.37 Dr Turner commented:

“[I]f a court’s power to declare a clause unenforceable is a power simply to declare what is the case—rather than a judicial power, in crude terms, to do whatever justice the court thinks fit to do—then there seems no convincing reason why courts should cease to hold such a power.”

20.38 The 2016 DP asked consultees whether judicial modification of a penalty clause should do no more than remove its excessive element.<sup>32</sup> Consultees generally agreed with this proposition. The Senators commented that:

“We think that this ‘intermediate’ approach has much to commend it. Under the present law, modification results in the removal of the whole penal element of a penalty. While there are strong grounds for modifying a penalty to the extent that it is grossly excessive, there are equally strong grounds for refusing to modify it to the extent that it is not grossly excessive. In this respect the suggested approach would be consonant with the model of the DCFR ... and with the approach of civil law systems and of other mixed civil law/common law systems .... In our view it would strike a fairer balance between the interests of the penalty debtor and the penalty creditor than the existing law.”

20.39 Consultees (including the Senators) also favoured giving the court a general discretion to make such modifications as it sees fit to meet the statutory aim of removing the exorbitant element of the penalty.<sup>33</sup> In the bad leaver type of case where an employee’s very valuable shareholding has to be sold back to the employer at par, the court might take

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<sup>28</sup> As in *Dingwall v Burnett* 1912 SC 1097. See further SME, *Obligations*, para 796.

<sup>29</sup> *Craig v McBeath* (1863) 1 M 1020 at 1022, per the Lord Justice Clerk (Inglis): “it is a penalty of that kind which we are bound to modify to the actual loss if duly required by the defender to do so.”; SME, *Obligations*, para 783; McBryde, *Contract*, para 22.172.

<sup>30</sup> Debts Securities (Scotland) Act 1856 s 5.

<sup>31</sup> 2016 DP, question 11.

<sup>32</sup> 2016 DP, question 23.

<sup>33</sup> 2016 DP, question 21.

account of the employee's contribution to the value of the shareholding in its modification of the term.

### *Liquidated damages*

20.40 The 2016 DP asked whether there could be utility in a specific legislative statement that a clause which liquidates damages, that is, one which at the time of contracting was based on a genuine pre-estimate of the loss likely to be suffered as the result of a breach of contract, cannot be treated as penal whatever the subsequent circumstances might suggest.<sup>34</sup> This was prompted by concerns expressed after *Cavendish/ParkingEye* that liquidated damages clauses are now more vulnerable to challenge than they were before the judgments.

20.41 We continue to think that this is not a justified fear, given what the Supreme Court said on the subject, and most consultees agreed with that. They nonetheless thought that such a provision might be useful in any legislative reform. The Senators made the important point that the non-applicability of judicial modification powers to such clauses would then be clear, while Dr Turner observed that it would reinforce the need to take full account of the parties' intentions and understandings at the time of contracting.

### *Onus of proof of penalty*

20.42 In our 1999 Report we recommended that the initial onus of proof should lie with the party who makes the allegation of penalty. In the 2016 DP we asked whether this should continue to be the approach.<sup>35</sup> Consultees said that it should.

### *Cumulation of penalty and other remedies*

20.43 When a penalty is due for delayed performance (for example in a construction contract), the creditor may be entitled both to enforce performance of the contract by way of specific implement and to claim the penalty due for lateness of performance. But if the penalty is enforceable the creditor cannot ignore it and instead claim damages for any breach of contract that triggered the clause. Nor does the debtor have the option of paying the penalty instead of performing the contract.<sup>36</sup>

20.44 In our 1999 Report we did not think it necessary to make legislative provision for this matter in Scotland. Any problems of cumulation of remedies could be left to the courts in the light of what the parties have expressly agreed and the general principle that there cannot be any cumulation of inconsistent remedies.<sup>37</sup> A provision on cumulation was thought unnecessary by all consultees responding to our question on this matter.<sup>38</sup>

### *Contracting out*

20.45 Our 1999 Report recommended that any new law on penalty clauses should make it clear that parties cannot contract out of the application of the law, describing having such a

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<sup>34</sup> 2016 DP, question 25.

<sup>35</sup> 2016 DP, question 28.

<sup>36</sup> For this see McBryde, *Contract*, para 22.173.

<sup>37</sup> On the general principle of cumulation see 2017 DP, paras 11.9 to 11.11.

<sup>38</sup> 2016 DP, question 29.

provision as “prudent”. The 2016 DP expressed agreement with this view, having in mind in particular the public policy dimension that is the basis for regulation of penalties. It is also important for the purposes of international private law, in making the rules non-derogable for the purposes of article 3(3) of the Rome I Regulation: if a contract was subject to, say, English law but all other elements pointed to Scots law as the applicable law, the Scots penalties rules would have to be applied by the court with jurisdiction in the case. All but one of the consultees agreed with our view. Dr Turner suggested however that the point is so obvious that an explicit provision is not needed.

#### *Application to bonds and unilateral obligations*

20.46 In our 1999 Report we recommended that the proposed rules on penalty clauses should apply to penalty clauses in bonds and other unilateral voluntary obligations in the same way as to penalty clauses in contracts. This was considered to be appropriate as the same principles and policy considerations apply to unilateral voluntary obligations and contracts. We continued to see the matter in this way in the 2016 DP,<sup>39</sup> and the proposal received unanimous support from consultees.

#### *Transitional provisions*

20.47 In our 1999 Report we recommended that any new legislation should apply only to penalty clauses agreed after it came into force. In the 2016 DP we asked if consultees agreed with this recommendation.<sup>40</sup> There is a counter-argument for retrospective effect, in that control of clauses with excessively penal effects is called for by justice and public policy considerations. The argument against this is that a person might have been advised under the previous law that a proposed clause could not be regarded as liquidated damages and so, being unenforceable, could be safely accepted: it would be unfair to that person if it was suddenly transformed into a valid and enforceable penalty. Consultees indicated their agreement with the 1999 recommendation.

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<sup>39</sup> 2016 DP, question 31.

<sup>40</sup> 2016 DP, question 32.

## **PART 6**

# **Concluding material**

# Chapter 21 Summary of recommendations

*Click on any of the recommendations below to be taken to the relevant section of the Report.*

## **PART 2 Formation of Contract**

### **Chapter 3 Formation: an introduction**

1. There should be a statutory statement of the law on formation of contract.

(Draft Bill, Part 1)
2. The statutory statement of the law on formation of contract should make clear that it is not concerned with:
  - (a) providing protection against unfair contract terms;
  - (b) providing protection for a particular category of contracting person;
  - (c) the requirements of writing;
  - (d) prescribing the form for a contract;
  - (e) the essential validity of the contract or of any of its provisions.

(Draft Bill, section 23(b) to (f))
3. The statutory statement should also specify that existing enactments and the common law continue to apply in relation to any question relating to the formation of a contract that is not otherwise provided for in the statement.

(Draft Bill, section 23(a)(i))

### **Chapter 4 General principles**

4. The statutory statement of the law on formation of contract should provide that:
  - (a) a contract is formed by the agreement of parties which is intended to have legal effect and which, after taking account of any other relevant legal rule, has both the essential characteristics of a contract of the kind in question, and sufficient content for it to be given legal effect as a contract of that kind;

(Draft Bill, section 2(1))

- (b) if parties are agreed on sufficient matter for the law to recognise that agreement as a contract, they will be held to be bound by that contract even if they are continuing to negotiate on other matters relevant to their transaction;

(Draft Bill, section 2(2))

- (c) if one of the negotiating parties refuses to conclude a contract unless the parties have agreed on some specific matter, there is no contract unless agreement on that matter has been reached; and

(Draft Bill, section 2(3))

- (d) completion of agreement and intention of legal effect are to be determined from assessment of the relevant statements and conduct of the parties.

(Draft Bill, section 2(4))

- 5. The statutory statement of the law on formation of contract should provide that parties are free to exclude or derogate from its provisions.

(Draft Bill, section 1)

- 6. The statutory statement of the law on formation of contract should provide that, in relation to formation of contract, a notification by one party takes effect when it reaches the person to whom it is addressed.

(Draft Bill, section 13(1))

- 7. The statutory statement should provide that a statement reaches the person to whom it is addressed when it is made available to the person in such circumstances that it is reasonable to expect the person to be able to access it without undue delay.

(Draft Bill, section 13(3))

- 8. The statutory statement should also set out examples of when a notification reaches a person in the following common situations:

- (a) personal delivery;
- (b) delivery to the person's place of business;
- (c) delivery to the person's habitual residence, if the person has no place of business or if the notification does not relate to a business matter;
- (d) delivery by electronic means.

(Draft Bill, section 13(4))

- 9. The statutory statement of the law on formation of contract should provide that a party is to be taken as being aware of an electronic communication addressed to it when the communication becomes accessible to the addressee.

(Draft Bill, section 13(4)(d))

10. The statutory statement of the law on formation of contract should provide for the abolition of the postal acceptance rule.

(Draft Bill, section 14)

11. The statutory statement of the law on formation of contract should enable a contract to be concluded by performance of an act unnotified to the offeror in cases where:

- (a) the offer itself so provides, expressly or impliedly;
- (b) the parties have established a practice to that effect between or among themselves; or
- (c) there is a usage to that effect common to the parties.

(Draft Bill, section 3(1))

12. The rule should also state that a contract is concluded when the offeree begins to perform the required act.

(Draft Bill, section 3(2))

#### **Chapter 5 Offer and acceptance**

13. The statutory statement of the law on formation of contract should provide for an offer to be defined as a proposal (made to one or more specific persons, to one or more persons in general, the public at large or persons of a particular description):

- (a) by which the offeree must have reasonable grounds to suppose that the proposer intends the proposal to result in a contract if it is accepted;
- (b) that is capable of being given legal effect if accepted, after taking into account any relevant enactment or rule of law.

(Draft Bill, section 4(1) and (2))

14. Any provision on offers to the general public should state that it is without prejudice to the possible application of the law on unilateral promises.

(Draft Bill, section 4(3))

15. The statutory statement of the law on formation of contract should provide that an offer, even if it is irrevocable, may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer.

(Draft Bill, section 10(a))

16. The statutory statement of the law on formation of contract should provide that an offer may be revoked if the revocation reaches the offeree before the offeree has accepted the offer or, in cases of acceptance by conduct, before the offeror may

determine from the conduct of the offeree that agreement has been reached, or before the offeree begins performance of certain acts which conclude the contract.

(Draft Bill, section 5(1) and (2))

17. The statutory statement of the law on formation of contract should provide that an offer made to the public can be revoked by the same means as were used to make the offer.

(Draft Bill, section 5(3))

18. The statutory statement of the law on formation of contract should provide that where an offeror indicates that an offer is irrevocable, either in the offer or in a separate declaration, it may not be revoked.

(Draft Bill, section 5(4))

19. The statutory statement of the law on formation of contract should include a general rule that when a rejection of an offer reaches the offeror, the offer lapses.

(Draft Bill, section 9)

20. The statutory statement of the law of formation of contract should provide that any form of statement or conduct by the offeree is an acceptance if it indicates unqualified assent to the offer.

(Draft Bill, section 7(1))

21. The statutory statement of the law of formation of contract should provide that acceptance by conduct is effective when the offeror becomes, or ought to have become, aware of the conduct in question.

(Draft Bill, section 7(2))

22. The statutory statement of the law on formation of contract should provide that silence or inactivity by the offeree does not, of itself, constitute acceptance.

(Draft Bill, section 7(3))

23. The statutory statement of the law on formation of contract should provide that notification of the acceptance of an offer is effective only if in the case of acceptance by a statement, if the statement reaches the offeror, or in the case of acceptance by conduct, if the offeror is aware or ought to be aware of the conduct, before the expiry of the time limit for a response stipulated in the offer (or if no time limit is specified, within a reasonable time).

(Draft Bill, section 11(1)(a))

24. The statutory statement of the law on formation of contract should provide that, in relation to the conclusion of contract by an unnotified act (where the offer provides,

where the parties have established a practice to the effect or where there is usage common to those parties, that certain acts by the offeree will conclude the contract), the act must be performed (even without notification of performance or of acceptance to the offeror) within any time limit fixed by the offeror or within a reasonable time after the offer is made.

(Draft Bill, section 11(1)(b))

25. The statutory statement of the law on formation of contract should provide that a period of time stated for an acceptance begins to run from the moment that the offer reaches the offeree.

(Draft Bill, section 12)

26. The statutory statement of the law of formation of contract should provide that where a purported acceptance states different terms from those contained in the offer to which it is a reply, it should be treated as a rejection of the offer and as a new or counter-offer.

(Draft Bill, section 8)

27. The statutory statement of the law on formation of contract should provide that an acceptance may be withdrawn if the withdrawal is communicated to the offeror before or at the same time as the acceptance.

(Draft Bill, section 10(b))

## **Chapter 6 Change of circumstances**

28. The statutory statement of the law on formation of contract should provide that an offer lapses upon a fundamental change of circumstances.

(Draft Bill, section 6(1))

29. The statutory statement of the law on formation of contract should provide that, as an example of a fundamental change of circumstances, an offer ceases to be capable of acceptance as a result of the death or loss of capacity of either party before the conclusion of the contract.

(Draft Bill, section 6(2))

30. The statutory statement of the law on formation of contract should provide that:
- (a) the insolvency of either an offeror or an offeree prior to the acceptance of an offer is not in itself a fundamental change of circumstances causing the offer to lapse;

- (b) this rule is without prejudice to the application of any other enactment or rule of law to the transaction proposed in the offer.

(Draft Bill, section 6(3) and (5))

## **PART 4 Remedies for Breach of Contract**

### **Chapter 10 Recommendations for reform**

31. It should be provided that a party in breach of contract may nonetheless exercise any right, or pursue any remedy arising out of the other party's breach provided that the latter breach occurred before the second party rescinded the contract for the first breach. The first party should not be able to seek performance of any obligation of the second party that would have been due in the period following the rescission; or of an obligation that is being lawfully retained or withheld by the second party in response to the first party's breach. These rules should be subject to the contrary agreement of the parties.

(Draft Bill, sections 16(1), 17)

32. Subject to the power of the parties to agree otherwise, where a contract is rescinded for breach and parties have previously rendered conforming performances under the contract but not received the reciprocal counter-performances, there should be reciprocal restitution of the benefits received through the unreciprocated performances.
33. Again subject to the power of the parties to agree otherwise, there should also be detailed rules on the valuation of non-money benefits, and provisions on (i) compensation for any reduction in the value of a returned benefit and (ii) payment for use or improvement of the benefit by the recipient.

(Draft Bill, sections 16(1), 18 to 21)

34. The definition of "fault" in section 5 of the Law Reform (Contributory Negligence) Act 1945 should be extended so that the reference in section 1(1), (2), (5) and (6) of the Act to the fault of either party includes a reference to a breach of contract by either party.

(Draft Bill, section 22)

35. The new contributory negligence rule for breach of contract should be subject to contrary provision in parties' contracts.

(Draft Bill, section 16(2))

# **APPENDICES**

# Appendix A

## Contract (Scotland) Bill [DRAFT]

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# Contract (Scotland) Bill

[DRAFT]

An Act of the Scottish Parliament to make further provision as respects formation of contract and remedies for breach of contract; and for connected purposes.

## PART 1

### FORMATION OF CONTRACT

#### *Autonomy of parties*

#### **1 Autonomy of parties: application of sections 2 to 13**

- (1) Sections 2 to 13 apply in relation to the formation of a contract except in so far as—
  - (a) the offer, or any counter-offer, provides otherwise, or
  - (b) the parties to the contract have, before the contract is concluded, come to an agreement which (whether in regard to the formation of that contract or to the formation of contracts which include that contract) provides otherwise.
- (2) Such provision as is referred to in paragraph (a) or (b) of subsection (1)—
  - (a) may be express or implied, and
  - (b) may be to the effect that the contract will be formed—
    - (i) in a way other than in accordance with those sections, or
    - (ii) in accordance with those sections but with such modifications to them as the parties may agree between themselves.

#### NOTE

This section implements recommendation 5 in the Scottish Law Commission Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses (Scot Law Com No 252, 2018). Section 1(1) recognises and provides for the principle of party autonomy in contracting and has the effect that most of the other provisions or rules in Part 1 of the Bill (sections 2 to 13) are default rules. The principle of party autonomy is discussed in paragraphs 4.46 to 4.55 of the Report and paragraph 4.55 of the Report recommends that the statutory statement of the law on formation of contract should provide that parties are free to exclude or derogate from its provisions.

This provision therefore allows a person making an offer or counter-offer to provide for alternative rules to govern the formation of the contract or for parties to come to an agreement as to the rules governing formation of contract, prior to any offer being made. Section 1(2)(a) provides that any such alternative arrangement may be express or implied.

Examples of party autonomy include: parties agreeing that no contract will be concluded between them until its terms are recorded in writing and signed by each person; an offeror specifying that a particular form or method of acceptance is required; or a party making agreement on some specific matter a requirement for the conclusion of a contract despite agreement having been reached on other issues.

*Requirements for the conclusion of a contract*

**2 Formation of contract: general**

- (1) A contract is concluded on the parties coming to an agreement—
  - (a) which they intend to have legal effect, and
  - (b) which, taking any relevant enactment or rule of law into consideration, has both—
    - (i) the essential characteristics of a contract of the kind in question, and
    - (ii) sufficient content,for it to be given legal effect as a contract of that kind.
- (2) A contract is concluded on the parties coming to an agreement on all but one matter or all but some matters provided that the agreement is, notwithstanding the failure with regard to that matter or those matters, an agreement such as is mentioned in subsection (1).
- (3) But where a party requires that, for a contract to be concluded, there must be agreement on a specific matter there is no contract unless the parties come to an agreement on that matter.
- (4) For the purposes of subsections (1) to (3), whether there is agreement or not may be determined from the statements and conduct of the parties (whether or not such statements and conduct consist of, or include, the acceptance of an offer).

NOTE

This section implements recommendation 4 of the Report. It provides for the general principle that contracts are agreements having sufficient content between two or more parties which they intend to take legal effect between them. This general principle underpins the statutory statement for formation.

The principle is discussed in paragraphs 4.6 to 4.22 of the Report where it is noted that for the formation of contract there must be (i) agreement on the essentials of a contract (the usual minima being the parties to the agreement, the subject-matter of the contract (e.g., the property to be transferred, the service to be supplied) and the price if any); (ii) an intention to create legal relations; and (iii) certainty of terms. This is provided for in section 2(1).

The requirement in section 2(1)(b) that the agreement is one which, after taking any relevant enactment or rule of law into account, can be given legal effect, ensures that general concepts such as illegality and incapacity are recognised in the statutory formulation. Therefore not only must the contract meet any statutory or common law requirements for that specific type of contract, it must also be one which the courts would enforce. The parallel definition of “offer” in section 4(1)(b) means that an offer accepted in terms of section 7 concludes a contract under section 2(1).

Section 2(2) provides that if parties agree on sufficient matter for the law to recognise their agreement as a contract under section 2(1), then there can be a contract even although the parties are continuing to negotiate on other matters relevant to their transaction.

However section 2(3) allows parties to guard against being found to be in contract under the rule in section 2(2), before they are ready for that, if they specify in advance the matter or matters on which they must be agreed before any contract is concluded.

Section 2(4) provides that the existence of agreement between parties is to be determined from their statements and conduct, including but not limited to offers and acceptances. Thus for example, agreement

may be expressed in a single document subscribed by all parties or implied from parties' actings only, or from a combination of their conduct with statements not amounting to offer and acceptance.

By virtue of section 1 parties can contract out of any or all of these provisions.

### **3 Conclusion of contract by unnotified acts**

- (1) Subsection (2) applies, in relation to the formation of a contract, where—
  - (a) an offer provides expressly or impliedly,
  - (b) the parties to the prospective contract have established a practice between or among themselves to the effect, or
  - (c) there is a usage common to those parties to the effect,that the performance (even without notification of performance or of acceptance to the offeror) of certain acts by the offeree will conclude the contract.
- (2) The contract is concluded on the offeree's beginning to perform the acts in question.
- (3) Subsections (1) and (2) are subject to section 11(1)(b).

#### **NOTE**

Section 3(1) implements recommendation 11 of the Report. It provides an exception to the general rule that an acceptance must reach the offeror in order to form a contract between the parties (see section 13). The reasoning for including such an exception to the general rule is discussed in paragraphs 4.95 to 4.99 of the Report, which explains that such an exception is consistent with the overarching principle of party autonomy in that the offeror either explicitly allows for the possibility in its offer, or impliedly permits it by a course of dealing with the offeree, or there is a more general customary usage. Section 3(1) avoids arguments about the extent to which the principle of party autonomy allows implicit departures from the general default rule about acceptance having to reach the offeror through the general nature of the preceding offer, course of dealing between the parties, or customs of a trade or geographical area.

Section 3(2) implements recommendation 12 of the Report. It provides that a contract is concluded on the offeree beginning to perform certain acts, even though these acts are not notified or known to the offeror at the time they take place.

Under section 3(3), sub-sections (1) and (2) are subject to section 11(1)(b), which provides that the performance must begin within any time limit for acceptance stated in the offer.

By virtue of section 1 parties can contract out of any or all of these provisions.

### *Offers*

#### **4 What constitutes an offer**

- (1) For a proposal to constitute an "offer" in relation to the formation of a contract—
  - (a) the offeree must have reasonable grounds to suppose that the proposer intends the proposal to result in a contract if accepted, and
  - (b) the proposal must be one which, after taking any relevant enactment or rule of law into account, could be given legal effect as a contract if accepted.
- (2) Any such offer may be addressed—

- (a) to a specific person,
  - (b) to persons in general,
  - (c) to the public at large, or
  - (d) to persons of a particular description.
- (3) Subsections (1) and (2) are without prejudice to the application of any—
- (a) enactment, or
  - (b) rule of law,
- as respects the constitution of a unilateral promise.

**NOTE**

This section implements recommendation 13 of the Report. Section 4(1) specifies what constitutes an offer. Paragraphs 5.7 to 5.11 of the Report discuss the definition of an offer (a proposal made to one or more specific persons containing sufficiently definite terms to form a contract and indicating the intention of the offeror to be bound if the offer is accepted by the other party or parties). Section 4(1)(b) mirrors section 2(1)(b), with the effect that an offer accepted in terms of section 7 concludes a contract under section 2(1).

Section 4(2) makes clear that an offer may be addressed to various persons (provided the offer otherwise meets the criteria in section 4(1)). Paragraph 5.8 of the Report notes that a proposal made to the general public (for example, to pay a reward for the performing of a specified act) may alternatively be analysed as a unilateral promise to pay to the person who satisfied the stipulated conditions. Section 4(3) implements recommendation 14, so that subsections (1) and (2) are without prejudice to the possible application to the proposal of any enactment or rule of law in relation to the constitution of a unilateral promise.

By virtue of section 1 parties can contract out of any or all of these provisions.

**5 Revocation of offer**

- (1) An offer in relation to the formation of a contract may be revoked by the offeror but only if the revocation takes effect before—
- (a) the offeree accepts the offer,
  - (b) from the statements or conduct of the offeree it may be determined that, as mentioned in section 2(4), agreement has been reached, or
  - (c) the offeree begins performance such as is referred to in section 3(2).
- (2) Subsection (1) is subject to subsections (3) and (4).
- (3) Where such an offer is addressed to persons in general, the public at large or persons of a particular description—
- (a) revocation is, in a case—
    - (i) other than is mentioned in sub-paragraph (ii), to be effected by the same means as were used to make the offer, and
    - (ii) where the means of effecting revocation is specified in the offer, to be effected by the means so specified, and

- (b) subsection (1) is to be construed, in determining whether revocation affects a particular person, as if for references in the subsection to the offeree there were substituted references to that person.
- (4) Revocation under subsection (1) is ineffective if—
  - (a) it is manifest from the terms of the offer in question that it is intended to be irrevocable, or
  - (b) the offeror has, in a declaration which has taken effect, stated that it is irrevocable.

#### NOTE

This section implements recommendation 16 of the Report. It relates to the scenario where an offer has reached but has not yet been effectively accepted by the offeree. Section 5(1)(a) provides that in this scenario the offer may be revoked and cease to be capable of acceptance if the revocation reaches the offeree in terms of section 13 before an acceptance is completed (i.e. reaches the offeror). Section 5(2)(b) deals with the possibility that an agreement may have been reached other than through acceptance of an offer before the revocation became effective, in which case a contract is concluded and cannot be unilaterally revoked. Section 5(2)(c) deals with the case of acceptance by un-notified conduct provided for in section 3. Here the revocation of the offer is effective only if it reaches the offeree before the latter begins the performance which concludes the contract.

Section 5(3) implements recommendation 17 of the Report. It relates to offers to the general public, where there is no specific offeree (which is discussed in paragraphs 5.21 and 5.22 of the Report). Where an offer is addressed to persons in general, the public at large, or persons of a particular description, revocation is to be effected by the same means as were used to make the offer. Where the means of effecting revocation is specified in the offer, it is to be effected by the means so specified. The provision encourages those making general offers to consider whether or not to include in such offers express statements about their revocation.

Section 5(4) implements recommendation 18 of the Report. It deals with irrevocable offers (which are discussed in paragraphs 5.23 to 5.26 of the Report). An irrevocable offer arises (i) when the offer itself makes its intended irrevocability apparent on its face, or (ii) if the offeror otherwise declares that the offer is irrevocable and this declaration reaches the offeree.

By virtue of section 1 parties can contract out of any or all of these provisions.

## **6 Lapsing of offer on fundamental change of circumstances**

- (1) An offer in relation to the formation of a contract lapses on a fundamental change of circumstances and having lapsed can no longer be accepted.
- (2) Without prejudice to the generality of subsection (1), there is a fundamental change of circumstances if, after the offer is made but before a contract is concluded, the offeror or offeree—
  - (a) dies, or
  - (b) becomes incapable of making any decision as to whether to conclude the contract.
- (3) But an offer such as is mentioned in subsection (1) does not lapse where, after it is made but before a contract is concluded, the offeror or offeree becomes insolvent.
- (4) For the purposes of subsection (3)—

- (a) an offeror or offeree who is an individual, or the estate of which may be sequestrated by virtue of section 6 of the Bankruptcy (Scotland) Act 2016, becomes insolvent when—
  - (i) that person’s estate is sequestrated,
  - (ii) that person grants a trust deed for creditors or makes a composition or arrangement with creditors,
  - (iii) a voluntary arrangement proposed by that person is approved,
  - (iv) that person’s application for a debt payment programme is approved under section 2 of the Debt Arrangement and Attachment (Scotland) Act 2002, or
  - (v) that person becomes subject to any other order or arrangement analogous to those mentioned in sub-paragraphs (i) to (iv) anywhere in the world, and
- (b) an offeror or offeree other than is mentioned in paragraph (a) becomes insolvent when—
  - (i) a decision approving a voluntary arrangement entered into by that person has effect under section 4A of the Insolvency Act 1986,
  - (ii) that person is wound up under Part 4 or 5 of that Act of 1986 or under section 367 of the Financial Services and Markets Act 2000,
  - (iii) a receiver is appointed, under section 51(1) or (2) of that Act of 1986, over all or part of the property of that person,
  - (iv) that person enters administration (“enters administration” being construed in accordance with paragraph 1(2) of schedule B1 of that Act of 1986), or
  - (v) that person becomes subject to any other order or arrangement analogous to those mentioned in sub-paragraphs (i) to (iv) anywhere in the world.
- (5) Subsections (1) to (4) are without prejudice to the application of any enactment, or rule of law, in relation to the transaction with regard to which the offer is made.
- (6) The Scottish Ministers may, by regulations subject to the negative procedure, amend subsection (4)(a) or (b).
- (7) Without prejudice to the generality of subsection (6), the Scottish Ministers may under that subsection specify further circumstances in which a person becomes insolvent for the purposes of subsection (3).
- (8) In subsection (2)(b), “incapable” has the meaning given to that expression by section 1(6) of the Adults with Incapacity (Scotland) Act 2000.

NOTE

This section implements recommendations 28 and 29 of the Report. Section 6(1) provides generally that an offer lapses and can no longer be accepted on a fundamental change of circumstances, while section 6(2) provides specifically that death or loss of capacity of either party before conclusion of the contract are examples of such a fundamental change of circumstances. Section 6(2) does not however change the rule that contracts and other obligations, as distinct from offers, generally continue to bind the estates of parties to such obligations who happen to die during their currency.

Lapsing of an offer on a material change of circumstances is discussed in Chapter 6 of the Report. The chapter outlines the general effect that a change of circumstances (in particular, death or supervening incapacity of an individual, and insolvency) may have on an offer, essentially that death of the offeror

should terminate the offer and death of the offeree should render ineffective any acceptance that has been dispatched by the offeree but not received by the offeror. It notes that the case of a company ceasing to exist after making an offer or having dispatched an acceptance which has not yet reached the offeror can be dealt with under the general rule in section 6(1).

Section 6(3) implements recommendation 30 of the Report. Paragraphs 6.25 to 6.29 of the Report discuss the effect of a party's supervening insolvency (noting that persons may contract until the date of their sequestration and that a trustee in sequestration has powers to adopt or disclaim contracts previously entered into, while businesses may continue to trade despite insolvency, and may even manage to trade their way out of insolvency, so that it would be inappropriate for the rule to be that offers lapse on apparent insolvency). Section 6(3) therefore provides that an offer in relation to the formation of a contract does not lapse where, after it is made, but before a contract is concluded, the offeror or offeree becomes insolvent and section 6(4) sets out when an offeror or offeree becomes insolvent.

Section 6(5) also implements recommendation 30 of the Report. The rules in section 6(1) to (4) do not affect the application of any other enactment or rule of law to the transaction proposed in the offer.

Section 6(6) provides that the Scottish Ministers may, by regulations subject to the negative procedure, amend the existing examples of when an offeror or offeree becomes insolvent in subsection (4)(a) or (b), and section 6(7) sets out that the Scottish Ministers may specify further circumstances in which a person becomes insolvent.

Section 6(8) provides that "incapable" has the same meaning as used in section 1(6) of the Adults with Incapacity (Scotland) Act 2000. Section 1(6) defines incapable as meaning incapable of acting, making decisions, communicating decisions, understanding decisions, or retaining the memory of decisions, by reason of mental disorder or of inability to communicate because of physical disability. But a person does not fall within this definition by reason only of a lack or deficiency in a faculty of communication if that lack or deficiency can be made good by human or mechanical aid (whether of an interpretative nature or otherwise).

By virtue of section 1 parties can contract out of any or all of these provisions.

## **7 Acceptance of offer**

- (1) In this Part, any reference to acceptance of an offer is to—
  - (a) a statement (in whatever form), or
  - (b) conduct (of whatever kind),of the offeree which shows the unqualified assent of the offeree to the offer.
- (2) But any such conduct as is mentioned in subsection (1)(b) must be conduct of which the offeror is, or ought to be, aware.
- (3) Silence or inactivity is not in itself to be taken to show such assent.
- (4) This section is without prejudice to section 2(2) and (3).

### **NOTE**

This section implements recommendation 21 of the Report. Section 7(1) and (2) provide that any form of statement or conduct by the offeree is an acceptance if it indicates unqualified assent to the offer, and that by virtue of section 13 acceptance must reach the offeror to conclude a contract. An offer accepted is a contract by virtue of section 2. Under section 7(2) acceptance by conduct is effective to conclude the contract when the offeror becomes or ought to become aware of the conduct in question. This does not affect the further possibility of acceptance by an un-notified act under section 3.

Section 7(3) implements recommendation 22 of the Report. Silence or inactivity from the offeree is not to be taken in itself to show assent. This is not however an absolute prohibition, and it will be possible for silence or inactivity to be sufficient in exceptional cases. An example of such an exceptional case cited in the Report is *Shaw v James Scott Builders & Co* [2010] CSOH 68.

Section 7 is without prejudice to the possibility under section 2(2) that to have a contract parties need not be agreed about all matters on which they are negotiating if they are in agreement on sufficient matters for there to be a contract, or to the further possibility under section 2(3) that a party requires there to be agreement on a particular matter before a contract can be concluded.

By virtue of section 1 parties can contract out of any or all of these provisions.

## **8 Qualified acceptance of offer**

- (1) Subsection (2) applies where, as regards an offer (in this section referred to as “the original offer”) in relation to the formation of a contract, a qualified acceptance by the offeree provides for any or all of the following—
  - (a) terms additional to those of the original offer,
  - (b) terms different from those of the original offer,
  - (c) the omission of terms of the original offer.
- (2) The qualified acceptance (however expressed) is taken to be both—
  - (a) a rejection of the original offer, and
  - (b) a counter-offer.
- (3) Subsection (2) is without prejudice to section 2(2).

### **NOTE**

This section implements recommendation 26 of the Report. It deals with the scenario where a purported acceptance is not a simple outright assent to the offer (an issue discussed in paragraphs 5.64 to 5.73 of the Report).

Section 8(1) and (2) provide that an acceptance by the offeree also providing for any terms additional to or different from those of the offer, or for the omission of any terms from the original offer, then it is to be treated as both a rejection of the initial offer (meaning under section 9 that the offer lapses and ceases to be capable of acceptance) and a new or counter-offer. It also provides that subsection (2) is without prejudice to the possibility under section 2(2) that parties need not be agreed about all matters on which they are negotiating to have a contract if they are in agreement on sufficient matters for there to be a contract.

By virtue of section 1 parties can contract out of any or all of these provisions.

## **9 Rejection of offer**

On the rejection of an offer (whether or not an irrevocable offer) in relation to the formation of a contract the offer lapses.

### **NOTE**

This section implements recommendation 19 of the Report, which is discussed in its paragraphs 5.32 and 5.33. An offer lapses and ceases to be capable of acceptance upon its rejection by the offeree. It does not

matter whether or not the offer is irrevocable under section 5. An acceptance that is qualified in the way described in section 8 is to be treated as a rejection of the offer.

By virtue of section 1 parties can contract out of any or all of these provisions.

### *Withdrawal of offer or acceptance*

## **10 Withdrawal of offer or acceptance**

In relation to the formation of a contract—

- (a) an offer, whether or not an irrevocable offer, may be withdrawn by the offeror if notification of the withdrawal takes effect before, or at the same time as, notification of the offer takes effect, and
- (b) an acceptance may be withdrawn by the offeree if notification of the withdrawal takes effect before, or at the same time as, notification of the acceptance takes effect.

### **NOTE**

This section implements recommendation 15 of the Report. It provides that an offer, even if it is irrevocable under section 5, may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer. It also makes similar provision in relation to the withdrawal of an acceptance by the offeree. Section 13 defines reaching for these purposes.

Paragraphs 5.17 to 5.20 of the Report discuss the difference between withdrawal and revocation of offers (the difference centring around whether the offer has reached the offeree or not) noting that if an offer bears or is declared to be irrevocable, it may still be withdrawn so long as the statement of irrevocability has not yet reached the offeree.

By virtue of section 1 parties can contract out of any or all of these provisions.

### *Time limits*

## **11 Time limits**

(1) In relation to the formation of a contract—

- (a) notification of the acceptance of an offer is effective only if, in the case of acceptance—
  - (i) under paragraph (a) of section 7(1), the statement in question reaches the offeror before, or
  - (ii) under paragraph (b) of that section, the offeror is aware, or ought to be aware, of the conduct in question before,

the expiry of any period of time stipulated in the offer as a period within which the offeree must respond to the offer (or, in any case where there has been no such stipulation, within a reasonable time after the taking effect of the notification of the offer), and

- (b) such performance as is mentioned in section 3(1) is effective only if it is begun before the expiry of any such period of time.

- (2) Subsections (3) and (4) of section 13 apply for the purposes of subsection (1)(a)(i) as they apply for the purposes of subsection (1) of that section.

NOTE

This section implements recommendation 23 of the Report. It makes provision for time limits for acceptances of offers (both by statement and by conduct). This issue was discussed in paragraphs 5.47 to 5.52 of the Report. In general acceptances must be completed within any time limit stated in the offer. A statement of acceptance must become available to the offeror in such a way as to make it reasonable to expect that party to access it without delay before the offer time limit expires (see section 13(3) and (4)); while likewise the offeror must be or ought to be aware of conduct forming acceptance before the expiry of the time limit (see also section 7(1)). Where there may be acceptance by an un-notified act under section 3, the performance of the act must have begun before the expiry of the time limit.

By virtue of section 1 parties can contract out of any or all of these provisions.

**12 Commencement of a period of time within which a response to an offer is required**

- (1) Subsection (2) applies where, in relation to the formation of a contract, the terms of an offer—
  - (a) stipulate that the offeree must respond to the offer within a period of time, but
  - (b) do not make clear when the period is to begin.
- (2) The period begins on the taking effect of the notification of the offer.

NOTE

This section implements recommendation 25 of the Report. The commencement of a period of time within which a response to an offer is required is discussed in paragraphs 5.53 to 5.55 of the Report. If an offer requires a response from the offeree within a period of time without making it clear when the period begins, time starts to run when the offer reaches the offeree (see also section 13).

By virtue of section 1 parties can contract out of any or all of these provisions.

*Notification*

**13 When notification takes effect**

- (1) In relation to the formation of a contract, a notification to a person of an offer, acceptance, counter-offer, withdrawal, rejection, revocation or declaration takes effect on reaching that person.
- (2) Subsection (1) is subject to section 11(1)(a).
- (3) For the purposes of subsection (1), a notification reaches a person when it is made available to the person in such circumstances as make it reasonable to expect the person to be able to obtain access to it without undue delay.
- (4) Without prejudice to the generality of subsection (3), a notification is to be taken to reach a person—
  - (a) when it is delivered to the person,
  - (b) when it is delivered to the person's place of business,

- (c) in a case where either the person does not have a place of business or the notification does not relate to a business matter, when it is delivered to the person's habitual residence, or
- (d) in the case of a notification transmitted by electronic means, when it becomes available to be accessed by the person.

#### NOTE

This section implements recommendations 6 to 9 of the Report. Section 13(1) provides that any notification in relation to formation of contract takes effect when it reaches the person (the addressee). The significance of a statement reaching the other party is that, in general, it only has legal effect from that point onward. Notification includes offers, acceptances, counter-offers, withdrawals, rejections, revocations and declarations (such as a declaration that an offer already made is irrevocable (see section 5)).

The issue of when notification of statements take effect is discussed in paragraphs 4.56 to 4.71 of the Report. Paragraphs 4.72 to 4.85 focus on when electronic communications take effect.

Section 13(3) provides that a notification reaches its addressee when the notification is made available to that person in such circumstances as make it reasonable to expect the person to be able to obtain access to it without undue delay. This is a broad and flexible test which enables contracting parties to deliver notifications to each other in the way which suits their needs best.

Section 13(4) gives instances of when reaching occurs in commonly encountered situations. These are illustrative rather than additional to the general rule of section 13(3).

One instance is a notification transmitted by electronic means (section 13(4)(d)), which is to be taken to reach a person when it becomes available to be accessed by the person (recommendation 9). The provision focuses on the accessibility to the addressee as the test of legal effectiveness, in order to avoid some of the technical difficulties that may arise from the nature of electronic communications (for example, delays and failures in the transmission of emails between servers). With regard to a notification made by email, however, an appropriately worded, automatically generated out-of-office response may make it unreasonable under section 13(3) to expect the addressee to be able to obtain access to it without delay. The same applies where an electronic communications system generates an automatic message advising of a notification's non-delivery in the addressee's system.

By virtue of section 1 parties can contract out of any or all of these provisions. This leaves it open to parties to make alternative provision, for example requiring the use of read receipts to emails, or something similar if they chose.

#### **14 Abolition of any rule of law as to when notification of postal acceptance takes effect**

Any rule of law whereby, in relation to the formation of a contract, an acceptance sent by means of a postal service takes effect when posted is abolished.

#### NOTE

This section implements recommendation 10 of the Report. The postal acceptance rule is an exception to the general rule that an acceptance must reach the offeror to conclude a contract. Under the rule, an unqualified acceptance takes effect when the acceptance was posted, rather than when it reached the offeror. The rule only applies to acceptances: postal offers, withdrawals and revocations of offers, and qualified acceptances did not benefit from it, and qualified acceptances in particular only become counter-offers when actually communicated to their offerees. This rule and the question of whether there is a need

to retain special protection for acceptances sent by post in modern conditions and a digital age, is discussed in paragraphs 4.86 to 4.90 of the Report. Section 14 provides that in relation to the formation of a contract, any rule of law whereby an acceptance sent by means of a postal service takes effect when posted is abolished.

Section 1 does not apply to section 14. By virtue of section 1's application to section 7, however, parties can agree that a postal acceptance will conclude a contract upon the former's dispatch.

### *General*

## **15 Interpretation of Part 1**

- (1) In this Part (except where the context otherwise requires)—
  - “acceptance” is to be construed in accordance with section 7,
  - “counter-offer” is to be construed by reference to section 8(2),
  - “offer” is to be construed in accordance with section 4 (and includes a counter-offer),
  - “offeree” means a person to whom an offer is made,
  - “offeror” means a person who makes an offer, and
  - “postal service” has the meaning given to that expression by section 27(1) of the Postal Services Act 2011.
- (2) In this Part, any reference to the taking effect of a notification is to be construed in accordance with section 13.

## **PART 2**

### REMEDIES FOR BREACH OF CONTRACT

#### *Autonomy of parties*

## **16 Autonomy of parties: application of sections 17 to 21 and of the Law Reform (Contributory Negligence) Act 1945**

- (1) Sections 17 to 21 apply in relation to any breach of contract—
  - (a) except in so far as the parties to the contract have agreed otherwise, and
  - (b) except that if the contract includes any term which the parties intend should continue to have effect even after the contract is rescinded, those sections are without prejudice to that term.
- (2) The parties to a contract may agree that the Law Reform (Contributory Negligence) Act 1945 is to be disregarded in determining any question as to reducing, by virtue of a breach of the contract by a party, any damages recoverable from the other party.

#### NOTE

As with the statutory statement for formation, the principle of party autonomy in contracting is also recognised in Part 2 of the Bill in relation to remedies for breach of contract.

As with section 1(1) of the Bill, section 16(1)(a) provides for this principle of party autonomy and has the effect that most of the other provisions or rules in Part 2 of the Bill (section 17 to 21) are default rules. It is therefore left open to parties to provide their own, different, rules on what remedies apply in relation to breaches of contract. Section 16(1)(b) applies where a contract has been rescinded (terminated) by a party in response to another party's material breach of the contract (the situations to which in particular sections 17 to 21 apply). The Bill's provisions do not prevent the continuing effectiveness of any term of the rescinded contract which was intended to remain effective after rescission.

Section 16(2) implements recommendation 35 of the Report. It similarly provides for the principle of party autonomy, by allowing the contributory negligence rule in section 22 of the Bill to be subject to contrary provision in parties' contracts.

### *Mutuality of contract*

#### **17 Mutuality of contract**

- (1) Subsection (2) applies where any two parties to a contract (those parties being in this section referred to as "PA" and "PB") are each in breach of the contract.
- (2) PA is entitled to exercise any right, or pursue any remedy, arising out of PB's breach provided PB's breach occurs before the contract is lawfully rescinded for PA's breach.
- (3) But subsection (2) does not entitle PA to require PB to perform the contract in so far as—
  - (a) such performance falls due after the contract is so rescinded, or
  - (b) PB is (for PA's breach) lawfully withholding such performance.

#### **NOTE**

This section implements recommendation 31 of the Report. It applies where any two parties to a contract are each in breach of contract (those parties being referred to in the provision as "PA" and "PB"). The concept of mutuality of contract has two major consequences: (a) if one party does not perform, the other need not perform, and (b) a party which has not performed or is not willing to perform its obligations cannot compel the other to perform (this concept is discussed in paragraphs 10.1 to 10.11 of the Report). This second consequence creates significant difficulties (such as a party in breach not being able to exercise any rights under the contract or sue for damages for its breach by the other party). Section 17(2) addresses these difficulties by abolishing any rule of law to the effect that a party who is in breach of contract is thereby not entitled to exercise any right or pursue any remedy arising from a breach of contract by the other contracting party.

However section 17(3) makes it clear that the party in breach (PA) may not claim performance of duties which are lawfully retained (for example because they are not mutual or reciprocal to the first party's (PB's) breach).

It is open to parties to contract out of this provision, in terms of section 16 of the Bill.

### *Rescission for breach of contract*

#### **18 Rescission for breach of contract: return of benefits received**

- (1) On a contract being lawfully rescinded for breach of contract, this section and sections 19 to 21 apply if a party to the contract received any benefit from the performance by another party of an obligation under the contract

- (2) But this section and sections 19 to 21 do not apply in respect of any benefit which fully reciprocated the performance of such an obligation by the party which received the benefit.
- (3) The party which received the benefit is in those sections referred to as “the recipient”.
- (4) The benefit must be returned to the other party provided that the other party concurrently returns any benefit it received from the performance by the recipient of an obligation under the contract.
- (5) In so far as the performance was a payment of money, the amount received must be repaid.
- (6) In so far as the benefit was not a payment of money but is transferable by the recipient, it must be transferred to the other party unless it would be unreasonable or impracticable to do so, in which case its return is to be by the payment to the other party of its value.
- (7) In so far as the benefit was not a payment of money and is not transferable by the recipient, its return is to be by the payment to the other party of—
  - (a) its value, or
  - (b) if it has been disposed of for an amount greater than its value, that greater amount.
- (8) The requirement to return a benefit includes a requirement to return the fruits of the benefit (whether natural or civil).

#### NOTE

This section, along with sections 19 to 21, implements recommendations 32 and 33 of the Report. Together the sections define a new remedy of return after rescission (termination) of a contract for material breach. As discussed in paragraph 10.27 of the Report, in line with the general principles of Scots law on remedies for breach of contract, this new remedy may be cumulated with other remedies so long as their exercise together is compatible with one another. This is one effect of section 23(a)(iii) of the Bill, which provides that the Bill is without prejudice to any enactment or rule of law regulating any question related to remedies for breach not provided for in the legislation.

Section 18(1) and (4) provides that where a contract is rescinded for breach, and parties have previously rendered conforming performances under a contract but not received the reciprocal counter-performances, there should be reciprocal restitution of the benefits received through the unreciprocated performances. This therefore redresses the economic imbalances caused by rescission of a partly performed contract (see discussion of the issue in paragraphs 10.12 to 10.27 of the Report).

Section 18(2) makes it clear that sections 18 to 21 do not apply to the extent that conforming performance of an obligation by one party has been met by conforming performance by the other of a reciprocal obligation. This is required to prevent restitution after rescission meaning that every rescinded contract has to be unwound back to the position at the outset of the contract.

Sections 18(5) to 21 implement recommendation 33 of the Report and provide detailed rules as to how reciprocal restitution works in practice: in particular, rules on how the benefit is to be returned according to whether or not it took the form of money, with non-money benefits to be returned if still transferable. If however the transfer would be unreasonable or impracticable, return is to be effected by way of payment to the other party of its value. Similarly, if a non-money benefit is not returnable by its recipient (e.g. it took the form of a service having no tangible end-product), restitution is to be effected by a payment of its value or, if the benefit has been disposed of by the recipient for an amount greater than its value, that greater amount. Valuation of a benefit is dealt with in section 19 of the Bill.

A useful example of a benefit that is not a payment of money but nonetheless must be returned to the party who is in breach of contract, is supplied in the Commentary for the equivalent Article to this provision in the Draft Common Frame of Reference (on which sections 18 to 21 are modelled). The commentary gives the example of a firm of accountants who agree to lease a computerised accounts system, but contrary to the contract only hardware, and no software, is supplied to them. The accountants, who have not yet paid, can rescind the contract for material breach, but are required to return the hardware.

It is open to parties to contract out of this section in terms of section 16 of the Bill.

## **19 Value of benefit**

- (1) This section applies where the recipient is required, by section 18(6) or (7), to pay the value of a benefit.
- (2) The payment is the value of the benefit as at the time of the performance of the obligation by the other party.
- (3) Where there was an agreed price, the value of the benefit is that proportion of the price which the value of the actual performance bears to the value of the promised performance.
- (4) Where there was no agreed price, the value of the benefit is the sum of money which a willing and capable provider and a willing and capable recipient would reasonably be taken to have agreed for the actual performance.
- (5) But subsections (2) to (4) are subject to subsection (6).
- (6) The recipient's liability to pay the value of a benefit is reduced to the extent that, as a result of the non-performance of an obligation owed by the other party to the recipient (being an obligation under the contract) the recipient is compelled, without compensation, either to dispose of the benefit or to sustain a disadvantage in order to preserve it.

### **NOTE**

This section further implements recommendations 32 and 33 of the Report and sets out rules on the valuation of a non-money benefit that is not returnable by the recipient under section 18(6) and 7. The valuation is assessed at the time of the other party's performance (section 19(2)). If there was an agreed price for that performance, the value is that proportion of the price which the value of the actual performance bears to the value of the promised performance (section 19(3)). Where there was no agreed price, the value is the sum of money two willing and capable parties would be reasonably expected to have agreed for the actual (as distinct from the promised) performance (section 19(4)). All this is subject to the provision that if the recipient of the benefit is, without compensation, compelled to dispose of the benefit or to sustain a disadvantage in order to preserve the benefit because of the other party's non-performance of an obligation owed to the recipient under the contract, the payment of the value of the benefit is to be reduced accordingly.

Again, it is open to parties to contract out of this section in terms of section 16 of the Bill.

Another useful example is given in the DCFR Commentary, this time of a non-transferrable benefit, which is the result of work that cannot be returned. The example is as follows: a building contract specifies that the builder is to be paid upon completion of the work; however midway through the builder becomes insolvent and stops work. Thereafter the employer terminates the contractual relationship and hires a second builder to complete the work. The amount the employer is required to pay the second builder is less than the original contract price, and therefore the employer enjoys a net benefit. Under the section, the employer will have to pay the first builder a reasonable sum for the value of the work received.

## **20 Compensation for reduction in value of a returned benefit**

- (1) This section applies where the recipient is required, by section 18(6), to transfer a benefit.
- (2) The recipient must pay compensation for any reduction in the value of the benefit as a result of a change in the condition of the benefit between the time of receipt and the time of transfer to the other party.
- (3) But the recipient's liability to pay compensation under subsection (2) is reduced to the extent that the change in condition is a result of—
  - (a) the non-performance of an obligation owed by the other party to the recipient (being an obligation under the contract), or
  - (b) conduct of the recipient in the reasonable, but mistaken, belief that the other party's performance of an obligation so owed conformed with the contract.

### NOTE

This section further implements recommendations 32 and 33 of the Report. Section 20 requires the recipient of the benefit to pay compensation for any reduction in its value through a change in its condition between the time of receipt and the return to the other party. The liability to pay compensation is reduced if the change in condition was through a non-performance of an obligation which the other party owed to the recipient, or the recipient's conduct causing the change was made in the reasonable but mistaken belief that the other party's performance conformed with the contract.

Again, it is open to parties to contract out of this section in terms of section 16 of the Bill.

## **21 Use and improvement**

- (1) The recipient must pay the other party a reasonable amount for any use which the recipient made of the benefit (except in so far as the recipient is liable to pay compensation to the other party under section 20(2) in respect of that use).
- (2) If a recipient improved a benefit which the recipient is required by section 18(4) to return, the recipient has a right to payment for the value of the improvement (provided that the other party could readily obtain that value by dealing with the benefit) unless—
  - (a) the making of the improvement was in itself a breach of the contract, or
  - (b) the recipient made the improvement when the recipient knew, or ought to have known, that the benefit would require to be returned.

### NOTE

This section further implements recommendations 32 and 33 of the Report. Section 21(1) requires the recipient of the benefit to pay a reasonable amount for any use made of it. Section 21(2) entitles the recipient to payment of the value of any improvements made to the benefit which the other party can readily obtain by dealing with it. This entitlement does not exist, however if either the improvement was itself a breach of contract, or the recipient made the improvement knowing, or when it ought to have known, that the benefit would have to be returned.

An example of use and improvement from the DCFR Commentary involves the purchase by D of a number of motorcycles from M, which D proceeds to improve by customising them. However D is unable

to re-sell the bikes upon discovery that contrary to the terms of the contract the motorcycles at the time of purchase did not satisfy certain safety regulations. D therefore terminates the contractual relationship with M. Restoration of the bikes to their state at the time of purchase is impossible due to the nature of the customisation. Therefore, while D is required to return the bikes to M under section 18(4), M is liable to pay to D the value of the improvements made, if M can readily obtain that value by selling the bikes.

Again, it is open to parties to contract out of this section in terms of section 16 of the Bill.

*Amendment of Law Reform (Contributory Negligence) Act 1945*

**22 Amendment of Law Reform (Contributory Negligence) Act 1945**

In section 5 of the Law Reform (Contributory Negligence) Act 1945—

- (a) in paragraph (a), after “; and” insert “subject to paragraph (aa)”, and
- (b) after paragraph (a) insert—

“(aa) without prejudice to the generality of section 1—

- (i) in subsection (1) of that section the reference to a person’s “own fault” includes a reference to that person’s breach of a contract and the reference to “the fault of any other person or persons” includes a reference to a breach of a contract by that other person or those other persons; and
- (ii) in each of subsections (2), (5) and (6) of that section, references to being “at fault” are to be construed accordingly.”

NOTE

This section implements recommendation 34 of the Report. The subject-matter of the recommendation is discussed at paragraphs 10.28 to 10.54 of the Report. The Law Reform (Contributory Negligence) Act 1945 applies to delictual claims of damages for negligence, but it has been unclear how far or even whether it extends to breach of contract claims. Section 22 of the Bill allows contributory and blameworthy conduct of the pursuer as a means of limiting any claim for damages for breach of contract.

This is achieved by way of addition to the 1945 Act making clear that the defence of contributory negligence under the Act applies to all claims of damages for breach of contract. The definition of “fault” in section 5 of the 1945 Act is subject to a new provision, which has the effect of extending the definition to include “breach of contract”. The approach incorporates all the other relevant jurisprudence under the 1945 Act (e.g. on causation of the loss by both parties, and consideration of their relative blameworthiness in assessing damages for breach). Thus the defence of contributory negligence will arise where the pursuer in a claim of damages for breach of contract suffers loss partly through its own fault and partly through the breach of contract by the other party. The damages recoverable in respect of the breach will be reduced to the extent the court considers just and equitable having regard to the pursuer’s share in the responsibility for the loss.

When section 22 comes into force, the effect will be that the 1945 Act is amended and section 22 of the Bill itself is then spent.

It is open to parties to contract out of this section in terms of section 16 of the Bill.

## PART 3

### GENERAL

#### **23 Saving**

The provisions of this Act are without prejudice to any enactment or rule of law which—

- (a) regulates any question which relates to—
  - (i) the formation of a contract,
  - (ii) mutuality of contract, or
  - (iii) remedies for breach of contract,but is not provided for by the provisions of this Act,
- (b) requires writing for the formation of a contract,
- (c) prescribes a form for a contract,
- (d) regulates any question which relates to the essential validity of a contract,
- (e) provides protection against unfair contract terms, or
- (f) provides protection for a particular category of contracting person.

#### NOTE

This section implements recommendations 2 and 3 of the Report. It regulates the scope of the Bill, and contains a number of savings for other matters that affect formation of contract (including preserving the common law on formation to deal with matters that have not been envisaged and included in the Bill), mutuality of contract, and remedies for breach of contract.

#### **24 Commencement**

- (1) This section and sections 15, 23 and 25 come into force on the day after Royal Assent.
- (2) The other provisions of this Act come into force on such day as the Scottish Ministers may by regulations appoint.
- (3) Different days may, under subsection (2), be appointed for different purposes.

#### **25 Short title**

The short title of this Act is the Contract (Scotland) Act 2018.

# Appendix B

## Advisory Group membership

### Interpretation of Contract Discussion Paper (2011)

#### *Advisory Group*

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**Formation of Contract Discussion Paper (2012)**

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**Remedies for Breach of Contract Discussion Paper (2017)**

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# Appendix C

## Responses to consultations

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### Formation of Contract Discussion Paper (2012)

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Society of Solicitor Advocates



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