Observed in the breach

David Sagar

How do you know whether a contractual term is a condition or a warranty, and what is the effect of a breach?

Students preparing for the Business Law exam are required to study the law of contract – a subject that accounts for 30 per cent of the syllabus. Section 3b(iii) "Performing the contract" has a syllabus weighting of 10 per cent. Students are required to:

A explain in detail how the contents of a contract are established;

B explain the status of contractual terms and the possible consequences of non-performance on these terms;

C explain how the law controls the use of unfair terms for both consumer and non-consumer business agreements;

D explain what the law regards as performance of the contract, and valid and invalid reasons for non-performance.

Question A is satisfied by explaining which of the various statements made by negotiating parties become terms of the contract. This in turn requires students to know how the law determines that the parties have reached agreement, through the rules of offer and acceptance, and how terms are incorporated into the contract.

The law on incorporation of express terms can be summed up in a single sentence: "Thus to be bound by a clause a person must know of that clause, or have been given reasonable notice of it at or before the time when the contract was entered into." (*Thornton v Shoe Lane Parking Ltd* (1971)). More specifically, express terms can be incorporated by the following means:

- actual notice (knowledge) of the terms;
- signature;
- provision of reasonable notice;
- a "course of dealings".

In addition, various statutes imply terms into contracts, irrespective of the express wishes of the contracting parties. For example, the Sale of Goods Act 1979 contains a number of provisions that are implied into all contracts for the sale of goods. And the Unfair Contract Terms Act 1977 prohibits the exclusion of some of those provisions in certain types of contract, in particular those involving the sale of retail goods by a business to a consumer.

There is no need to explain further the rules of incorporation for question B, as information can be found in the CIMA Business Law study pack, and many other business law texts. Once the contents of the contract have been ascertained, the next step is to determine the status of the terms. Terms may be classified as conditions or warranties. If it is not known into which category the clause falls, it is "inominate".

A condition is a fundamental term going to the root of the contract. In other words, conditions set down the primary obligations of the parties. The difference between conditions and warranties can be illustrated in two cases from the late 19th century.

In *Poussard v Spiers and Pond* (1876), Madame Poussard was under contract to appear in an operetta for the season. In fact she was unavailable because of illness until one week after the season had started. It was held that the obligation to perform from the first night was a condition and the producers were entitled to terminate her contract.

In *Bettini v Gye* (1876), Bettini was under contract to appear in concert for a season. The term required him to be in London for rehearsals six days before the season started. When Bettini arrived three days late, Gye refused to accept his services. It was held that Bettini's late arrival was simply a breach of a warranty so Gye was himself in breach by terminating Bettini's contract.

A breach of a condition does not automatically cause a contract to be terminated, but it gives the innocent party a choice about how to proceed. They may choose to cancel ("repudiate") the contract and claim damages and rescission, or they may choose to carry on with ("affirm") the contract and claim damages.

Let's take another example. Tom, a self-employed sales representative, bought a new car for £10,000. He paid a deposit of £5,000 and agreed to pay the balance in instalments. The first time Tom drove the car the engine failed. The manufacturer was prepared to replace the engine, which was covered by its guarantee.

It is an implied condition under Section 14 of the Sale of Goods Act 1979, that goods sold must be of a "satisfactory quality". This leaves Tom with two possible options on how he should legally proceed:

- He may repudiate the contract, and claim rescission and damages. Repudiation means that Tom is no longer bound to make any payments on the car. Rescission enables him to recover his deposit of £5,000 and any instalment payments. In addition, he may recover damages to compensate him for any additional costs such as having the car towed to a garage, the cost of hiring a car or arranging alternative transport.
- He may accept the manufacturer's promise to repair the car – in other words, he may affirm the contract and recover damages only – for example, compensation as under the first option. In this option Tom has, in effect, chosen to treat the breach as one of warranty rather than that of condition.

You might ask: so what about warranty? In this case, warranty is a relatively unimportant term. The innocent party is not entitled to repudiate a contract simply for a breach of a warranty and is restricted to a claim for damages. In fact, if the innocent party should proceed by repudiating the contract following a breach of warranty, they are no longer innocent, but have acted in breach of contract (see *Bettini v Gye*).

Imagine, for example, that Tom discovered the car radio was faulty and needed to be replaced. This is a relatively minor breach and entitles Tom to be compensated for the cost of a replacement radio. Tom would not, however, be entitled to repudiate the contract to purchase the car.

Unfortunately, contracting parties do not always make it clear whether a particular term is a condition or a warranty. This can create many problems but, in general, the law allows parties freedom of contract in that they are free to classify terms as they choose. What may appear to be a minor issue to one person may be of crucial importance to another. It is down to the courts therefore to determine the intention of the parties involved.

The status of terms may be determined by asking the following questions:

- Does the contract state expressly that breach of a particular term gives the innocent party rights to terminate the contract?

If the answer is yes, then the term must be a condition. This is so even if, when looked at

objectively, the term appears to be of relatively minor importance. If the answer is no, it is necessary to ask additional questions, such as:

- Does the contract describe a particular term as a condition or a warranty?

Even where the parties use the word "condition" or "warranty" to describe a particular term, the courts have stated that this will not in itself be conclusive. In *Schuler AG v Wickman Machine Tools Sales Ltd* (1974) a term described as a "condition" required Wickman to make weekly visits over a four-and-a-half year period to six named firms, a total of 1,400 visits.

Wickman failed to make some of the weekly visits so Schuler terminated the contract. It was held that Schuler acted in breach by repudiating the contract. Even though the word "condition" had been used to describe the term, the House of Lords did not believe that it was the parties' intention that a failure to make a single visit would give Schuler the right to terminate.

- Does the law state that the term in question is a condition?

For example, suppose a dispute arose because goods delivered to the buyer differed from their description in the seller's catalogue. Is this a breach of a condition or a warranty? The answer lies in Section 13 of the Sale of Goods Act 1979, which states: "In contracts for the sale of goods by description there is an implied condition that the goods shall correspond with their description."

The law clearly states that the term is a condition. So in this case there is no room for argument and, consequently, the innocent party is entitled to claim for breach of a condition.

- Has the innocent party been deprived substantially of what it was intended they should receive under the contract?

This test has been criticised on the basis that the courts should be attempting to determine the intention of the parties at the time the contract was entered into, rather than looking at the effect of the breach. As a result, it should be seen as a last resort.

Where the other questions have not produced a conclusive answer, and evidence of intention is unclear, a pragmatic way of resolving the dispute is to look at the severity of the breach. If the effect of breaking a term is to deprive the innocent party of the main benefit of the contract, then that term must have been a condition. If not, it follows that the term must have been a warranty. ■

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How to tackle the case study

John Williams

The lessons you can learn from the May 2001 final level case exam

The purpose of this article is to provide guidance to candidates for future sittings of the case exam. It does not address common errors and problems with the May 2001 exam, as this would detract from the general standard achieved.

This was the first exam under the new syllabus and, inevitably, it was quite different from previous exams since it was designed to test a wide range of skills in a new way. The pilot paper and marking matrix offered some guidance on what to expect, but the findings from a "live" case should prove far more useful.

Inevitably, candidates in May will have experienced uncertainty about the balance between the pre-seen and unseen elements of the scenario, and they will have faced difficult choices about how to prepare for the exam. You need to recognise that every case is different and, therefore, an approach which works for one case may not be entirely appropriate for future cases.

There are two basic ways you can embark on general preparation for the exam, before the pre-seen scenario is sent out:

- you can revise the skills and techniques needed for final level examinations and earlier papers. This is a relatively minor problem for those sitting the case at the same time as other final level papers, but is significant for those sitting it later;
- you can undertake exam practice.

The revision problem is likely to be more serious if a significant amount of time has passed since you sat the other final level papers – the expected knowledge of techniques and skills can change fast, notably in information strategy. Similar change also affects financial strategy and business strategy – for example, the boom and subsequent bust in dotcom companies has produced a range of new problems and new techniques, and adaptations of old techniques.

There are two issues involved in exam practice. The simple part is the need to develop planning and writing skills for an exam which gives little guidance in the way of breakdown of the marks available, or the time you should allow for the different parts of the requirement.

The first case did give an indication that equal time should be spent on both parts of the requirement; but a subsequent case may have only one requirement. You must plan your answer and allow time for the various parts. There will always be some time pressure, because cases are open-ended – you will always think you could write more, but good candidates will prioritise issues and concentrate on the important ones.

The other important point is to practise doing case exams. Practice cases do not need to be CIMA cases, or even in the same pre-seen/unseen format, but you should practise rapidly analysing case material, since you will need to exercise this skill when dealing with the unseen material in the exam.

You should also practise developing outline answer plans from this analysis, and make sure you can get down to writing the answer without delay. Aim to complete your analysis and planning in not much more than half an hour. It may be possible to save time by using a table of contents for a report function as an answer plan.

Case exam requirements are quite likely to involve writing a report, although this could vary. You should practise basic report layouts, but don't waste too much time providing excessive presentations at the expense of detailed content.

The format expected in an exam is, of course, going to be simpler than the kind you would expect in a large organisation – this recognises the constraints of time and the lack of a computer. Apart from the normal headings, the key requirement is that it

should have a clear and logical table of contents, and that each part of the report should be clearly headed.

The pre-seen scenario is distributed well before the exam so that all candidates have plenty of time to analyse it and no one is disadvantaged because of problems such as postal delays or work pressure. This does not imply that nearly three months' work on the scenario is either necessary or sensible.

The pre-seen material provides some general background material, enabling candidates to undertake general research into the industry, the type of firm and its potential problems. Identifying the firm which may have been used as a partial model for the development of the case is not necessarily helpful as significant changes will have been made and the exam is dealing with a hypothetical firm in the scenario, not a real firm.

While the internet provides wonderful scope for research, it should not be regarded as the only possible route. For the May 2001 exam, candidates would have been well prepared if their background reading included the *Financial Times*, the *Economist* and *Investors Chronicle* in the months before the examination. It was noticeable that the candidates who had undertaken good background reading right up to the exam were able to quote relevant analyses from these publications and scored highly on business awareness.

It may be possible to predict techniques that may be needed in the exam. This certainly applied in the May 2001 exam. Candidates should have identified the obvious problems of extremely high and possibly unrealistic initial expectations and forecasts, and the problems of cash burn and difficult refinancing.

They could also have identified the problems of valuing firms without significant tangible assets and without an established record of earnings. There might have been other possible issues that could have been identified, including some which were not taken up in the unseen and the requirement.

Some tutors developed predicted unseens and questions based on the published pre-seens. While this was enterprising and potentially beneficial for candidates, in practice it was no more than a qualified success. It helped to develop awareness of the type of industry and some potential problems, but some candidates clearly mixed up the CIMA pre-seen information and CIMA unseen information with hypothetical information.

The closer a predicted unseen is to the CIMA unseen, the more this will be a problem. However, there will often be new financial data in the CIMA unseen, and tutors are unlikely to forecast this successfully.

When it comes to the actual exam, the first thing to remember is that this is still a formal exam and all the old rules still apply:

- Read, re-read, analyse the requirement, and plan an answer to the question asked, not the answer to the question you would have preferred.
- Plan the way you use the available time. Balance the time spent reading the new information and the time spent mentally merging it with the information you already have. Allow time for planning an answer as well as for writing it.
- Do not assume that the question(s) will be largely based on the pre-seen material; this is unlikely. The unseen material, given out together with the question, has to be substantial enough to change the overall balance of the situation, so that candidates have to answer a question on a situation assessed on the day, rather than using answers they planned in advance.
- Analyse and use any new financial data. This will probably show some change from any previous data and it will be relevant to the answer. Senior management would always expect a chartered management accountant to make sensible calculations and to provide clear comment explaining the significance of any figures.
- It is sensible to make all preliminary calculations legible and to ensure that they are well explained. They can then be labelled as a report appendix.
- Ensure that all parts of the requirement are answered in some way, even if you cannot write all that you may want to write on another part. There is always scope to write more on some aspects of cases, but you must prioritise.
- Ensure that your answer is easy to navigate – that all sections are clearly headed, and that these headings link up with the concise table of contents.

The case exam also has some distinctive features which should be reflected in all your answers:

- Marks for knowledge are limited, so a detailed description of particular techniques, although valid and important, will not earn any more marks than a brief, but relevant, comment.
- Numerical skills are important, but being able to comment on the significance of figures is even more vital.
- Recommendations will always be needed and reasons must be stated clearly. In any case study, the information provided is limited and may also be ambiguous. Nevertheless, recommendations are still required. They must be developed and justified using all the available information – stating the need for more information or commenting on the need for further investigation will not suffice. ■

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