COMMERCIAL LAW

BUSINESS LAW FOR ENTREPRENEURS

GUIDE Block 3.- Planning the Business Activity and Concluding Transactions in the Market

BLOCK 3
READING MATERIALS, CASES AND PROBLEMS

4. CONTRACTS AND TRANSACTIONS

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Reading materials and other additional references:

- (A further analysis of all issues of Block 3) RODRÍGUEZ DE LAS HERAS BALLELL, Teresa, *Introduction to Spanish Private Law: Facing Social and Economic Challenges,* London: Routledge, 2009, Chapter 6, pp. 213-267, in particular from p. 235 on
NOTE: Please note that the Book is published in 2009, therefore do always double check with rules in force.

Main ideas, aims and questions:

Transactions are the driving force propelling trade in the market. Individuals, private undertakings and public entities run their activities in the market by concluding contracts and performing transactions with each other. A market is indeed a collection of exchange relationships among the participants governed by a certain set of rules.

An entrepreneur wishing to run his/her business in the market, either acting alone or incorporating a company, needs to conclude a number of contracts with providers, clients, independent contractors, agents, distributors, or collaborating partners.

A contract is an agreement reached by the contracting parties to satisfy mutually their respective interests. Therefore, when contracting parties enter into a contract, assuming that it is valid and enforceable, they are bound by its covenants. In other words, contract terms are binding law between parties. Indeed, it is presumed that contracting parties have freely agreed on contractual terms that maximize their expected benefits and meet their interests. Hence, if the contract is fulfilled in their own terms, contracting parties will be fully satisfied; whereas one party departs from the agreement, he/she breaches the contract and the other party will wish to remedy the default and compensate his/her damages deriving from the lack of satisfaction of his/her interests.

However, even if, in general terms, parties are widely free to decide whom to contract with and under which conditions, some limits apply to prevent abuses and restore possible imbalances between contracting parties. In those cases, binding legal rules will replace what the parties had presumably agreed. Likewise, as a general rule, only the parties to the contract are bound thereby, could sue or be sued under the contracts; and third parties could not derive rights from, nor have

obligations imposed on them by. Privity of contract should be the natural consequence of private autonomy

Accordingly, we have to study: firstly, which limits private autonomy is subject to; secondly, which requirements a contract has to meet to be valid and enforceable; thirdly, when a valid contract arises from negotiations between parties; and finally, which remedies parties are entitled to exercise in case of default.

A.- Private autonomy

Primordial role of contract in economic transaction dynamics is supported by the principle of private autonomy exalted by the liberalist model of *laissez faire laissez passer* within a period characterized by the flourishing of mass trade, industry and commerce.

In Spanish Private Law, Article 1255 *Civil Code* encapsulates the enshrinement of private autonomy and the establishment of its general limits (law, morality and public order). The autonomy of will (*autonomía de la voluntad*) must be then exercised in accordance to law, morality and public order. Otherwise, such agreement will not be respected by the Law because does not comply with its main principles.

Apart from these general limits that empowered the courts to adapt legal provisions to social reality, circumstances concurring in modern trade and evolving markets has given rise to new phenomena that require the establishment of specific limits: the increasing participation of consumers in commercial transactions, the advent of adhesion contracts and standard contract terms articulating mass trade, the development of antitrust legislation, the growing receptiveness to a notion of freedom of contract conditioned by human rights and fundamental liberties.

A.1. Specific limits to private autonomy: mandatory law regarding commercial and consumer contracts

To respond to the intensive participation of consumers in market relationships, Consumer Law has started to conquer traditionally mercantile-law realms establishing specific limits on the liberal conception of private autonomy.

Consumer-biased legislation has recourse to the mandatory character of provisions to prevent abuses and unconscionability. Consumer law system is basically based on two legal tools: the provision of obligations and duties to companies, deemed as the strong party in the transaction; and the granting of rights and privilege to consumers, treated thereby as the weakest party in the prospective contract. Underlying economic rationale is evident, market fails and State intervention to repair them is demanded. Legal rationale is also clear. Certain circumstances revealing an imbalance between the parties render private autonomy illusory. With the ultimate goal of protecting the weakest party legislators set mandatory limits on private autonomy aiming at rebalance the unfair situation.

A.2. Private autonomy in modern economy: standard form contracts and adhesion contracts

Unlike ideal contractual process seemingly underlying code provisions, characteristics of mass production and mass trade in modern economies demands more flexible, standard and better suited instruments. The advent of the so-called adhesion contract and the standard contract terms redraw transactional dynamics towards "no bargain", "mute trade" or "contract without dealings" scenario. Despite the profound controversy aroused by the *contrat d'adhesion* they have demonstrated a satisfactory ability to meet mass trade demands: need of uniformity, depersonalization, expeditious pace of modern contracting, better management of cost, and rationalization of economic activity.

Given the economic patterns of mass trade, contract terms are not negotiated individually and the adherent is compelled to decide according to the two-option scheme of "take-it or leave-it". Legal concept of "standard terms" or "general conditions" is defined in the Spanish legal system by the *Standard Contract Terms Act 1998* according to the following features: not individually negotiated conditions predisposed by the seller or supplier (one of the contracting parties) for an indefinite number of transactions, particularly in the context of pre-formulated contracts, to be accepted by the other contracting party (consumer but also professional) under the radical alternative take-it or leave-it.

Standard Terms contracts are valid and enforceable provided that they ensure adequate notice of the existing standard terms, give the adherent (the contracting party accepting the standard terms contract) opportunity to review them, and enable the adherent to express a valid consent.

A.3. Freedom to contract. Refusal to deal. Abuse of rights

Freedom to contract should also mean freedom not to contract and freedom to agree conditions to contract. Therefore, it might be affirmed that parties are free to refuse to deal with a contracting party regardless of the reason basing the refusal to deal. Nevertheless, market conditions where refusal to deal takes place are naturally relevant. Therefore, in monopolistic or oligopolistic markets certain behaviors likely to be inherent in the exercise of the freedom to contract are treated as abuse of dominant position or inadmissible refusal to deal, in particular, when the doctrine of *essential facilities* is applicable. In fact, if a monopolistic provider does systematically refuse to deal with a company with no good reasons, the company might be unjustifiably expelled from the market. Additionally, in a competitive environment such exclusion practices might be considered unfair.

Taking into consideration market conditions and structure, certain behaviors purportedly sheltered behind freedom to contract may involve abuse of right or antisocial exercise of a right (i.e. Article 7.2. Spanish Civil Code). Private autonomy would be kept within bounds accordingly. But limits should always be construed on exceptional and restrictive basis. In conformity with the opinion expressed by the *Spanish Constitutional Court*, (Decision 1069/1987, of 30 September 1987) no constitutional or legal provision (apart from, in certain situation, the principle of good faith) forces an individual to exercise rights in the same manner or in coherent basis against or in relation to different third parties except for the prohibition of abuse of right and the requirements of good faith. To assess the abuse character of a behavior, the intention, the substance and the environment circumstances must be pondered.

B.- Contract formation

Even if many cases in modern trade parties enter into an agreement instantaneously (daily transactions), in general terms, a contract is the result of a multi-phased and considerably complex process: the contract formation process.

In this process, three stages might well be worth being distinguished.

- Pre-contractual stage or negotiation period: all acts, negotiations and conducts intending to reach an agreement between the parties.
- Conclusion of the contract: that describes the moment or the phase where the agreement arises as a result of the offer and the acceptance
- Performance stage: once the contract is concluded, it has to be fulfilled in order to satisfy parties' interests.

B.1. Negotiation and preliminary deals. Pre-contractual liability.

Broadly speaking, preliminary deals embrace a wide-ranging, elastic and multiform stage of the formation process comprising acts and statements whose common factor is precisely temporal: acts, behaviors and statements made by parties aimed at reaching an agreement in the future but prior to the arising of an offer (or under an extended understanding of formation stage, prior to the arising of a contract). Such deliberating period is not indispensable for the agreement to be concluded but it is commonplace in complex transactions and in contracts between big companies where a number of issues have to be discussed, detailed and agreed before reaching an agreement for the whole transaction. Then, if preceding the reaching of an agreement they are decisive to:

- construe parties' intent for interpretation purposes;
- fill gaps in the final agreement;
- detect vices of consent (i.e. mistaken consent due to lack of information provided by the counterpart during negotiations).

Preliminary deals are aimed at reaching an agreement but do not entail yet the existing of any contract between the negotiating parties. Therefore, in absence of contract, parties are not to abide by a set of rules agreed thereby. Good faith principle is the only guiding rule governing negotiation period. Parties are expected to bargain in good faith. Accordingly, even if parties cannot be held liable to breach a contract that does not exist yet, they might be, in any case, responsible for acting in bad faith and causing damages to the other negotiating party reasonably relying on the expected success of negotiations.

Despite that there are no specific rules on pre-contractual liability in the Spanish legal system currently in force, situations giving rise to liability in the pre-contractual stage are common and easy to identify: failure to duly inform the contracting party, unexpected breaking-off of negotiations, abusive withdrawal of an offer, infringement of good faith requirements in bargaining.

In contrast with the absence of regulation in domestic legislation, several supranational texts are expressly including rules on pre-contractual duties: UNIDROIT Principles, Principles of European Contract Law or Draft.

In practice, pre-contractual liability may arise in three different scenarios:

- Unfounded interruption of negotiations before reaching an agreement frustrating other party's reasonable expectations on the seriousness of the dealings: extracontractual (or tort) rules would enable to compensate all costs and expenses that were undertaken in the belief and for the purposes of the expected agreement and the loss of opportunities to negotiate with other parties. Several factors are to be met for pre-contractual liability to arise: reliance deserving of protection, unfair breaking-off of negotiations and losses caused thereby.
- Conclusion of an agreement that happens to be null and void due to the violation of pre-contractual duties (duty to inform).
- Conclusion of an agreement that is valid despite of the fact that the injured party would have entered into the agreement under different conditions if the other party

B.2. Offer and invitation to treat

An offer is an act of initiative aimed at reaching an agreement provided that the other party accepts it. Whereas the offer is deemed an initial act or act of initiative, the acceptance is treated as an adhesion act dependent of the prior offer.

According to Vienna Convention on International Sales of Goods (Article 14), a proposal for concluding a contract constitutes an offer if, firstly, it indicates the intention of the offeror to be bound in case of acceptance, and, secondly, it is sufficiently definite (including the essential elements of the envisaged contract). The easier-to-use rule of "sufficient precision" tempers the traditional principle of completeness of the offer. By exclusion, the concept of invitation to treat is described as a proposal for concluding a contract that it is not sufficiently definite and/or it does not express the intention of the proposer to be bound in case of acceptance (including formulas such as "subject to confirm", or "subject to approval" or lacking real intention to conclude a contract – *animus jocandi* -).

An offer becomes effective when it reaches the addressee/offeree. Until that moment, the offer may be withdrawn, provided that the withdrawal reaches the offeree before or at the time as the offer. Once the offeree has received the offer, it is still revocable until the dispatch of the acceptance and unless the offer states a period for acceptance or it is reasonable to rely on the irrevocability thereof. Likewise, as far as an offer is accessible on Internet it is deemed to be in effect. In other words, to the extent that an offer is visible on the website the potential offeree can reasonably rely on the fact that it has not been revoked or withdrawn.

B.3. 'Mirror image rule' – acceptance and counter-offer

An agreement arises as a result of an offer and an acceptance. Whereas the offer is the act of initiative, the acceptance is the act of adhesion. The graphic expression of "mirror image rule" is illuminating. A statement made by or other assent-indicating conduct of the offeree constitutes acceptance if is coincident with the offer. Acceptance is the mirror image of the offer. Should the mirror break, the statement purporting to be an acceptance but containing additions, limitations or other modifications constitutes a counteroffer and entails the rejection of the offer and consequently negotiations follow (Article 19, Vienna Convention).

B.4. Methods of acceptance: acceptance by silence and facta concludentia

An agreement arises as a result of the offer and the acceptance. Therefore, to ascertain which statements and behaviours mean acceptance and when is of great importance to determine the arising of an agreement. Unless otherwise stated in the offer, the offeree is free to opt for an express or tacit method to manifest assent.

Within the tacit forms of acceptance, the offeree may express acceptance by means of assent-meaning conducts (*i.e.* dispatch of goods) or remain silent or inactive when silence or inactivity may amount to acceptance according to the circumstances. Whereas express methods of acceptance are normally undisputed, tacit forms of expressing assent arouse certain legal concerns insofar as acceptance is to be inferred or deduced from a set of facts and conducts.

- On the one hand, no obstacle is found to affirm that certain facts are enabled to express consent provided that they are sufficiently meaningful of the party's unequivocal intention (*facta concludentia)*.
- On the other hand, like under the uniform rules of Vienna Convention (Article 18), under Spanish domestic rules neither silence nor inactivity does in itself amount to acceptance. Nevertheless, under certain circumstances silence or inactivity means assent where making a statement on the offer is due in accordance to generally observed usages, practices between the parties or good faith and fair dealing requirements.

C.- Interpreting a contract

The interpretation is a task aimed to ascertain the meaning and the sense of statements made by and other conduct of the contracting parties in order to state their effects and consequences on the contractual sphere.

One of the guiding rules on contract interpretation is the search for the "intent of the parties" (i.e. Articles 1281-2 and 1289 *Spanish Civil Code*). Intent of the parties means the common intent, not the intent of each of them. The common intent describes the area where both wills agrees. In order to discover the real intent of the parties, a series of interpretation rules are provided.

In the interpretation of the contract regard is to be had to customs and usages regularly observed in the country (in the place of the conclusion of the contract) to resolve ambiguities and fill eventual gaps with normally used clauses. Hence, customs and usages intervene for interpretation

purposes when a common intent of the parties has unable to be ascertained. Interpreting usages are to be proved by the party alleging them.

In addition to customs and usages, the good faith principle guides the interpretation of contract with the following consequences: manifested will prevails over real will provided that they differ due to mischievous or careless conduct of the party and the good faith of the other party; manifested will prevails if it has been understood or should have been understood in the sense wished by the declaring party despite the objective meaning of the used expression. Likewise, unclear or obscure clauses are not to be interpreted in a way being favourable to the party liable for the obscurity (*contra proferentem* rule). The foregoing rule is particularly relevant for the interpretation of standard contract terms.

Sales agreements: main features

A sales agreement is subject to commercial rules when the following conditions are met: acquisition of movable assets, with the purpose of resale, and for profit.

In a nutshell, in a sales agreement, one of the parties, the seller, commit to deliver the good in conformity with the contract whereas the buyer must pay the price in return. Therefore, delivery of the goods and payment of the price constitute the most representative obligations in a sales agreement. As a general rule, in B2B agreements, parties are free to agree on sales conditions (price, payment method, place of delivery, quantity, quality, warranties). Accordingly, parties have to perform their obligations in accordance with the agreed terms. Otherwise, whether a party fails to perform any obligations under the contract, other party is entitled to exercise available rights and remedies in case of default.

The seller must deliver the goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract. The uniform concept of "conformity with the contract" in the CISG comprises arguably the domestic concepts of "*vicios ocultos"* and *"vicios aparentes"*. Under domestic rules, periods to claim are significantly different depending of the nature of non-conformity (immediately, in 4 days, in 30 days). Therefore, the doctrine of *aliud pro alio* has been used to alleviate the severe time limits and the serious effects.

Finally, when the risk is passed from the seller to the buyer has to be clearly fixed. For any loss or damage to the goods after the risk has passed to the buyer would not discharge the latter from the obligation to pay the price, unless the loss or damage is due to an act or omission of the seller. Unless otherwise agreed by parties (INCOTERMS), the risk passes to the buyer when the seller hand over the goods.

D.- Performance and remedies

By virtue of the contract, parties are committed to comply with the agreed terms. Accordingly, both parties are expected to perform obligations and duties arising from the contract in the conditions provided by it and accordingly in conformity with the contract terms. When one of the parties departs from the agreement, a breach of contract occurs. The idea of breach of contract

has two senses. From the viewpoint of the creditor, breach of contract entails the dissatisfaction of his/her interest whose fulfilment the agreement is intended for. From the position of the debtor, breach of contract means failure to comply with the duty assumed by virtue of the agreement.

Breach of contract may be a **total non-fulfilment** (i.e. sold goods are not delivered), a **partial non-fulfilment** (i.e. half of the agreed goods are delivered), a **delayed fulfilment** (i.e. goods are delivered in the agreed conditions but later than the expected date), or a **defective fulfilment** (i.e. the delivered goods are defective and cannot be used to the expected aims).

Since contracting parties expect, when reaching the agreement, that their respective interests would be fully satisfied, breach of contract means that they have to find other ways to fulfil their expectations and meet their needs. Remedies try to offer an alternative satisfaction of parties' interests when the agreement has been breached. Besides the need to satisfy the main interest (i.e. in a sale, the main interest of the buyer is to acquire the goods), the breach of contract might also cause damages that should be compensated if duly proved.

Overall, the disappointed party can exercise (joint or separately) one or several of the following **remedies for breach of contract**. The most suitable remedy in each case will depend on the type of contract (sale, provision of services, licence, leasing), the nature of the obligation that has not been fulfilled and who is the contracting party resorting to the remedy (buyer-seller, provider-user, licensor-licensee, lessor-lessee):

- to claim damages
- to require specific performance according to the contract
- to require the delivery of substitutive goods in case of lack of conformity
- to require the repair of the defective goods
- to fix an additional period of time for performance in case of delay
- to reduce the price and accept the partial/defective fulfilment
- to avoid the contract that entails the termination of the contract in its entirety or partially.

D.1. Concept and scope of liability

When a contracting party does not fulfil contractual obligations, one says that he/she is liable against his/her opposing contracting party. But also, when an accident occurs and a person is damaged by the act committed by another person, the latter is liable for the damage caused as well, although no contract (not even a prior contact) exists between the parties. Therefore, a distinction has to be drawn between the said cases and their legal consequences.

As a premise, liability embodies the binding of a person breaching a duty of conduct imposed in the interest of another person to compensate for damages. The foregoing generic formulation of liability forks into two kinds of liability commonly named as contractual liability and extra-contractual liability (also referred as *aquiliana,* civil, non-contractual or tort liability). The former entails the infringement of a duty of conduct set out in a contract. The latter involves the breaching of the generic duty *neminem laedere,* that is, the duty to refrain from any behaviour damaging anybody.

Although both of them are rooted in the same foundations, a negligent or intentional conduct inflicting harm to another person, rules governing each kind of liability are different. Because in the contractual liability, the model to compare with the expected behaviour of contracting parties is the contract, what they agreed. Whereas in the extra-contractual liability, the criterion to assess the damaging behaviour is a general rule: nobody should cause, with fault or negligence, damage to anybody.

Compensation can be also obtained as a complementary measure in criminal proceedings, although the aggrieved party can opt in any case to claim compensation before civil courts. It is the so-called liability *ex delicto* or liability derived from a crime. Civil liability *ex delicto* comprises restitution, redress and compensation for (material and moral) damages. As a general principle, the restitution is due even if the property has been transferred to third parties. Compensation for damages may cover material and moral damages caused either to the aggrieved party, and its family members, or to third parties. In case of multiple authors and accomplices, they will be jointly and severally liable within each class.

D.2. Insurance against liability

Modern societies engender contingencies of future and uncertain needs that in case of occurring are likely to produce unfavorable pecuniary effects on the person sustaining the damages. Hence, today societies are commonly described as risk societies. Risk does therefore mean the possibility that a future and uncertain event happens likely to cause damages or give rise to a pecuniary need. Insurance is closely linked to the concept of risk, since it aims at preventing or restoring the pecuniary consequences or the needs unleashed by an accident. Notwithstanding the foregoing, all risks are not susceptible of being insured. Four prerequisites are to be fulfilled: the event must be possible, uncertain, fortuitous, and likely to provoke damage or pecuniary need.

Liability entails the obligation of the party who has been declared liable to compensate the damaged party. Therefore, liability is a risk that has to be managed in market transactions and its patrimonial consequences should be minimized, prevented or, to the maximum extent, covered. Insurance policies provide an instrument to prevent and restore those undesirable and unexpected situations.

In particular, civil liability can be insured by a (professional) civil liability insurance policy.

Insurance market has devised a mechanism to prevent and cover the risk on the insured's patrimony created by the obligation to compensate for damages caused by a fact the latter is civilly liable for. The civil liability insurance has significantly expanded and developed in last days as far as modern economies have demanded the coverage of increasing risk-creating activities.

An insurance aiming at covering the damages resulting from a negligent conduct of the insured was seen with cautious and certain hostility. Nevertheless, modernly shaped civil liability insurance has become an indispensable instrument of coverage for the economic activity and a key element of Law of Damages. As a consequence, more and more frequently, compulsory civil liability insurance is a prerequisite to run certain activities either under fault-based liability or strict rules.

Contracting civil liability insurance may be voluntary by the insured or compulsory as a prerequisite to carry on an activity as defined by statute or regulation. In the latter case, the failure to enter into an insurance contract as stated shall entail the application of administrative sanctions or the suspension of the ongoing activity until the contracting of the insurance policy. Among the compulsory civil liability insurance (air transport, vessels for pleasure or sports, nuclear energy, hunting), the best known and more commonly contracted is the compulsory civil liability insurance for motor vehicles. If an accident occurs and the person that is civilly liable for the damages has no insurance, the *Consorcio de Compensación de Seguros* – or, in case of foreign vehicles circulating in domestic territory, the *Oficina Española de Aseguradores de Automóviles* (OFESAUTO) – shall afford the due compensation.

Likewise, civil liability insurance related to professional activities has also experienced a significant increase in last days (lawyers, notaries, registrars, doctors, managers, accountants).

D.3. Dispute resolution

When a conflict arises, either in the context of a breached contract or due to an accident/tort, Law provides parties in conflict with dispute resolution methods.

The main dispute resolution system is the judicial one. Courts embody the independent and exclusive power to judge and execute judgments in a State. Therefore, States are responsible for enabling citizens to access to an efficient, fast, easy (and presumably free) Justice system. The Right to Access to Justice is a fundamental right enshrined in our Constitutions.

In last decades, the capacity of courts to provide an easy, fast, efficient and real justice has been questioned, and alternative legitimate dispute resolution methods (out of or in parallel to Courts) have been considered. Although Civil Law legal systems, unlike Common Law systems, used to show reluctance to accept extrajudicial methods to administer justice, the manifest deficiencies sustained by judicial system overloaded with cases and with slander economic and human resources, on the one hand, and the appealing advantages (speed, efficacy, professionalism, neutrality, impartiality, confidentiality) offered by the alternative dispute resolution methods (ADR), on the other, have boosted a real trend towards the "extrajudicialization" of dispute resolution in most countries. Along with conclusive international initiatives thereon, European Union has launched on resounding campaign to urge Member States to implement alternative dispute resolution methods of extrajudicial character to realize the universal access to justice (*European Directive 2008/52/EC, of the European Parliament and the Council,* of 21 May, *on certain aspects of mediation in civil and commercial matters*).

Alternative Dispute Resolution (ADR) is mainly Arbitration and Mediation. Recently, those dispute resolution methods do also operate on Internet to multiply their advantages (they are called ODR: On-line dispute resolution).

ADR are especially suitable for dealing with international, interpersonal and cross-border conflicts. Thus, it makes sense that ADR and so-called ODR (*On-line Dispute Resolution*) have

proliferated as alternative dispute resolution methods in electronic transactions and markets, where judicial methods for dispute resolution encounters severe pitfalls stemming from delocalization, a-national character, lack of supranational courts and non-existence of universal legislation. ODR add to the abundant advantages associated to ADR, efficiencies contributed by the use of new technologies. Most ODR are designed on voluntary and non-exclusive basis. Access to ODR is contractually established and regulated. Having recourse to ODR to settle a dispute does not prevent parties from accessing to judicial methods to further resolution.