

# When is a subject to contract agreement a binding contract?

On 10 March 2010, the Supreme Court handed down a decision in *RTS Flexible Systems Ltd-v-Molkeroi Alois Muller GMBH* [2010] UKSC 14. The Supreme Court had to determine the deceptively simple question of whether or not the parties had entered into a contract in circumstances where the parties never signed a formal written agreement, which was expressed to be subject to contract.

## The Facts

In January 2005, RTS successfully tendered for a £1.68 million project to supply an automated system for packaging yoghurt pots to Muller, the well-known dairy foods supplier.

To enable work to begin, the parties entered into a Letter of Intent ('the LOI'). The LOI lapsed on 27 May 2005 and the parties continued to negotiate the terms of a more formal contract.

RTS continued to work on the project and payments were made by Muller, albeit not by reference to the stage payments contemplated by the formal contract.

The negotiations proceeded on a subject to contract basis. Clause 48 of the proposed contract provided that “ This Contract may be executed in any number of counterparts provided that it shall not become effective until each party has executed a counterpart and exchanged it with the other.”

The essential terms of the formal contract were agreed by 5 July 2005; but that contract was never signed as contemplated.

The project ran into difficulties between June and August 2005, which meant that RTS would be unable to meet the original delivery timetable. As a result, there was a meeting on 25 August 2005, at which it was agreed by the parties to vary the more formal contract primarily to alter the delivery schedules of the lines of the automated system, so that line 1 would be installed first to allow production to begin on that line as soon as it could be made operational.

RTS subsequently delivered the project equipment to Müller, but did not carry out the site acceptance testing provided for in its original tender document and the draft contract, and Müller subsequently alleged the equipment had defects. Müller paid only part of the contract price and RTS brought a claim against Müller for the outstanding balance of the contract price or alternatively damages.

## The issues

The issue of whether a contract had been made and, if so, on what terms, depended on the resolution of two issues.

Firstly, were all the essential terms of the contract agreed?

Secondly, even if they were, did the contract not become effective as the parties did not execute counterparts and exchange them with each other, as contemplated by clause 48?

## The Decision

The Supreme Court unanimously concluded that the parties had reached a binding agreement on or about 25 August 2005 on the 5 July terms (as subsequently varied on 25 August). The parties had by their conduct waived the subject to contract provision on or by that date.

## Essential Terms

As already indicated, after a careful review of the facts, the Supreme Court found that all the essential terms of the formal contract, including crucially the price for the entire project, were agreed by 5 July; and accordingly that a contract would have been made, but for clause 48.

## Subject to contract

Given that the formal contract was not executed or exchanged, the Supreme Court accepted that, unless and until the parties agreed to vary or waive clause 48, the formal contract would not become binding or effective; notwithstanding that all the essential terms had been agreed.

## Waiver

It was not necessary for such a variation or waiver to be made by an express statement. A variation or waiver could in principle be inferred from the parties' correspondence and conduct.

Indeed, the Supreme Court decided that the subsequent agreement on 25 August to vary the formal contract, so that RTS agreed to provide line 1 before line 2 was reached without any suggestion that there was no contract and thus nothing to vary or that that variation was agreed subject to contract. The parties treated the agreement of 25 August as a variation of the agreement that they had reached by 5 July.

Nobody suggested that RTS could have refused to perform the contract as varied pending a formal contract being signed and exchanged; and it did not.

The Supreme Court decided that the only reasonable inference to draw from that conduct was that, by or on 25 August, the parties had unequivocally agreed to waive the 'subject to contract' condition in clause 48; and accordingly concluded that there was a contract on the more formal terms agreed as at 5 July as subsequently varied by the agreement of 25 August.

The parties had, in effect, departed from their earlier agreement that the formal contract was to be subject to contract, until it had been executed and exchanged and had agreed that there was no necessity for the agreement to be executed and exchanged.

## Conclusions

The main conclusions to be drawn from this case are that:

1. Parties proceed at their peril if they start work without a formal signed contract being in place. Indeed, the Supreme Court itself commented “ *The different decisions in the courts below and the arguments in this court demonstrate the perils of beginning work without agreeing the precise basis upon which it is to be done. The moral of the story is to agree first and to start work later.*” The case was a long drawn-out and expensive battle which went to the Supreme Court, with each court reaching a different decision. The Court of Appeal held that there was no contract and the High Court held that a contract consisting of only part of the formal agreement's terms had come into existence.
2. It may not always be possible to act on that advice, but parties should be aware that by beginning to carry out their side of the contract they may waive the protection offered by a 'subject to contract' provision.
3. The words subject to contract are not rendered meaningless by this decision. A contract which is being negotiated on a subject to contract basis will not normally be binding until the negotiations have been completed and the contract executed and exchanged.
4. Indeed, to avoid the risk of a contract being made when that was not intended, negotiations should be marked subject to contract and the contract itself should provide that it is not to be effective until signed by both parties and the counterparts exchanged. That would have prevented a contract coming into existence in this case, had it not been for the waiver point.

5. It is possible for an agreement 'subject to contract' or 'subject to written contract' to become legally binding if the parties later agree to waive that condition, for they are in effect waiving the 'subject to [written] contract' term or understanding.
6. The fact that a contract has been fully or substantially performed on both sides will often make it unrealistic to argue that there was no intention to enter into legal relations and difficult to submit that the contract is void for vagueness or uncertainty.
7. The fact that a contract has been performed makes it easier to imply a term resolving any uncertainty, or, alternatively, it may make it possible to treat a matter not finalised in negotiations as inessential.
8. If the price is agreed, that price must have formed a part of a contract between the parties.
9. It does not necessarily follow from the fact that work was performed that the parties must have entered into a contract. It is, however, plainly a very relevant factor pointing in that direction and the courts are, in those circumstances, strongly inclined to find the existence of a contract. It may often be unrealistic and contrary to commercial sense to suppose that a party would agree to proceed with detailed work and complete the whole contract on a non-contractual basis, subject to no terms at all.
10. On the other hand, a contract will not exist if the parties have not agreed all the terms which they regarded or the law requires as essential for the formation of legally binding relations.
11. This decision goes against a recent trend in which the Court of Appeal has tended to decided against the existence of a contract; and may lead to a reversal of that trend.
12. However, these cases depend on their facts and hence the judgment in one case may well not be the answer to another set of facts.
13. As the Supreme Court said *“In a case where a contract is being negotiated subject to contract and work begins before the formal contract is executed, it cannot be said that there will always or even usually be a contract on the terms that were agreed subject to contract. That would be too simplistic and dogmatic an approach. The court should not impose binding contracts on the parties which they have not reached. All will depend upon the circumstances.”*

## Contact

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