HANDLE WITH CARE

Clarity on enforceability of obligations in firms' and clients' contracts can be hard to find, so auditors should approach with caution says **Christopher Arnull**

Contracts will often need to be considered by auditors. Client contracts might provide context to the client's business and financial position, or help the auditor to consider the strength of material revenue covenants, liabilities and going concern issues. Auditors have their own contracts, too - and for all contracts, issues around enforceability can arise.

Auditors will look for clear obligations that can be enforced, but often obligations are softened during the contract negotiation process. This can take the form of altering things that "must" or "shall be done" to things that the relevant party will "try to do". The value of an undertaking to try to do something, rather than just do it, can be unclear.

Auditors might encounter several variations on contractual obligations to try or endeavour to do something. The usual options follow what is generally seen as a sliding scale of duty, starting with "reasonable" and ending with "best": so typically we might see "reasonable endeavours", "all reasonable endeavours", and "best endeavours".

THE PITFALLS OF PRAGMATISM

Unfortunately, a pragmatic compromise reached when the contract is signed can later become a source of dispute. For example, in a 2010 court case arising from a joint venture project to redevelop Chelsea Barracks, CPC Group claimed that Qatari Diar Real Estate Investment Company had not tried hard enough to achieve certain site objectives. The project to redevelop the site had generated controversy and following a meeting between the Emir of Qatar and the Prince of Wales, Qatari Diar had withdrawn. One aspect of the resulting dispute centred on whether Qatari Diar had done enough to obtain planning permission. The relevant contractual term required Qatari Diar to use "all reasonable but commercially prudent endeavours".

Often, "all reasonable" is perceived as being close to "best" and as setting a very high standard, so the caveat about commercial prudence was no doubt designed to soften the blow, on the basis that it is not commercially prudent to take steps that will damage the business. The court decided that the caveat helped Qatari Diar, which was entitled to take account of its own commercial interests when deciding how hard to try.

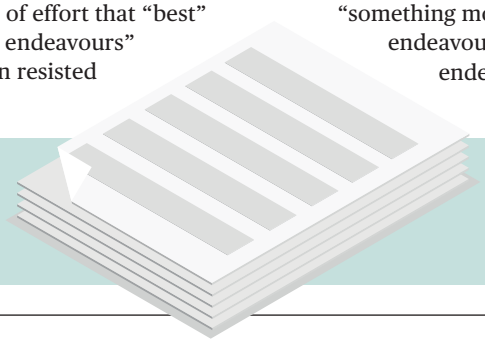
There is in any event some uncertainty about the degree of effort that "best" requires. A "best endeavours" obligation is often resisted but as a matter of English language, leaving aside the law, it is clearly an onerous obligation. Yet case law suggests that on a strict analysis the obligation is not absolute.

WHAT DOES 'BEST' MEAN?

One court ruling tells us that although it does "not mean second-best endeavours", it does require a party to do all that it can within its power, as if "acting in his own interests". This would include spending money to achieve the desired result. Against that, in another case the court indicated that it does not require money to be spent to "the certain ruin of the company".

An obligation to use "reasonable endeavours" is a softer obligation, seen as the least onerous option, but the nature of that obligation is not always clear, either. Some effort is certainly required and the degree of effort might involve balancing commercial considerations against the importance of achieving the desired result.

Applying "all reasonable endeavours" is generally seen as sitting somewhere between the two - as one court put it, "something more than reasonable endeavours but less than best endeavours". Another



A pragmatic compromise reached when the contract is signed can later become a source of dispute

court suggested that using best endeavours involves "at least" doing "all that reasonable persons reasonably could do in the circumstances". On that basis, "all reasonable" might be seen as in effect the same as "best".

Because the difference between the various options is unclear, it can help to spell out specific steps that must be taken to discharge an obligation to try, in order to achieve certainty – such as whether to spend anything, how much, whether to take court action, and so on. The rationale is that agreed steps clearly stated will be enforceable, even if they are against the relevant party's commercial interests.

COSTLY MUDDLES

A case involving a low-cost airline operating out of a small airport illustrates the difficulties. The case shows how contracting parties can get into a costly muddle when they use expressions that are not clear and certain.

Jet2.com Ltd (Jet) contracted with Blackpool Airport Limited (BAL) to use Blackpool airport (BA) for 15 years. In the contract, BAL agreed to provide airport facilities at rates that would support Jet's need for low-cost pricing. The contract provided that: "Jet2.com and BAL will co-operate together and use their best endeavours to promote Jet's low-cost services from BA and BAL will use all reasonable endeavours to provide a low-cost base that will facilitate Jet's low-cost pricing."

For several years, with BAL's co-operation, Jet made some flights outside of BA's usual operating hours, but when BAL's financial circumstances changed, BAL tried to stop this. Some of Jet's flights were diverted to Manchester at short notice and Jet brought a breach of contract claim.

The court was not impressed with the drafting (describing the contract as one "prepared with little legal assistance"). Using two expressions in the same sentence was not helpful. Jet and BAL tried to explain, but on the evidence provided the court observed that it was "extremely interesting but much... was irrelevant".

As to "best" and "all reasonable", the court reviewed various cases and found, as already stated here, that the meaning can vary from one contract to another. The court concluded that "best endeavours" did not permit BAL to limit or abandon performance once it became commercially undesirable or unprofitable. In context, "all reasonable endeavours" however "must impose a lesser obligation than an absolute commitment to provide these specific hours regardless throughout a 15-year period".

The court ruled that BAL was in breach and that it was obliged to open BA outside of normal operating hours for Jet. But Jet could not insist on particular opening hours for all 15 years as circumstances might change. The court observed that "this case may prove to be little more than a practice run for the next one", so the drafting deficiencies could come back to haunt these parties again.

Auditors looking at client contracts with obligations to try will no doubt challenge whether the obligation is certain and can be enforced. If the contract or obligation is material to the client's financial reporting, certainty will be important. Auditors will be cautious about the nature of "endeavours" obligations in their own contracts, too. The legal position on "endeavours" variants is unfortunately not as clear as it might be.

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