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A New Case on Lessor Liability - Lobster Group Limited V Heidelberg (Equipment) Limited and Close Asset Finance Limited

On 30 July 2009 the Technology Construction Court gave judgment in the above case which related to a Heidelberg CD102.6 press manufactured by Heidelberg and leased to Lobster Press Limited by Close Asset Finance.

The court found that, despite the exclusion clauses contained in the lease, CAF was liable in damages to LPL.

The facts

The facts of the matter as found by the Court were: LPL was a printer, which entered into discussions with Heidelberg to acquire the press to give it the capacity to deal with larger paper sizes and a greater variety of media. It seems to have been assumed from the start that the press would be leased on an operating lease basis and the judgment refers to an agreement between CAF and Heidelberg under which CAF could sell the press back to Heidelberg for its residual value at the end of the lease.

The deal originally proposed was a 36 month contract which incorporated a purchase option at £750,000 for LPL but eventually a 48 month contract without the purchase option was entered into.

At one stage, LPL signed a purchase agreement directly with Heidelberg, which incorporated a 12 month warranty for the machine. The basic terms of this warranty were that the sole liability of Heidelberg was to repair or replace defective parts. Otherwise all forms of liability were excluded. However, in the normal way, the eventual sale was between Heidelberg and CAF and CAF supplied the machine on its standard operating lease terms. At the same time there was a service agreement between Heidelberg and LPL in respect of the press, although the schedule to that agreement does not seem to have been adequately completed.

The Court found that there was a defect in the press which related to "image fit". Although there were a number of minor problems over the first 12 months of the use of the press, this particular problem only really emerged after 12 months. It seems not to have been completely remedied for a number of years when it was suddenly, inexplicably, remedied by the replacement of a cylinder (although it

was agreed that the previous cylinder had not been defective in any respect). LPL made extensive claims for loss of profits based on the problems with the machine but the underlying evidence was not very persuasive. In the end, the Court found that the damage suffered by LPL as a result of the image fit problem was around £14,000.

An interesting feature of the case is that LPL actually went into administration in July 2005 and then into liquidation in July 2006. It commenced proceedings against Heidelberg and CAF in May 2007. These proceedings seem to have been funded by a company called IM Litigation Funding, which provides a litigation funding service to insolvency practitioners under which any damages ultimately paid out are shared between them and IM. Otherwise it seems unlikely that the proceedings would have been brought and perhaps the outcome of them was disappointing to LPL and IM.

In any event, the case discusses a number of issues which often arise in relation to vendor finance.

What were the legal issues?

Where there is a dispute between the supplier or lessor of equipment and its user over the performance of the equipment, the dispute can arise out of a number of issues:

- (a) the equipment may not work satisfactorily by normal standards. The equipment is not of "satisfactory quality" under the relevant legislation;
- (b) where the supplier/lessor is aware that the machine is required for a particular purpose, then it may not be fit for that purpose even though it would be perfectly capable of working in other circumstances. It is not fit for the particular purpose for which it was supplied;
- (c) the equipment may be in perfect working order but fail to comply with specifications. For instance, it may be substantially slower than advertised or it may not achieve the specified quality of output. There has been a breach of warranty or representation.

In this case, the Court found that the equipment simply did not work as it should have with regard to the image fit. It was not of satisfactory quality.

The Court found that LPL had not relied on CAF with respect to the fitness for purpose issue but had relied on Heidelberg. However, it did not appear that there was any particular

allegation that the machine was unfit for the purpose. What was wrong with it was that it was slightly defective.

LPL alleged that Heidelberg failed to comply with representations and warranties made to it by in advance of the purchase but the Court found that there was inadequate evidence that these representations had been made.

This left issues relating to Heidelberg's 12 month warranty and the liability of CAF because the press was not of satisfactory quality.

Heidelberg's 12 month warranty

As mentioned above, LPL originally entered into a purchase agreement with Heidelberg, which contained a 12 month warranty restricted to repair or replacement. However, that contract never came into effect because the machine was purchased by CAF. Nonetheless it seemed to be accepted by all parties that the warranty was enforceable by LPL - even though there was no written contract between LPL and Heidelberg. However, it seemed that Heidelberg had performed its obligations under the warranty. The judge thought it was reasonable that Heidelberg excluded any wider liability (but not that it excluded direct loss for non-performance of its obligations, although no actual liability arose under this heading).

In the course of the case the Judge suggested that if it were not for this warranty then LPL would have had no recourse against Heidelberg. Although this may be true in the particular circumstances, because no performance warranties given by Heidelberg to LPL were actually breached, there is a line of "collateral contract" cases in which a supplier gives warranties to a user with respect to a product and the user enters into a contract with a third party in relation to that product, which then fails to perform as warranted.

The best known example is the case of *Shanklin Pier Limited v Detel Products*¹ where a paint supplier warranted to the owners of the Shanklin Pier that a paint would have a life of from 7 to 10 years when applied to the pier. On that basis, the owners entered into a contract with a painting firm specifying that particular paint, which actually turned out to have a very short life. The pier owners successfully sued the paint suppliers, with whom they had no written contract, on the basis of a collateral contract between the supplier and the pier company which induced the pier company to enter into the painting contract.

¹ [1951] 2K.B.854

A similar approach could apply in relation to leased equipment, where a lessee will enter into a lease on the basis of its expectations of the performance of the equipment as discussed with the original supplier. Had LPL been successful in claiming that Heidelberg was in breach of its warranties then, even if there had never been any form of written contract between Heidelberg and LPL, there seems no reason why LPL should not have successfully sued Heidelberg on the basis of a collateral contract.

CAF's liability because the machine was not of satisfactory quality

However, in this case, the primary problem was that the machine simply did not work as any such machine should have with respect to "image fit". It was an implied term of the lease that the machine would be of satisfactory quality under the provisions of S 9(2) of the Supply of Goods and Services Act 1982 (but it was not).

However, CAF attempted to exclude liability for that implied term in its standard terms, which provided:

5.3 *"CAF does not let or otherwise supply the Equipment with the benefit of any term condition warranty or stipulation, written or oral, express or implied, whether by statute or otherwise. The terms of Sections 8 to 10 inclusive of the Supply of Goods and Services Act 1982 will not apply to this Agreement."*

5.4 *"subject to the above [CAF] will not be liable in contract or tort or otherwise for any loss or damage suffered by [LPL] or another whether or not caused by the negligence of [CAF]"*.

This exclusion is subject to the Unfair Contract Terms Act 1977 under which liability under the implied term of satisfactory quality can only be excluded so far as the term excluding liability is reasonable.

A reasonable term is

"A fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made."

In determining reasonableness, the court takes into account the following factors to the extent they appear to be relevant:

"(a) the strength of the bargaining positions of the parties relative to each other, taking into account (among other

things) alternative means by which the customer's requirements could have been met;

(b) whether the customer received an inducement to agree to the term, or in accepting it had an opportunity of entering into a similar contract with other persons, but without having to accept a similar term;

(c) whether the customer knew or ought reasonably to have known of the existence and extent of the term (having regard, among other things, to any custom of the trade and any previous course of dealing between the parties);

(d) where the term excludes or restricts any relevant liability if some condition is not complied with, whether it was reasonable at the time of the contract to expect that compliance with that condition would be practicable;

(e) whether the goods were manufactured, processed or adapted to the special order of the customer.

The judge said in relation to these issues:

"I do not consider that it was reasonable under Clause 5.3 for CAF to exclude liability which would otherwise arise under s. 9(2) of the 1982 Act, for the following reasons:

"(1) The change in arrangements meant that the supply of the Press was taking place under the terms of the Hire Agreement and in such circumstances, if the implied term as to satisfactory quality were excluded, LPL would be left without the obligations that would otherwise be implied in a contract to which the Sale of Goods Act applied.

"(2) Whilst the Hire Agreement provided for the costs of the Service Agreement to be included within the hire rental, this and the Warranty Agreement only made provision for the repair and replacement of the mechanical and electrical parts of the Press, that provided only a limited remedy if the Press contained components which were not of satisfactory quality.

"Further I consider that the exclusion in Clause 5.4 of all loss or damage suffered by LPL is an unreasonable provision. Whilst, as I have said above, exclusion of loss of profits and losses referred to as consequential damages would, in my judgment, be reasonable because it would be LPL who would know what losses might be suffered and could insure against that risk, I consider that a complete exclusion of losses would be unreasonable in circumstances where the Press failed to perform properly because it was not of satisfactory quality."

In (1), the judge is referring to the frequent arrangement in leasing under which any purchase contract between the supplier and the lessee is terminated and the equipment provided to the lessee under the lease instead. Equally frequently, there is no purchase contract in existence at any time between the supplier and the lessee.

It was agreed that the parties were in equally strong bargaining positions so that was not an issue in terms of the reasonableness of the exclusion. This was not a situation where the bargaining strength of the lessor forces the lessee to accept unreasonable terms. Although it seems unlikely that CAF would have changed the exclusion at the request of the lessee, it could have gone to another lessor or borrowed the money to buy the press (although all lessors would exclude liability and the CAF lease would have offered lower cash outgoings than a loan). The view has been taken in the past that, in big ticket leases, it is acceptable to exclude liability completely. This decision, while about a commercial middle ticket lease, may cause some doubt on that issue (except in sale and leaseback cases) given the equal bargaining power of the parties and make it important that the lessor ensures the lessee has adequate recourse against the supplier.

The decision leaves lessors under terms such as CAF's in very much the same position as the supplier would have been if it had sold the goods directly to LPL. A total exclusion of liability in a sale contract is always unlikely to succeed - by contrast with limitations in relation to amounts and classes of liability, which have been accepted in sale of goods cases. The argument of lessors has always been that they are merely the suppliers of finance and not the equipment, whatever the form of the facility. The courts over the years have said that a financier must accept the liability which accompanies the form of facility. A lender to LPL financing the cost of the press would never have been liable for the defect but the lessor was.

In this case, the lessee did have the benefit of a manufacturer's warranty but the judge considered that the warranty was not wide enough to cover all the liability which the lessor or supplier should have borne.

In fact, it seems that Heidelberg agreed to cover CAF's exposure at the outset and Heidelberg's lawyers represented CAF as well. Presumably, Heidelberg took the view that if CAF was liable to LPL, there was a good chance that Heidelberg would be liable to CAF under the purchase contract between Heidelberg and CAF. Perhaps, an existing agreement between them already obliged Heidelberg to indemnify CAF.

However, there may be cases in which the original supplier is no longer available to be sued by the lessor or, for some other reason, the lessor cannot be sure that a claim against the supplier will be met. Does the case suggest any way in which a lease can be drafted so that the lessor is not exposed to liability in the first place?

The following approaches may help:

- (1) a statement that it has been agreed between the parties that the risk of the equipment not being satisfactory has been allocated to the lessee on the basis that the rental payable would be increased if it was being borne by the lessor;
- (2) a requirement on the lessee to obtain all the warranties it requires in relation to the equipment directly from the supplier or manufacturer. This is intended to overcome the argument that the lessee is insufficiently protected by any existing warranty, by requiring it to take a positive role in ensuring that it is adequately covered by the person who bears the ultimate responsibility for providing equipment of a satisfactory standard. If this were to be effective then it would not matter if the supplier or manufacturer has ceased to trade because that was a risk run by the lessee; and
- (3) it seems clear from the judgment that the exclusion of consequential loss will be acceptable in similar circumstances so a clause of this sort will be worth inserting as a separate provision within the lease.

LPL's liability to pay the termination sum

LPL stopped paying rent for the machine in March 2004. This was contrary to the terms of the lease, which required rent to be paid notwithstanding any alleged breach of contract on the part of CAF. This provision does not appear to have been considered unreasonable.

Accordingly, it was permissible for CAF to terminate the lease for non-payment of rent. LPL went on to argue that, because of CAF's breach of contract in providing unsatisfactory equipment, LPL was not liable to pay rent after termination or indeed the termination sum which CAF demanded. The Judge said that the breach was not a "repudiatory" breach but only a minor breach which entitled LPL to the damages awarded in its favour but not to regard the lease as at an end so that it did not have to pay the termination sum. (A repudiatory breach is one which demonstrates that the defaulting party intends no longer to be bound by its obligations. That is only likely to have occurred if the press was completely unusable. However, if that had been the case then it seems likely that LPL would have been entitled not to pay the termination sum.)

LPL's claim for a share in the proceeds of sale of the press

Finally, it seems that the press was ultimately sold to another printer for £600,000. LPL claimed that this should be taken into account and deducted from the termination sum of £304,000. The basis for this claim is not clear but it seems that it would either have been on the basis that the original lease proposal had said that CAF would pass any surplus proceeds of sale to LPL or on the basis that the termination sum was penal given that CAF had not brought the £600,000 into consideration. (However, the price Heidelberg got for selling in the open market does not seem to be as relevant as the price CAF got for selling to Heidelberg.)

It certainly is established, in the case of a finance lease, that proceeds of sale should be taken into account² but there is every indication from the present case, although the issue is not expressly discussed, that this was an operating lease. Indeed the comment seems that it is likely that CAF cleared its position by selling the press to Heidelberg under the buyback agreement mentioned above. It is not clear why the eventual price obtained by Heidelberg should be considered to be relevant.

² *Butterworth v Lombard* [1987] Q.B. 527

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