Wrongful termination of negotiations

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A party involved in negotiations to conclude an agreement may in principle bring the negotiations to an end at any time. The Dutch Supreme Court recently clarified matters in what had become, the complicated area of wrongful termination of negotiations. Termination becomes wrongful only if it must be considered unacceptable. That is a severe test to meet, according to the Court. Practical guidance for the negotiations of commercial contracts.

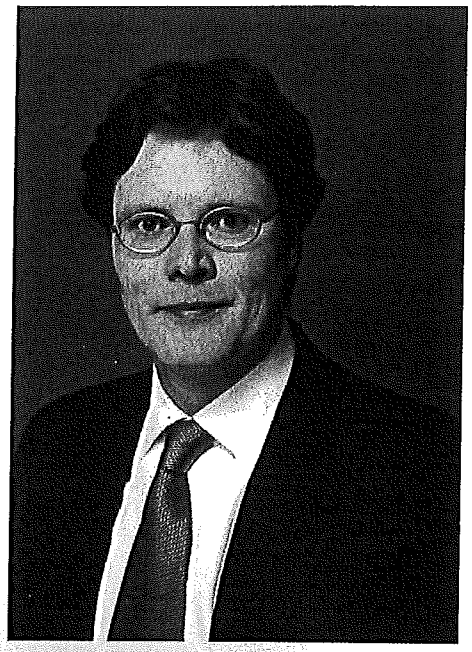
Since the 1980's elaborate and far-reaching rules governing pre-contractual liabilities have been developed in Dutch case law. Based on these rules negotiating parties were limited in their capability to terminate contractual negotiations. Liability could even extend to lost profits, all according to which phase the negotiations were in. Three such phases were generally distinguished. In the first phase of negotiations a party was free to terminate. In the second phase termination was only permitted if the terminating party paid the costs incurred by the non-terminating party. The last phase occurred when negotiations had reached such a stage that termination was wrongful. As a consequence, the terminating party had to pay the profits that the other party was missing now that no formal agreement was concluded. These rules on liability for wrongful termination of contract negotiations made the Netherlands stand out somewhat internationally. That has changed with a recent judgement of the Dutch Supreme Court (Centraal Bureau Bouwtoezicht / JPO Projecten).

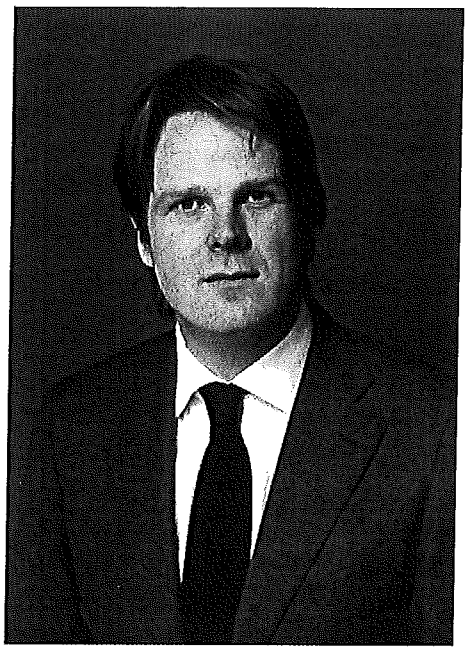
With the judgement the Court basically restates Dutch law on the subject. It provides the standard to be used to determine when a party is under an obligation to pay damages for its termination of contract negotiations to the non-terminating party. The Court rules that the guiding principle should always be that each party is free to terminate. Liability arises only if termination is "unacceptable" in light of the justified expectations of the other party that the agreement would be concluded, or in light of other circumstances. This test is a "severe" one and "impels restraint" for judges, the Court goes on to specifically state.

This is a different approach than had been taken to date. Based on the concept that parties, by entering into a negotiation process, have to take each other's justified interests in mind, during the last twenty years fuzzy rules for wrongful termination were developed based on various stages of the negotiation process. Although parties still have to take each other's justified interests in mind, the basic premise has been replaced: it no longer seems to be "no termination, unless..", but rather "freedom to terminate, unless...". And that really is another way of confronting the issue. A party is free to terminate. Only when termination becomes "unacceptable" is it not. In that case the terminating party has to pay damages.

Judges, however, still have great latitude to determine the extent of damages and can take all relevant factors into consideration. So even now that the somewhat

artificial distinction of phases in the negotiation process seems to have been abandoned, damages may still consist of costs incurred (the "old phase 2") or, in extreme cases, even that which is necessary to put the other party in the financial position it would have been in if an agreement would have been concluded (the "old phase 3": costs + lost profits). It is good to note that damage awards for wrongful termination of negotiations were rare under the "old" rules. Under the "new" rules this will certainly not change.





This judgement fits in a trend of court decisions limiting the use of the principles of reasonableness and fairness in Dutch contract law and (pre-) contractual liability. For example, recently the Court emphasised the freedom of an individual creditor not to enter into a debt-restructuring contract between a debtor and its creditors, where the debtor had argued that such refusal was unreasonable. In another case the Court pointed to the importance of the literal text of a contract for determining the meaning of provisions in that contract, especially for contracts on which numerous parties rely and where such parties did not all participate in the negotiations leading to the contract, such as collective labour agreements.

Dutch judges do seem to have an eye for the needs of parties in a commercial business context. Based on the current state of case law it is fair to say that the focus should be on what parties write down and on what they discuss, and less on what the principles of reasonableness and fairness dictate. That is a good thing because parties can control the negotiation and drafting process. It is essential, of course, that they maintain the discipline to do so. Perhaps the recent judgement of the Supreme Court therefore provides not only a rule of law, be it an important one, but also provides a practical lesson. It should serve as yet another incentive for parties to pay close attention to their conduct in contract negotiations and in the drafting of both contracts and contract proposals.

For the issue of wrongful termination of negotiations drafting and negotiation discipline entails the following. It is perfectly acceptable to include conditions to final agreement in contract negotiations. Common examples are provisions that subject final agreement to board approval or to the availability of financing. If a party included conditions to final agreement in contract proposals and maintained these conditions during the negotiations, and subsequently one or more of these conditions is not fulfilled, it is difficult for the non-terminating party to argue that it validly expected final agreement to be reached. This was already the case prior to the Supreme Court decision discussed in this article. Together with the recent express statement of the Court that parties in principle are free to terminate negotiations, the inclusion of conditions goes a long way toward protecting this freedom.

The issue of the risks involved in late-stage termination of negotiations frequently arises. Few claims for wrongful termination have been awarded since the Court first started devising the body of case law on the subject twenty years ago, especially claims for lost profits. However, the body of case law was unpractical and out of step with the relevant laws of other countries. That has now changed. Commercial parties can rest assured. They have control over the process. Liability for termination of negotiations is exceptional. Moreover, parties can also protect their right to terminate themselves, for example by including conditions to final agreement in their negotiations and contract proposals. It is important that they do so, because the non-terminating party will then have an even more "severe" test to meet if it wants to pursue damages for wrongful termination of negotiations.

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