Davies Middleton & Davies Ltd v Toyo Engineering Corporation [1997] APP.L.R. 08/29

CA on appeal from QBD, ORB (HHJ Thornton QC) before Simon Brown LJ; Phillips LJ; 29th August 1997.

LORD JUSTICE PHILLIPS:

1. This hearing started as an application by the Defendants, "Toyo", for leave to appeal against an order of His Honour Judge Thornton QC, sitting as an Official Referee, made on the 25th July 1997. By that order the Judge refused to stay the Action pursuant to Section 9 of the Arbitration Act 1996. The application has been brought on as a matter of urgency because, on Monday, 1st September the Official Referee proposes to hear applications by the Plaintiffs, "DMD" for payments pursuant to Order 14 and Order 29 RSC.

2. This Court had been in no doubt that leave to appeal should be given, and had warned the parties that they might be required to argue the merits of the appeal. We gave leave to appeal at the outset of the hearing and this judgment is addressed to the appeal. I would like to express my appreciation for the quality of the argument of counsel who have had to prepare for this appeal at very short notice indeed.

The 1996 Act

3. Section 9 of the Arbitration Act 1996, in so far as material, provides:

"(1) A party to an arbitration agreement against whom legal proceedings are brought (whether by way of claim or counterclaim) in respect of a matter which under the agreement is to be referred to arbitration may (upon notice to the other parties to the proceedings) apply to the court in which the proceedings have been brought to stay the proceedings so far as they concern that matter.

(2) An application may be made notwithstanding that the matter is to be referred to arbitration only after the exhaustion of other dispute resolution procedures.

(4) On an application under this section the court shall grant a stay unless satisfied that the arbitration agreement is null and void, inoperative, or incapable of being performed."

4. Section 82(1) of the Act provides that *"dispute" includes any difference.*

The Claim

5. DMD is a United Kingdom construction company. Toyo is a Japanese engineering company. The basis of the claim is remuneration alleged to be due for extensive engineering works performed by DMD at a plant at Ocean Park Cardiff under a series of contracts concluded with Toyo. The claim is pleaded on an alternative basis. The first alternative claims £3.452,201.32 as due under what I shall call the initial contracts themselves. The second alternative claims sums of similar magnitude alleged to be due under the provisions of an agreement contained in a letter dated the 1st August 1996, which was sent by Toyo and countersigned by DMD, in the following terms:

"Dear Sir,

Following our recent meetings, we feel it constructive to summarise the situation.

We concur that the current divergence of opinion is so great that a speedy compromise solution does not appear possible. DMD are adamant that their evaluation of £7,323,183.70 is appropriate, whereas TEC find it difficult to conceive that any improvement is warranted regarding the TEC offer of a final settlement at £4,200,000.00.

DMD proposed three courses of action to resolve the impasse, namely:

A proper ´Q.S.' approach to deliver full substantive documentation to support the claim;

an ´open book' approach, whereby TEC would be allowed full access to DMD cost records, to which would be allocated a negotiated percentage mark-up for ´overheads and profit', or,

DMD would take legal advice regarding the possibility to seek redress via arbitration or legal action.

It is recognised that each of such courses would involve some considerable time to deliver a solution, and thereby permit an additional payment (if any) to DMD.

Nevertheless, TEC would like to propose a workmanlike solution, whereby some additional funds would be immediately made available to DMD on the condition that both parties co-operate in a serious manner to produce a proper evaluation of a final account in a ´Q.S. style'.

TEC's proposal is as follows:

Toyo Engineering Corporation will make an immediate payment of £863,741.00 to DMD.

This will make the total payment to DMD related to all three contracts (Piping, Batch Plant, EP and Category 1) amount to £4,200,000.00, which equates to TEC's present position (as summarised in our letter, ref. TU/DM-016, dated 30.07.96).

DMD will assemble and hand over to TEC all outstanding Contractual Documentation, records, or other items, including, but not necessarily limited to:

i) As-Built drawings and calculations etc. for the Batch Plant (On, or before 6 September 1996)
ii) Volume 2 of the Pipework (on, or before 5th August 1996)
iii) QA records, As-Builts, and design date etc. for the EP (On, or before 6th September 1996)
iv) The walkway (and drawings) for the Main Pipe Rack (On, or before 5th August 1996)

TEC will make, as a gesture of good faith, a further payment of £250,000.00 to DMD in the week beginning 05.08.96; and, upon receipt of all of the Documents/Records/Items mentioned above, a further payment of £50,000.00 will be made by TEC to DMD.

Both Parties agree to nominate a representative with the authority to address the speedy preparation and agreement of a final account package in a ´Q.S.' style, which will deliver a result which both Parties will recognise. This exercise shall have a target completion date of 6th September 1996. Should such agreed total final account require either

Party to make financial adjustment to payments made, or received, then both Parties agree to make such a financial adjustment.

It is understood that no further payment(s) will be made by TEC until the full final evaluation is agreed.

To witness their agreement to such a proposal, and in recognition that the attached cheque and the payment to be made in the week beginning 05/08/96, is offered under such conditions, DMD have placed their signature on the copy of this letter provided for such a purpose."

6. Pursuant to that letter Toyo paid £863,741 but they did not pay the further sums of £250,000 or £50,000. They nominated a representative who, together with a representative nominated by DMD, proceeded to attempt to agree the final account. DMD allege that these representatives agreed that a further £2,484,475 remained outstanding and were still negotiating about a further £967,726.

7. At that point, Toyo withdrew their representative and no final account was agreed. DMD's alternative claim under the August letter is for £50,00, alternatively damages; £250,000 alternatively damages; £2,484.475.01, alternatively damages, less the earlier sums if recovered and such part of the sum of £967,726.31 as the Court shall think fit, alternatively damages; and for declarations. The declarations sought are as follows:

"that, by reason of the Defendant's breaches aforesaid, the machinery of the 1st August 1996 Agreement has broken down; and

that effect can, and will, be given to the 1st August 1996 Agreement by the Court substituting its own machinery for that of the Agreement."

Provision for Arbitration

8. Toyo contend that the contracts under which they performed the works were subject to their standard conditions, which included the following:

"´3(1) The contract embodies the entire agreement between the parties hereto. The parties shall not be liable for or bound by inducement, promise, representation, statement or understanding of any kind or nature not set forth in the CONTRACT.

Amendment of the CONTRACT shall only be by way of written form duly signed by both parties hereto.'

9. Then the arbitration clause, which reads as follows:

´30. Arbitration

The parties hereto shall first try to settle amicably any dispute out from or in connection with the CONTRACT. If not settled by amicable negotiation, such dispute shall, unless otherwise specified elsewhere in the CONTRACT, be finally settled under the Rules of Conciliation and Arbitration of the International Chamber of Commerce, by one(1) or more arbitrators appointed according to the said Rules.'"

10. Toyo contend that the provision for arbitration applies, not only to the initial contracts for the works, but to any claim based on, or dispute arising in relation to, the August letter.

11. DMD deny that the initial contracts were concluded on Toyo's standard conditions, or subject to any provision for arbitration. They further contend, however, that the agreement in the August letter was not subject to the arbitration clause even if this applied to the original contracts.

The approach of the Official Referee.

12. Judge Thornton did not decide the issue of whether the initial contracts were subject to Toyo's conditions and, thus, to the arbitration clause. This was because he accepted a submission by Toyo that they should be permitted to file further evidence before this issue was resolved. In these circumstances the Judge assumed for the purposes of argument that the arbitration clause was incorporated in the initial contracts, and went on to consider whether, in that event, the August letter was subject to the arbitration clause. He held that it was not and, thus, that he could properly entertain the alternative claim advanced by DMD under the August letter.

13. Before Judge Thornton and, again before us, counsel for Toyo took objection to the procedure taken by the Judge. He argued that the course taken was only legitimate provided that DMD were first put to an election. If his judgment correctly records the argument put to him, the election for which counsel argued before the judge is not quite the same as the election for which Mr Andrew White QC has contended before us. Before the judge it was argued that DMD had to elect to drop their contention that the initial contracts did not incorporate the arbitration clause if they were to develop a case based on the assumption that they were so incorporated. Before us Mr White has contended that DMD should have been required to elect to drop their claim based directly on the initial contracts if the determination of the stay issue was to be confined to their alternative claim based on the August letter.

14. I do not understand the submission on election made to the Judge, if I have correctly summarised it, and I conclude that the Judge was correct to reject it. So far as Mr White's submission is concerned, the course adopted by the Judge necessarily involved leaving unresolved the question of his jurisdiction to try the claim based by DMD on the initial contracts themselves. Thus, in accepting his approach, they were implicitly accepting that they would, at least in the first instance, have to restrict their claim to the second of the alternative ways in which it was pleaded. Should this appeal fail, it seems to me that that is the course that they will have to adopt. Should this appeal succeed, it will then be necessary for the Judge to address the seminal question of whether the initial contracts were subject to Toyo's standard conditions, in order to decide whether or not this action must be stayed under Section 9 of the 1996 Act. In my judgment it was entirely proper for the judge, as a matter of case management, to adopt a course which carried these consequences.

15. I now turn, in a little more detail, to Judge Thornton's approach, which is set out in a careful reserved judgment of 42 pages. I say reserved. It was initially given I think extempore but very thoroughly revised subsequently.

16. He was faced with two major arguments advanced by Toyo:
    (i) The August letter was ´an agreement to agree' and incapable of giving rise to legal relations;
    (ii) In any event, the issue as to the nature and effect of the August letter fell to be determined by arbitration, not by the court.

17. He was thus confronted with something of a chicken and egg situation, for it is not possible to consider whether the August letter is subject to the arbitration provisions (assuming them to have formed part of the initial contracts) without considering the nature and effect of that letter. The Judge's conclusions can be summarised as follows:
    1) The August letter identified the basis upon which extra works fell to be valued, namely by reference to the rates in the contractual bills of quantities for the same or similar work, rather than on a cost plus basis.
    2) The August letter provided that valuation on this basis was to be carried out by two independent experts, employing the expertise of quantity surveyors.
    3) The machinery provided for by the August letter would necessarily result in a final account agreed by the two experts.
    4) The August letter thus provided a complete scheme that would resolve the parties' issues as to valuation by subjecting them to final determination by experts.
    5) If the initial contracts were subject to Toyo's terms, then the August letter constituted an amendment to the contracts that replaced the provisions for arbitration with the agreed scheme of expert evaluation.

18. Each link in this chain of reasoning requires examination.

The basis of valuation.

19. The Judge appears to have accepted as common ground the following passage in an affidavit of Mr Sato of Toyo: *"The intention was to achieve a valuation on a QS style valued in accordance with the existing contract rates. Whilst this would not involve the usual very full analysis which would have been involved in a QS approach...it was intended that the valuation must be based on tender packages and tender submissions which must form the basis of all discussions and claims."*

20. That passage is not one that one can deduce from the terms of the August letter itself nor, as I understand it, is it common ground that the parties were agreed that that was the basis upon which the valuation exercise should be carried out. Indeed, as I understand it, the reason why the valuation exercise was broken off was because of a fundamental disagreement on the part of Toyo as to the basis that the two valuers were adopting for their common exercise.

Valuation by independent experts.

21. The relevant finding of the Judge is at page 30 of the judgment: *"The parties have contracted to accept and abide by the result of the determination of two experts in the relevant field of expertise required by the valuation envisaged. Each is to have authority to achieve that determination without recourse to the party that appointed him. The appointees are, therefore, not agents but are to act independently of the party appointing them."*

22. Once again I find it difficult to reconcile this passage with the wording of the August letter which provides that each side is to appoint a "representative" and the representative is to have authority to reach agreement. For myself I do not find it axiomatic that the inference is that the representatives would be independent and not entitled to have regard to the interests or views of the parties that they were representing.

The machinery would necessarily result in a final account.

23. The relevant findings appear first at page 32 in this passage: *"... although the task was both detailed and time-consuming, the work of valuing the work carried out would not present any significant difficulties of either measurement of valuation for the quantity surveyor representatives to be appointed"* and from these passages at page 34:

    "There might remain a residue of items where an agreed compromise was not possible. Here, in default of agreement, the lowest valuation or that which involved the least payment by the defendant would obviously prevail. This was because the experts would be under a contractual obligation to produce a final account which both parties could give effect to in circumstances in which no further money would be payable until such a document had been finalised. The final account would then be capable of being finalised and settled...

    The conclusion to be drawn is that the process set in train by the letter was one which could and should have produced a final account and a final result."

24. Mr White has submitted that there were a number of possibilities that might lead to the breakdown of the machinery provided for by the August letter and thus prevent any final accounts being drawn up. He cites in his skeleton argument by way of examples:
    - *"failure on the part of DMD to provide the required documentation to facilitate the negotiation*
    - *failure to give the nominated representative authority to prepare and agree a final account package*
    - *failure of the parties to cooperate in a serious manner*
    - *failure on the part of the representatives to reach agreement."*

25. In my judgment those were possible ways in which the machinery of the August letter might break down, some of them involving a failure by one of the parties to comply with the requirements of that agreement and some a

form of breakdown that might take place without any failure on either side as a result of a genuine inability to operate the machinery so as to produce a final agreement. I am unable to accept the Judge's conclusion that there would have been a contractual obligation where the two valuers were in disagreement to include in the final valuation the lower of the two rival figures and indeed I do not believe that Mr Wilmot-Smith has felt able to support that particular part of the Judge's reasoning. It follows that the process provided for by the August letter was not one which necessarily would or could produce a final account and thus the letter did not provide a complete scheme for resolving the issues between the parties.

26. Mr Wilmot-Smith QC has sought to rely upon the decision of this court in ***The Didymi*** [1988] 2 Lloyds Rep 108 as demonstrating that the August letter contained a free standing agreement which was capable of enforcement. I do not see that this particular decision assists DMD. Indeed, insofar as it bears on the issue that we have to decide, and that is not greatly, it seems to me that it supports Toyo.

27. The case concerned a clause covering the rate of hire of a 5 year time charter which provided:

"30(1) The ... speed and fuel consumption of the vessel as stipulated in this charter-party are representations by the owners. Should the actual performance of the vessel taken on an average basis throughout the duration of this charter-party show any failure to satisfy one or more of such representations, the hire shall be equitably decreased by an amount to be mutually agreed between owners and charterers ..."

28. The issue for the Court was whether this clause provided sufficient certainty to give rise to a binding contractual obligation - i.e. with the substantive obligation of the parties, not with the procedural question of how the substantive right should be determined. The charterparty was, in fact, subject to an Arbitration clause, but the issue of law was one of a number that had been referred directly to the Court by agreement. The charterers argued that the clause was not enforceable, because it was an agreement to agree. Neither Hobhouse J. at first instance nor the Court of Appeal accepted that argument. They held that the substantive obligation was sufficiently spelt out by the reference to *"equitably"* and that the provision for mutual agreement was no more than procedural mechanics. In the context of the present dispute, it is worth reading what Hobhouse J. had to say on the topic:

"However, even on the wording of par.1 I do not consider it right to categorise the provision as merely an agreement to agree. The words of a contract are used objectively to state the intention of the parties to the contract. They may do so skilfully or clumsily, but the function of the Court is to extract from the words used their objective intention. The words of this paragraph do not disclose an intention merely to require an agreement. The words ´to be mutually agreed' are directory or mechanical and do not represent the substance of the provision. The substantive provision is that there shall be an equitable decrease in the hire. The reference to ´equitable' is not surprising since on any view the assessment is quite probably going to involve some elements of advantage and disadvantage. More than one of the aspects of performance may be involved. An advantage on consumption may qualify a disadvantage on speed or there may be other factors to be taken into account. For example, reduced speed amy already have been compensated under cl. F(b). These types of consideration are to be taken into account in assessing what is equitable, the overall criterion being what is required to indemnify, in this context, charterers for financial loss. If the parties can agree, there is no need to refer the matter to arbitration. If they cannot, then the decrease in hire is for the arbitrator to determine."

The Court of Appeal endorsed this analysis.

29. In the present case we are not concerned with the substantive rights of the parties, but with the agreement of the parties as to the procedure by which those rights are to be determined.

30. In my judgment the latter part of the August letter did no more than to agree a mechanism for attempting to resolve the differences between the parties without the need to resort to arbitration or litigation. It was a praiseworthy agreement to attempt a form of alternative dispute resolution but nothing in the August letter itself indicates how any disputes or differences in carrying out the provisions of the August letter are to be resolved.

If the arbitration clause was incorporated in the initial contracts, does it apply to issues unresolved by the procedure under the August letter?

31. On this issue, I would adopt most of the analysis in the following passage of the judgment of Thornton J. *"It is now necessary, against that background, to examine the wording of the letter to see whether it provides for arbitration. The underlying valuation disputes in existence immediately prior to the letter being signed fall squarely within the terms of clause 30. The relevant provisions of clause 30, which defines the width of the clause and the extent to which disputes between the parties are to be referred to arbitration under its terms, is in these terms: ´***any dispute out from or in connection with the contract.'**

32. Thus, any dispute which is in connection with the contract is referrable to arbitration. This expression is wide enough to cover disputes arising out of a second contract which is related to the contract containing the arbitration clause as can be seen from the decision of Mustill J. in ***A and B v. D and C*** [1989] 1 Q.B. 488, (CA).

33. In ***the A and B***_case, Mustill J. held that a dispute which ´may arise in connection with this agreement' covered a dispute as to inspection and repair work carried out under a contract with no arbitration clause which related to the supply of a liquified gas plant pursuant to a different contract which had an arbitration clause containing that phrase. In the ***Ashville*** case, the Court of Appeal held that the phrase *´arising in connection with the contract'* was wide enough to cover disputes as to whether the contract had been entered into as a result of a mistake, as to whether there was a claim for alleged misrepresentation or negligent mis-statement and as to whether the

contract in question should be rectified. It follows that a dispute arising out of a contract entered into to provide a means of resolving disputes that had arisen under an earlier contract are disputes which, in principle, arise in connection with that earlier contract.

34. However, although the words *´in connection with'* are wide enough to cover disputes arising out of the operation of the procedure in the related contract arising out of the letter, such disputes would not be subject to arbitration if an express or implied term of the underlying contracts has the effect that the disputes arising out of the letter were not referable to arbitration. This is, in fact, the effect of the terms of clause 30. Reference to arbitration in clause 30 of the defendant's conditions is subject to this proviso: *´such dispute shall, unless otherwise specified in the contract, be finally settled under the rules of conciliation and arbitration of the International Chamber of Commerce by one or more arbitrators appointed according to the said rules.'*

35. It follows that, if the effect of the letter is to *´otherwise specify'*, any dispute arising out of the letter is not subject to reference to an ICC arbitration pursuant to ICC rules.

36. The letter does specify an alternative method of deciding the disputes as to valuation."

37. It is only with the last two lines that I differ. The August letter set out a way of attempting to reach agreement without resort to arbitration, but in my judgment it left the parties bound to arbitrate any issues that were not resolved by the procedure set out in the letter. Had that procedure resulted in a final account which Toyo did not challenge, but simply refused to pay, the question would then have arisen of whether DMD had to enforce their right to payment by an arbitration award or by action. My view is that they would have needed an award. In this context I would endorse the approach to Section 9 of the 1996 Act adopted by Clarke J. in ***Halki Shipping Corp v. Sopex Oils*** [1997] 3 All E.R. 833. As it is, no final account has been reached, and DMD's right to any further payment is in issue and must be determined by arbitration. These conclusion are all of course premised on the assumption that the initial contracts were subject to the arbitration clause. The validity of that assumption has yet to be established. But it is for this reason that I would allow the appeal and remit the case to the Judge to decide whether or not the initial contracts were subject to the Arbitration clause.

38. Mr Wilmot-Smith had argued that there was or might be a form of half-way house under which the tribunal which would have to resolve a dispute in relation to the August letter would depend upon the nature of the dispute. If the dispute arose simply because, without any breach or alleged breach on either side, the machinery of the letter simply failed to produce the desired result, then there might have to be a reference to Arbitration but that any claim for breach of the letter was a claim which would fall to be referred to the courts. In my judgment that would not be a workable construction of the agreement nor one which accords with the natural ambit of the arbitration clause. I would, however, emphasise that this court is not determining the question of whether or not any independent claim exists for breach of the August letter. That remains an issue which may have to be determined by whichever tribunal is ultimately seized of this dispute.

39. There is one further matter that I should mention. By the August letter Toyo unequivocally agreed to make an interim payment of £250,000 as a gesture of goodwill, pending final resolution of the parties' position. It is, as I understand it, no longer contended by Toyo that there was no consideration for this agreement and I do not at present see what answer there can be to DMD's entitlement to receive this sum, albeit that it will have, of course, to be taken into account on the final reckoning and repaid if Toyo are shown to have overpaid. I am surprised that a payment that a Japanese company agreed to make as a gesture of good faith has not been made. A similar comment is probably justified in relation to the further payment of £50,000.

40. If these sums remain unpaid they should, subject to any defence of which I am unaware, be susceptible to relatively speedy recovery, whether by court or arbitration proceedings, dependant upon the manner in which Thornton J. resolves the issue that is being remitted to him. In my judgment the approach in ***Halki*** applies as much to these sums as it would have applied to a final account.

LORD JUSTICE SIMON BROWN: I agree and there is nothing I can usefully add.

Order: Appeal allowed with the costs here and of the day devoted to the case below; case remitted to the Judge.

MR A WHITE QC (Instructed by Eversheds) appeared on behalf of the Applicant
MR R WILMOT-SMITH & MR S HARGREAVES (Instructed by Winward Fearon) appeared on behalf of the Respondent