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Agenda
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Negotiating damages: no walk in the (Wrotham) park?

In commercial disputes and arbitrations, the remedy for a breach of contract may involve awarding damages calculated by reference to the wrongdoer's profits. This is referred to as negotiating damages (previously, 'Wrotham Park' damages), and it can be controversial. The recent UK Supreme Court ruling in *Morris-Garner v One Step* provides further clarity, while economics and finance provide the tools needed for this type of quantification exercise

In 2018, the UK Supreme Court handed down a landmark judgment in *Morris-Garner v One Step* that offered much-needed clarity on when a party can claim for negotiating damages.[1] The extent to which this decision affects the number of claims for negotiating damages is yet to be seen, but the role of economics and finance in estimating such damages is clear.

The judgment refers to a well-known case, *Wrotham Park Estate Co Ltd v Parkside Homes Ltd*, which concerned the breach of a restrictive covenant placed on the development of a plot of land.[2] The concepts developed in *Wrotham Park* have since been applied in a large number of cases—for example, they are commonly used in claims for breaches of non-compete clauses.

Wrotham Park is a country house in the north of London that was once surrounded by a substantial area of land. The local government authority, Potters Bar Council, came to own a portion of the land and sold it to Parkside Homes Ltd, which then began developing a small housing estate on the land. However, this was in breach of the Wrotham Park estates covenant, which restricted the extent to which the land could be built on.

Wrotham Park brought a damages claim against Parkside for breach of this restrictive covenant. However, instead of granting an injunction that required that the covenant be adhered to, in this instance the court decided to award damages as a remedy:

> the defendants argue that the damages are nil or purely nominal, because the value of the Wrotham Park Estate as the plaintiffs concede is not diminished by one farthing [i.e. something of minimal value] in consequence of the construction of a road and the erection of 14 houses on the allotment site. If, therefore, the defendants submit, I refuse an injunction I ought to award no damages in lieu. That would seem, on the face of it, a result of questionable fairness on the facts of this case[3]

The court therefore engaged in an analysis of what a reasonable negotiation would have looked like between the Wrotham Park Estate and Parkside Homes for the relaxation of the restrictive covenant in advance of the development of the housing estate. The court ultimately awarded damages calculated as 5% of the developers' anticipated profit.

This decision—and some others that followed—put the legal community in a quandary.[4] Under what circumstances can one claim for negotiating damages? What is a reasonable negotiation? How does this tie in with the conventional measure of awarding damages, which aims to 'put the innocent party in the position he would have been in had the contract been properly performed'?[5]

Enter *Morris-Garner v One Step*.

One Step, but in which direction?

The Morris-Garner v One Step case involved the sale of a business that provided support for young people leaving care. In December 2006, the defendant sold their stake in the business as part of a buy-out agreement that included restrictive covenants prohibiting the defendants 'from engaging in a business that was in competition with [One Step] or soliciting its clients, without its consent, such consent not to be unreasonably withheld' for a period of three years.[6] However, within a year, Positive Living Limited

(a company in which the defendants also held a stake) began to trade and (successfully) compete with One Step. This led the latter to initiate proceedings alleging breach of contract.

In the first instance, the High Court found the defendants to be in breach of the contract and decided that One Step was 'entitled to judgment for damages to be assessed on the alternative bases of (i) Wrotham Park damages and (ii) ordinary damages, and to elect as between those two bases'.[7] This decision was in part driven by the difficulty of quantifying the plaintiff's financial loss, and was upheld by the Court of Appeal. Subsequently, the Supreme Court was asked to comment on:

> where a party is in breach of contract, in what if any circumstances is the other party to the contract entitled to seek negotiating damages, ie damages assessed by reference to a hypothetical negotiation between the parties, for such amount as might reasonably have been demanded by the claimant for releasing the defendants from their obligations[8]

The Supreme Court disagreed with the lower courts. It determined that One Step was not a case in which the concept of negotiating damages should be applied, as the harm could be assessed using the normal principles of breach of contract—in this context, directly determining the extent to which Positive Living had harmed One Step due to the breach of the covenant. This could be done by (for example) identifying lost revenue. In coming to this conclusion, the Supreme Court has narrowed the scope of negotiating damages.

The Supreme Court noted, however, that negotiating damages does have a role in certain cases—in particular, there are some circumstances in which the loss for which compensation is due is the economic value of the right that has been breached, which is considered as an asset. These circumstances include cases where the breach of contract results in the loss of a valuable asset created or protected by the right that was infringed. The Supreme Court gave as examples of such cases those that involve the breach of a restrictive covenant over land, an intellectual property agreement, or a confidentiality agreement.

Calculating negotiating damages

While the specific circumstances under which negotiating damages are available might well continue to be contested, economics and finance provide the tools for quantifying the 'economic value of the right which has been breached, considered as an asset'.[9] For instance, in economics, bargaining theory can provide meaningful insights for implementing the framework of a hypothetical negotiation between parties for the relaxation of a restrictive covenant. This is not new to the real world (see the box to the right).

The framework under bargaining theory can be implemented in two steps.

Bargaining theory in practice

Despite the name, bargaining theory is not just a theory; it is the cornerstone of many guidelines published by standard-setting organisations for the licensing of standard essential patents. For instance, in its guidance on intellectual property rights, ETSI, the European Telecommunications Standards Institute, notes that the commercial terms and conditions of a fair, reasonable and non-discriminatory (FRAND) licence should be determined through bilateral negotiations between the parties, and should be reflective of industry practice.[1] The terms of such a licence would therefore be influenced by the relative bargaining power of the parties. These principles have also been applied in US courts, following the *Georgia-Pacific* case of 1970, which laid out the precedent in the USA by awarding negotiating damages as 'the amount that a licensor and a licensee would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement'.[2]

Note: [1] See ETSI, 'Guide on Intellectual Property Rights (IPRs)', https://bit.ly/1oPfw2D. [2] *Georgia-Pacific Corp. v United States Plywood Corp.*, 318 F. Supp. 1116, 166 U.S.P.Q. (BNA) 235 (S.D.N.Y. 1970).

- Step 1: **what** is the size of the pie to be shared?
- Step 2: **how** should the pie be shared?

Determining the size of the pie involves an assessment of the maximum willingness to pay of the party seeking consent and the minimum willingness to pay of the party offering consent.

These can often be informed by the parties' outside options (that is, their next-best alternative if they were to walk away from the deal) at the time of their hypothetical negotiation.

In some cases, a useful starting point is the set of outside options available to the party seeking a relaxation of the covenant. This translates into putting a number to the question 'what does the party seeking consent have to lose from failing to reach an agreement?' Estimating profits at stake is one way to do this, but it might vary depending on the specific context of the case and the types of outside options available.

The outside options available to the party that is offering consent also have an important role to play. It may not always be practical to reflect these in the assessment for determining the size of the pie, but that does not mean that they can be ignored. The outside options available to the party that is offering consent can be accounted for in the next step, which determines how the pie should be shared. For instance, if the party offering consent risks losing potential royalties from failing to strike a deal, this weakens its relative bargaining power vis-à-vis the party seeking consent. One might therefore allocate a lower share of the pie to the party offering consent, all else being equal.

The dispute between the World Wide Fund for Nature against the (then) World Wrestling Federation for breach of an agreement governing the use of the initials 'WWF' serves to illustrate this in practice. Each of the parties was asked to provide evidence of the factors that would have come into play in a hypothetical negotiation.[10] For example, the wrestlers were asked to show that their outside option was very good—for example, that their efforts would have been a more important determinant of profitability than using the WWF initials. The Fund was asked to show to what extent association with the wrestlers would have harmed its reputation, which was an important factor in determining its willingness to accept any negotiated value.

Generally speaking, the relative bargaining powers of the parties involved in a hypothetical negotiation are likely to be influenced by many considerations—including the urgency with which any one party wants to reach an agreement, as well as the wider commercial relationship between the parties. Assigning a precise proportion to the sharing of the pie between the parties is inherently more of a qualitative exercise than a quantitative one, but a concrete view can be reached by assessing the weight that is attributable to the relevant considerations for each party.

As each case is different, the factors that determine negotiating strength will need to be considered individually. A good example of this is the dispute between the travel agent, Lunn Poly (now part of the Tui group), and the landlord of a shopping centre in Manchester where Lunn Poly had a branch.[11] In that case, the factors that were debated included whether Lunn Poly's negotiating position was weakened by the fact that it was in breach of a lease covenant by allowing a related group company (also a travel agent) to operate from the store, rather than itself; and the extent to which the focus of the dispute—relocating a fire door—might have caused gain or detriment to each of the parties.

In practice, a range of practical challenges can crop up when estimating negotiating damages. What was the set of information available to each party at the time of their hypothetical negotiation? Do the negotiating damages need to be adjusted if another party is also seeking consent, and if so, how? While the answers depend on the specifics of each case, these questions highlight the need for the valuation exercise to go hand in hand with the legal framework and the facts of the case.

No more parking the issue?

The extent to which One Step affects the number of claims for negotiating damages is yet to be seen, but the good news is that economics and finance provide the tools (such as bargaining models) needed for quantifying such damages.

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[1] *One Step (Support) v Morris-Garner* [2014] EWHC 2213 (QB), [2015] IRLR 215.

[2] *Wrotham Park Estate Company Limited v Parkside Homes Limited* [1974] 1 WLR 798

[3] *Wrotham Park Estate Company Limited v Parkside Homes Limited* [1974] 1 WLR 798.

[4] For example, *Attorney General v Blake* [2000] UKHL 45, [2001] 1 AC 268 and *Experience Hendrix LLC v PPX Enterprises Inc* [2003] EWCA Civ 323 involved restitutionary damages that 'aim to strip from a wrongdoer gains made by committing a wrong or breaching a contract'. See Practical Law, 'Restitutionary damages', Glossary, https://tmsnrt.rs/2rdRRw1. Also see *Morris-Garner v One Step* [2018] UKSC 20, Press Summary, p. 2.

[5] See Practical Law (1999), 'Remedies for breach of contract', 1 October, https://tmsnrt.rs/2KJ0XK6.

[6] *One Step (Support) v Morris-Garner* [2014] EWHC 2213 (QB), [2015] IRLR 215, para. 9.

[7] *One Step (Support) v Morris-Garner* [2014] EWHC 2213 (QB), [2015] IRLR 215, para. 108.

[8] *One Step (Support) v Morris-Garner* [2014] EWHC 2213 (QB), [2015] IRLR 215, para. 23.

[9] *One Step (Support) v Morris-Garner* [2014] EWHC 2213 (QB), [2015] IRLR 215.

[10] *WWF – World Wide Fund for Nature vs World Wrestling Federation Entertainment Inc*, [2006] EWHC 184 (Ch), para. 174, step 7.

[11] *Lunn Poly Limited vs Liverpool and Lancashire properties Ltd* [2006] EWCA Civ 430.