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Germany: How to Avoid Risk Deriving from Standard Contract Language

Most national or international business transactions include standard business terms. This is certainly true for transatlantic business. However, if US-companies use their standard business terms in Germany, e. g. to limit or exclude their liability for breach of contract, this will normally be considered as invalid by German courts. In theory, this risk can harm liquidity and, in severe cases, the existence of the company.

Pre-formulated standard business terms (*Allgemeine Geschäftsbedingungen or AGBs*) are common business practice. They are frequently used in order to regulate business risks and to implement a uniform business procedure. In actual practice, the sales personnel rarely take the time and effort to negotiate every single aspect of a proposed business transaction. Rather, the parties negotiate the economic framework of their business and refer to standard business terms for the legal details, such as performance/delivery, transfer of risk, payment terms, warranties, etc. Through the use of such standard business terms, each party seeks to shift the risk to the other party. Limitation of liability clauses aim to determine and economically manage the exposure to liability. In many legal systems, as in the USA, the principle of freedom of contract is typically respected and the contents of such clauses are upheld by courts.

However, German law provides for rigorous legal control of standard business terms. This derives from the risk which such terms can pose to consumers from companies in an age of mass distribution of products and services. Therefore, if a provision contained in standard business terms unreasonably disadvantages the other party, this provision is ineffective by matter of law. This consequence, which is part of mandatory German law, also applies in the area of business to business dealings. It is therefore imperative for foreign companies to avoid the scope of standard business terms or to adapt them to the requirements of German law.

Definition of Standard Business Terms

The statutory definition is straightforward: “Standard business terms are all contract terms pre-formulated for more than two contracts which one party to the contract (the user) presents to the other party upon the entering into of the contract. It is irrelevant whether the provisions take the form of a physically separate part of a contract or are made part of the contractual document itself, what their volume is, what typeface or font is used for them and what form the contract takes. Contract terms do not become

standard business terms to the extent that they have been negotiated in detail between the parties", see Sec. 305 para 1 German Civil Code (*Bürgerliches Gesetzbuch or BGB*).

A critical element with strong practical relevance is mentioned in the last sentence of this statutory definition: Negotiation. If one party insists on the use of its own set of standard business terms and makes the use of its standard business terms a mandatory requirement for its signature, then this party has unilaterally imposed the standard business terms on the other party. In this case, there have clearly not been any negotiations of the business terms. On the other hand, if contract terms have been individually discussed between the parties, with several drafts and change proposals sent back and forth, then they are considered as the result of a negotiation and do not constitute standard business terms.

"Negotiation" of contract terms

A large number of case law exists as to the element of "negotiation". The German Federal Supreme Court (*Bundesgerichtshof or BGH*) generally requires that the user of the standard business terms must seriously put the core of the clause to its disposition and provide the other party with the opportunity to preserve its interests by granting the other party the serious opportunity to influence the contents of the proposed business term. A general statement by the user of the standard business term that he would be willing to change detrimental clauses is not sufficient. Also, a written confirmation by the other party that it has taken note of and consented to the detrimental clause is not sufficient.

In a business to business setting, these requirements are less strict. The user of the standard business terms must provide the other party with adequate opportunity to negotiate and the other party must have reasonable opportunity to protect its interests in the specific negotiation. However, the detailed requirements and their scope are in dispute among courts and legal literature. Further, the party which relies on a clause contained in a contract (i. e. on a limitation of liability clause) bears the burden of proof that the clause was individually negotiated and does not constitute standard business terms in the legal sense. It is only possible to demonstrate individual negotiation if meticulous documentation exists about the course of the communication between the parties while initiating the contract. In practice, such documentation is rarely available, when it comes to a dispute maybe months or years later. Therefore, the requirement of "negotiation" bears considerable risk for the user of standard business terms.

Content control of standard business terms

If a German court should find a decisive clause contained in a contract between two litigants to be classified as standard business terms in the sense Sec. 305 para 1 German Civil Code, then it will examine whether the clause is fair. Provisions in standard business terms are unfair and therefore ineffective by operation of law, if they unreasonably disadvantage the other party contrary to the requirement of good faith, whereby an unreasonable disadvantage may also arise from the provision not being clear and comprehensible (Sec. 307 para 1 German Civil Code). German courts have developed vast case-law as to the question, when these requirements are fulfilled. For example, in contracts among entrepreneurs, an exclusion or limitation of liability is not possible in the case of bodily injury, in the case of gross negligence or in the case that a material contractual obligation ("cardinal obligation") is violated. Similar restrictions apply for most other types of customary clauses, for example warranties, retention of title-clauses, risk taking clauses, limitation period clauses, as well as clauses relating to the applicable law and the venue for disputes.

Invalid clauses are replaced by the corresponding provisions of German law

As already mentioned, a clause in standard business terms that is considered as unfair is fully ineffective by operation of German law. In particular, it is not possible to reduce such invalid provision to preserve its legally permitted core. To the extent that the standard business terms are invalid, the contents of the contract are determined by the statutory provisions (Sec. 306 para 2 German Civil Code). For example, with regard to an invalid limitation of liability clause, this means that the party using this contractual clause under which limitations and restrictions to its liability shall apply, can not enforce this clause. The user of the clause is fully liable for breaches of contract under statutory law, and without any limitation or restriction.

Current developments: reduction of strict "negotiation" standard?

The German law on standard business terms and the case-law by German courts regarding the control of standard business terms are causing increasing dissatisfaction. Although it was originally intended to protect consumers, it significantly affects the design of commercial contracts. An initiative supported by trade associations and the Frankfurt Chamber of Commerce is proposing to modify the German law on standard business terms. It has given rise to a discussion in the legal literature. However, other trade associations have launched a campaign in favor of the existing legal regime.

It seems that the Frankfurt Court of Appeals has now responded to the continuing criticism. In a recent ruling dated 25 August 2011 (file no.: 5 U 209/09), it upheld a contractual clause contained in a complex construction contract which excluded liability for consequential damages, in particular loss of production, lost profits and financial loss. The court initially found that the contract *prima facie* constituted standard business terms in the legal sense because a pre-formulated contract template provided by one of the parties had been used. In this case, the clause would be invalid and the defendant fully liable. However, the court relied on the testimony by two witnesses who had described the negotiation process and stated that several changes had been incorporated into the contract during the negotiation phase. The court found that the contract was the result of the free decision of the party being confronted with the initial contract template. The court held that this party had been free in the choice of possible wordings and that it had been given the opportunity to introduce its own wording into the negotiations with an effective possibility of achieving acceptance. The court therefore qualified the relevant clause as individually negotiated and upheld it. The defendant was only liable within the limits and restrictions contained in the liability clause.

Remarkably, the court did not investigate, whether the specific contractual clause in question was individually negotiated, but only gave consideration to the negotiation of the full contract as such. The Frankfurt Court of Appeals thereby departed from the very strict case-law which requires "individual negotiation" of every single contract clause in order to withdraw it from the critical scope of German law on standard business terms. It remains to be seen whether this trend will find a continuation in the rulings of other courts.

Key aspects for risk reduction

Although the judgment by the Frankfurt Court of Appeals is a ray of hope for those opposing the strict German law on standard business terms, one can not rely on this individual matter. For avoidance of painful pitfalls, foreign companies are well advised to observe precautionary measures. These should include the following guidelines:

Don't simply use foreign templates: if you intend to use your company's standard business terms for business

in Germany, don't rely on the validity or enforceability of these terms. Any pre-formulated standard language originating from abroad should be adapted to the minimum requirements of German law.

Negotiate: to avoid the qualification of a contract as standard business terms, you should openly negotiate all legal aspects of the transaction with the German counterpart, which requires that you must be prepared to deviate from the proposed contract terms.

Keep records: in order to be prepared for the worst case, i. e. the validity of a contractual clause being challenged before court, you should keep a meticulous documentation of the course of the negotiations in your files, along with notes of the individuals involved in the negotiation process.

How we can help?

Please contact Kai Graf v. der Recke at HAVER & MAILÄNDER who can help you with any queries on this topic.

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