Smoke on the characterization of the contract

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The difference between a Contract for Work and Services and a Simple Agency Contract, and its impact on the calculation of damages.

Judgment of the Federal Supreme Court of 22 March 2022

Case reference: 4A_436/2021

Facts

AG ("A"), a hotel, entered into a contract in 2016 with B. GmbH ("B") to prepare and serve shishas (waterpipes) to the clients of the hotel. The contract was performed in 2016 and 2017 but in 2018, A terminated it, which led to a disputebetween the parties.

The Zurich Commercial Court ruled in favor of B. In essence, it considered that the contract was a "Contract for Work and Services", and that the early termination was not justified, allowing B to be indemnified for the net profit the contract would have generated, *i.e.* CHF 90,000.

A decided to appeal to the Federal Supreme Court.

Issue

The Federal Supreme Court had to decide how the contract should be characterized, and what indemnification B could claim following the early termination.

Decision

A first tried to challenge that the contract was entered into with B, rather than its Director. While the Director was effectively the one negotiating the successive contracts, including a first contract entered into personally before the company was created, there was no indication that the parties did not understand nor want to have the contracts entered into between A and B.

Second, A argued that the contract had not been renewed in 2018. However, the terms were negotiated and agreed between B's Director and two of A's Managers, without any reservation as to a need to have it approved by the General Director. The contract was thus valid.

The third and final argument of A relied on the qualification of the contract, a point which the Federal Supreme Court can freely review.

B alleged that the nature of the contract was a "Contract for Work and Services" in the meaning of Art. 363 ff. SCO ("A contract for work and services is a contract whereby the contractor undertakes to carry out work and the customer undertakes to pay him for that work"), where the contractor has to provide a certain result to the customer. In such contracts, in case of early termination, the customer has to indemnify "in full" the contractor, meaning that it has to pay the contractor the benefit the latter would have made if the contract had been completed (so-called "positive interest"; Art. 377 SCO "The customer may withdraw from the contract at any time before the work is completed provided he pays for work already done and indemnifies the contractor in full").

A disputed the contract type and claimed it was a "Simple Agency Contract" in the meaning of Art. 394 SCO, where the agent has to provide a service to the principal. This contract can be terminated at any time, and the terminating party only has to indemnify the other if the termination occurred "at an inopportune juncture" (Art. 404 SCO).

The Commercial Court considered that the main objective of the parties was to deliver the waterpipes to the clients of the hotel. It consequently held that the result of the activities was the prevalent activity so the contract had to be characterized as a Contract for Work and Services. The Federal Supreme Court, however, considered that the relationship with the clients – which are not a party to the contract – is irrelevant. If one focused on the obligation of the parties to the contract, B was mainly providing a service to A, with the result of delivering the waterpipes depending on external factors (the clients), as well as the collaboration between the two parties. As a result, he contract was to be characterized as a mixed contract (i.e. a contract which mixes obligations resulting from various types of contracts), but predominantly a Simple Agency Contract.

Given that the contract was terminated without A providing an alternative solution to preserve the performance of the contract (i.e. relocating the waterpipe service to another site), Art. 404 SCO applied.

According to the well-established case law of the Federal Supreme Court, Art. 404 SCO is mandatory (*i.e.* it is non-waivable) so that the parties cannot contractually waive their right to terminate. The termination was therefore valid, and B could only claim damages and not performance.

A had no just cause to terminate the contract and did not allege any motive to do so. Given that the termination occurred just before the performance was scheduled to begin – with B having already invested in material and hired employees, the termination occurred "at an inopportune juncture" in the meaning of Art. 404 para. 2 SCO. Therefore, B could claim an indemnification for its negative damage – *i.e.*, the costs it would not have borne if the contract had never been negotiated and entered into. The onus was on B to allege and prove these costs. This was a question for the Commercial Court to decide, after taking into account the relevant evidence.

In conclusion, the Swiss Federal Supreme Court reversed the decision and remanded the case to the Commercial Court.

Key takeaway

Characterization of the contract is a matter of interpretation of the obligations of the parties towards one another, and does not ultimately depend on the activity to be performed for the benefit of third parties (in this case the clients of the hotel). The characterization of a contract is not a mere scholarly distinction between contracts but may also have a direct impact on the conditions and consequences of termination as well as on the calculation of damages.

Comments

As a general rule, parties cannot agree on the characterization of the contract – e.g. choosing that the contract is a Simple Agency Contract rather than an Individual Employment Contract. Usually, the main risk associated with characterization is the application of mandatory provisions (protection of the employee, form requirement, etc.), but this case demonstrates that the type and the resulting calculation of damages can also be affected.

Under Swiss procedural rules, the aggrieved party has to allege – and provide relevant evidence – in order to calculate the damage. Should it provide evidence only for its claim of positive damages, it risks having its claim dismissed entirely if the court rules that only negative damages may be awarded. It is thus advisable to have both arguments ready when the proceedings begin.

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