

Contractual interpretation - a victory for common sense

A recent House of Lords decision has highlighted the importance to those who negotiate and draft contracts of ensuring that the contract wording reflects the parties' intentions. However, it also confirmed that the courts are prepared to construe terms liberally where it is obvious that something has gone wrong with the language of the contract. This article considers the judgment in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38.

Chartbrook Limited v. Persimmon
Homes Limited and another

[2009] UKHL 38

On the face of it, the decision is a victory for common sense and represents the right outcome. As Collins LJ had said in the Court of Appeal: "...this is a case in which, if one puts aside the drafts of the Agreement, every contemporary document prior to the conclusion of the Agreement, and every piece of paper which throws light on the commercial purpose of the provision, supports Persimmon's case...".

Having failed at first instance and in the Court of Appeal, Persimmon finally succeeded before the House of Lords, thereby reducing the amount it is required to pay Chartbrook under their contract by some £3.5 million to approximately £900,000. Significantly, the so-called "exclusionary rule", which prevents reliance on evidence of the pre-contractual negotiations for the purposes of construing a contract, remains good law. What is also of interest is how, on the facts, the potentially harsh consequences of the rule were overcome so as to enable "justice to be done".

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Key points from the judgment

- The exclusionary rule was upheld by the House. Therefore, when construing the meaning of a term of a contract, a party cannot rely on evidence of the pre-contractual negotiations.
- Nevertheless, applying an objective test, the House was prepared to construe the provision in question liberally as the literal interpretation flouted commercial common sense. It mattered not that this involved a fair amount of "red ink".
- In any event, rectification would have been possible - the pre-contractual negotiations revealed, objectively, that a prior consensus had been reached, and there was no evidence of any subsequent discussions to suggest an intention to depart from that consensus.

Whilst the exclusionary rule was upheld, it is clear that there were some who are not persuaded as to its benefits. In her judgment, Baroness Hale of Richmond confessed that she "would not have found it quite so easy to reach this conclusion had we not been made aware of the agreement which the parties had reached on this aspect of their bargain during the negotiations which led up to the formal contract. On any objective view, that made the matter crystal clear. This, to me, increased the attractions of accepting counsel's eloquent invitation to reconsider the [exclusionary] rule in *Prenn v Simmonds*.... However, the [objective] approach to rectification adopted by Lord Hoffmann would go a long way towards providing a solution".

Background

In October 2001, Chartbrook and Persimmon entered into an agreement for Persimmon to develop a site acquired by Chartbrook. For a while everything went smoothly: planning permission was granted and the development was carried out. However, a dispute arose

as to the amount due from Persimmon under the contract and Chartbrook commenced proceedings. The disputed element of the pricing formula was described as the Additional Residential Payment ("ARP"). On Chartbrook's construction, the ARP amounted to approximately £4.5 million. Persimmon's view was that, properly construed, the ARP was just under £900,000.

First instance decision

Briggs J held that the ordinary meaning of the words used in the ARP pointed clearly towards Chartbrook's construction. In declining to allow evidence of the pre-contractual negotiations for the purposes of construing the ARP provision, Briggs J refused to depart from the well-established exclusionary rule. Furthermore, the "private dictionary" inroad into the exclusionary rule (the seeds of which were sown in the *Karen Oltmann* [1976] 2 Lloyd's Rep 708) could not apply here given that ARP was a defined term. Finally, after a detailed analysis of the pre-contractual negotiations, Persimmon's counterclaim for rectification on the grounds of either common or unilateral mistake was refused. "Convincing proof" was required in either case, but this had not been made out.

Court of Appeal

By a majority, the court refused Persimmon's appeal, holding that there was nothing unclear, uncertain or ambiguous about the definition of ARP. Collins LJ, dissenting and applying *Antaios Cia Naviera v Salen Rederierna AB* [1985] AC 191, felt that Chartbrook's literal construction of ARP flouted commercial common sense. Accordingly, he accepted Persimmon's construction. The Court was unanimous in refusing to have recourse to the pre-contract negotiations as part of the construction exercise, nor could the private dictionary exception be invoked in this case. Finally, although Persimmon had, according to Collins LJ, a "very powerful case for rectification", the Court declined to order it.

House of Lords

Overturning the Court of Appeal, the House held that Persimmon's construction of the ARP provision was the correct one. The key question was what a reasonable person would have understood the parties to be using the language in the contract to mean, having all the background knowledge which would have been available to the parties (other than pre-contractual negotiations and declarations of subjective intent), (*Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, 912-913). Where the context and background demonstrated that "something must have gone wrong with the language", a court was not required to attribute to the parties an intention which would not have been understood by a reasonable person.

As Lord Hoffmann stated, the cases made it clear that, "*There is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed. All that is required is that it should be clear that something has gone wrong with the language and that it should be clear what a reasonable person would have understood the parties to have meant. In my opinion, both of these requirements are satisfied.*"

As a consequence, the House of Lords did not need to address the application of the exclusionary rule or rectification. Nevertheless, these were issues "of very considerable general importance". Accordingly, Lord Hoffmann dealt (obiter) with both issues in some detail.

The exclusionary rule

Lord Hoffmann recognised that a strict application of the exclusionary rule could, in certain circumstances, deny the court the opportunity of being given access to "*the gold of a genuine consensus on some aspect of the transaction expressed in terms which would influence an objective observer in construing the language used by the parties in their final agreement.*"

Whilst he rejected Persimmon's submissions in relation to the exclusionary rule, he did say that, "*[t]he general rule is that there are no conceptual limits to what can properly be regarded as background. Prima facie, therefore, the negotiations are potentially relevant background.*"



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Such evidence would, however, usually be inadmissible because it was irrelevant to the objective assessment of what the parties would reasonably be taken to have meant by the language in the contract. Having considered the arguments, Lord Hoffmann concluded that there was *"no clearly established case for departing from the exclusionary rule"*.

As for the private dictionary exception, Lord Hoffmann confirmed that *"evidence may always be adduced that parties habitually used words in an unconventional sense in order to support an argument that words in a contract should bear a similar unconventional meaning"* and for this purpose, pre-contractual negotiations were admissible (although he felt that the *Karen Oltmann* had been wrongly decided)..

Lord Hoffmann concluded by identifying two legitimate safety devices which would in most cases prevent any injustice caused by the exclusionary rule, namely rectification and estoppel by convention. The latter was not explored in any detail in the judgment.

Rectification

Lord Hoffman agreed with Persimmon's submission that rectification required a mistake as to whether the contract correctly reflected the prior consensus, not whether it accorded with what the parties believed was the consensus. At first instance, the judge had held that the mistake was not common to both parties on the basis of the evidence of the Chartbrook witnesses as to what they believed had been agreed pre-execution of the contract. However, such an approach was wrong.

On the facts of this case, all the Law Lords agreed that, had they found in favour of Chartbrook's construction of ARP, Persimmon would have been entitled to rectification. A prior consensus had been reached during the course of the pre-contractual negotiations and no evidence had been proffered of any subsequent discussions which might have suggested an intention to depart from that consensus.

Conclusion

Notwithstanding the House's liberal approach to construction, when negotiating and finalising the terms of a contract, parties should:

- ensure that the contract accurately reflects the parties' intentions;
- bear in mind that evidence of pre-contractual negotiations is unlikely to be admissible for the purposes of construing a contract;
- nevertheless keep an accurate written record of pre-contractual negotiations, particularly discussions concerning the key provisions: it may assist in a rectification claim or in convincing the court that the private dictionary exception should apply.

Future Developments

Another important House of Lords decision is due to be handed down in the autumn (*Re Sigma Finance Corp (In Administration)*). In this case, the House will decide whether to uphold the first instance and Court of Appeal decisions in favour of a literal interpretation of a clause in a security trust deed or whether to depart from the clear and natural meaning of the words.

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