TRAVERS SMITH

Contract drafters beware!

A recent Court of Appeal decision reminds those who negotiate and draft contracts of the importance of ensuring that the contract wording reflects the parties' intentions.

Chartbrook Limited v. Persimmon Homes Limited and another

[2008] EWCA Civ 183

Introduction

Where there is a dispute as to the meaning of a contractual term, a question on which we have frequently been asked to advise by clients is whether the parties are able to interpret the term by reference to the pre-contractual negotiations. After all, the disputed term may well have been the subject of detailed discussion between the parties or their respective solicitors and it may be apparent from previous drafts, correspondence or attendance notes what the parties intended the term in question to mean.

Consider the following scenario – after several years of negotiations, party A and party B enter into a contract whereby A agrees to develop land owned by B for the purpose of on-selling flats to third party buyers. The contract contains a clause ("the pricing provision") setting out how the proceeds of the sales are to be split between A and B. A dispute then arises between A and B as to the amount payable by A to B. On A's reading of the pricing provision, B is owed approximately £900,000. B on the other hand claims to be entitled to just over £4.6 million. Read literally, B's construction appears to be correct. However, the pre-contractual negotiations point strongly in favour of A's construction, which appears to have been the commercial intention of the parties throughout. The dispute goes to court. Surely justice requires that the court finds in favour of A, and that to find in favour of B would be to give B a windfall that it barely deserved?

Not so. These were, broadly, the facts underlying the dispute in the recent Court of Appeal decision in *Chartbrook Limited v Persimmon Homes Limited*. In that case (analysed in more detail below), the Court felt that the pre-contractual materials favoured the construction put forward by the developer, Persimmon. However, these materials were not admissible. Consequently, the wording of the pricing provision was to be read in isolation and Chartbrook recovered £4.6 million. The message is clear – failure to record accurately the parties' intentions in the contract could have disastrous consequences, as it did for Persimmon. The party adversely affected is unlikely to have recourse to the pre-contractual negotiations to support its position.

The general rule

Chartbrook is the latest in a long line of cases that make it clear that, subject to the "private dictionary" exception discussed below (which it is now clear will only apply in the rarest of circumstances), evidence of pre-contractual negotiations is inadmissible for the purposes of construing a contract ("the exclusionary rule").

Lord Hoffmann famously stated in the 1998 House of Lords decision in *Investors Compensation Scheme v West Bromwich Building Society* ("ICS") that:

- *"Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.*

Evidence of pre-contract negotiations is rarely admissible when construing a contract, even if the result seems to give one party a windfall.

- *…. Subject to…. the exception to be mentioned next, [the relevant background] includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.*
- *The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification….. The boundaries of this exception are in some respects unclear….”*

The justification for the exclusionary rule was set out by Lord Wilberforce in 1971 in *Prenn v. Simmonds*:

“…. such evidence is unhelpful. By the nature of things, where negotiations are difficult, the parties’ positions, with each passing letter, are changing and until the final agreement, though converging, still divergent. It is only the final document which records a consensus….”

However, Lord Nicholls, in a 2005 lecture to the Chancery Bar Association has forcefully argued that the exclusionary rule is far too rigid, arguing that taking into account pre-contract negotiations “*would recognise that pre-contract negotiations are themselves part of the background of a contract and that, like other background material, they may be relevant when interpreting a contract* ”.

The “private dictionary” exception to the general rule

As Lord Nicholls pointed out, the exclusionary rule is not absolute. In the 1976 case of *The Karen Oltmann*, the court had to determine the meaning of the word “after” in a clause giving charterers a break option “after 12 months' trading….”. It concluded that where words used are capable of bearing more than one meaning, “*if it is alleged that the parties have in effect negotiated on an agreed basis that the words bore only one of the two possible meanings, then it is permissible for the Court to examine the extrinsic evidence relied upon to see whether the parties have in fact used the words in question in one sense only, so that they have in effect given their own dictionary meaning to the words as the result of their common intention. Such cases would not support a claim for rectification of the contract, because the choice of words in the contract would not result from any mistake.*”

Having established that the pre-charterparty exchanges were admissible, the judge found that both parties clearly understood “after” to mean “on the expiry of” 12 months and not “at any time after the expiry of” 12 months.

It is now clear that the “private dictionary” exception will only apply in the rarest of circumstances.

Since Lord Nicholls’ lecture, there have been a number of decisions regarding the scope of the “private dictionary” rule established in *The Karen Oltmann*.

Recent cases

In 2006, in *Proforce Recruit Ltd v The Rugby Group Ltd*, the Court of Appeal heard an appeal against Field J’s decision to strike out Proforce’s claim. Proforce claimed that Rugby had failed to give them “preferred supplier status”, as required by the contract and sought to have admitted in evidence a witness statement by its managing director that, during the pre-contract negotiations, a Rugby executive had explained what was meant by “preferred supplier status”. Field J. held that the evidence was inadmissible, as a result of which the claim was struck out.

Field J.'s decision was overturned by the Court of Appeal, who, applying the *The Karen Oltmann,* held that it was reasonably arguable that on its true interpretation the undefined phrase “preferred supplier status”, which was an unusual combination of words lacking an obvious natural and ordinary meaning, bore the meaning that the parties gave them in their communications leading up to the signing of the agreement. As a consequence, the dispute proceeded to a full trial, where, having analysed the admissible factual matrix (i.e. excluding the evidence of the pre-contractual negotiations), Cresswell J found that the term “preferred supplier” meant “approved supplier”, not “sole supplier”. The Judge then assessed the evidence relating to the pre-contractual negotiations. He found that the parties did not come to an agreed

meaning of the term in question. Accordingly the "private dictionary" exception did not apply.

The key issues for the first instance judge.in *Chartbrook v Persimmon* were whether the parties' negotiations were admissible for the purposes of construing the pricing provision, known as the Additional Residential Payment ("ARP") and if not, whether the ARP could be rectified on the basis of either a common or a unilateral mistake.

The judge held that the "private dictionary" exception should not apply, on the basis that ARP was a defined term. As for rectification, there was insufficient evidence of a common intention that the pricing provision was to have the meaning contended for by Persimmon. Nor had there been a unilateral mistake by Persimmon of which Chartbrook was aware and where good conscience required Chartbrook to speak out. In reaching this conclusion, the judge was heavily influenced by the honesty and reliability of a key Chartbrook witness.

On appeal, Collins LJ, whilst accepting the exclusionary rule as the starting point, stated that the policy reasons behind it were not convincing, citing, amongst other things, the admissibility of pre-contractual negotiations in the US. He also dismissed the first instance judge's emphasis on the effect on third parties as a strong policy reason for the exclusionary rule. As for the "private dictionary" exception, he felt that the exception could apply equally to defined terms. Nevertheless, he (along with the two other judges) held that this was not a case where the exception should apply because the pre-contractual negotiations did not establish a sufficiently clear evidential basis for it, even though as above, he felt that the pre-contractual materials pointed strongly in favour of Persimmon's construction. Rimer LJ, who emphasised that the general rule was that evidence of pre-contractual negotiations was "*out of bounds*", was scathing about Persimmon's attempt to "*seduce the court into accepting that the parties' subjective intentions with regard to the ARP calculation were different from what the ARP definition in the agreement actually provide[d], and then to invite the interpretation of that definition…. in line with the alleged intentions*." Persimmon had sought "*to have recourse to the negotiations for the purpose of rectifying the ARP definition under the guise of interpretation*" – this was not allowed, applying *ICS*.

Finally, although the Court of Appeal felt that Persimmon had a powerful case for rectification, the first instance judge's finding on the evidence heard by him should not be interfered with.

Conclusion

Despite Collins LJ's statements in *Chartbrook* that (i) the policy reasons underpinning the exclusionary rule are debatable, (ii) the pre-contractual materials in that case pointed very strongly in favour of Persimmon's construction and (iii) the "private dictionary" exception could apply to defined terms, the decision in *Chartbrook* makes it clear that only in exceptional cases where it is crystal clear that the parties have negotiated a term on an agreed basis as to its meaning will evidence of the pre-contractual negotiations be admissible when construing the term. Furthermore, compelling evidence will be required for rectification to succeed. Accordingly, 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;
- 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.

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