

This article was first published in Greens Business Law Bulletin, Issue 102 (published October 2009) and is reproduced here with the kind permission of W. Green, The Law Publishers

**Pre-Contractual Negotiations and Construction of Commercial Contracts:
Chartbrook Limited v Persimmon Homes Limited [2009] UKHL 38**

Andrew Bowen, Advocate

Introduction

Commercial lawyers are well aware of the rule, established by the House of Lords in *Inglis v Buttery* (1878) 3 App Cases 552 and then a century later in *Prenn v Simmonds* [1971] 1 W.L.R. 1381, that prior negotiations are inadmissible in the construction of a commercial contract. The justification for the rule is that a formal contract is designed to put an end to the disputes that might arise if the scope of the agreement was left to be decided by what the parties said or wrote to each other during the period of their negotiations; the formal contract records the bargain, which might be different from what the parties had sought during negotiations. It is more difficult to apply the rule when considering the construction of a commercial contract, particularly with the background knowledge admissible post-*Investors Compensation Scheme Ltd*. In *Chartbrook* the House of Lords was invited to revisit the rule in a dispute about the meaning of a provision valuing development land and, in rejecting that invitation, clarified why the rule should remain.

The Disputed Provision

In 2001 C entered into an agreement with P to develop a site in London which C owned. They agreed that P would obtain planning permission and then, in terms of a licence from C, build a mixed residential and commercial development and sell the properties on long leases granted by C. P would receive the sale proceeds and pay C an agreed price for the land. The price payable for the land by P was defined in the agreement as the aggregate of the “Total Land Value” and the “Balancing Payment”. The Total Land Value was calculated by multiplying the area (sq ft) for which planning permission for flats, shops or parking spaces had been granted by a pre-determined value. It was payable as each flat, shop or parking space was sold although there was a backstop provision for payment of specified percentages of the Total Land Value if the properties had not been sold within a two and a half year period. Lord Hoffmann at [7] described these provisions as “quite straightforward” since they only required the insertion of the appropriate undisputed figures from the planning permission into the formulae provided.

The dispute turned on the definition of the Balancing Payment, referred to (or “pointlessly relabelled” according to Lord Walker) as the Additional Residential Payment (“ARP”), which was defined as “23.4 per cent of the price achieved for each Residential Unit in excess of the Minimum Guaranteed Residential Unit Value less the Costs and Incentives.” Residential Unit meant a flat, Minimum Guaranteed Residential Unit Value (“MGRUV”)

meant the Total Residential Land Value divided by the number of flats, and Costs and Incentives (“C & I”) meant the additional expense which P might incur to induce someone to buy a flat, such as providing fittings better than specification or paying legal expenses. Lord Hoffmann said the formula was “outwardly uncomplicated”. C argued that in terms of the formula C & I should be deducted after calculating the 23.4 per cent while P argued that it should be deducted before; the difference between the two approaches was £4million which P argued gave C a windfall and was more than P had offered to pay and which C had agreed to receive.

At first instance (Briggs J., [2007] EWHC 409 (Ch)), and in a majority of the Court of Appeal (Tuckey and Rimer L.JJ., Lawrence Collins L.J. dissenting, [2008] EWCA Civ 183), C succeeded in their argument that their construction was in accordance with conventional syntax, in other words, that C & I was deducted after calculation of the 24 per cent. The House of Lords (Lords Hope, Hoffmann, Rodger and Walker and Baroness Hale) preferred the views of Lawrence Collins L.J. and allowed the appeal. The judgments dealt with the issues of construction and admissibility of pre-contractual negotiations.

Construction

Lawrence Collins L.J. at [85] said that the starting point for construction of commercial contracts was not controversial. He said that interpretation was 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. Subject:

- (i) to the requirement that the background should have been reasonably available to the parties; and
- (ii) the exclusion of previous negotiations of the parties and their declarations of subjective intent, it included anything that a reasonable man would regard as relevant and which would have affected the way in which the language of the document would have been understood by a reasonable man (Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 W.L.R. 896 at 912; *BCCI v Ali* [2002] 1 A.C. 251, 269; and also *Mannai Investment Co Ltd v Eagle Star Life Assurance Ltd* [1997] A.C. 749, 779).

If a semantic analysis of words in a commercial contract led to a conclusion which flouted business common sense, it must be made to yield to business common sense (*Antaios Cia Naviera v Salen Rederierna AB* [1985] A.C. 191, 201, per Lord Diplock) but that did not mean that the language could be rewritten in order to make the language conform to business common sense (*Co-operative Wholesale Society Ltd v National Westminster Bank Plc* [1995] 1 EGLR 97). He held at [93]–[94] that syntactical analysis had to yield to business common sense because on P’s case the MGRUV was the equivalent of 23.4 per cent of a realistic anticipated aggregate price, being what C would receive if the flats sold at or below that price, and it would receive 23.4 per cent of the excess if they sold for a higher price, while on C’s case the MGRUV was arbitrary, since it made no sense to specify it as the figure of 23.4 per cent of a realistic price and then provide for *Chartbrook* to receive 23.4 per cent of the

excess not over that price but over the MGRUV. Lord Hoffmann agreed with this analysis and the other Law Lords adopted Lord Hoffmann's view.

Pre-Contractual Negotiations

As the Court had decided the appeal on a matter of construction, its views on pre-contractual negotiations were obiter but of interest nonetheless. It was argued on behalf of P that evidence of negotiations should be admitted if they assisted a court in deciding what an objective observer would have construed the contract to mean. Lord Hoffmann accepted that, in principle, previous negotiations might be relevant and said at [32]–[33] that:

“it would not be inconsistent with the English objective theory of contractual interpretation to admit evidence of previous communications between the parties as part of the background which may throw light upon what they meant by the language they used”

since (per *Bank of Credit and Commerce International SA v Ali* [2002] 1 A.C. 251, Lord Hoffmann at 269) there were no conceptual limits to what could properly be regarded as background. He then looked to pragmatic reasons for the rule and said at [38] that pre-contractual negotiations were capable of raising practical questions different from those created by other forms of background.

“Whereas the surrounding circumstances are, by definition, objective facts, which will usually be uncontroversial, statements in the course of pre-contractual negotiations will be drenched in subjectivity and may, if oral, be very much in dispute.”

While accepting that excluding negotiations might sometimes deprive the court of relevant background, he held that the more general interest of economy and predictability in obtaining advice and adjudicating disputes justified retaining the rule. Lord Rodger said at [20] that repeal of the rule had to be a matter for Parliament.

Conclusion

The House of Lords confirmed that pragmatic policy reasons were the basis for the rule excluding pre-contractual negotiations since those negotiations might well be relevant to the exercise of construction. However, the very generous width given to the scope of background knowledge and the trumping of business common sense over syntactical analysis suggests that the enforcement of the rule will not prejudice commercial clients with a sensible claim based on objective commercial facts.