[CONTRACTS]

Lost in interpretation

When negotiating contracts, make sure the provisions in the final document are what you intended – otherwise, the courts may end up interpreting them for you, warns **Alan Ma**

Consider a situation where after months of negotiation, a contract is finally drawn up and executed by supplier and buyer. There is a pricing provision in the contract and the payment is based on the supplier's performance. A dispute arises as to its actual meaning. Literally, the supplier is entitled to a payment of £4.6 million, but the buyer claims only £900,000 is due based on the actual intention of the parties.

These were the underlying facts of the House of Lords' decision on *Chartbrook Limited v Persimmon Homes* (*Court report, 27 August*). The contract was a development agreement such that the landowner, Chartbrook, should be entitled to receive an excess payment if the price achieved by the developer for each flat sold exceeded a base figure. The excess payment was expressed to be "23.4 per cent of the price achieved for each residential unit in excess of the Minimum Guaranteed Residential Unit Value (MGRUV) less Costs and Incentives (C&I)".

The literal meaning of the pricing provision reflected the formula:
Payment = (23.4% x (Price – MGRUV – C&I)

However, the actual meaning of the parties is:
Payment = (23.4% x (Price – C&I)) – MGRUV.

Persimmon claimed the second equation represented the actual intention of the parties and only £900,000 was payable. It argued the parties were in agreement over the meaning of the payment term during negotiations and they should be allowed to use evidence of the negotiations to prove this.

Both the High Court and the Court of Appeal rejected Persimmon's submission and ruled that pre-contract negotiations were inadmissible. But the House of Lords allowed the appeal by unanimous decision.

Prior to this case there is a line of cases on this issue and the courts' approach in contract interpretation can be summarised as follows:

- The test is objective. How would a reasonable person have understood the meaning of the provisions? The reasonable person should have all the available background knowledge to the parties in the situation during the time of the contract.
- Pre-contract negotiations are inadmissible for the purpose of interpreting a contract. The rationale is that parties' positions change during negotiation and only the final document records a consensus.
- The court decides to go beyond the literal meaning of a provision and examines the true intention of the parties when it is clear that there has been a misunderstanding with the language and it should be clear what a reasonable person would have understood the parties to have meant.

Pre-contract negotiations are inadmissible – parties' positions change during negotiation and only the contract records a consensus

Chartbrook confirms that the above approach is still good law. The reason that Persimmon's appeal was allowed is that Chartbrook's interpretation made the structure and language of the relevant provisions appear arbitrary and irrational, when it was possible for the concepts employed by the parties to be combined in a rational way. The law lords preferred Persimmon's view of the proper construction of the contract.

Careful drafting ensures contracts reflect parties' true intentions. Reviewing, commercially and legally, a drafted contract prior to its execution should reduce the risks of problems arising in the future.

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COURT REPORT

[University of Plymouth v European Language Centre Ltd]

THE CASE

Contracts may arise from informal communications if the essential elements of a contract are clearly present. The use of the phrase "subject to contract" will indicate that you do not intend your communications to form the basis of a contract.

The European Language Center (ELC) had a long-standing agreement with the University of Plymouth for the provision of accommodation and teaching space at the university for their language courses. In May 2005, the university contacted ELC by e-mail to inform them that the estimated number of beds available for use by ELC was 200. Later, the university informed ELC that only 100 beds would be available.

ELC sued, claiming that the e-mail exchanges and phone calls with the university constituted a binding contract and the university was obliged to provide at least 200 beds. No communications had been stated to be "subject to contract".

Initially, Plymouth County Court found in favour of ELC and agreed that the university had committed to providing 200 beds. But the university took the case to the Court of Appeal which found that there was no contract in place and the university was under no such obligation. The Court's reasoning was that the e-mail communications and phone calls failed to contain the ingredients necessary to establish the presence of a contract – there was no clear offer from the university, and no acceptance from ELC.

Following the university's e-mail in May 2005, ELC did not give an immediate response, and further messages were exchanged regarding numbers and possible prices, suggesting that the contract terms were still being negotiated. Furthermore, the Court of Appeal seems to have been influenced by the fact that previously the parties had entered into detailed written contracts, but had failed to do so on this occasion.

WHAT THIS MEANS

It is easy to put the cart before the horse and carry on business before a written contract has been agreed. In these situations the courts will attempt to find that there is an informal contract in place based on the conduct of the parties, as well as written and verbal communications. But it would be unwise to rely on the courts. This case illustrates the inherent risk of failing to agree a written contract.

ELC should have insisted on a written agreement. When it transpired that the rooms were unavailable, it would then have been in a much better position to sue Plymouth University. It is always preferable to have a written contract setting out the all the terms of the relationship, rather than an uncertain informal contract, the details of which are decided by the courts.

This case was decided on the facts and does not challenge the principal that a contract can arise from informal communications. If you are in the course of negotiations you should be careful not to enter into a contract inadvertently. It is crucial you consider the basic contractual principles of offer and acceptance and ensure that communications are headed up "subject to contract" if they could be construed as forming the basis of a contract.

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LAW BRIEFS

Companies Act becomes law

The Companies Act came into force on 1 October, reforming legislation for private public and quoted companies.

The Act should have been implemented in October 2008, but was delayed for a year because computer systems were not ready to deal with the changes.

The new reforms aim to simplify the way companies can be set up and operate (*Law update, 1 February 2007*). Further details on the changes can be found at http://tinyurl.com/lkhyme

What's French for 'rip off'?

The European Consumer Centre has launched a guide to help people make claims against traders abroad.

Buyers can take traders to the European Small Claims Court if their claim is worth less than €2,000 (£1,813). The goal is to speed up and simplify cross-border cases.

The Guide to the European Small Claims Court can be downloaded from http://tinyurl.com/lvlyto

Excluding suppliers from bids

The list of reasons for excluding a bidder from a procurement process under the services directive is exhaustive, according to the European Court of Justice. But buyers can still exclude suppliers from bidding as long as the process allows equal treatment and is transparent.

It follows a challenge from an Italian company that felt a competitor that was awarded a contract should have been excluded from the bidding process because of its links to another rival bidder.

Case report: http://tinyurl.com/kufmeq

Office of Unfair Trading

The Office of Fair Trading (OFT) broke the principles of fair and equal treatment when it did not reopen an offer of leniency to a company under investigation for cartel activity.

The company rejected the OFT's initial offer – because it could not verify the claims made against it – and the OFT refused to repeat the offer when asked later.

The High Court said it should have been clear the company was in a different position to other firms that had been offered clemency, and the OFT had a duty to consider different circumstances.

Case report: http://tinyurl.com/koj7px