



Can your pre-negotiation discussions come back to haunt you?

When a contract is signed and the champagne corks fly, often there is a secret sigh of relief from the sales team that all the extravagant promises they made to secure the deal have been wiped out by the “entire agreement” clause. If the signed document is the agreed record of the deal, then nothing said by either party before signature matters – or does it?

Most people know that an agreed contract can be brought down if one or other of the parties lied in order to get the deal. There are also occasions where pre-contract representations which fall short of fraud but go beyond mere hype and sales puff can be relied on in court. We are waiting for the judgment in the dispute between EDS and BSkyB on this latter point to give us more guidance about where the courts will draw the line. In addition, a pre-contract promise or understanding can, in certain circumstances, be relied on in court.

However, last week the House of Lords did give us a very clear judgment about what happens when there is ambiguity in a contract and whether they will look to the pre-contractual negotiations in order to work out what the parties actually intended. The case¹ involved Persimmon Homes and a developer, Chartbrook, and related to a land development contract (the “*Persimmon Contract*”) in Wandsworth (south London). We’ll refer to the case itself as the “*Persimmon Case*”.

As a general rule, the courts make the reasonable assumption that what is written in the contract is exactly what the parties wanted to say and it is extremely difficult to persuade them to fix incorrect drafting except in very limited circumstances. Even trickier is where the drafting isn’t so much wrong as capable of more than one interpretation. That is what happened in the *Persimmon Case*.

Under most Continental legal systems, pre-contractual negotiations can be admitted in court, because the courts try to work out subjectively what the particular parties intended when they signed the contract. Our system is very different: the courts try to work out what a reasonable outside person in the circumstances at the time of the signature of the contract would have taken the parties to have agreed – in other words, it is an objective test. For that reason, the to-and-fro of e-mails and drafts and discussions are not helpful: it’s what the parties intended at the end of that process which matters.

The *Persimmon Contract* contained a formula for working out what was to be paid by one party to the other, and this formula was set out in words. Unfortunately, the wording could be read in one of two ways (as to whether some costs should be subtracted before or after a percentage of the sales price was calculated). The difference between the outcomes of the two alternative implementations of the formula was several million pounds. The House of

Lords did what the court usually does: it looked at the contract as a whole, and decided which of the two possible interpretations accorded with what a rational observer would have assumed the parties meant. In doing so, it overturned the view of the Court of Appeal, which goes to show how difficult (and expensive) it can be to sort out this kind of mess.

The leading Law Lord made it clear that, when a court interprets a contract, evidence of pre-contractual negotiations would remain – as most lawyers thought – inadmissible in all but the most unusual circumstances. (This would be different in a misrepresentation or “promise” claim). This of course pre-supposes that the parties have an agreed contract – where work has started prior to formal agreement (as so often happens) then something goes wrong before it is signed, the court may have to sift through the negotiation material to work out what was actually governing the parties’ actions at the time.

The discussion of the facts by the Law Lords, and their comments, have led us to come up with some tips for drafting complex contracts, which we wanted to pass on.

How to draft a contract that shouldn’t end up in court...

- **DON’T deliberately incorporate pre-contract material.** We always advise clients not to incorporate documents such as an ITT/RFP or a response to them into the final contract. For some reason, some lawyers think that adding in inches of paper which contain contradictory statements and requirements and which probably bear little relationship to the final deal will make matters clearer. Lord Hoffman pointed out that pre-contractual material may be “drenched in subjectivity” and “merely reflect the aspirations of one or other of the parties”. Quite.
- **Always check your formulae!** If the parties to the *Persimmon Contract* had written out the formula using mathematical notation – and better still, added some worked examples – the ambiguity would have been spotted and cleared up. We always advise clients to try out formulae in contracts with example numbers, to check that the answer makes sense. It’s amazing how often a formula to vary price, for example, ends up with an answer of an infinite number of pounds!
- **Be careful with your definitions.** Lawyers are apt to say that definitions are merely arbitrary labels and that you could just as well call a “Data Centre” a “Banana” or an “Elephant”. Broadly this is right, but in this case, where the defined terms related to the formula, the Law Lord said that “The words used as labels are seldom arbitrary. They are usually chosen





as a distillation or the meaning or purpose of a concept...". So, where defining terms such as, say, "Permitted Downtime" be aware that you may be implying something as to permission.

- **Another point on formulae.** One of the other problems with the written formula in the Persimmon Contract was that it did not compare like with like: some elements measured cost on a per unit basis, others looked at the total cost and the two did not work together properly. Where you have (as is often the case) a formula which contains averages and percentages (for example, as to the meeting of service levels at a per site and a total network basis or on a monthly and annual basis), take care that all the elements end up giving numbers which make sense – another reason for trying out your formula before you sign up to the contract.
- **Don't proceed without a contract...** Of course, work often does have to begin while negotiations are still going on, in order to meet deadlines or deal with lead times for ordering equipment. However, just starting work without being clear about the basis on which this is being done is a recipe for disputes, even if the final contract is signed. Beware of loose "Instructions to Proceed", "Letters of Intent", "Statements of Works" etc – they are a mine-field for the uninitiated. If the parties must proceed before signing the substantive contract, make sure that the parameters and cost of such work, and the contractual basis on which it is being done, is clearly agreed and linked to a process for finalising the "proper" contract.
- **"RTFM".** Exasperated IT support staff are apt to require useless users to "Read The Flipping (or worse) Manual!" It really is a good idea to read a major contract through BEFORE signing it to make sure it all hangs together – and to spot those mistakes that you have been glossing over because you thought you knew what it said! In particular, look out for:

- Terms that are defined inconsistently as between the main body of the document and the schedules – or have capital letters but are not defined at all. We like to make sure that all the defined terms are collected together in one place, even if that then cross-refers to somewhere else in the document where a term is actually defined.
- Other contradictions between different parts of the document that may have been negotiated in different streams. How often it happens that one team has set out its definitive view of what the services are in one schedule, only to have that undermined by a "get out" provision elsewhere...

A totally watertight agreement is impossible to guarantee, but the application of common sense and treating the contract as the definitive record of the deal can go a long way to avoiding later disputes and litigation.

For further information or for advice on your contracts (or contact disputes), please contact us:

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ⁱ *Chartbrook Limited v Persimmon Homes Limited and others [2009] UKHL 38*