

## Contract construction after Chartbrook

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**With contracts being of vital importance to businesses, this article examines what lawyers need to consider in the construction of contracts.**

Thousands of contracts are made every day and having a clear understanding of what they mean is vital to commercial life. The House of Lords put its latest gloss on contract construction in *Chartbrook v Persimmon*. The leading speech was given by Lord Hoffmann following a long line of decisions he has given on contractual interpretation.

The speech of Lord Hoffmann in *Chartbrook* needs to be seen in the context of the basic principles of contract construction. These can be conveniently summarised as follows:

Firstly, the aim of the exercise is to ascertain the meaning of the relevant contractual language in the context of the document and against the background to the document. The object of the enquiry is not necessarily to probe the 'real' intention of the parties, but to ascertain what the language they used in the document would signify to a properly informed observer.

Secondly, the interpretative exercise must not be done in a vacuum, but in the context of the admissible background material. Lord Hoffmann had explained in the earlier case of *ICS v West Bromwich* what was admissible background material. He said:

"The meaning which a document... would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words of syntax ..."

In *BCCI v Ali* Lord Hoffmann had explained the above words:

'But the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage: "we do not easily accept that people have made linguistic mistakes, particularly in formal documents". I was certainly not encouraging a trawl through "background" which could not have made a reasonable person think that the parties must have departed from conventional usage.'

Thirdly, evidence of negotiations and subjective intent are not admissible for the purposes of the construction exercise.

Fourthly, a commercial document must be interpreted so as to make business common sense in its context. But if a 'detailed semantic and syntactical analysis of a word in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense'. (See *Antaios Compania Naviera SA v Salen Rederierna AB per Lord Diplock*).

Those closing words by Lord Diplock in *Antaios* had been considered by Hoffmann LJ (as he then was) himself in *Co-Operative Wholesale Society Ltd v National Westminster Bank plc* where having just quoted the passage above by Lord Diplock, he said: "This robust declaration does not, however, mean that one can rewrite the language which the parties have used in order to make the contract conform to business common sense.'



One might have thought that words can, therefore, be interpreted but not rewritten, Lord Hoffmann was, at the very least, to develop his thinking on this point.

In *Chartbrook* a developer agreed to pay his seller a price which was adjustable dependent on the outcome of the sales of the complete units in the estate. The price was to be made up of a land price plus an additional payment. The way in which the additional payment was defined gave rise to all the difficulties. The wording was:

'23.4 per cent of the price achieved for each residential unit in excess of the Minimum Guaranteed Residential Unit Value (i.e. the land value per flat) less the Costs and Incentives (i.e. discounts given to purchasers).'

Read one way, the payment could have been £4,485,000. The alternative reading produced £897,000.

Based on the natural syntax of the working, one deducts both the land value and the costs and incentives from the sale price achieved. The amount to be paid is 23.4 per cent of the resulting figure. This produced the figure in excess of £4million claimed by the sellers.

The developer argued that one should look at the net sale price which is the aggregate of the sale prices achieved less the costs and incentives. Of this net sale price, 23.4 per cent is the land value actually achieved. From this should be deducted the land value per flat originally assessed. This balance is the sum payable to the seller. The figure was £897,000.

The argument was raised that the pre-contract negotiations would make clear what was intended. The House of Lords upheld the longstanding principle that negotiations themselves are inadmissible – not because there is some inhibition to do so but because they are usually irrelevant. To hear evidence on pre-contract negotiations will throw into doubt the agreed wording adopted by the parties in the final document. However, although the negotiations are normally inadmissible they may, in exceptional cases, be admitted to give effect to what a reasonable man in the position of the parties would have taken them to have meant. This is in accordance with the first principle discussed above.

Lord Hoffmann said in *Chartbrook* that there is no limit to the amount of 'red ink or verbal rearrangement or correction'. With respect that was not the commonly held view prior to *Chartbrook*, as reflected by Hoffmann LJ's own judgement in *Co-Operative Wholesale*. The law for supplementing or supplying words, prior to *Chartbrook*, was accurately summarised in *Chitty on Contracts*.

'In principle, the court will not interpolate words into a written instrument, of whatever nature, unless it is clear both that words have been omitted and what those words were... In more complex cases concerning

commercial contracts the courts have gone further and supplied such words as were required to make commercial sense of the agreements.'

The ability to interpolate words was thought not to be an unfettered right as demonstrated by Neuberger LJ (as he then was) in the Court of Appeal in *Somerfield v Skanska*.<sup>1</sup>

'... the interpretation of the provision in the commercial contract is not to be assessed purely by reference to the words the parties have used within the four corners of the contract but must be construed also by reference to the factual circumstance of commercial common sense. However, it seems to me right to emphasise that the surrounding circumstances and commercial common sense do not represent a licence to the court to re-write a contract merely because its terms seem somewhat unexpected, a little unreasonable, or not commercially very wise. The contract will contain the words the parties have chosen to use in order to identify their contractual rights and obligations ... Particularly in these circumstances, it seems to me that the court must be careful before departing from the natural meaning of the provision in the contract merely because it may conflict with its notions of commercial common sense of what the parties may, must or should have thought or intended. Judges are not always the most commercially-minded, let alone the most commercially experienced, of people and should, I think, avoid arrogating to themselves overconfidently the role of arbiter of commercial reasonableness or likelihood. Of course, in many cases, the commercial common sense of a particular interpretation either because of the peculiar circumstance of the case or because of more general considerations, is clear. Furthermore, sometimes it is plainly justified to depart from the primary meaning of words and given them what might, on the face of it, appear to be a strained meaning, for instance where the primary meaning, of the words leads to a plainly ridiculous or unreasonable result.'

The insertion of words, or the so-called common law rectification, had in practice, been very circumscribed pre-*Chartbrook*. All of the reported cases prior to *Chartbrook*, had fallen into one or more of the following categories; plainly the wrong word had been used; there had been a failure to copy type a word or phrase from a standard clause; or a typist had not followed the earlier draft.

In each case the stricture, identified by Lord Bingham of Cornhill in *The Starsin* that 'I take it to be clear in principle that the court should not interpolate words into a written instrument, of whatever nature, unless it is clear both that words have been omitted and what those words were' had been satisfied. In the decided cases pre-*Chartbrook* the clauses made no grammatical sense as they stood and the missing words were either

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<sup>1</sup> [2006] EWCA Civ 1732.

plainly obvious or could be identified from either a standard clause or an earlier draft. This is all perfectly sensible and logical and accords with what the properly informed observer must have appreciated. The court is using ‘common law rectification’ to alter the meaning of a document so as to accord with that judge’s view of commercial reality.

The reasoning for the House in *Chartbrook* was based on an analysis of how the price formula was reached: there was an initial land price and a balancing payment. It followed that the balancing payment should not include the basic land price. The formula should therefore be applied so as to address the surplus over the basic land payment. On the facts of *Chartbrook* no doubt the correct decision was reached but the difficulty recognised by Neuberger in *Somerfield* is that many judges may not be the best judge of commercial reality. Lord Hoffmann himself recognised this problem: ‘It is, I am afraid, not unusual that an interpretation which does not strike one person as sufficiently irrational to justify a conclusion that there has been a linguistic mistake will seem commercially absurd to another ...’

An example of an ‘error’ in construction was *The Starsin* where Lord Hoffmann (again) held that where the Court of Appeal ‘went wrong is that they conscientiously set about trying, as lawyers naturally would, to construe the bill of lading as a whole’.

Whatever the result between the parties in *Chartbrook*, the legacy is that lawyers must assess words and phrases and advise clients on degrees of absurdity and irrationality: is it sufficiently nonsensical so as to cross the line to absurd or irrational then permitting the interpolation of words so as to accord with commercial reality? That creates uncertainty in advice and hence in the business community. Contractual construction therefore joins the law on the assessment of damages when conventional orthodoxy was cast aside in favour of the overriding compensatory principle in *The Golden Victory*. As Lord Bingham said in his dissenting speech in the case: ‘The importance of certainty and predictability in commercial transactions had been a constant theme of English commercial law at any rate since the judgement of Lord Mansfield CJ in *Vallejo v Wheeler* (1774) ...’

We are now in an era where certainty and predictability have all but gone and although there will be clear cases, at the margins there will simply be doubt and that cannot be good for commerce.

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