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Without prejudice interpretation – with prejudice negotiations[1]

Abstract

It is well known that the rule that disallows extrinsic evidence to contradict, vary, add or subtract from the terms of a written contract cannot be taken at face value. Evidence may be given of the surrounding facts, the factual matrix, to explain the meaning of the written contract. This may include facts imparted by one party to another. Therefore, judges have to draw a difficult distinction between admissible material which forms part of the pre-contractual negotiations and material which forms part of the pre-contractual negotiations but which is not part of the factual matrix and is not therefore admissible for interpretation. In effect, any part of pre-contract negotiations which a reasonable bystander would regard as relevant to understanding the contract would be admissible for the purpose of interpretation. The recent UK Supreme Court decision in Oceanbulk Shipping and Trading SA v TMT Asia Ltd [2010] UKSC 44, [2010] 4 All ER 101 held that a written contract resulting from "without prejudice" negotiations may be interpreted in the same way. This means that anything said during settlement discussions is admissible for the purpose of interpretation provided it is within the permissible factual matrix. It follows that settlement negotiations are now "without prejudice except for interpretation", with the result that parties have to be much more careful about what they say in the course of settlement discussions.

For a long time the law of contract has grappled, not altogether successfully, with the tension between intention and meaning. Contracts are voluntarily undertaken obligations. Therefore, a person is contractually bound only by those obligations he intended to assume and none other. But how do we know what a person intends? We cannot see into the minds of others. We cannot therefore know what others intend to promise except by what they say. But, as the Latin proverb goes, *verba volant scripta manent* (words fly away, writings remain). To avoid the ephemeral nature of the spoken word, the uncertainty of oral communications, people write down their agreements so that their rights and duties would be governed by the written word. The written word encapsulates what was intended. And this is due not to a special legal principle but to the fact that both parties intended to be bound by the written agreement. For why else would they have taken the trouble of recording their agreement in writing?

Since, as a matter of fact, a written contract is intended to be the source of the parties' rights and obligations, there is a rule of law that renders it impermissible to adduce evidence of statements made in the course of contract negotiations in order to change the meaning of the contract; or, put differently, in order to determine the meaning of the contract. A party is not allowed to adduce evidence of what was said during the negotiations to show that the

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intention was different from what the written contract because this will defeat the purpose of a written contract, which is to encapsulate the intended agreement.

However, the rule that "[e]xtrinsic evidence ... does not usurp the authority of the written document or contradict, vary, add to or subtract from its terms" (Chitty on Contracts, 30th ed, 12-117) comes against the indeterminacy of language. "In all fields of experience," HLA Hart wrote, "not only that of rules, there is a limit, inherent in the nature of language, to the guidance which general language can provide. There will indeed be plain cases constantly recurring in similar contexts to which general expressions are clearly applicable ... but there will also be cases where it is not clear whether they apply or not" (The Concept of Law, 2nd ed, 1994, 126). Words do not have fixed meaning for all time and in all circumstances. What is often referred to as dictionary meaning is nothing but a range of meanings (not infrequently large) in which a particular word can be used. The simple word "home" may be used in a large number of senses, ranging from "habitual abode" through "one's own country" to "the den or base in a game" (according to the Chambers 20th Century Dictionary). The meaning of many words is highly context sensitive.

The rule that disallows extrinsic evidence to contradict, vary, add or subtract from the terms of a written contract cannot therefore be taken at face value, for how are we to know what the terms of the written contract mean unless we look beyond the written words? No sooner was the inadmissibility rule formulated than it was also cut down by holding extrinsic evidence to be admissible where the meaning of the written words was doubtful or where difficulty arose in applying the words to an unforeseen situation. But even this relaxation proved too restrictive, because whether the meaning is doubtful may well be context dependent. The sentence "I am going home", for example, would be rendered ambiguous if we are told that the person who uttered it was at his usual abode at the time.

For this reason it has come to be accepted that no "contracts are made in a vacuum; there is always a setting in which they have to be placed" (*Reardon Smith Line Ltd v Yngvar Hansen-Tangen*,[1976] 1 WLR 989, 995, Lord Wilberforce). It has therefore been accepted that evidence may be given of the surrounding facts, the factual matrix, to explain the meaning of the written contract. "The starting point is that language in all legal texts conveys meaning according to the circumstances in which it was used. It follows that the context must always be identified and considered before the process of construction or during it. It is therefore wrong to say that the court may only resort to evidence of the contextual scene when an ambiguity has arisen." (*R (Westminster City Council) v National Asylum Support Service* [2002] UKHL 38, [2002] 1 WLR 2956, Lord Steyn).

At the same time, however, the inadmissibility rule remains: it is inadmissible to adduce evidence of what was said or done during the course of negotiating for a contract for the purpose of drawing inferences about what the contract meant (*Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, [2009] 1 A.C. 1101. See also *Pratt v Aigaion Insurance Co SA* [2008] EWCA Civ 1314, [2009] 1 Lloyds Rep. 225 at [9]; *ING Lease (UK) Ltd v Harwood* [2007] EWHC 2292 (QB), [2008] Bus. L.R. 762).

A distinction must therefore be drawn, between what is in the factual matrix and what is outside it. This is far from straightforward because a relevant fact may be one communicated by a party to another. In approaching this distinction one has to bear in mind a further principle: that the words of the contract (whether spoken or written) must be given the meaning that "a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the

contract to mean" (*Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, [2009] AC 1101, [14], Lord Hoffmann). As Lord Clarke put it recently in *Oceanbulk Shipping and Trading SA v TMT Asia Ltd* [2010] UKSC 44, [2010] 4 All ER 1011, [39], which forms the subject matter of this commentary, judges "have to distinguish between material which forms part of the pre-contractual negotiations which is part of the factual matrix and therefore admissible as an aid to interpretation and material which forms part of the pre-contractual negotiations but which is not part of the factual matrix and is not therefore admissible".

What falls within the permissible use of pre-contract negotiations depends on what a reasonable person would consider as relevant background knowledge that was available to the parties. We know, of course, that only relevant evidence is admissible in legal proceedings (civil or criminal). The concession that the relevant factual matrix is admissible in the interpretation of written contracts comes as near as may be to saying that anything that a reasonable bystander would regard as relevant would be admissible. A reasonable bystander who has to interpret a contract may well consider much of what was said by the parties to each other during pre-contract negotiations relevant to the interpretation of the contract. He may well consider the parties' statements of fact, of understanding and intention part the factual matrix against which the contract should be understood.

With this in mind we can now approach *Oceanbulk Shipping and Trading SA v TMT Asia Ltd* [2010] UKSC 44, [2010] 4 All ER 101. The issue was whether statements of fact made during without prejudice negotiations which lead to a settlement agreement were admissible to construe the agreement. The without prejudice rule provides that statements made by parties to a dispute during settlement negotiations are inadmissible in evidence. The reason for this rule is rooted in the public policy of encouraging parties to settle their disputes without litigation. To settle, the parties must first negotiate. Were statements made during negotiations admissible in evidence, parties would be reluctant to speak freely for fear that anything said may be later used as evidence against them. This would in turn stifle negotiations and obstruct settlement. The without prejudice rule frees parties of such fear and thereby encourages settlement (*Cutts v Head* [1984] Ch. 290 at 306, [1984] 1 All E.R. 597 at 605–606, Oliver L.J). In *Rush & Tompkins Ltd v Greater London Council* [1989] A.C. 1280 at 1299, [1988] 3 All E.R. 737 at 739–740, HL, Lord Griffiths said that "the 'without prejudice rule' is a rule governing the admissibility of evidence and is founded on the public policy of encouraging litigants to settle their differences rather than litigate them to a finish.... The rule applies to exclude all negotiations genuinely aimed at settlement whether oral or in writing from being given in evidence".

The importance of a safe channel of inter-party communications as a vehicle for settlement cannot be exaggerated. The prospects of settlement are increased by the availability of a secure zone for negotiations, in which the adversaries can feel free to exchange information, appraise each other of their constraints and their objective, and discuss possible compromises without fear that what they say may be used later to their disadvantage. Accordingly, a court called upon to decide the scope of protection afforded by the rule must bear in mind the strength of the policy of encouraging settlement; especially as this policy is now part of the overriding objective (CPR 1.4(2)(e) and (f)).

It must be stressed that once parties have agreed to enter "without prejudice" negotiations, their communications are protected on further grounds, and not just by public policy considerations. Without prejudice discussions are also protected by convention. For parties to such discussions proceed on a mutually shared assumption that what they say would not be later admissible in evidence and that therefore they would not be prejudiced by what has

passed during their negotiations. In other words, the parties agree to a self-imposed ban on evidential use of their communications. As Jacob L.J. observed, "parties who have negotiated on a wholly 'without prejudice' basis have always done so in the faith and expectation that what they say cannot be used against them even on the question of costs." (*Reed Executive Plc v Reed Business Information Ltd* [2004] EWCA Civ 887, [2004] 4 All E.R. 942, [21].) A party to without prejudice negotiations is therefore bound by agreement to refrain from adducing in evidence without prejudice material.

In *Oceanbulk* the Supreme Court focused not on the convention basis of the rule but on its public policy foundation. Its understanding of the rule was, however, rather narrow. It said that "in general the rule makes inadmissible in any subsequent litigation connected with the same subject matter proof of any admissions made with a genuine intention to reach a settlement and that admissions made to reach a settlement with a different party within the same litigation are also inadmissible, whether or not settlement is reached with that party" ([21]).

There are two questionable aspects to this account of the rule. First, the inadmissibility cannot be said to be limited to subsequent proceedings connected with the same subject matter. Second, the rule cannot be said to be confined only to proof of admissions. To facilitate free exchange between adversaries the rule must free them of the fear that what they say may be used in other proceedings to their prejudice, whether such proceedings are related to the same subject matter or not. Further, parties also need to be free of fear that without prejudice communications would be later used to their prejudice regardless of whether they are adduced as evidence of an admission. For this reason, it is suggested, the rule is not just a rule of inadmissibility but also a rule that provides immunity from disclosure of without prejudice negotiations to non-parties, where such negotiations would otherwise be relevant and disclosable under the ordinary disclosure rules. However, it is unnecessary to dwell here on these matters since the above dictum was peripheral to the issue in the case.

On the issue of the admissibility of statements made in without prejudice negotiations the Supreme Court noted that the general principle was subject to several exception. The most pertinent to the issue before the court was the exception that permits without prejudice communications to be adduced in evidence in order to prove that the negotiations resulted in an agreement. The Supreme Court held that "[n]o sensible line can be drawn between admitting without prejudice communications in order to resolve the issue of whether they have resulted in a concluded compromise agreement and admitting them in order to resolve the issue of what that agreement was" ([33]).

Issue may, however, be taken with this reasoning. It is true that without prejudice negotiations may be used to establish that the negotiations resulted in an agreement. Where the existence of the agreement is in issue, then, clearly, there is no difference between showing the existence of the agreement and its contents. After all an empty agreement is no agreement at all. But it is quite different where, as in *Oceanbulk*, there was no issue as to the existence or terms of the settlement agreement, and it was accepted that all the terms of the agreement were accurately recorded in the written settlement agreement. On the contrary, there was a carefully considered written agreement and therefore there was no need to break the without prejudice restrictions in order to secure the fruits of the without prejudice negotiations by proving an agreement.

Perhaps conscious of the weakness of relying on the exception of proving a concluded agreement the Supreme Court provided a further justification. Lord Clarke stated ([40]):

> "... I see no reason why the ordinary principles governing the interpretation of a settlement agreement should be any different regardless of whether the negotiations which led to it were without prejudice. The language should be construed in the same way ..., namely what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean. That background knowledge may well include objective facts communicated by one party to the other in the course of the negotiations. As I see it, the process of interpretation should in principle be the same, whether the negotiations were without prejudice or not. In both cases the evidence is admitted in order to enable the court to make an objective assessment of the parties' intentions."

The Supreme Court reasoned that since an agreement arising from settlement negotiations is a contract, and since a contract can be properly understood only in its particular context, and since the context is provided by the settlement negotiations, it follows that statements made in these negotiations are relevant to the interpretation of the contract and must therefore be admissible to the same extent that they would if the negotiations were open.

Undoubtedly, this reasoning explains the relevance of the without prejudice negotiations to the interpretation of the contract. But relevance is not enough to overcome the without prejudice rule, which excludes even relevant evidence in order to promote settlement. In order to overcome the public policy objection to the use of without prejudice negotiations for construction purposes the Supreme Court had to provide a different explanation. To this end Lord Clarke said that "if a party to negotiations knows that, in the event of a dispute about what a settlement contract means, objective facts which emerge during negotiations will be admitted in order to assist the court to interpret the agreement in accordance with the parties' true intentions, settlement is likely to be encouraged not discouraged" ([41]).

The Supreme Court reasoned therefore that by allowing without prejudice statements to be used for construction purposes the law promotes the public policy of encouraging settlement rather than obstructs it. If this assumption is right, then the supreme ruling has provided an ideal, and not just an optimal, solution: a ruling that encourages free exchange during settlement negotiations and, furthermore, promotes faithful interpretation of any ensuing settlement agreements.

It is, however, difficult to assess the Supreme Court's projection about the likely effect of is ruling on settlement negotiations. On the one hand, it is undoubtedly the case that parties to agreements, including settlement agreements, expect them to be interpreted in accordance with their true intentions. But when a dispute arises about the meaning of an agreement the parties are divided not about whether the agreement should be interpreted in accordance with their respective intentions, but about the interpretation of their shared intention. In the law of contract, it is the shared intention that counts not the parties' individual aims or aspirations.

In *Oceanbulk*, the parties were represented by their agents and by their lawyers. They took care to define their mutual rights and obligations in a written document. The settlement agreement was therefore the embodiment of their shared intention. As the Supreme Court was at pains to point out, "[i]t is common ground that all the terms of the agreement between them are accurately recorded in the written settlement agreement. For that reason neither party seeks rectification of it". ([6]) Since it is now permissible to examine the negotiations to be able to interpret the agreement, it means that we can look beyond what the parties regarded as the embodiment of their intention. In principle, there nothing wrong with this because, as already noted, meaning is contextual and the context in this case if provided by the settlement negotiations. But it does mean that what is said in the negotiations could affect the rights and

obligations of the parties just as much as the written agreement, which goes against the grain of the without prejudice rule and its supporting public policy.

In theory, the public policy of encouraging free exchange between the parties cannot be undermined by a rule that allows an interpretation in accordance with the parties' shared intentions. But in practice negotiating parties must now take great care in what they say during the negotiations, for the rights arising out of the ensuing agreement may well be shaped by things said during the negotiations. It therefore follows that the parties cannot be as tongue free as the public policy behind the without prejudice rule would like to encourage. For this reason it unclear whether the present ruling promotes the public policy of encouraging free negotiations.

There is one aspect of the without prejudice rule that seems to have received scant attention in *Oceanbulk*. It concerns the probative relevance of statements made in without prejudice negotiations. Statements made in the course of settlement negotiations are normally made for the purpose of reaching an accommodation and not for the purpose of asserting factual truths (J.H. Wigmore, *Evidence* (Chadbourn rev edn, 1976), vol.4, para.1061; Vaver, "Without Prejudice Communications—Their Admissibility and Effect" (1974) 9 UBC LR 85 at 101). For this reason, little probative weight can be attached to the fact that a defendant has said "I accept that half the goods supplied were defective". Such statement may merely reflect the defendant's economic judgment about the value of a settlement, not necessarily his belief about the correct quantity of defective goods. A settlement, Pill L.J. explained in *Gnitrow Ltd v Cape Plc* [2000] 3 All E.R. 763, [2000] 1 W.L.R. 2327, may have been reached for commercial reasons, perhaps in order to put to rest a whole class of potential cases, or in order to save the costs of litigation or for other similar reasons.

Since settlement statements are influenced by such considerations, assertions concerning facts in issue are normally denuded of probative value; they are not relevant as admissions of fact. In the above example, it is impossible to infer from the defendant's statement that half the goods were in fact defective. It follows that by its very nature, the without prejudice rule strips settlement statements of probative use for the purpose of inferring facts from without prejudice statements. If so, the following question inevitably arises. Given that only objective facts which emerge during negotiations are admissible in aid of interpretation, how can they be provided by statements made without prejudice which in their nature lack probative value? As we have seen, when interpreting a contract we must ask what a reasonable person having all the background knowledge which would have been available to the parties would have understood the agreement to mean. But how can a reasonable person infer any objective facts from relevance-free statements?

To appreciate the significance of this question it is necessary to take a closer look at the facts of *Oceanbulk*. The dispute related to forward freight agreements ("FFAs"). A FFA is a swap agreement which consisted of a bet on whether the settlement rate (being the average of the published rates, as stated in the relevant index) would, on specified future date, be higher or lower than the contract rate as defined in the FFA. Under a FFA the seller bets that the market rate on the settlement dates would be lower than the contract rate and the buyer bets that it would be higher. If it was higher on a given settlement day, the seller would be obliged to pay the difference between the two rates multiplied by the contract period. If it was lower the buyer would be obliged to pay the seller the appropriate amount.

In 2008 there was extraordinary volatility of the freight markets. The Baltic Exchange index of daily rates of time charter hire fell from about US$200,000 per day in May 2008 to

US$3,000 per day in December 2008. The relevant FFAs had settlement days during that period. At the end of May 2008 the appellants, TMT, were short against the market and owed the respondent (Oceanbulk) more than US$40m and were likely to owe a further US$30m for the following month. If Oceanbulk had terminated the FFAs on the basis of an event of default, TMT would have been potentially liable for some US$300 to 400m by way of liquidated damages. TMT failed to pay and sought time for payment. The parties entered into settlement negotiations, conducted by the parties' representatives and their solicitors. The parties entered into a written settlement agreement. They agreed (a) to crystallise 50 per cent of each of the FFAs for 2008 based on the difference between the contract rate and the average of the ten day closing prices for the relevant Baltic indices from 26 June 2008; and (b) to co-operate to close out the 50 per cent balance of the open 2008 FFAs against the market on the best terms achievable by 15 August 2008.

A dispute arose about the meaning of clause (b) above. Oceanbulk alleged that TMT was in breach of (b), the co-operation term, because it did not co-operate to close out the balance of 50 per cent of the open FFAs for 2008 against the market on the best terms achievable by 15 August ([8]). Oceanbulk therefore claimed the difference between the sums that would have been owed by TMT had the FFAs been closed out by 15 August, when the market was still in Oceanbulk's favour, and the amount that is due to TMT under the FFAs as a result of those positions having remained open. Oceanbulk's argued that, on the true construction of the co-operation term, the parties' obligation was to close out the open FFAs between Oceanbulk and TMT.

TMT's case is that the meaning of the co-operation term depended upon a fact which was in the contemplation of both parties: that the FFAs between Oceanbulk and TMT were to be "sleeved" by Oceanbulk. Sleeving is an arrangement by which one party (party B) will, at the request of another party (party A), enter into a specific FFA trade with a third party (party C) and party B will then replicate that position back-to-back with party A. The usual reasons for such an arrangement are that (i) party C would not be willing to trade with party A (eg because of perceived counterparty risk) and/or (ii) party A does not wish to reveal to the market that he is seeking that position, eg because he is concerned that he will move the market.

TMT argued that, in the context of the relevant negotiations, the words "co-operate to close out … against the market" meant that TMT would (if Oceanbulk so requested) assist Oceanbulk to agree fixed figures payable by Oceanbulk to counterparties to close out Oceanbulk's "opposite market positions"; that Oceanbulk would then close out those positions; and that thereafter the FFAs between Oceanbulk and TMT " would be crystallised at rates to be agreed." There was therefore a dispute as to whether the "closing out" process envisaged by the co-operation term was bilateral (on Oceanbulk's case) or trilateral (on TMT's case).

In support of its case TMT relied upon four representations made by Oceanbulk during the negotiations. Some were open communications and admissible in evidence on the issue of construction as part of the factual matrix. But some were without prejudice. The issue in the Supreme Court concerned the admissibility of the without prejudice statements.

The trial judge was of the view that the disputed evidence was "potentially of significant probative value and might possibly be crucial upon an issue of construction that is central to these proceedings" ([13]). There were two without prejudice statement to which the judge attached potential probative value: (i) an email from Oceanbulk to TMT in which the former

said that Oceanbulk had to pay US$40.5m on TMT's behalf against zero receipts; (ii) at two meetings Oceanbulk asserted (or allowed the negotiations to proceed on the assumption) that the FFAs were sleeved.

These statements may be relevant in one of two ways. First, they may be taken to prove that Oceanbulk did pay US$40.5m on TMT's behalf and that the FFAs were in fact sleeved. However, this reasoning process is foreclosed by the fact that without prejudice statements lack probative value in the sense that they cannot be used as tending to prove the truth of facts asserted, for the reasons just elaborated. Indeed, there is nothing in the Supreme Court's decision that says that without prejudice statements may be relied on as admissions.

There is, however, another route to relevance. Whether or not true, the statements may be taken as representations which formed the assumption upon which the parties proceeded in making their agreement. There are two recognised established exceptions that are relevant here. First, evidence of without prejudice statements is admissible to show that the agreement was procured by misrepresentation, fraud or undue influence (*Oceanbulk* [32]). Second, evidence of without prejudice statement is admissible to show that a party made a statement to the other with the intention that the other would act on it and the latter did in fact so. Such a statement may give rise to an estoppel notwithstanding that it was made under the cover of without prejudice.

No allegation of fraud or misrepresentation was made by TMT in this case, but they did plead the estoppel ground. They alleged that Oceanbulk were stopped from denying that the swap agreements were sleeved and from denying that the parties proceeded on the shared assumption that they were so sleeved. To sustain this allegation TMT would, however, have to prove that Oceanbulk made the representations above mentioned with the intention that TMT would rely on it. However, in advancing the estoppel argument TMT would have to overcome the obvious objection that if the intention was that the FFAs would be sleeved, one would have expected an express stipulation in their settlement agreement; in the drafting of which the parties and their lawyers took so much trouble. They would have to explain why they used the ambiguous expression "co-operate" when they could have made their intention clear by using the term of art appropriate to their intentions: "sleeved". Be that as it may, if all that TMT wished to allege was estoppel, there was no need for the Supreme Court to create a new exception to the without prejudice rule.

This exception now states that the ordinary principles governing the interpretation of contract would operate in the same way in relation to settlement agreement following without prejudice negotiations. The language of such agreements should receive the meaning that a reasonable person having all the background knowledge which would have been available to the parties would have given. That background knowledge may include objective facts communicated by one party to the other in the course of the without prejudice negotiations. In practice, this greatly extends the use to which without prejudice statements may now be put.

Several consequences may follow from this weakening of the without prejudice protection. It is possible that negotiating parties would be more circumspect and careful in their exchanges now that they can no longer be sure that what they say would not be used to their disadvantage later on. It is also possible that the more sophisticated negotiators would seek to limit their exposure to later use of their negotiating postures by entering into an express collateral agreement that nothing said during the negotiations would be admissible for the purpose of interpretation, thus re-establishing the without prejudice protection they always enjoyed. Such agreement will not affect the public interest exceptions, such as those

concerning fraud and misrepresentation, impropriety and estoppel. But it would ensure that settlement agreements have to be interpreted without reference to what was said without prejudice.

While these possible consequences are somewhat conjectural, we can fairly confidently expect an increase in the use of without prejudice statements and much argument about the scope of the Supreme Court's ruling. For quite apart from the without prejudice rule the extent to which pre-contract negotiations may be used to interpret a contract is unclear. They may not be used to vary, add or subtract from the written contract, only to clarify its meaning. But, as we have seen, we do not know whether a particular interpretation varies the contract unless we know that it says in the first place. It follows that the permissible use of pre-contract negotiations for the purpose of interpretation is fairly wide open. By importing this permissible use into without prejudice negotiations the Supreme Court in *Oceanbulk* has widened the hitherto understood admissibility of without prejudice statements.

From now on, settlement negotiations are without prejudice except for the purpose of interpretation. To the well established category of *"without prejudice except as to costs",* the Supreme Court has added a new qualified without prejudice category *"without prejudice except as to interpretation"*. But there is an important difference between the two. The former will apply only where a party has expressly stated that a communication is without prejudice except as to costs. The latter will apply automatically, unless the parties expressly stipulated that their without prejudice negotiations would be inadmissible even for the purpose in interpretation.