Michaelmas Term
[2010] UKSC 44
On appeal from: 2010 EWCA Civ 79

JUDGMENT

Oceanbulk Shipping & Trading SA (Respondent) *v* TMT Asia Limited and others (Appellants)

before

Lord Phillips, President
Lord Rodger
Lord Walker
Lord Brown
Lord Mance
Lord Clarke
Sir John Dyson SCJ

JUDGMENT GIVEN ON

27 October 2010

Heard on 14 and 15 July 2010

Appellant
Jonathan Crow QC
James Leabeater
(Instructed by Ince & Co)

Respondent
Alistair Schaff QC
James Willan
(Instructed by Berwin Leighton Paisner LLP)

LORD CLARKE (with whom Lord Rodger, Lord Walker, Lord Brown, Lord Mance and Sir John Dyson agree)

Introduction

1. This appeal raises a question as to the scope of the exceptions to the principle that statements made in the course of without prejudice negotiations are not admissible in evidence ("the without prejudice rule"). Specifically, the question is whether facts which (a) are communicated between the parties in the course of without prejudice negotiations and (b) would, but for the without prejudice rule, be admissible as part of the factual matrix or surrounding circumstances as an aid to construction of an agreement which results from the negotiations, should be admissible by way of exception to the without prejudice rule.

2. The dispute between the parties relates to a series of forward freight agreements ("FFAs") and is set against the background of the extraordinary volatility of the freight markets in 2008. Capesize bulk carriers are large vessels, so called because they were historically too large to pass through the Suez Canal. The Baltic Exchange index of daily rates of time charter hire for such vessels fell from about US$200,000 per day in May 2008 to US$3,000 per day in December 2008. Each FFA was 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, for each index publication day in the relevant settlement month) would, on specified future settlement dates, be higher or lower than the contract rate as defined in the FFA.

3. Under each FFA the seller bet that the market rate on the settlement dates would be lower than the contract rate and the buyer bet that it would be higher. If it was higher on a given settlement day, the seller was obliged to pay the difference between the two rates multiplied by the contract period, which was usually the number of days in the month. If it was lower the buyer was obliged to pay the seller the appropriate amount. The relevant FFAs had settlement days at the end of one or more months within the period May to December 2008. At the end of each month all settlement sums due under all the FFAs were to be netted off and payment made by the indebted party under the net position to the other party. (I use the word "bet" because it was used by the parties in the agreed statement of facts and issues and because it appears to me to be accurate, but in doing so I do not intend to suggest that the FFAs were unenforceable or that FFAs are not a commonly used method of hedging against market fluctuations.)

4. All the FFAs were on the same underlying terms. As at the end of May 2008 the appellants, whom I will together call "TMT", were short against the market and, as a result of the netting off process, owed the respondent ("Oceanbulk") more than US$40m for that month 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.

5. TMT failed to pay the May 2008 instalment when it fell due and sought time for payment. The parties entered into settlement negotiations which were expressed to be "without prejudice". They were between the parties' representatives and solicitors. The negotiations were partly in writing but included two lengthy meetings on 19 and 20 June 2008 which were attended both by the parties' representatives and their solicitors. The parties entered into a written settlement agreement dated 20 June, in which they agreed (among other things): (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.

6. There is no issue between the parties as to the existence or terms of the settlement agreement. It 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. There is however a dispute between the parties as to the true construction of one of the terms of the agreement. The issue which divides the parties in this appeal is whether it is permissible to refer to anything written or said in the course of the without prejudice negotiations as an aid to the interpretation of the agreement.

The issues

Construction of the settlement agreement

7. Oceanbulk's claim is based on the alleged breach by TMT of clause 5 of the agreement, which provides as follows:

> "In respect of FFA open contracts between TMT interests and [Oceanbulk] for 2008, the parties shall crystallise within the ten trading days following 26 June 2008, as between them, 50 per cent of those FFAs at the average of the ten days' closing prices for the

> relevant Baltic Indices from 26 June 2008 and will 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 2008."

8. The parties crystallised 50 per cent of the contracts within ten days following 26 June. There is accordingly no dispute about that part of the clause. However, Oceanbulk says that TMT is in breach of the second part of the clause ("the co-operation term") on the basis that, so it is said, TMT 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". By way of damages Oceanbulk claims the difference between the sums it says 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 said to be due to TMT under the FFAs as a result of those positions having remained open. The loss arises (in part at least) out of the dramatic fall in the market to which I have referred.

9. Oceanbulk's case is that, on the true construction of the co-operation term, the parties' obligation was to close out the open FFAs bilaterally, that is as between Oceanbulk and TMT. TMT's case is that the meaning of the term depends upon a fact which it says was in the contemplation of both parties: viz that the FFAs between Oceanbulk and TMT were "sleeved" by Oceanbulk. In para 5 of his judgment Andrew Smith J ("the judge") quoted Oceanbulk's summary of what the parties meant by sleeving, which the parties have agreed is sufficient for the purposes of this appeal. It is in these terms:

> "'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. However, once the contracts have been concluded then (absent eg an agency arrangement), the two contracts are independent and each party acts as a principal: the contracts do not necessarily remain 'coupled'."

10. In para 18(1)(ii) of the re-re-amended defence and counterclaim TMT pleads that, in the context of the relevant negotiations, the words "co-operate to close out … against the market" mean 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." As it is put in the agreed statement of facts and issues, there is 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).

11. The phrase "opposite market position" is defined in para 18(1)(i) of TMT's re-re-amended defence and counterclaim by references to "sleeves". TMT pleads that both parties understood that, in respect of all or substantially all the FFAs between Oceanbulk and TMT, Oceanbulk held an opposite position with other participants in the FFA market – so that the liabilities TMT had to Oceanbulk were "sleeved" by Oceanbulk in that they were equal in amount to liabilities Oceanbulk had to counterparties under equivalent swap agreements.

12. In support of its case that the parties understood that the FFAs were "sleeved", TMT relies upon four representations made or allegedly made by Mr Pappas on behalf of Oceanbulk. They are pleaded in para 18(1)(i) of the re-re-amended defence and counterclaim and are summarised in the agreed statement of facts and issues.

i) In an email dated 1 June 2008 from Mr Pappas to Mr Su of TMT he said that Oceanbulk was expecting US$40.5m from TMT on Friday, 5 June and that "most of this position is in any case due to sleeves we did for you when you asked us in the past to assist". It is common ground that this was an open communication and that it is arguably admissible in evidence on the issue of construction as part of the factual matrix.

ii) TMT says that at a meeting on 5 June Mr Pappas said that he had sleeved TMT's trading at Mr Su's request. It is common ground that this was an open meeting and that, to the extent that any such representation was made, it is arguably admissible in evidence on the same basis.

iii) In an email dated 10 June from Mr Pappas to Mr Su he said that Oceanbulk had to pay US$40.5m on TMT's behalf against zero receipts. The judge held that this email was sent without prejudice and there was no appeal against that finding.

iv) TMT says that at meetings on 19 and 20 June Mr Pappas again asserted (or allowed the negotiations to proceed on the assumption)

> that the FFAs were sleeved. It is common ground that these meetings were without prejudice.

13. The issue between the parties is whether TMT are entitled to rely upon representations or alleged representations iii) and iv) as an aid to interpretation of the agreement. Oceanbulk seeks to exclude the evidence relating to them on the ground that they were made in the course of without prejudice negotiations. The construction of clause 5 will of course be a matter for the trial judge. At para 35 of his judgment the judge expressed the view that the evidence was "potentially of significant probative value and might possibly be crucial upon an issue of construction that is central to these proceedings". By contrast, in the Court of Appeal, Longmore LJ said at para 22 that it was "not entirely easy" to see how the facts relied upon by TMT assisted the construction of clause 5. It is not for this court to express a view on that question in this appeal. For present purposes it is sufficient to note that, at any rate at this interlocutory stage, Oceanbulk does not seek to exclude the evidence simply on the ground that it does not form part of the admissible factual matrix. It follows that it must be assumed for the purpose of this appeal that, subject to the question whether it is excluded by the without prejudice rule, the evidence will be admissible at the trial on the issue of construction of the agreement. Indeed, given the conclusion reached by the judge, it must be assumed that (in the judge's phrase already quoted) the evidence is "potentially of significant probative value and might possibly be crucial upon an issue of construction that is central to these proceedings".

14. The judge held that the evidence was admissible notwithstanding the without prejudice rule. The majority of the Court of Appeal (Longmore and Stanley Burnton LJJ) allowed Oceanbulk's appeal, holding that the evidence was not admissible. Ward LJ agreed with the judge and thus dissented. This appeal is brought with the permission of this court.

Estoppel

15. In para 18(1)(ia) of the re-re-amended defence and counterclaim TMT pleads an estoppel in these terms:

> "In its amended reply and defence to counterclaim Oceanbulk has denied that all the transactions were in fact 'sleeved'. [TMT] will say that for the reasons pleaded in para 18(1)(i) above Oceanbulk is estopped from denying that the swap agreements Oceanbulk had entered into with [TMT] were 'sleeved' transactions; alternatively Oceanbulk is estopped from denying that in negotiating and entering

into the settlement agreement the parties were proceeding on the common assumption that they were 'sleeved' transactions."

16. In support of that plea TMT seeks to rely upon representations iii) and iv). Oceanbulk says that such reliance is excluded by the without prejudice rule.

Remoteness

17. Essentially the same issues arise under this head. In para 27(2)(iii) of the re-re-amended defence and counterclaim TMT denies that Oceanbulk is entitled to recover the loss and damage it asserts because:

> "(1) As pleaded in para 18 above, clause 5 of the settlement agreement was agreed in reliance upon and on the basis of Mr Pappas's representation or representations on behalf of Oceanbulk and the parties understood that the swap agreements between Oceanbulk and [TMT] were 'sleeved' transactions with the Oceanbulk opposite market positions; and
>
> (2) Accordingly, it was or should have been in the parties' reasonable contemplation that closing out the 2008 FFAs left the risk of the market rising and the benefit of the market falling on [TMT] but no risk or benefit on Oceanbulk because Oceanbulk was (until completion of the closing out process) protected by Oceanbulk's opposite market positions; accordingly, the loss which Oceanbulk seeks to claim … is too remote and/or is not loss for which [TMT] had assumed responsibility…"

18. TMT seeks to rely upon representations iii) and iv) in support of the case that Oceanbulk's loss is too remote to be recoverable and/or that it is not a loss for which TMT assumed responsibility. Oceanbulk says that TMT is not entitled to rely upon those representations for the same reasons as stated above, namely that they were made (if at all) in the course of without prejudice negotiations.

Without prejudice – the legal principles

19. The approach to without prejudice negotiations and their effect has undergone significant development over the years. Thus the without prejudice principle, or, as it is usually called, the without prejudice rule, initially focused on the case where the negotiations between two parties were regarded as without

prejudice to the position of each of the parties in the event that the negotiations failed. The essential purpose of the original rule was that, if the negotiations failed and the dispute proceeded, neither party should be able to rely upon admissions made by the other in the course of the negotiations. The underlying rationale of the rule was that the parties would be more likely to speak frankly if nothing they said could subsequently be relied upon and that, as a result, they would be more likely to settle their dispute.

20. Thus in *Walker v Wilsher* (1889) 23 QBD 335 at 337 Lindley LJ asked what was the meaning of the words "without prejudice" in a letter written "without prejudice" and answered the question in this way:

> "I think they mean without prejudice to the position of the writer of the letter if the terms he proposes are not accepted. If the terms proposed in the letter are accepted a complete contract is established, and the letter, although written without prejudice, operates to alter the old state of things and to establish a new one."

21. It is now well settled that the rule is not limited to such a case. This can be seen from a series of decisions in recent years, including most clearly from *Cutts v Head* [1984] Ch 290, *Rush & Tompkins Ltd v Greater London Council* [1989] AC 1280, *Muller v Linsley & Mortimer* [1996] PNLR 74, *Unilever plc v The Procter & Gamble Co* [2000] 1 WLR 2436 and most recently *Ofulue v Bossert* [2009] UKHL 16, [2009] AC 990.

22. In particular, in *Unilever* Robert Walker LJ (with whom Simon Brown LJ and Wilson J agreed) set out the general position with great clarity at pp 2441-2444 and 2448-2449. He first quoted from Lord Griffiths' speech in *Rush & Tompkins*, with which the other members of the appellate committee agreed. *Rush & Tompkins* is important because it shows that the without prejudice rule is not limited to two party situations or to cases where the negotiations do not produce a settlement agreement. It was held 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.

23. The passage quoted by Robert Walker LJ is at p 1299 of the report of *Rush & Tompkins* as follows:

"The 'without prejudice' rule is a rule governing the admissibility of evidence and is founded upon the public policy of encouraging litigants to settle their differences rather than litigate them to a finish. It is nowhere more clearly expressed than in the judgment of Oliver LJ in *Cutts v Head* [at] 306:

> 'That the rule rests, at least in part, upon public policy is clear from many authorities, and the convenient starting point of the inquiry is the nature of the underlying policy. It is that parties should be encouraged so far as possible to settle their disputes without resort to litigation and should not be discouraged by the knowledge that anything that is said in the course of such negotiations (and that includes, of course, as much the failure to reply to an offer as an actual reply) may be used to their prejudice in the course of the proceedings. They should, as it was expressed by Clauson J in *Scott Paper Co v Drayton Paper Works Ltd* (1927) 44 RPC 151, 156, be encouraged fully and frankly to put their cards on the table. ... The public policy justification, in truth, essentially rests on the desirability of preventing statements or offers made in the course of negotiations for settlement being brought before the court of trial as admissions on the question of liability.'
>
> The rule applies to exclude all negotiations genuinely aimed at settlement whether oral or in writing from being given in evidence."

24. Robert Walker LJ observed at p 2442D that, while in that well known passage the rule was recognised as being based at least in part on public policy, its other basis or foundation is in the express or implied agreement of the parties themselves that communications in the course of their negotiations should not be admissible in evidence if, despite their negotiations, a contested hearing ensues. Robert Walker LJ further noted that these two justifications for the rule are referred to in some detail by Hoffmann LJ in *Muller v Linsley & Mortimer*. At pp 2442 and 2443 he quoted two substantial passages from the judgment of Hoffmann LJ in that case which it is not necessary to repeat here because in this appeal the issue is not so much about the scope of the rule as about the extent of the exceptions to it.

25. It is therefore sufficient to quote two paragraphs from the judgment of Robert Walker LJ which show that the rule is not limited to admissions but now

extends much more widely to the content of discussions such as occurred in this case. He said this at pp 2443H-2444C:

> "Without in any way underestimating the need for proper analysis of the rule, I have no doubt that busy practitioners are acting prudently in making the general working assumption that the rule, if not 'sacred' (*Hoghton v Hoghton* (1852) 15 Beav 278, 321), has a wide and compelling effect. That is particularly true where the 'without prejudice' communications in question consist not of letters or other written documents but of wide-ranging unscripted discussions during a meeting which may have lasted several hours.
>
> At a meeting of that sort the discussions between the parties' representatives may contain a mixture of admissions and half-admissions against a party's interest, more or less confident assertions of a party's case, offers, counter-offers, and statements (which might be characterised as threats, or as thinking aloud) about future plans and possibilities. As Simon Brown LJ put it in the course of argument, a threat of infringement proceedings may be deeply embedded in negotiations for a compromise solution. Partial disclosure of the minutes of such a meeting may be, as Leggatt LJ put it in *Muller*, a concept as implausible as the curate's egg (which was good in parts)."

26. Finally, at pp 2448-2449 Robert Walker LJ expressed his conclusions on the cases as follows:

> "[they] make clear that the without prejudice rule is founded partly in public policy and partly in the agreement of the parties. They show that the protection of admissions against interest is the most important practical effect of the rule. But to dissect out identifiable admissions and withhold protection from the rest of without prejudice communications (except for a special reason) would not only create huge practical difficulties but would be contrary to the underlying objective of giving protection to the parties in the words of Lord Griffiths in *Rush & Tompkins* [at p 1300] 'to speak freely about all issues in the litigation both factual and legal when seeking compromise and, for the purpose of establishing a basis of compromise, admitting certain facts'. Parties cannot speak freely at a without prejudice meeting if they must constantly monitor every sentence, with lawyers or patent agents sitting at their shoulders as minders."

27. The without prejudice rule is thus now very much wider than it was historically. Moreover, its importance has been judicially stressed on many occasions, most recently perhaps in *Ofulue*, where the House of Lords identified the two bases of the rule and held that communications in the course of negotiations should not be admissible in evidence. It held that the rule extended to negotiations concerning earlier proceedings involving an issue that was still not resolved and refused, on the ground of legal and practical certainty, to extend the exceptions to the rule so as to limit the protection to identifiable admissions.

28. The speeches of the majority contain a number of references to the importance of the rule which are relied upon on behalf of Oceanbulk. I take some examples. Lord Hope said at para 12:

> "The essence of [the rule] lies in the nature of the protection that is given to parties when they are attempting to negotiate a compromise. It is the ability to speak freely that indicates where the limits of the rule should lie. Far from being mechanistic, the rule is generous in its application. It recognises that unseen dangers may lurk behind things said or written during this period, and it removes the inhibiting effect that this may have in the interests of promoting attempts to achieve a settlement. It is not to be defeated by other considerations of public policy which may emerge later, such as those suggested in this case, that would deny them that protection."

In para 2 Lord Hope had said that where a letter is written without prejudice during negotiations conducted with a view to a compromise, the protection that these words claim will be given to it unless the other party can show that there is a good reason for not doing so.

29. In para 43 Lord Rodger recognised the breadth of the without prejudice rule and rejected the proposed exception. So too did Lord Walker. He said at para 57 that he would not restrict the without prejudice rule unless justice clearly demands it. This seems to me to be entirely consistent with the approach of Lord Griffiths in *Rush & Tompkins* at p 1300C, where he said that the rule is not absolute and that resort may be had to the without prejudice material for a variety of reasons where the justice of the case requires it. See also per Lord Neuberger at para 89, endorsing the passage from the judgment of Robert Walker LJ in *Unilever* at pp 2448-2449 (referred to above).

The exceptions to the without prejudice rule

30. The cases to which I have referred (and others) show that, because of the importance of the without prejudice rule, its boundaries should not be lightly eroded. The question in this appeal is whether one of the exceptions to the rule should be that facts identified during without prejudice negotiations which lead to a settlement agreement of the dispute between the parties are admissible in evidence in order to ascertain the true construction of the agreement as part of its factual matrix or surrounding circumstances.

31. This issue must be put in the context of the exceptions which have already been permitted to the rule. In this connection I again turn to the illuminating judgment of Robert Walker LJ in *Unilever*. Having set out the general principles at pp 2443-2444 (quoted above), which included the general working assumption that the rule has a wide and compelling effect, he said at p 2444C-D that there are nevertheless numerous occasions on which the rule does not prevent the admission into evidence of what one or both parties said or wrote in the course of without prejudice negotiations.

32. Robert Walker LJ then set out (at pp 2444D-2446D) a list of what he called the most important instances. He described them thus (omitting some of the references):

> "(1) … when the issue is whether without prejudice communications have resulted in a concluded compromise agreement, those communications are admissible. …
>
> (2) Evidence of the negotiations is also admissible to show that an agreement apparently concluded between the parties during the negotiations should be set aside on the ground of misrepresentation, fraud or undue influence. *Underwood v Cox* (1912) 4 DLR 66, a decision from Ontario, is a striking illustration of this.
>
> (3) Even if there is no concluded compromise, a clear statement which is made by one party to negotiations and on which the other party is intended to act and does in fact act may be admissible as giving rise to an estoppel. That was the view of Neuberger J in *Hodgkinson & Corby Ltd v Wards Mobility Services* [1997] FSR 178, 191 and his view on that point was not disapproved by this court on appeal.

(4) Apart from any concluded contract or estoppel, one party may be allowed to give evidence of what the other said or wrote in without prejudice negotiations if the exclusion of the evidence would act as a cloak for perjury, blackmail or other 'unambiguous impropriety' … But this court has, in *Forster v Friedland* and *Fazil-Alizadeh v Nikbin*, [1993 CAT 205], warned that the exception should be applied only in the clearest cases of abuse of a privileged occasion.

(5) Evidence of negotiations may be given (for instance, on an application to strike out proceedings for want of prosecution) in order to explain delay or apparent acquiescence. Lindley LJ in *Walker v Wilsher* [at] … 338, noted this exception but regarded it as limited to 'the fact that such letters have been written and the dates at which they were written'. But, occasionally, fuller evidence is needed in order to give the court a fair picture of the rights and wrongs of the delay.

(6) In *Muller's* case (which was a decision on discovery, not admissibility) one of the issues between the claimant and the defendants, his former solicitors, was whether the claimant had acted reasonably to mitigate his loss in his conduct and conclusion of negotiations for the compromise of proceedings brought by him against a software company and its other shareholders. Hoffmann LJ treated that issue as one unconnected with the truth or falsity of anything stated in the negotiations, and as therefore falling outside the principle of public policy protecting without prejudice communications. The other members of the court agreed but would also have based their decision on waiver.

(7) The exception (or apparent exception) for an offer expressly made 'without prejudice except as to costs' was clearly recognised by this court in *Cutts v Head*, and by the House of Lords in *Rush & Tompkins*, as based on an express or implied agreement between the parties. It stands apart from the principle of public policy (a point emphasised by the importance which the new Civil Procedure Rules, Part 44.3(4), attach to the conduct of the parties in deciding questions of costs). There seems to be no reason in principle why parties to without prejudice negotiations should not expressly or impliedly agree to vary the application of the public policy rule in other respects, either by extending or by limiting its reach. In *Cutts v Head* Fox LJ said (at p 316) 'what meaning is given to the words "without prejudice" is a matter of interpretation which is capable of variation according to usage in the profession. It seems to me that, no

> issue of public policy being involved, it would be wrong to say that the words were given a meaning in 1889 which is immutable ever after'.
>
> (8) In matrimonial cases there has developed what is now a distinct privilege extending to communications received in confidence with a view to matrimonial conciliation: …"

33. Although it is not included in that list, it is not in dispute between the parties that another of the exceptions to the rule is rectification. A party to without prejudice negotiations can rely upon anything said in the course of them in order to show that a settlement agreement should be rectified. It was so held at first instance in Canada in *Pearlman v National Life Assurance Co of Canada* (1917) 39 OLR 141 and in New Zealand in *Butler v Countrywide Finance Ltd* (1992) 5 PRNZ 447. Neither case contains much reasoning but both courts treated the point as self-evident. In my opinion the parties correctly recognised such an exception because it is scarcely distinguishable from the first exception. No 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. This can be seen most clearly where the alleged agreement is oral but, in my opinion, must equally apply where the agreement is partly oral and partly in writing and where the agreement is wholly in writing but the issue is whether it reflects the common understanding of the parties.

34. It was submitted on behalf of Oceanbulk that none of those exceptions applies here and that the general principle that one party should not be permitted to cross-examine the other party (or its witnesses) on matters disclosed or discussed in without prejudice negotiations should be applied in its full rigour. Although it was correctly accepted that the point for decision in this appeal was not decided in *Unilever* or any of the other cases, it was submitted that the decided cases, especially *Unilever* and *Ofulue*, strongly point the way.

35. By contrast, it was submitted on behalf of TMT that facts which (a) are communicated between the parties in the course of without prejudice negotiations, (b) form part of the factual matrix or surrounding circumstances and (c) would, but for the without prejudice rule, be admissible as an aid to construction of a settlement agreement which results from the negotiations should be admissible in evidence by way of exception to the rule because the agreement cannot otherwise be properly construed in accordance with the well recognised principles of contractual interpretation and because there is no distinction in principle between this exception ("the interpretation exception") and, for example, the rectification exception.

Should the interpretation exception be recognised as an exception to the without prejudice rule?

36. I have reached the conclusion that this question should be answered in the affirmative for these reasons. The principles which govern the correct approach to the interpretation of contracts have been the subject of some development, or at least clarification, in recent years as a result of a number of important decisions of the House of Lords. The position was clearly stated by Lord Steyn in *R (Westminster City Council) v National Asylum Support Service* [2002] UKHL 38, [2002] 1 WLR 2956. He summarised the position thus in para 5:

> "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. In regard to contractual interpretation this was made clear by Lord Wilberforce in *Prenn v Simmonds* [1971] 1 WLR 1381, 1384-1386, and in *Reardon Smith Line Ltd v Yngvar Hansen-Tangen* … [1976] 1 WLR 989, 995-996. Moreover, in his important judgment in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, 912-913, Lord Hoffmann made crystal clear that an ambiguity need not be established before the surrounding circumstances may be taken into account."

37. As Lord Hoffmann himself put it in para 14 of his speech in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, [2009] AC 1101, in every case in which the interpretation of the language used in the contract is in issue, the question is 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. In *Chartbrook* the House of Lords considered and rejected the submission that what at para 42 Lord Hoffmann called the exclusionary rule, which excludes evidence of what was said or done in the course of negotiating an agreement for the purpose of drawing inferences about what the contract means, should now be abolished. It accordingly remains part of English law. The exclusionary rule does not exclude such evidence for all purposes. Lord Hoffmann put it thus in para 42:

> "It does not exclude the use of such evidence for other purposes: for example, to establish that a fact which may be relevant was known to the parties, or to support a claim for rectification or estoppel. These are not exceptions to the rule. They operate outside it."

38. It is not in dispute that, where negotiations which culminate in an agreement are not without prejudice, the exclusionary rule applies to the correct approach to the construction of the agreement. Nor is it in dispute that in those circumstances evidence of the factual matrix is admissible as an aid to interpretation even where the evidence formed part of the negotiations. The distinction between objective facts and other statements made in the course of negotiations was clearly stated by Lord Hoffmann in para 38 of *Chartbrook*:

> "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."

39. Trial judges frequently 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. This is often a straightforward task but sometimes it is not. In my opinion this problem is not relevant to the question whether, where the pre-contractual negotiations that form part of the factual matrix are without prejudice, evidence of those negotiations is admissible as an aid to construction of the settlement agreement. The two questions are, as I see it, entirely distinct.

40. In these circumstances, 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 and the question posed by Lord Hoffmann should be the same, 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.

41. The parties entering into such negotiations would surely expect the agreement to mean the same in both cases. I would not accept the submission that to hold that the process of interpretation should be the same in both cases would be to offend against the principle underlying the without prejudice rule. The underlying principle, whether based in public policy or contract, is to encourage parties to speak frankly and thus to promote settlement. As I see it, the application in both cases of the same principle, namely to admit evidence of objective facts,

albeit based on what was said in the course of negotiations, is likely to engender settlement and not the reverse. I would accept the submission made on behalf of TMT 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. Moreover this approach is the only way in which the modern principles of construction of contracts can properly be respected.

42. Any other approach would be to introduce an unprincipled distinction between this class of case and two others which have already been accepted as exceptions to the without prejudice rule. I have already expressed the view that the rectification exception is correctly accepted because no sensible line can be drawn between admitting without prejudice communications in order to resolve the issue whether they have resulted in a concluded compromise agreement, which was the first exception identified by Robert Walker LJ in *Unilever*, and admitting them in order to resolve the issue what that agreement was. There is also no sensible basis on which a line can be drawn between the rectification case and this type of case.

43. This can clearly be seen by a consideration of Sir Richard Buxton's article at [2010] CLJ 253 entitled '"Construction' and Rectification after *Chartbrook*", where he compares the fifth principle identified by Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society* ("the *ICS* case") and the principles of rectification. It is not necessary to set out in full the five principles which Lord Hoffmann set out in that case at [1998] 1 WLR 896, 912H-913E. However, his fourth and fifth principles were in these terms:

> "(4) The meaning which a document (or any other utterance) 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 or syntax: see *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749.
>
> 5) The 'rule' that words should be given their 'natural and ordinary meaning' reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes,

> particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had."

44. In his article Sir Richard Buxton expresses the view at p 256 that the fifth principle was revolutionary because it overrode the previous understanding that, rectification apart, the court could not depart from the words of a document to find an agreement different from that stated in the document. Whether that is so or not, Sir Richard is in my opinion correct when he notes that the principles enshrined in *ICS*, especially the fifth principle, point to the close relationship between interpretation and rectification. He notes at p 257 the essence of rectification as described in the judgment of Slade LJ (with whom Oliver and Robert Goff LJJ agreed) in *Agip SpA v Navigazione Alta Italia SpA* ("*The Nai Genova"*) [1984] 1 Lloyd's Rep 353 at 359:

> "In principle, the remedy of rectification is one permitted by the Court, not for the purpose of altering the terms of an agreement entered into between two or more parties, but for that of correcting a written instrument which, by a mistake in verbal expression, does not accurately reflect their true agreement."

Sir Richard then says that a closer expression of the process necessarily envisaged by principle 5 of *ICS* could scarcely be found.

45. I am not sure that I would put it quite as high as Sir Richard does but I entirely agree with him that the problems with which both the principles of rectification and the principles of construction (as explained in recent cases) grapple are closely related. This is an important factor in leading to the conclusion that evidence of what was said or written in the course of without prejudice negotiations should in principle be admissible, both when the court is considering a plea of rectification based on an alleged common understanding during the negotiations and when the court is considering a submission that the factual matrix relevant to the true construction of a settlement agreement includes evidence of an objective fact communicated in the course of such negotiations.

46. For these reasons I would hold that the interpretation exception should be recognised as an exception to the without prejudice rule. I would do so because I am persuaded that, in the words of Lord Walker in *Ofulue* (at para 57), justice clearly demands it. In doing so I would however stress that I am not seeking either to underplay the importance of the without prejudice rule or to extend the

exception beyond evidence which is admissible in order to explain the factual matrix or surrounding circumstances to the court whose responsibility it is to construe the agreement in accordance with the principles identified in *ICS* and *Chartbrook*. In particular nothing in this judgment is intended otherwise to encourage the admission of evidence of pre-contractual negotiations.

Conclusion

47. For these reasons, I would hold that evidence in support of representations iii) and iv) is in principle admissible as part of the factual matrix or surrounding circumstances on the true construction of the agreement. It is I think common ground that it follows that it is also in principle admissible on the issues of estoppel and remoteness. In short I have reached a different conclusion from the majority of the Court of Appeal but essentially the same conclusion as was reached by Andrew Smith J at first instance and by Ward LJ in the Court of Appeal. For the reasons I have given I would allow the appeal.

LORD PHILLIPS

48. I agree with the reasoning and the conclusion of Lord Clarke. The principle to be derived from this appeal can be shortly stated. When construing a contract between two parties, evidence of facts within their common knowledge is admissible where those facts have a bearing on the meaning that should be given to the words of the contract. This is so even where the knowledge of those facts is conveyed by one party to the other in the course of negotiations that are conducted "without prejudice". This principle applies both in the case of a contract that results from the without prejudice negotiations and in the case of any other subsequent contract concluded between the same parties. Accordingly I would allow this appeal.