



## INTERPRETING TERMS OF SETTLEMENT AGREEMENTS: NEW EXCEPTION TO THE “WITHOUT PREJUDICE RULE”

We previously reported on the English Court of Appeal decision in *Oceanbulk Shipping & Trading SA v TMT Asia Limited* [2010] EWCA Civ 79,<sup>1</sup> which considered the important issue of whether established exceptions to the “without prejudice rule” should be extended to cover precontractual negotiations for the purpose of interpreting the terms of a settlement agreement.

Generally speaking, written and oral communications between parties during negotiations genuinely aimed at settling a dispute so as to avoid litigation or arbitration cannot be put into evidence if those negotiations subsequently fail and the parties continue litigating or arbitrating their dispute. The rule is based upon the public policy of encouraging parties to settle disputes rather than becoming embroiled in court

or arbitration proceedings. The rule achieves this purpose by protecting either or both parties from being embarrassed or prejudiced in court or in arbitration proceedings because of admissions that may have been made by them during the negotiations.

Despite the decision of the Court of Appeal refusing to extend the exceptions to the without prejudice rule to precontractual negotiations, the issue remained uncertain due to a strong dissenting judgment given by Lord Justice Ward. The issue has now been laid to rest by appeal to the Supreme Court,<sup>2</sup> where it was unanimously held that precontractual settlement negotiations are admissible to “ascertain the true construction of the agreement as part of its factual matrix or surrounding circumstances.”

1 “When Without Prejudice Communications Are No Longer Without Prejudice,” *Jones Day Commentary*, March 2010

2 The Supreme Court of the United Kingdom was established under the Constitutional Reform Act 2005 and took over the judicial functions of the House of Lords on October 1, 2009.

## THE HIGH COURT AND COURT OF APPEAL DECISIONS

The dispute over this matter began in 2009 when Oceanbulk claimed against TMT for noncompliance of a settlement agreement that they entered into to settle outstanding payments due from TMT to Oceanbulk. During the hearing, TMT, in its defense, sought to rely on the without prejudice negotiations leading up to the settlement agreement to interpret the meaning of terms of the agreement.

The High Court handed down a judgment in July 2009 holding that the exceptions to the without prejudice rule extended to precontractual negotiations if they would assist the court in properly construing the meaning of the terms of a settlement agreement. However, the decision was subsequently overturned by a 2–1 majority in the Court of Appeal. The majority held that the policy of protecting without prejudice communications to encourage and facilitate parties to settle their differences was stronger than the policy of providing the judge with all conceivable help to arrive at a just solution.

## THE SUPREME COURT

TMT appealed the decision to the Supreme Court. At trial, Oceanbulk submitted that none of the exceptions to the without prejudice rule applied and that the without prejudice negotiations were privileged and could not be raised in the proceedings.

TMT argued that communications between the parties in the course of the without prejudice negotiations should be admissible by way of an “interpretation exception” to the without prejudice rule if the communications i) form part of the factual matrix or surrounding circumstances; and ii) would, but for the without prejudice rule, be admissible as an aid to the construction of a settlement agreement. TMT asserted that there must be this exception or else the agreement could not be properly construed in accordance with the principles of contractual interpretation.

In considering the principles of contract interpretation as well as the essence of the without prejudice rule, the Supreme Court unanimously held that the “interpretation exception” should be recognized as an exception to the without prejudice rule. In giving his judgment, Lord Clarke first defined one of the principles for contract interpretation by quoting Lord Hoffmann in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] AC 1101, where his lordship indicated that in a case where the interpretation of a contract was in issue, “the correct question to be asked 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.”

Under these circumstances, Lord Clarke went on to state that there is no reason why the ordinary principles governing the interpretation of a settlement agreement should be any different regardless of whether the negotiations that led to it were without prejudice. Similarly, if it is an exception that without prejudice communications can be admitted to show whether there was a concluded agreement between the parties, there is no reason why such communications should not be admitted to resolve the issue of what that agreement meant.

In addressing the public policy issue, Lord Clarke stated that the underlying principle behind the without prejudice rule is to promote settlement by encouraging parties to speak frankly in negotiations. The “interpretation exception” does not undermine this principle because parties can be confident that in the event of a dispute arising over the settlement agreement, objective facts will be admitted to assist the court in interpreting the meaning of the agreement. According to the Supreme Court, this may actually encourage the parties to reach a settlement. For this and other reasons outlined above, it was held that the “interpretation exception” would be recognized as an exception to the without prejudice rule.

## COMMENTARY

This important decision by the Supreme Court confirms yet another exception to the without prejudice rule, which adds to the already established exceptions, including:

1. communications that indicate whether or not there was a concluded agreement;
2. communications that evidence grounds to set aside a concluded agreement on the basis of misrepresentation, fraud, or undue influence; and
3. communications that would give rise to an estoppel.

Despite the Court of Appeal's view to give more weight to the underlying principle behind the without prejudice rule, the Supreme Court seems to place more emphasis on the need to maximize the court's ability to interpret contracts or agreements in a manner that is fair and just. That is not to say that the Supreme Court disregarded public policy issues surrounding the without prejudice rule. First, only objective facts from without prejudice negotiations that would aid in the interpretation of the agreement will be admitted. Second, it was pointed out by the Supreme Court that if parties are aware that without prejudice negotiations may be admitted as evidence for the purposes of interpretation, this may serve to encourage parties to settle. In other words, parties can be confident that if a dispute arises over the interpretation of a settlement agreement, their otherwise without prejudice discussions may be put before the court or arbitrator as an aid to interpret the meaning of the terms of agreement.

The Supreme Court's decision is likely to be of strong persuasive precedence in Hong Kong. Currently, the furthest Hong Kong courts will go to lift the protection of privilege and look into without prejudice negotiations is when there is a need to determine whether an agreement has in fact been concluded. Other factors, such as estoppel or undue influence, may also lead to courts examining without prejudice negotiations. Nonetheless, parties should be aware that this decision from the Supreme Court will likely sway the courts in Hong Kong to examine without prejudice negotiations in circumstances where such negotiations will assist in construing the meaning of the terms in a settlement agreement.

## LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at [www.jonesday.com](http://www.jonesday.com).

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