Ian Pease discusses two cases showing the difficulty of applying the rules of contractual construction

Ian Pease is a practising solicitor

Mind your language

The importance of keeping up with the legislation

Aside from the now-ubiquitous procedure of adjudication, one of the primary successes of the Housing Grants (Construction and Regeneration) Act 1996 (the 1996 Act) is the outlawing of the once-omnipresent 'pay when paid' clause, which used to be the bane of sub-contractors' lives. However, the 1996 Act will still allow such a clause if it limits itself to where the third-party employer is insolvent. The provision has not been much used in the boom times since the 1996 Act came into force, but insolvencies are now much more likely.

The Court of Appeal's judgment in *William Hare Ltd v Shepherd Construction* [2010] shows what can happen to a main contractor when it seeks to rely on such a clause.

Self-certification creates uncertainty

Under the 1996 Act, pay-when-paid clauses were dealt with as follows:

> 113(1) A provision making payment under a construction contract conditional on the payer receiving payment from a third person is ineffective, *unless that third person*, or any other person payment by whom is under the contract (directly or indirectly) a condition of payment by that third person, *is insolvent*. [Emphasis added.]

Originally the clause then set out the modes of insolvency as:

> (a) on the making of an administration order against it under Part II of the Insolvency Act 1986;
>
> (b) on the appointment of an administrative receiver or a receiver or manager of its property under Chapter I of Part III of that Act, or the appointment of a receiver under Chapter II of that Part;
>
> (c) on the passing of a resolution for voluntary winding-up without a declaration of solvency under section 89 of that Act; or
>
> (d) on the making of a winding-up order under Part IV or V of that Act.

However, because of the perceived unwieldy nature of the administration order procedures, changes were introduced in 2002. The Enterprise Act 2002 added new ways to go into administration, and a new Schedule B1 identified three different routes:

> (1) the appointment of an administrator by the court following the making of an administration order;
>
> (2) the appointment of an administrator by the holder of a floating charge; and
>
> (3) the appointment of an administrator by a company or directors.

The first of these was available under the original Insolvency Act, but the second and third were new. The parties in *William Hare* labeled them 'self-certifying options'. These changes meant that after the Enterprise Act it was no longer necessary to obtain a court order to appoint an administrator.

There were consequential amendments to s113 of the 1996 Act (by the Enterprise Act 2002 (Insolvency) Order 2003) which substituted wording into (a), above, as follows:

PLJ250 p19-21 Pease.indd 19 30/04/2010 17:07:25

> ... when it enters administration within the meaning of Schedule B1 to the Insolvency Act 1986.

As a result the 1996 Act now clearly included both administration through court order and self-certification.

Facts in *William Hare*

In December 2008 Shepherd engaged Hare to fabricate and erect steelwork. The employer was Trinity. The sub-contract contained a provision which allowed Shepherd not to pay, in similar terms to the original s113 of the 1996 Act, ie without making reference to the new self-certification routes. The court noted:

> Precisely how we have no real explanation, but in 2008 Shepherd, as the main contractor for the employer, Trinity, used the same clause in the same terms without reflecting the amendment to section 113 in 2002.

Trinity went into administration by a self-certifying route, Hare claimed under two valuations against Shepherd for just under £1m, and Shepherd issued withholding notices, relying on the pay-when-paid clause mentioned above.

Hare's uphill struggle

Hare's case was simple: look at the 'natural and ordinary meaning' of the words used. If you want to withhold payment you have to have a contractual clause that is effective to do that. The one in this case was not: it did not cover the scenario that the parties found themselves in, as there had been no 'order' of the court.

Shepherd did not seek to rely on any mutual mistake or seek rectification of the agreement, since the evidence was against it. Instead it argued on the proper construction of the agreement. It admitted that the ordinary meaning of the words was against it, but claimed that the court should construe the clause as covering all routes to administration. This was because it was obvious that 'something must have gone wrong with the language'. This idea comes from Lord Hoffmann in the well-known *Investors Compensation Scheme v West Bromwich Building Society* [1997], where he said:

> (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. Lord Diplock made this point more vigorously when he said in *Antaios Compania Naviera SA v Salen Rederierna AB* [1985] AC 191, 201:
>
> > '... if detailed semantic and syntactical analysis of words 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.'

Lord Hoffmann elaborated this in the more recent *Chartbrook v Persimmon Homes & ors* [2009]:

> 14... It is agreed that 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. The House emphasised that 'we do not easily accept that people have made linguistic mistakes, particularly in formal documents'... but said that in some cases the context and background drove a court to the conclusion that 'something must have gone wrong with the language'. In such a case, the law did not require a court to attribute to the parties an intention which a reasonable person would not have understood them to have had.
>
> 15. It clearly requires a strong case to persuade the court that something must have gone wrong with the language and the judge and the majority of the Court of Appeal did not think that such a case had been made out.

It is apparent from these passages that it will be difficult to persuade a court that 'something must have gone wrong with the language' in the case of 'formal documents' like contracts. Consequently whoever proposes such an argument has to come to the court with a 'strong case'. That strong case will revolve around the degree of business absurdity the clause produces.

However, the court in *William Hare* added a further brick to this already high wall. This was due to the nature of the clause itself in this dispute. The judgment says:

> We pressed [counsel for Hare] as to whether the principles on which he relied from the speeches of Lord Hoffmann were applicable at all or in any event with the same force in the case of an exclusion clause inserted by one party entirely for his own benefit.

Mr Furst QC, for Hare, denied that this was an exclusion clause, arguing that it was, in his words, a clause sharing the risk. The court was unconvinced and concluded:

> 15... Pay when paid clauses were made ineffective unless the third party was insolvent and insolvency was defined by reference to the ways in which a company could become insolvent. If a main contractor wishes to have a pay when paid provision in a subcontract he would be bound, if it was to be effective, to identify a way in which the third-party employer became insolvent as defined in the legislation. If he chose a way which was not in accordance with the legislation because he mis-drafted the provision, I can see no reason why, however obvious it was that he had mis-drafted the provision, the principles identified by Lord Hoffmann would come to his rescue.

Conclusion

William Hare shows that pay-when-paid clauses are exclusion clauses, and any degree of business absurdity will not matter when the clause's beneficiary seeks to rely on it. The lesson is that parties should not rely on stock clauses that may be past their sell-by dates.

PLJ250 p19-21 Pease.indd 20 30/04/2010 17:07:30

Eyes wide open

The latent problems of settlements

The ambit and drafting of a settlement agreement is equally crucial. This was the subject of the Court of Appeal's judgment in *Priory Caring Services v Capita Property Services* [2010].

Background

The parties made an agreement in 2003 that Priory would not issue proceedings against Capita:

> … in relation to matters arising from Capita's appointment as surveyors to Priory in relation to the Priory Hotel.

At the time Priory needed Capita's help in an ongoing arbitration against its insurers. Priory also agreed to pay Capita the fees outstanding in relation to its work on the hotel, conditional on them being recovered from the insurers.

In 2005 Priory discovered that the refurbished hotel was affected by damp penetration. Priory then sued Capita, alleging that Capita negligently undertook the design, specification, supervision and refurbishment of Priory's hotel. Capita's defence was that the 2003 compromise agreement covered the causes of action alleged.

Arguments

Priory sought to limit the agreement to those claims of which the parties were aware at the time, alleging that it did not extend to claims which were then unknown to the parties. Additionally, it said that the agreement really related to the recovery by Capita of its fees for the job, and that in any case the agreement lacked consideration.

Given that there was no specific reservation for latent defects in the agreement, Priory faced a struggle to convince the court that the words of compromise, 'in relation to matters arising from Capita's appointment as surveyors to Priory in relation to the Priory Hotel', did not cover all claims, both known and unknown.

The crucial legal argument revolved around *Bank of Credit and Commerce International SA v Ali* [2001]. The facts there were:

- Some bank employees released the bank from redundancy claims in return for money.
- The money was paid:

  > … in full and final settlement of all or any claims… of whatsoever nature that exist or may exist.

  A widely worded release.
- The employees then sought to claim damages for breach of an implied term of their employment contracts in respect of disadvantage on the labour market.
- The employees' new claims followed a change in the law (*Mahmud v Bank of Credit and Commerce International SA* [1997]) subsequent to the settlement agreement.
- The change was that corrupt and dishonest activities by an employer became capable of giving rise to claims in damages. These are called 'stigma damages'.
- Hence it was said that when they executed the release neither party:

  > … could realistically have supposed that such a claim lay within the realm of practical possibility.

Analysis

The question for the court in *Priory* was whether *BCCI v Ali* applied. The short answer was no. In reaching that conclusion the court looked at another release case, *Mostcash Plc v Fluor Ltd* [2002], which had also addressed *BCCI v Ali*. It had found that *Ali* was driven by its particular facts, especially that the stigma claim 'could not have been in [Mr Ali's] contemplation'. The court found that the facts of *Priory* were nowhere near as extreme as those in *Ali*. It said:

> Priory was a commercial concern which, with the assistance of its lawyers, made a deal with its eyes open, knowing of the possibility of negligence… willing to forgo claims that might arise out of those circumstances, even if ignorant of how important such claims might turn out to be, and extremely keen to buy the assistance of Capita… so as to achieve success in its arbitration against its insurers.

In other words, although Priory did not appreciate the exact extent of the problems that were later discovered, it certainly comprehended them as a possibility, so it could not step outside the ambit of the settlement agreement.

Conclusion

Priory shows that compromise agreements need to be carefully considered and that get-out-of-jail-free situations, such as *Ali*, are very rare indeed. ■

Antaios Compania Naviera SA v Salen Rederierna AB
[1985] AC 191

Bank of Credit and Commerce International SA v Ali
[2001] UKHL 8

Chartbrook v Persimmon Homes & ors
[2009] UKHL 38

Investors Compensation Scheme v West Bromwich Building Society
[1997] UKHL 28

Mahmud v Bank of Credit and Commerce International SA
[1997] UKHL 23

Mostcash Plc v Fluor Ltd
[2002] EWCA Civ 975

Priory Caring Services v Capita Property Services
[2010] EWCA Civ 226

William Hare Ltd v Shepherd Construction
[2010] EWCA Civ 283

PLJ250 p19-21 Pease.indd 21 30/04/2010 17:07:30