# WHAT WERE WE THINKING? – NEW GUIDANCE ON RECTIFICATION OF CONTRACTS

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## IN A SIGNIFICANT CASE RELATING TO A CORPORATE DEBT RESTRUCTURING, THE ENGLISH COURT OF APPEAL HAS CLARIFIED THE LAW ON RECTIFICATION, PROVIDING INVALUABLE GUIDANCE ON WHEN THE COURTS WILL STEP IN TO CORRECT A WRITTEN AGREEMENT WHICH DOES NOT REFLECT THE PARTIES' INTENTIONS.

> "The English court has a well-established power to rectify a contract to give effect to the parties' intentions or prior agreement. "

Mistakes can happen. What happens when, as a result of such a mistake, parties enter into a contract which does not reflect their prior agreement or their intentions? Such situations can cause commercially absurd results or lead to a party taking on onerous obligations that it never contemplated when negotiating the contract. The English court has a well-established power to rectify a contract to give effect to the parties' intentions or prior agreement. However, the circumstances in which the courts will exercise that power, and in particular the relevance of the parties' state of mind, have been the subject of substantial controversy for the past decade following obiter dicta comments of Lord Hoffmann in an influential House of Lords decision, *Chartbrook Ltd v Persimmon Homes Ltd*. ***[2]***

Following the trend towards a more literal approach to the interpretation of contracts, focussing on the natural and ordinary meaning of the language used[3], the principles governing the alternative remedy of rectification have taken on increased significance. The Court of Appeal's decision in *FSHC Group Holdings Ltd v GLAS Trust Corp Ltd* is therefore a welcome and timely confirmation of the law in this area.

## THE LEGAL UNCERTAINTY IN RECTIFICATION

Though rectification is often expressed as a single remedy, it is available in various circumstances which have their basis in either contract or the court's equitable jurisdiction. In this judgment, the court focussed on rectification for "common mistake", where both parties have a common intention and understanding as to the effect of a contract. However, when the contract is executed it operates differently to that intention. The requirements have been summarised in *Swainland Builders Ltd v Freehold Properties Ltd*,[1] which explains that a party seeking rectification in such circumstances must show:

1. That the parties had a "common intention", whether or not amounting to an agreement, in respect of a particular matter in the contract to be rectified;
2. There was "an outward expression of accord" – i.e. that the parties had made clear their understanding to each other through communication (though in limited circumstances the understanding could be so obvious as to go without saying);
3. The intention continued at the time of the execution of the contract to be rectified; and
4. By mistake, the contract did not reflect the common intention.

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How the court goes about establishing whether a party meets these requirements has been the source of ongoing controversy. To what extent should the court take into account the subjective views of the parties as to their intentions? Or should the court only consider an objective view of the situation to assess whether there is a common intention, and disregard subjective views?

In *Chartbrook,* Lord Hoffmann contended that the court should only consider objectively what a reasonable observer would have understood from the pre-contractual state of affairs between the parties. In effect, he considered that the approach should be the same as when interpreting a contract, where the subjective views of the parties are disregarded for a focus on the view of a reasonable objective observer. Although not binding, this emphasis on objective views has been controversial, forming the subject of numerous journal articles and speeches, despite being (reluctantly) followed by the Court of Appeal in *Daventry District Council v Daventry & District Housing Ltd*.[2]

## FACTS

In this case, the claimant was the parent company of Four Seasons Health Care Group, the largest independent provider of elderly care services in the UK ("FSHC"). The defendant was the successor security agent to Barclays Bank Plc ("Barclays"), which had acted as security agent in relation to the financing of the acquisition of the FSHC group by an investment fund in 2012.

As part of the security taken in relation to the acquisition, FSHC was required to assign the benefit of a shareholder loan it had made. However, by an oversight, the assignment was never entered into, with no one at the time noticing that it had been omitted. In 2016, FSHC was looking to restructure its debt and its lawyers noticed that the assignment was missing, which would have led to an event of default that FSHC was keen to avoid heading into the restructuring negotiations. As a solution, FSHC's lawyers proposed that FSHC accede to two pre-existing Intercompany Receivables Security Assignments ("IRSAs"), which would cover the assignment of the benefit of the shareholder loan. However, while considered a simple solution to make good the missing security, the IRSAs in fact imposed far more extensive obligations on FSHC than were envisaged, a result that had not been identified by FSHC's lawyers when they were considering how to address the missing assignment.

At first instance the court found that a genuine mistake had been made, as FSHC's lawyers genuinely believed the accession of FSHC to the IRSAs (which had not been reviewed) would not entail additional obligations. Likewise Barclays had, the court found, understood that FSHC were entering into agreements to provide the missing security and nothing more. The parties had the "legally specific" intention of binding FSHC to particular contract terms, and so this was "a classic case for rectification".

IF THERE IS NO CONTRACT BUT THE PARTIES HAD A COMMON INTENTION IN RESPECT OF A PARTICULAR MATTER WHICH, BY MISTAKE, THE DOCUMENT DID NOT ACCURATELY RECORD, IT WOULD BE UNCONSCIONABLE TO TAKE ADVANTAGE OF SUCH A MISTAKE.

## THE COURT OF APPEAL'S CLARIFICATION

The findings of fact were not challenged on appeal. Instead, the key issue concerned the correct legal test for rectification. This gave the Court of Appeal a welcome opportunity to provide guidance in light of the uncertainty created by Lord Hoffmann's dicta in *Chartbrook*.

In addressing the controversy, the Court of Appeal noted the difference between cases where there is a prior or preliminary contract, and cases where there is no prior contract and only the parties' intentions. The Court of Appeal has now clarified that in respect of each situation "different principles are in play":

- If a document fails to give effect to a prior concluded contract, the court will construe the prior contract objectively, in line with the rules for interpretation of contracts or
- If there is no prior contract but the parties had a common intention in respect of a particular matter which, by mistake, the document did not accurately record, it would be unconscionable and contrary to good faith for a party to take advantage of such a mistake. This basis for rectification was thus entirely concerned with the parties' subjective states of mind.

In relation to the latter, the court found this to be in line with previous authority, which had recognised the above distinction. Its clarification was also in line with most other common law jurisdictions (in particular Australia) and the policy objective of rectification, which is to protect, through looking at the parties' subjective intentions, "the certainty and security of commercial transactions". The court further found the subjective approach preferable to the potential unfairness of the approach set out in *Chartbrook*, where a focus on an objective, pre-contract informal consensus between the parties could, the court considered, produce unfair results.

On the importance of the requirement for an "outward expression of accord", the court departed from earlier authorities[6] by emphasising that demonstrating "an outwardly expressed accord of minds" is more than an evidential factor and is a requirement of the legal test for obtaining rectification.

## CONCLUSION

The Court of Appeal clearly did not take its departure from Lord Hoffmann's dicta in *Chartbrook* lightly. The judgment contains a detailed and useful analysis of the origins and development of the law on rectification, and is a welcome clarification of the correct approach the courts should take to rectify a contract based on the intentions of the parties.

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In terms of the legal test for rectification, the confirmation that the court should look to the subjective intentions of the parties will lead to greater flexibility, and avoid injustice. However, this flexibility does not necessarily mean that successful rectification claims will become more common. The court emphasised that "as a matter of policy, rectification should be difficult to prove", with parties being required to show "convincing proof" to dislodge the normal rule that a written contract is an accurate record of what the parties agreed.

As this case shows, mistakes are inevitable, particularly in large and complex commercial transactions. However, while the Court of Appeal upheld the trial judge's decision to order rectification, it will remain a difficult task to convince a court to rectify a contract and it is worth observing that the facts in this case were unusual (in particular that the IRSAs were being entered into to comply with a specific pre-existing obligation, which significantly influenced the discussion between the parties leading up to the execution of the IRSAs). In this context, one final lesson from the judgment is that the best way to protect against mistakes is to maintain both good internal records and inter-partes correspondence demonstrating a common understanding of the deal so that, if worst comes to worst, a claim for rectification can be fully evidenced.

(This article was co-authored by Paul Hogarth).

[1] *FSHC Group Holdings Ltd v GLAS Trust Corp Ltd* [2019] EWCA Civ 1361. The High Court judgment was reported under the name *FSHC Group Holdings Ltd v Barclays Bank plc* [2018] EWHC 1558 (Ch)

[2] [2009] UKHL 38 – Note this case is also influential in relation to the interpretation of contracts (on which the case was decided) and so still remains good law on that issue

[3] See *Arnold v Britton* [2015] UKSC 36 and *Wood v Capita Insurance Services Ltd* [2017] UKSC 24

[4] [2002] EWCA Civ 560

[5] [2011] EWCA Civ 1153

[6] Such as *Munt v Beasley* [2006] EWCA Civ 370

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