

# Contractual interpretation: shades of grey

The principles for interpreting commercial contracts are easy to state but sometimes much harder to apply in practice. The two elements that go into the mix are the words used and the context in which the words were used. The most difficult issue is where the balance between these elements should fall: when should the words outweigh the context, and when should the context overwhelm the words? After a period in which context appeared to be king, the Supreme Court may now have signalled a reversal of this position, placing greater emphasis on the words.

We have previously observed how the English courts moved from a strict literal approach to the interpretation of commercial contracts to a more purposive approach and identified the tension this creates between the words chosen by the parties and the courts' view of the underlying commercial objective or of commercial common sense ([The strange death of literal England, November 2009](#)).

There might have been a feeling over the succeeding period that some courts were too willing to depart from the natural meaning of the parties' words if that meaning clashed with the court's view, formed many years later, of commercial common sense.

However, in *Arnold v Britton* [2015] UKSC 36, the Supreme Court has made an effort to counter any such trend. The Court emphasised that interpretation should focus on the words the parties have chosen to express their bargain. The interpretation of a contract should not involve a court in creating a deal that the parties might, if reasonable and judicial in outlook, have reached if they had anticipated the events that have transpired

## The starting point

The starting point when construing a commercial contract is (relatively) easy to state:

- "Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract." (*ICS v West Bromwich Building Society* [1998] 1 WLR 896, 912).
- "If... the court concludes that the language used is unambiguous, then the court must apply it, even though some other result might be thought more commercially reasonable, and even if it gives a result that is commercially disadvantageous to one of the parties. The court's function is to interpret the contract, not to rewrite it" (*US Bank Trustees Ltd v Titan Europe 2007-1 (NHP) Ltd* [2014] EWHC 1189 (Ch), at [25]).
- "[W]here a term of a contract is open to more than one interpretation, it is generally

## Key issues

- The Supreme Court has stressed the importance of wording over context when interpreting a contract
- Courts should respect parties' contractual autonomy by accepting the natural meaning of the parties' words
- Courts should interpret contracts, not re-write them
- Commercial common sense should only override the natural meaning of the words in rare cases

appropriate to adopt the interpretation which is most consistent with business common sense" (*Rainy Sky v Kookmin Bank* [2011] UKSC 50, at [30]).

- The court may conclude "that the parties made a mistake and used the wrong words or syntax. However [as]... the court does "not readily accept that people have made mistakes in formal documents"... the fact that the natural meaning appears to

produce "a bad bargain" for one of the parties or an "unduly favourable result" for another, is not enough to justify the conclusion that something has gone wrong. One is normally looking for an outcome which is "arbitrary" or "irrational", before a mistake argument will run... the court has to be satisfied both that there has been "a clear mistake" and that it is clear "what correction ought to be made" (*Pink Floyd Music Ltd v EMI Records Ltd* [2010] EWCA Civ 1429, at [20]-[21]).

The first of these points sets out what the court is trying to achieve when interpreting a commercial contract - the court's mission statement. A contract does not mean what the parties actually intend it to mean. Indeed, in most cases, the parties will in reality have had no actual intention, either individually or collectively, as to how to address the particular circumstance that has occurred but, even if they do, it is irrelevant to interpretation (though it may be relevant to the different exercise of rectification).

Rather, a contract means what a reasonable person in the position of the parties at the time they entered into the contract would have understood them to have meant. Interpretation is objective, not subjective.

The last of these bullet points is (or, at least, should be) a rarity. It requires an extreme situation - an arbitrary or irrational outcome, as well as its being clear what the mistake is and what the correction should be - before the court can conclude that the parties have made a mistake in their language and therefore correct that language.

Though rare, mistakes do happen. For example, in *BNY Mellon Corporate Trustee Services Ltd v LBG Capital No 1 plc* [2015] EWHC 1560 (Ch), the Chancellor of the High Court accepted as an obvious mistake the use of a defined term, "Core Tier 1 Capital", in one clause of the terms and conditions applicable to a note issue. This clause allowed the issuer of the notes to redeem them if changes to the regulatory capital regime reduced the benefit afforded by the notes. However, the defined term was expressly tied to the regulatory capital structure in place at the time of issue (May 2009).

The judge considered that the wording must have been intended to refer to the top tier of loss-absorbing capital as defined by the regulator from time to time (now common equity tier 1 capital) rather than only to the particular form of this capital at the time of issue. The parties knew at the time of the note issue that changes to the capital regime were coming, and the right of redemption was triggered by just such a change. A change to the capital requirements could not have been intended both to trigger the right of redemption and, simultaneously, to remove it because the change amended the definition of capital. The internal inconsistency led the judge to conclude that there was an obvious mistake.

### The central problem

The second and third bullet points above are the core of the interpretative task. They represent the courts' view of how the reasonable person (in practice, the reasonable judge) identified in the first point would approach the task allotted to him or her. If the words of a contract are obviously clear, the reasonable person would apply the

words; but if the language is manifestly ambiguous, the reasonable person would use the context or commercial common sense to try to understand, and give effect to, the intention behind the language.

An example is *African Minerals Ltd v Renaissance Capital Ltd* [2015] EWCA Civ 448, which turned on the meaning of "consummated", a term that the parties did not define. If the sale of a business had been consummated by a certain date, a financial adviser was entitled to commission; if it was not consummated by that date, the financial adviser got nothing. The rival interpretations were that "consummated" required only the material terms of the sale to have been agreed or that it required the sale to have been completed.

Considering the wording, both of the relevant clause and the wider contract, as well as the context (and applying a somewhat dubious analogy with marriage), the Court of Appeal disagreed with the first instance judge and concluded that "consummated" meant completed, even though "Completion" was a concept used in the document.

In *African Minerals*, "consummated" is (probably) inherently ambiguous. But there is seldom a digital divide between the second and third bullet points above - situations where the language is unambiguous and where it is open to more than one interpretation. Language tends to be more textured: it might be reasonably clear, fairly clear, mildly obscure and so on. How far along the road to ambiguity must language go before the court is entitled to redirect it in the name of commercial common sense. Indeed, can commercial common sense be used to create ambiguity?

## Plain words against a Rainy Sky

In *Rainy Sky v Kookmin Bank* (see the box on page 4), Patten LJ considered that the words used by the parties should be the starting point and, in most cases, the ending point of the judicial enquiry:

"Unless the most natural meaning of the words produces a result which is so extreme as to suggest that it was unintended, the Court has no alternative but to give effect to its terms. To do otherwise would be to risk imposing obligations on one or other party which they were never willing to assume and in circumstances which amount to no more than guesswork on the part of the Court." ([2010] EWCA Civ 582, at [41])

However, when *Rainy Sky* reached the Supreme Court ([2011] UKSC 50), Patten LJ's approach was rejected. The Supreme Court considered interpretation to be a "unitary" exercise, ie the court will not apply commercial common sense only if the words are, from a grammatical or linguistic point of view, unclear. The words do not exist in a vacuum. The courts will always consider the words and their context as part of a single exercise in interpretation.

Context and commercial common sense can therefore render words ambiguous that are, on their face, tolerably plain. And if words are ambiguous, the court can then pick what it considers to be commercially the most sensible interpretation.

In *Re Sigma Finance Corporation* [2009] UKSC 2, at [12], Lord Mance described interpretation as an "iterative process" that involves checking each of the rival meanings against other provisions of the

document and investigating its commercial consequences. Indeed, it

"is generally unhelpful to look for an "ambiguity", if by that is meant an expression capable of more than one meaning simply as a matter of language. True linguistic ambiguities are comparatively rare. The real issue is whether the meaning of the language is open to question. There are many reasons why it may be open to question, which are not limited to cases of ambiguity" (*Sans Souci Ltd v VRL Services Ltd* [2012] UKPC 6, at [14] (Lord Sumption)).

Words might be pretty plain, but if the commercial consequences are, in the court's view, implausible (even if not so implausible as to be arbitrary or irrational), other meanings might creep in, allowing the court to choose the most appropriate meaning.

## Whence commercial common sense?

Interpretation turns upon the meaning the reasonable person would attribute to the contract. For these purposes, neither drafts of a contract nor the parties' subjective intentions are admissible in evidence on an issue of interpretation. However, expert evidence is admissible as to what the parties to the contract would reasonably have known or as to any market practice that might inform how the reasonable person would understand the document (*Crema v Cenkos Securities plc* [2010] EWCA Civ 1444).

Despite this, courts don't really like evidence, especially from the parties, of the commercial purpose, tending to dismiss it as too argumentative and trespassing on the legal sphere (eg *Titan Europe* at [24]).

So if the courts don't like being told by the parties what their aim was, where do the courts divine the commercial purpose of the transaction from? The Courts "must seek to discern the commercial intention, and the commercial consequences from the terms of the contract itself; and that feeds in to the process of deciding whether a particular word or phrase is in reality clear and unambiguous" (*Napier Park European Credit Opportunities Fund Ltd v Harbourmaster Pro-Rata CLO 2 BV* [2014] EWCA Civ 984, at [33]). Recitals to an agreement, now seen by some as rather old-fashioned, might shed light on the parties' intended destination in complex transactions.

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Commercial common sense therefore flows from the contractual words as a whole. It's the big picture, but one that can potentially enable the court to conclude that smaller images - individual words or phrases - may be less than clear, thereby offering the opportunity to choose the meaning that the court considers is most consistent with business common sense.

## The limits of commercial common sense

The reasonable person in whose shoes the court must interpret the contract is the reasonable person to whom the document is addressed, not

just a random reasonable person gazing out of the windows of the Clapham omnibus. So if parties may adhere to, or depart from, a contract over its lifetime (as with, for example, bonds and syndicated loan agreements) "it is the wording of the instrument that is paramount. The instrument must be interpreted as a whole in the light of the commercial intention which may be inferred from the face of the instrument and the nature of the debtor's business" (*Re Sigma Finance Corp* [2009] UKSC 2, at [37] (Lord Collins)). Subsequent participants will know nothing of the negotiations, and can only assess what they are buying on the basis of an objective assessment of the wording.

However, lest it be thought that the wording might become too predominant even in these circumstances, in his next sentence Lord Collins emphasised that "[d]etailed semantic analysis must give way to business common sense."

Where market standard forms are used, the context of an individual transaction is also of limited, if any, significance. For example, "when parties choose to use for a contract a standard wording such as the ISDA Master Agreement form, generally their own circumstances at the time of the contract will not affect the interpretation of the wording. By choosing standard wording, parties usually evince an intention that the wording as incorporated into their contract should be given its usual meaning" (*SwissMarine Corporation Ltd v O W Supply & Trading A/S* [2015] EWHC 1571 (Comm), at [27]).

The meaning of the ISDA Master Agreement cannot realistically vary from transaction to transaction -

indeed, it "is intended to be normative, and to apply in many different situations and with as much straightforward application as possible" (*Lehman Brothers Finance SA v SAL Oppenheim jr & Cie KGAA* [2014] EWHC 2627 (Comm), at [25]). Context therefore slides still further into the background. If the parties want something else, they must draft their own terms.

Even when no market standard form is involved, the requirement to identify the commercial purpose and business common sense is not without its

problems. Not all judges are confident of their ability to do so. As one first instance judge put it recently:

"[t]here is... a need for caution in relying on arguments of "commercial common sense", particularly when they conflict with the intention naturally to be inferred from the language which the parties have chosen to express their bargain... Judges are not always the most commercially-minded, let alone commercially experienced, of people" (*Tartsinis v Navona Management Company* [2015])

### Sunshine from a Rainy Sky

A performance bond provided as follows:

"[2] Pursuant to the terms of the [underlying shipbuilding] Contract, you are entitled, upon your rejection of the Vessel in accordance with the terms of the Contract, your termination, cancellation or rescission of the Contract... to repayment of the pre-delivery instalments of the Contract Price...

[3] In consideration of your agreement to make pre-delivery instalments under the Contract... we hereby undertake to pay to you... all such sums due to you under the Contract..."

The shipbuilder entered an insolvency procedure under South Korean law. The Contract required the shipbuilder to refund pre-delivery instalments if this happened, but the insolvency did not involve the buyer in rejecting the Vessel or in terminating, cancelling or rescinding the Contract as set out in [2]. The shipbuilder refused to return the pre-delivery instalments, so the buyer called on the performance bond. The question was whether, as the buyer contended, "such sums" in paragraph [3] were all pre-delivery instalments that the shipbuilder was obliged to repay, whatever the reason, or whether, as the bank argued, they were only those pre-delivery instalments that the buyer was entitled to recover from the shipbuilder in the circumstances set out in paragraph [2], none of which had occurred.

In *Rainy Sky SA v Kookmin Bank*, the first instance judge ([2009] EWHC 2624 (Comm)) agreed with the buyer, deciding that it was able to recover the pre-delivery instalments under the performance bond.

The Court of Appeal (by a 2-1 majority: [2010] EWCA Civ 582) agreed with the bank that the buyer was only entitled to claim under the performance bond in the circumstances set out in paragraph [2], which had not occurred.

The Supreme Court ([2011] UKSC 50) agreed unanimously with the first instance judge that the buyer was entitled to payment from the bank. A prime influence was the inability of anyone to offer any credible reason as to why the parties would have chosen to exempt the bank from an obligation to repay pre-delivery instalments in the event of the shipbuilder's insolvency. That was, the Court considered, surely the quintessential circumstance in which a bank guarantee was needed. But is that what the words say?



EWHC 57 (Comm), at [54]).

Even the Court of Appeal (though not, at least until recently, the Supreme Court) suffers from the same doubts:

"commercial common sense" is not to be elevated to an overriding criterion of construction and, secondly... the parties should not be subjected to "...the individual judge's own notions of what might have been the sensible solution to the parties' conundrum"... still less should the issue of construction be determined by what seems like "commercial common sense" from the point of view of one of the parties to the contract" (*BMA Special Opportunity Hub Fund Ltd v African Minerals Finance Ltd* [2013] EWCA Civ 416, at [24]).

### A safe harbour?

An example of the dilemma faced by the court is *Napier Park European Credit Opportunities Fund Ltd v Harbourmaster Pro-Rata CLO 2 BV*.

This case concerned whether certain "Unscheduled Principal Proceeds" that arose in a collateralised loan obligation structure should be reinvested or returned to the noteholders in accordance with the payments waterfall in the documents. Unscheduled Principal Proceeds were required to be reinvested rather than returned if "the ratings of the Class A1 Notes have not been downgraded below their Initial Ratings".

The Class A1 Notes were downgraded in February 2010, but were then upgraded in November 2012. Unscheduled Principal Proceeds were received in late 2013 and early 2014. The question for the court was whether reinvestment was prohibited if the Notes had ever been downgraded, or whether the Notes had to be below their Initial Ratings at

the time the Unscheduled Principal Proceeds arose. The holders of the senior ranking notes, who drank from near the top of the waterfall, favoured immediate return, while the holders of more subordinated notes favoured reinvestment.

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**The parties should not be subjected to the individual judge's own notions of what might have been the sensible solution to the parties' conundrum.**

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At first instance ([2014] EWHC 1083 (Ch)), the Chancellor of the High Court recognised that he was addressing the terms of notes that would not remain with the original holders. He observed that "the parties will have been conscious of the need for clarity and certainty in the language they have used. It is for that reason that the court should be particularly cautious about departing from the ordinary and natural meaning of the words".

He considered that the "factual background is not really helpful in resolving the dispute and what is paramount is the wording used in the documentation interpreted as a whole in the light of the commercial intention which that documentation discloses". The judge concluded that the wording was clear and unambiguous: once the Notes had been downgraded, the condition that they "have not been downgraded" could never be fulfilled.

The Court of Appeal ([2014] EWCA Civ 984) disagreed with the Chancellor. The Court of Appeal considered that the test as to whether the Class A1 Notes had been

downgraded only applied when Unscheduled Principal Proceeds arose - it was taking a snapshot of the situation at that time. The document referred on other occasions to circumstances that were, or were not, continuing at the relevant time, but the Court of Appeal said that "to some extent whether such a phrase is necessary to make the meaning of [the reinvestment criterion] clear depends upon whether you think that a historic downgrade of the Class A1 Notes may be a relevant factor at all" (paragraph [40]).

The Court of Appeal was unable, commercially, to conceive that a "historic downgrade" might be relevant, and did not consider the words sufficiently clear to drive them to that conclusion. But was the Court of Appeal right or was the Chancellor correct? Did the Court of Appeal give too much weight to one side's commercial interests, and too little to the other's and to the words? Just how ambiguous are the words?

### Inflationary spirals

This leads to *Arnold v Britton* [2015] UKSC 36, the Supreme Court's most recent exploration of the issues raised by the interpretation of contracts.

The case concerned 99 year leases on plots in a caravan park on the Gower Peninsula. The leases, all of which ran from 1974 (though the relevant leases were granted, in the main, in the 1980s), provided in various formulations for the lessees to pay "a proportionate part of the expenses and outgoings incurred by the Lessor in the repair maintenance renewal and the provision of services hereinafter set out in the yearly sum of Ninety Pounds... for the first Year of the term hereby granted increasing thereafter by Ten Pounds per hundred for every subsequent year or

part thereof" (punctuation was then often omitted, particularly in agreements concerning real property, as more likely to confuse than to illuminate).

The problem, for the lessees, was that this seemed to compound the service charge at 10% annually. This meant that, by the end of the lease, the service charge would be more than £1 million a year. By the time the case got to court, the service charge was already some five times what inflationary increases in the starting £90 would have been; if inflation remains low, even negative, and as compounding takes its scaling effect, the real difference will accelerate.

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### It is not the function of the court when interpreting an agreement to relieve a party from the consequences of his imprudence or poor advice.

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As a result, the lessees argued that the clause should be read with "up to" inserted before "Ten", ie so that £90, duly compounded, acted as a cap on the service charge rather than representing the absolute sum due.

The majority of the Supreme Court would have none of this. The natural meaning of the wording was that lessees had to pay £90 a year, compounded annually at 10%. The unfortunate real escalation in payments was not enough to allow the court to depart from that meaning. In context, there was no obvious mistake, not least because, between 1974 and 1981, inflation had been well over 10% a year (and, indeed,

had been over 15% for six of those years). The lessor took the risk that inflation would continue at that kind of level for the remainder of the term, while the lessees took the risk that inflation would drop, as it has in fact done.

Of potentially more far-reaching importance than the actual result in *Arnold v Britton* are Lord Neuberger's comments about the importance of the language used by the parties, comments with which the rest of the majority agreed:

- "... the reliance placed in some cases on commercial common sense and surrounding circumstances (eg in *Chartbrook [Ltd v Persimmon Homes Ltd [2009] UKHL 38]*, paras 16-26) should not be invoked to undervalue the importance of the language of the provision which is to be construed. The exercise of interpreting a provision involves identifying what the parties meant through the eyes of a reasonable reader, and, save perhaps in a very unusual case, the meaning is most obviously to be gleaned from the language of the provision. Unlike commercial common sense and the surrounding circumstances, the parties have control over the language they use in the contract. And, again save perhaps in a very unusual case, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision."
- "... when it comes to considering the centrally relevant words to be interpreted... the less clear they are, or, put another way, the worse their drafting, the more ready the court can properly be to

depart from their natural meaning. That is simply the obverse of the sensible proposition that the clearer the natural meaning the more difficult it is to justify departing from it. However, that does not justify the court embarking on an exercise of searching for, let alone constructing, drafting infelicities in order to facilitate a departure from the natural meaning."

- "... commercial common sense is not to be invoked retrospectively. The mere fact that a contractual arrangement, if interpreted according to its natural language, has worked out badly, even disastrously, for one of the parties is not a reason for departing from the natural language. Commercial common sense is only relevant to the extent of how matters would or could have been perceived by the parties, or by reasonable people in the position of the parties, as at the date that the contract was made."
- "... while commercial common sense is a very important factor to take into account when interpreting a contract, a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed, even ignoring the benefit of wisdom of hindsight. The purpose of interpretation is to identify what the parties have agreed, not what the court thinks that they should have agreed. Experience shows that it is by no means unknown for people to enter into arrangements which are ill-advised, even ignoring the benefit of wisdom of hindsight, and it is not the function of the court when interpreting an

agreement to relieve a party from the consequences of his imprudence or poor advice. Accordingly, when interpreting a contract a judge should avoid re-writing it in an attempt to assist an unwise party or to penalise an astute party."

These comments are a reiteration of the concerns expressed by some lower courts about placing too much emphasis on commercial common sense. As such, it is a counterblast to the more context-focussed - even anti-textual - approach taken by, for example, Lords Clarke and Mance in *Re Sigma* and *Rainy Sky* (both of whom remain justices of the Supreme Court but were not on the panel in *Arnold v Britton*).

Lord Neuberger also places greater emphasis on the autonomy of the parties to the contract. The parties should be free when they enter into a transaction to decide where the risks are to lie.

Although, Lord Neuberger's approach might look suspiciously like the solution favoured by Patten LJ in the Court of Appeal in *Rainy Sky*, which was rejected by the Supreme Court in that case, Lord Neuberger is probably

not seeking to change fundamentally the approach to interpretation. Rather he is telling judges that, when considering the continuum between, at one end, words that are absolutely clear and, at the other, words that are obviously mistaken, the point at which a court can stray from the wording is further to the right than some might previously have thought.

### Conclusion

Interpreting a contract is often not easy. As Lord Hoffmann said in *Chartbrook*, at [15]: "It is, I am afraid, not unusual that an interpretation which does not strike one person as sufficiently irrational to justify a conclusion that there has been a linguistic mistake will seem commercially absurd to another".

Where the words are crystal clear and the commercial intent plain, construing a contract may pose no problems. But the exercise of interpretation is often a more nuanced process of balancing the clarity of the words against the commerciality of the outcome: the clearer the words, the more extreme the outcome must be to displace them, until the outcome becomes so wholly arbitrary that the words can be dismissed as a mistake.

A party arguing for its favoured interpretation will pray in aid commercial common sense. But if both sides do so, the court may struggle to say that one side's interpretation is necessarily more commercial than the other's. That leaves only the most natural meaning of the language used by the parties, and *Arnold v Britton* raises the bar for any judge who might feel inclined to leave the words behind.

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