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Client briefing
November 2009

The strange death of literal England

English courts pride themselves on their commercial approach to the interpretation of contracts. To the extent that this prevents a party succeeding on an obviously unmeritorious technicality, no one will object. But problems emerge when a technicality is not so obvious and, still more so, if the wording of the contract points in one direction but judicial desires in another. Can the parties' words be ignored and, if so, when? The recent *Sigma* case, about the distribution of assets on the failure of a structured investment vehicle, has brought these issues to the fore, with the suspicion that the courts – particularly the higher courts – are stepping too far in the direction of re-writing contracts rather than merely construing them. By doing so, they risk generating uncertainty.

Key Issues

- **Interpretation involves finding the meaning a document would convey to a reasonable person with all the background knowledge reasonably available to the parties**
- **The starting point is the parties' words, but the background can displace the natural meaning of the words**
- **Contractual certainty gives primacy to the words, but judicial conceptions of commerciality might point in another direction**
- **How willing should judges be to ignore the parties' words?**
- **We review recent developments in contractual interpretation**

Introduction

"The philosophers have only interpreted the world in various ways; the point is to change it", according to Karl Marx. When a court considers a written contract between commercial parties, its role is very definitely not to change the contract. The point is to find the outcome the parties intended in the particular circumstances that have arisen. The question is not what is fair or reasonable, but one of recognising the right of the parties to define their relationship in the way that they see fit. The courts have repeatedly asserted that their role is to identify and construe the parties' bargain, not to re-write it.

That much is easy to state. In an ideal world, of course, all possible scenarios will have been identified and the outcomes defined in language of perfect clarity. In such a world, the court's task is easy. Alas, this ideal world does not exist. The parties' objectives may be obscure or contradictory, their language may be vague and the unexpected always seems to happen. Construing a contract can be difficult, but the central aim of the exercise remains to determine the parties' intention.

What is the parties' intention for these purposes? It is not the parties' actual, subjective, intention. The English courts approach construction objectively: what would a reasonable person in the position of the parties and with all the information available to both parties have intended? The starting point is the parties' language, but what beyond that language is admissible and how ready should the courts be to twist and, ultimately, to break the parties' words in order to achieve the result the courts would like? If too little attention is paid to the parties' language, the process of interpretation becomes one of re-writing, of changing the bargain that the parties reached. The courts must take care to ensure that they do not reach that stage, but in *Re Sigma Finance Corporation* [2009] UKSC 2 they may already have done so.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Kate Gibbons +44 (0)20 7006 2544

Simon James +44 (0)20 7006 8405

Matthew Newick +44 (0)20 7006 8492

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

The death of legalism

The most cited statement of how contracts should be interpreted is that of Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, set out in Box 1. Lord Hoffmann announced that the changes in approach over the previous 30 years or so meant that any concept of a "legal" interpretation was dead. No longer should the parties be tripped up by linguistic accidents but instead the courts should look to find "the meaning which the document would convey to a reasonable person having all the knowledge which would have been available to the parties in the situation in which they were in at the time of the contract."

A clear example of this change in approach is the fate of *Hankey v Clavering* [1942] 2 KB 326 at the hands of the House of Lords in *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749. Both cases concerned notices to terminate a lease. In *Hankey*, a lease of 21 years from 25 December 1934 could be terminated by the landlord at the end of seven years by giving six months' notice. On 21 June 1942, the landlord gave notice purporting to terminate the lease on 21 December 1942 rather than on 25 December.

The Court of Appeal decided that the notice was invalid and that the lease did not terminate on either 21 or 25 December 1942. Lord Greene MR pronounced the uncompromising verdict: "The whole thing was obviously a slip on his [the landlord's] part, and there is a natural temptation to put a strained construction on language in aid of people who have been unfortunate enough to make slips. That, however, is a temptation that must be resisted, because documents are not to be strained and principles of construction are not to be outraged in order to do what may appear to be fair in an individual case."

Fifty-five years later, the House of Lords could resist anything but temptation. In *Mannai*, the facts were essentially the same (notice to quit giving a date of 12 January rather than the correct date of 13 January). The House of Lords decided that the issue was how a reasonable recipient would have understood the notice. The reasonable recipient would have read the lease, known the correct date, and understood what the landlord was trying to do. Outrage or not, since the reasonable recipient would have understood what the landlord was trying to achieve, the notice was valid. *Hankey* was wrong.

It is easy to have sympathy with this notion that technicalities should be abandoned (though the House of Lords only reached its conclusion in *Mannai* on a 3-2 majority), at least when the intention is as obvious as it was in both *Hankey* and *Mannai*. But when it comes to more complex transactions, how is the court to determine the

Box 1 – How to interpret contracts

"I do not think that the fundamental change which has overtaken this branch of the law... is always sufficiently appreciated. The result has been, subject to one important exception, to assimilate the way in which such documents are interpreted by judges to the common sense principles by which any serious utterance would be interpreted in ordinary life. Almost all the old baggage of "legal" interpretation has been discarded. The principles may be summarised as follows:

(1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.

(2) The background was famously referred to… as the "matrix of fact," but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.

(3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent… The law makes this distinction for reasons of practical policy…

(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 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.

(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… "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"." *Investors Compensation Service Ltd v West Bromwich Building Society* [1998] 1 WLR 896, 912-3 (Lord Hoffmann)

parties' intention behind a particular clause in a contract? The objective approach to interpretation frees them from the need to consider the parties' actual intention, but what else is there?

It's only words

The evidence that the court can admit in order to identify the parties' (objective) intention is limited. For example, in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 3 WLR 267, the House of Lords confirmed (albeit somewhat reluctantly) that evidence of the negotiations – in particular, drafts of the contract – is not admissible. The court is left with the words the parties have used, together with the relevant background, ie information that would have been reasonably available to the parties and that would have affected the way the language was understood.

Box 2 – What is commercial commonsense?

"27 …this court must have regard to the parties' aim, objectively ascertained, as part of the process of interpretation, if that aim can be ascertained.

28 In my judgment, this must be the case even if (as here) there is little evidence as to the circumstances surrounding the parties' agreement to the transaction other than the terms of the transaction itself. Even in that event, the court must consider whether the objective aim can be ascertained from the documentation. (Moreover, when the issue of interpretation arises as to documentation to which, as here, parties adhere at different points in time, the commercial aims as shown by the documentation are for obvious reasons of practicality of particular significance.) To that end, unless the contrary appears, the court must assume that the parties to a commercial document intended to produce a commercial result, and the court must thus take into account the commerciality of the rival constructions, if that commerciality can be identified. The commerciality of a particular construction may be a crystallising factor in its favour where it is implausible that parties would have intended any other result.

29. The line between giving weight to the commerciality of a provision and writing a provision into an agreement can become a fine one when the court finds that there are deficiencies in the drafting of the contractual documents. There are cases where the documentation simply leaves the parties' intentions as to what should happen in a foreseeable set of circumstances quite unclear. This is particularly liable to happen in what might be called multi-dimensional documentation because of the sheer number of permutations that those who negotiate and draft the documents have to take into account. The court can spend a great deal of time immersed in the detail of lengthy contractual documents searching for clues. That task has to be carried out but if, despite a thorough search, the position is still unclear, and more than one meaning is properly available, the right approach is surely to give greater weight to the presumption that the parties must have intended some commercial result than to the textual clues if the latter yields an uncommercial result." *Re Golden Key Ltd* [2009] EWCA Civ 636 (Arden LJ)

The starting point, therefore, is the parties' words: "the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage" (*BCCI v Ali* [2002] 1 AC 251, 269). If the words are ambiguous, the commercial background may be of assistance, but the background can be prayed in aid even where there is no ambiguity in the words. Despite the regular judicial appeals to the commercial expectations of the parties and whether a particular interpretation makes commercial sense, there remains a fundamental problem in identifying what that commercial background is.

In *Re Golden Key* [2009] EWCA Civ 636 (a case, like *Sigma*, about an SIV), it was argued that these appeals were meaningless because the court had no idea what the parties expected. The court rejected this argument (see Box 2). Even without evidence as to the parties' commercial aims, the court will assume that the parties intended to achieve a "commercial" result.

Further, the role of the actual background diminishes where the parties adhere to a contract at different times, as with many financial contracts, because that background will not be known to all the contracting parties. In these circumstances, there is nothing beyond the parties' words and, more significantly, the courts' own conceptions as to what a commercial result might be. But what is a commercial result to one person might be profoundly uncommercial to another. It is hard to resist the conclusion that the incantation of "commerciality" is often a means to allow judges to achieve the answer they think the parties should have come to - the answer that, in retrospect, seems fair - rather than the answer the parties actually provided.

This problems of identifying commerciality become starker when the parties' language is clear but the court decides to "correct" that language. According to the House of Lords in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 3 WLR 267, the courts can correct language when there is a clear mistake (though it is enough if the mistake is only apparent from the background rather than the document itself) and the correction is also clear. "It clearly requires a strong case to persuade the court that something must have gone wrong with the language… 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" (paragraph [15],

Lord Hoffmann). In other words, it's all very difficult, but that will not stop the court from trying.

Implication incorporated

Implying terms into a contract has traditionally been treated as distinct from construing a contract. However, in *Attorney General of Belize v Belize Telecom* [2009] 1 WLR 1988, implied terms were brought within the interpretative fold. Officious bystanders, business efficacy and the other traditional inhabitants of the world of implied terms were cast aside in favour of a single question: does the supposed implied term "spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean." In other words, interpretation and implication are part of the same process.

The introduction of the reasonable man into the process of implication caused some concern. Would it now be easier to imply terms than might have been the case in the past? In *Mediterranean Salvage & Towage Ltd v Seamar Trading & Commerce Inc* [2009] EWCA Civ 531, the Court of Appeal said no. The starting point is that if a contract does not address something expressly, nothing is to happen – any loss will lie where it falls. A term can only be implied if the term is necessary to make the contract work, not just because it might be reasonable. When it comes to implication, therefore, the reasonable man is conservative and will not readily insert terms into the parties' contract.

The range of reasonable persons

Even outside implied terms, the reasonable man is not a single species. He has been described by one judge as "the anthropomorphic conception of justice" but, when construing a contract, the characteristics of this anthropomorphism depends upon the "audience" to which the contract is addressed.

For example, in *The Starsin* [2004] 1 AC 715, the House of Lords considered that the audience for a bill of lading is the businessman. As a result, any contradiction between the front of the bill and the small print on the back was to be resolved in favour of the front because that was the part that the reasonable businessman would read. The courts will be less strict on the words if the audience is lay rather than lawyerly.

But where the issue turns solely upon the proper construction of the small print, the audience becomes a lawyer of the utmost sophistication. In particular, it becomes a lawyer who, on spotting that a clause did not read coherently, would research into the origins of the clause, see that it had been borrowed from another set of terms but that, in copying the clause from one document into the other, the copyist had committed a homoeoteleuton (ie the eye moving from a word on one line to the same word on the line below, omitting the intervening words). This sophisticated audience would therefore treat the missing words as if they were there.

The Starsin may be an unusual case, but the range of reasonable men offers the courts flexibility. In most cases, however, the average reasonable man approximates most closely to the average judge. The issue is what will the document mean to the average judge, with all the preconceptions and expectations that go with being a judge, including the desire to reach what the judge considers the right conclusion on the underlying merits. The less attractive a particular interpretation will be to a judge, the more clearly it must be spelt out in order to leave the judge no choice but to recognise that it was what the parties intended.

In *The Starsin*, the House of Lords endorsed every kind of homily about the process of interpretation: “business sense will be given to business documents”; “to seek perfect consistency and economy of drafting in a complex form of contract which has evolved over many years is to pursue a chimera”; “[the court] must seek to give effect to the contract as intended, so as not to frustrate the reasonable expectations of businessmen”; “in all mercantile transactions the great object should be certainty”; “commercial men must be given the utmost liberty of contracting. They must be left free to... allocate commercial risks”. But these maxims are not consistent. Commercial certainty means paying attention to the language chosen by the parties, but business sense is more likely to focus on the background to the detriment of the words. Judges are free to choose from these maxims the one that best enables them to reach the conclusion that they want to reach.

And that leads to *Sigma*.

Re Sigma Finance Corporation

Sigma was a structured investment vehicle that issued short term commercial paper, using the proceeds, together with other funds, to invest in asset-backed securities. Sigma granted security over all its assets to a Trustee under the terms of a Trust Deed. In the aftermath of Lehman's collapse, Sigma's directors decided that Sigma was insolvent. On 6 October 2008, the Trustee appointed Receivers to realise and distribute Sigma's assets in accordance with the Trust Deed.

The Trust Deed provided for a 60 day Realisation Period during which the Receivers were to establish short term (less than 365 days) and long term asset pools for creditors with short term and long term liabilities. However, "[d]uring the Realisation Period the [Receivers] shall so far as possible discharge on the due dates therefor any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer" (clause 7.6).

Sigma's assets amounted to US$450 million. Its total secured liabilities exceeded US$6 billion, of which some US$1.35 billion fell due in the Realisation Period. The question for the courts was whether Sigma's assets should be used to pay those secured creditors whose debts fell due within the Realisation Period, leaving nothing for the remaining creditors, or whether the assets should be applied pari passu across all creditors.

The lower courts were persuaded that clause 7.6 of the Trust Deed meant what it said. The Receivers were required to adopt a pay as you go approach, using Sigma's assets to meet liabilities as they fell due within the Realisation Period until all assets were gone. The Supreme Court (the recent replacement for the House of Lords) reached a different conclusion, by a 4-1 majority, requiring assets to be applied pari passu ([2009] UKSC 2).

Pari passu reflects the normal distribution of assets on an insolvency, and the majority of the Supreme Court simply could not bring themselves to believe that the parties could have intended anything else, notwithstanding the clear words in clause 7.6. Their justifications for this conclusion are in Box 3.

The majority did not suggest that the wording of clause 7.6 was a mistake – they could not have done so since the wording is as evidently deliberate as it is grammatically correct. Instead, they appealed to commercial intention in order, in effect, to ignore clause 7.6. They suggested that the clause 7.6 could have been clearer. May be that is so – the clause could have said expressly that debts falling due in the Realisation Period took priority – but the lack of clarity identified by the Supreme Court is only a major obstacle to those whose starting point is that the parties cannot have intended debts falling due in the Realisation Period to be paid before others. How was the drafter supposed to anticipate that the members of the Supreme Court would cling like barnacles to the pari passu approach of English insolvency law even though insolvency law was not engaged?

As the dissenting member of the Supreme Court, Lord Walker, put it: “One of the most striking features of the landscape of the deed… is that clause 7 does not provide for the immediate winding up of Sigma… On the contrary, secured creditors are prohibited from taking steps to wind up the company. It is therefore necessary to repress any instinctive feeling (and it is, I acknowledge, a strong instinctive feeling) that pari passu distribution.. is the most natural (one might almost say the only rational) solution.”

The Supreme Court’s approach also gives rise to a logical conundrum where there is no mistake in the language: how could it have been the parties’ intention to provide for a pari passu distribution in the Realisation Period when the parties expressly provided otherwise? Wording can always be clearer, but that is a long way from saying that clause 7.6 is not clear.

This tendency of courts to disregard the parties' words in favour of a "commercial" interpretation seems to be stronger in the House of Lords, and now the Supreme Court, than in the lower courts. For example, in *Sigma* itself, both lower courts held in favour of pay as you go (the Court of Appeal by a 2-1 majority, the dissenting judge being a member of the House of Lords temporarily sitting in the lower court). Similarly, in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 3 WLR 267, the lower courts decided in favour of one interpretation

Box 3 – *Re Sigma Finance*: a step too far?

"12. In my opinion, the conclusion reached below attaches too much weight to what the courts perceived to be the natural meaning of… clause 7.6, and too little weight to the context in which that sentence appears and to the scheme of the Security Trust Deed as a whole… I also think that caution is appropriate about the weight capable of being placed on the consideration that this was a long and carefully drafted document, containing sentences and phrases which it can, with hindsight, be see could have been made clearer, had the meaning now sought to be attached to been specifically in mind… Of much greater importance in my view, in the ascertainment of the meaning that the Deed would convey to a reasonable person with the relevant background knowledge, is an understanding of the overall scheme and a reading of its individual sentences and phrases which places them in the context of the overall scheme." (Lord Mance)

"35… In complex documents of the kind in issue there are bound to be ambiguities, infelicities and inconsistencies. An over-literal interpretation of one provision without regard to the whole may distort or corrupt the commercial purpose… this is not the type of case where the background or matrix of fact is or ought to be relevant, except in the most generalised way… 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 from the nature of the debtor's business. Detailed semantic analysis must give way to business common sense…" (Lord Collins)

(the Court of Appeal by a 2-1 majority, the dissenting judge now being a member of the Supreme Court), but the House of Lords reached a different conclusion despite acknowledging that the lower courts' interpretation accorded with the natural meaning of the words. A chasm could be opening up between the lower and the higher courts, but the lower courts should not try to cross to that chasm to the other side.

Conclusion

The Supreme Court in *Sigma* was far from saying that parties cannot agree on a pay as you go approach, but the further the parties wish to depart from what a judge might consider to be a commercial outcome, the clearer the drafting must be. This has long been the case with exclusion clauses, but that is at least dealing with a known category of clause with ample authority as to what is likely to pass judicial muster and what is not. The Supreme Court has extended this approach to the whole contract, requiring drafters to undertake the impossible task of predicting what a judge will like and what a judge will not.

Drafting a contract is therefore made (even) more difficult. Construing a contract after the event also risks being beset by uncertainty. The starting point remains the words. If the words say what you want them to say, you are in poll position. But that will not, on its own, secure victory. As in *Sigma*, the background can change the meaning of the words even if the words are not ambiguous. It is therefore necessary to go on to explain why that interpretation offers a sensible commercial outcome. For that reason, even if the words are against the interpretation that you want, it may still be possible to overturn their natural meaning by demonstrating the lack of supposed commerciality of any other outcome. The result is that even the clearest words are potentially vulnerable to reinterpretation, which can only produce uncertainty: how can anyone be sure that a particular document will not be subject to a "commercial" rather than a more literal interpretation? Uncertainty is a profoundly uncommercial outcome.

Lord Greene MR's thesis in *Hankey* was too severe in tripping up a party on an obvious mistake, but in *Sigma* the Supreme Court's antithesis has gone too far. A synthesis needs to be reached that pays proper regard to the words used by the parties while not being too technical. Courts must confine themselves to the interpretation of contracts, and not follow Marx in trying to change what comes before them.