The Interpretation of Commercial Contracts

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The object of interpretation

The interpretation of commercial contracts is a pre-eminent issue in commercial litigation and arbitration. Commercial lawyers spend much of their time reading and writing contracts. Understanding how the courts interpret contacts is therefore a key part of any commercial lawyer.

Lord Denning has written that, *"In the daily practice of the law, the most important subject is the construction of documents"*[1]

I must therefore congratulate the organisers of this seminar for having chosen a topic which is of ever increasing importance, given that we are inviting foreigners to invest in several of our sectors.

They will come with their standard format of documents and their own laws and their understanding of it, to work in an entirely different cultural, social and legal milieu and would no doubt wish to know from you how disputes over meaning of contractual terms will be resolved in Sri Lanka, either in

litigation or in arbitration. You might also have to bear in mind that the governing law of these contracts may

1 The Discipline of the Law (1979). Introduction

not be the law of Sri Lanka. If that be so, you may also have to understand and advice foreign business interests how disputes over meaning of terms may be resolved where other laws, chosen as the law applicable to contract, apply.

Given that, you are no doubt in for exciting times. But it also means you have to buckle up. Watch out for free trade agreements – lots of drafting to do!

The construction of documents generally

The process of construction of a document or a contract may be said to be the ascription of legal meaning or effect to the words of the document or of the contract. It is the outcome of a process of analysis that is said and intended to be objective. In seeking objective certainty, the courts seek to promote efficiency in commercial dealings. One strange consequence of the courts' approach to construction is that the objective meaning and effect ascribed to the parties' bargain may differ from the subjective understanding of the parties, or indeed their mutual subjective understandings. There is a remedy – rectification – for the latter; the former is part of the price of certainty.

Over the last quarter of a century or so, the English common law on the construction of documents, which I was taught by Mr. Fifoot (of the Cheshire and Fifoot -Law of Contract fame) in the 1960's has seen an explosion in the number of cases on contractual interpretation, and a corresponding increase in its academic discussion.

It is still evolving though, indicating a new direction of travel as would appear from recent judgments of the UK Supreme Court. But the general guiding principle is that the ultimate aim of interpreting a provision in a contract, especially a commercial contract, is to determine what the parties meant by the language used, which involves ascertaining what a reasonable person would have understood the parties to have meant.

You might of course well ask, who might this reasonable person be? Could it be that man on the famous 'Clapham Omnibus'? That hypothetical ordinary and reasonable person introduced by courts in England during the Victorian era to decide whether a party has acted as a reasonable person in actions in negligence? The answer is yes and no –it seems he is a modern man.

The answer of the English courts is that the relevant reasonable person is one who has 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.[2]

To discuss them all today is a task which will take me well beyond the time allotted to me this morning. But I must start somewhere in trying to help explain the way in which the courts interpret contracts and some of the divergences of views about the approach to interpretation.

The interpretation of contracts

In the interpretation of contracts several questions arise. Such as,

- what is the guiding principle?
- Can objective intention of parties be considered?
- Is subjective intention of any relevance?
- What materials are available when interpreting a contract?
- Has a contract to be read as a whole?

2 Arnold v Britton and others (2015) UKSC 36.

- Can it be read in the light of their background facts?
- Can words be implied?
- Can words in the contract be disregarded if the court thinks that the parties could not have intended them?
- Can the court change the words in a contract?
- Can the court make a contract for the parties?

- So on and so forth.

In dealing with all of these, as I said earlier, I must start somewhere, and I have chosen for that purpose what has become a much cited passage from the speech in 1998, of Lord Hoffmann in *Investors Compensation Scheme v West Bromwich Building Society*[3]. And I quote:

" My Lords, I will say at once that I prefer the approach of the learned judge. But I think I should preface my explanation of my reasons with some general remarks about the principles by which contractual documents are nowadays construed. I do not think that the fundamental change which has overtaken this branch of the law, particularly as a result of the speeches of Lord Wilberforce in *Prenn v. Simmonds* [1971] 1 W.L.R. 1381, 1384-1386 and *Reardon Smith Line Ltd. v. Yngvar Hansen-Tangen* [1976] 1 W.L.R. 989, 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

intellectual 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 background 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 by Lord Wilberforce 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. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

(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 its 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. (see Mannai Investments Co. Ltd. v. Eagle Star Life Assurance Co. Ltd. [1997] 2 WLR 945

3 (1998) 1 All E R 98

(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 The Antaios Compania Neviera S.A. v. Salen Rederierna A.B, The Antaios:[4]

> ". . . if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense."

This was the starting point of discarding the old intellectual baggage of "legal" interpretation and the beginning of the new. It came to be known as the five principles of interpretation of documents.

Lord Bingham of Cornhill, summarized it as follows:

"To ascertain the intention of parties the court reads the terms of the contract as a whole, giving the word used their natural and ordinary meaning in the context of the agreement, the parties' relationship and all the relevant facts surrounding the transaction so far known to the parties. To ascertain the parties' intention the court does not of course inquire into the parties' subjective states of mind but makes an objective judgment based on the materials already identified."[5]

The five Principles of Lord Hoffmann

The first principle, as you see, is "*the meaning which the document will convey.*"

Beguilingly simple though the formulation of this principle is, it contains a fundamental approach, in that it postulates that the interpretation does not involve the search for actual intentions of the parties, but for an objective

meaning- what the words would signify to a properly informed ordinary speaker of English.

The second principle deals with admissible evidence – the "*matrix of fact*".

In *B.C.C.I v Ali*,[6] Lord Hoffmann considered the scope of this rule and explained that "*absolutely anything"* meant "*anything that would have affected the way in which the language of the document would have been understood by a reasonable man… which can include the state of the law"* .

However, Lord Steyn in *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd*[7] qualified it saying, "*what is admissible as a matter of the rules of evidence under this heading is what is arguably relevant…The real question is what evidence of surrounding circumstances may ultimately be allowed to influence the question of interpretation. That depends on what meanings the language read against the objective contextual scene will let in."*

This qualification currently would appear to encapsulate the English approach.

The third principle is the exclusion of previous negotiations. As Lord Steyn put it in *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd*[8], *" the inquiry is objective; the question is what reasonable persons ,*

4 (1985) A.C. 191, 201.
5 Bank of Credit and Commerce International v Ali (2001) U.K.H.L. 8
6 Supra
7 (1997) AC 749 at 778
8 Supra

circumstanced as the actual parties were, would have had in mind."

This is a reflection of the principle that a contract must be interpreted objectively.

The fourth principle deals with the meaning of words as contextual, that is not the meaning in dictionaries and grammars but what the parties using those words against relevant background would reasonably have been understood to mean.

Lord Hoffmann in *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd*[9] expounds it as follows:

" It is of course true that the law is not concerned with the speaker's subjective intentions. But the notion that the law's concern is therefore with the "meaning of his words" conceals an important ambiguity. The ambiguity lies in a failure to distinguish between the meanings of words and the question of what would be understood as the meaning of a person who uses words. The meaning of words, as they would appear in a dictionary, and the effect of their syntactical arrangement, as it would appear in a grammar, is part of the material which we use to understand a speaker's utterance. But it is only a part; another part is our knowledge of the background against which the utterance was made. It is that background which enables us, not only to choose the intended meaning when a word has more than one dictionary meaning but also, in the ways I have explained, to understand a speaker's meaning, often without ambiguity, when he has used the wrong words.

When, therefore, lawyers say that they are concerned, not with subjective meaning but with the meaning of the language which the speaker has used, what they mean is that they are concerned with what he would objectively have been understood to mean. This involves examining not only the words and the grammar but the background as well. So, for example, in *Doe d.Cox v. Roe* (1803) 4 Esp. 185 the landlord of a public house in Limehouse gave notice to quit "the premises which you hold of me. . . commonly called . . . the Waterman's Arms." The evidence

showed that the tenant held no premises called the Waterman's Arms; indeed, there were no such premises in the parish of Limehouse. But the tenant did hold premises of the landlord called the Bricklayer's Arms. By reference to the background, the notice was construed as referring to the Bricklayer's Arms. The meaning was objectively clear to a reasonable recipient, even though the landlord had used the wrong name. We therefore will in due course have to answer the question: if, as long ago as 1803, the background could be used to show that a person who speaks of the Waterman's Arms means the Bricklayer's Arms, why can it not show that a person who speaks of 12 January means 13 January?"

The fifth principle is the importance of the words. One does not readily accept that people make linguistic mistakes in formal documents. But one could nevertheless conclude that something must have gone wrong in the use of words. Then the law is not obliged to attribute to the parties an intention that they plainly could not have had.

What this means is best put in the words of Lord Hoffmann in *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd*[10]. He said:

" I propose to begin by examining the way we interpret utterances in everyday life. It is a matter of constant experience that people can convey their meaning unambiguously although they have used the wrong words. We start with an assumption that people will use words and grammar in a conventional way but quite often it becomes obvious that, for one reason or another, they are not doing so and we adjust

9 Supra

10 Supra

our interpretation of what they are saying accordingly. We do so in order to make sense of their utterance: so that the different parts of the sentence fit together in a coherent way and also to enable the sentence to fit the background of facts which plays an indispensable part in the way we interpret what anyone is saying. No one, for example, has any difficulty in understanding Mrs. Malaprop.

When she says "She is as obstinate as an allegory on the banks of the Nile", we reject the conventional or literal meaning of allegory as making nonsense of the sentence and substitute "alligator" by using our background knowledge of the things likely to be found on the banks of the Nile and choosing one which sounds rather like "allegory".

Mrs. Malaprop's problem was an imperfect understanding of the conventional meanings of English words. But the reason for the mistake does not really matter. We use the same process of adjustment when people have made mistakes about names or descriptions or days or times because they have forgotten or become mixed up. If one meets an acquaintance and he says "And how is Mary?" it may be obvious that he is referring to one's wife, even if she is in fact called Jane. One may even, to avoid embarrassment, answer "Very well, thank you" without drawing attention to his mistake. The message has been unambiguously received and understood."

However, later in in *Jumbo King Ltd v Faithful Properties Ltd*[11] Lord Hoffmann pointed out:

"Of course in serious utterances such as legal documents, in which people may be supposed to have chosen their words with care, one does not readily accept that they have used the wrong words. If the ordinary meaning of the words makes sense in relation to the rest of the documents and the factual background, then the court will give effect to the language, even though the consequences may appear hard for one side or the other".

And in *B.C.C.I v Ali*[12] he reiterated *"… the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage : '…we do not easily accept that people have made linguistic mistakes, particularly in formal documents".*

It should be remembered that although the five principles deal with different aspects of the techniques of interpretation of contracts they must be read as a whole to avoid giving to any one of the principles a meaning and importance unqualified by the other rules set out by Lord Hoffmann.[13]

Commercial purpose of contracts- the business common sense

In the case of commercial contracts, the courts have over several decades sought in addition to the words of the instrument and the particular facts proved by evidence admitted in aid of construction have also been laying considerable emphasis on the commercial purpose of the contract under consideration.

Thus in *Mannai*[14] Lord Steyn said:

"In determining the meaning of the language of a commercial contract,…the law…favours a commercially sensible construction. The reason for this approach is that commercial construction is more likely to give effect to the intention of the parties. Words are therefore interpreted in the way in which a reasonable commercial person would construe them. And the standard of the reasonable commercial person is hostile to technical interpretation and undue emphasis on niceties of language."

11 (1999) H.K.C.F.A.R. 279

12 Supra

13 See Paten J., in HSBC Bank plc v Liberty Mutual Insurance (2001) All E.R. (D) 61.

14 Supra

Recall the words of Lord Diplock in *The Antaios*[15], where he said:

"…if a 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 yield to business common sense."

However, where the words of the contract are clear the commercial purpose as perceived by court cannot override the clear words of the contract. This is a limit to the business common sense rule. One of the difficulties inherent in the attempt to construe contracts in accordance with their apparent commercial purpose is that, in the first place, the parties may not give evidence of their intention in entering into the contract in the form they did. Nor may the court receive evidence of the negotiations between the parties: so it becomes impossible to ascertain if the matter has been the result of bargaining between the parties. Secondly, neither the advocates nor the judges who determine them are commercial men! There is the real danger that the intention of the parties may sometimes be frustrated. Courts therefore approach the application of this rule with caution.

Over the years the English courts have dealt with many disputes in this way over the meaning and effect of commercial bargains. But giving an account of the these developments is near impossible in a paper like this, but I might say that a recent judgment of the UK Supreme Court would appear to encapsulate "*the correct approach to be adopted to the interpretation , or construction, of contracts"* in the words of Lord Neuberger, President of the UK Supreme Court in the case of *Arnold v Britton and others*[16] [concerning the interpretation of a lease] delivered on the 10th of June 2015, with copious reference to all the earlier judgments on the subject.

Lord Nueberger has this to say on the interpretation of contractual provisions;

"Over the past 45 years, the House of Lords and Supreme Court have discussed the correct approach to be adopted to the interpretation, or construction, of contracts in a number of cases…

When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to "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", to quote Lord Hoffmann…it does so by focusing on the meaning of the relevant words, … in their documentary, factual and commercial context.

That meaning has to be assessed in the light of

(i) *the natural and ordinary meaning of the clause,*

(ii) any other relevant provisions of the lease,

(iii) the overall purpose of the clause and the lease,

(iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and

(v) commercial common sense, but

(vi) disregarding subjective evidence of any party's intentions…

For present purposes, I think it is important to emphasise seven factors.

First, the reliance placed in some cases on commercial common sense and surrounding

15 Supra

16 (2015) UKSC 36

circumstances… 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, that 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 a contract. And, again save perhaps in a very unusual case, the parties must have been specifically focusing on the issue covered by the provision when agreeing the wording of that provision.

Secondly, when it comes to considering the centrally relevant words to be interpreted, I accept that the less clear they are, or, to put it 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. If there is a specific error in the drafting, it may often have no relevance to the issue of interpretation which the court has to resolve.

The third point I should mention is that 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, or 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…

Fourthly, 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 a 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.

The fifth point concerns the facts known to the parties. When interpreting a contractual provision, one can only take into account facts or circumstances which existed at the time that the contract was made, and which were known or reasonably available to both parties.

Given that a contract is a bilateral, or synallagmatic, arrangement involving both parties, it cannot be right, when interpreting a contractual provision, to take into account

a fact or circumstance known only to one of the parties.

Sixthly, in some cases, an event subsequently occurs which was plainly not intended or contemplated by the parties, judging from the language of their contract. In such a case, if it is clear what the parties would have intended, the court will give effect to that intention…"

In quoting the above passage I have taken the liberty, to omit the "*seventh factor"* as it related to the facts of the case; as also the liberty, out of concern for brevity and attention span, to edit the passage by breaking them up and omitting references to case law and examples given to illustrate a point. Those who are interested in further research of this fascinating area of jurisprudence I would recommend that you read the whole passage in the full report of the case.

Question of fact and question of law

Hitherto I have been dealing with the object of interpretation – namely the various principles applied by courts to ascertain the mutual intentions of the

parties as to the legal obligations assumed by the contractual words in which they have sought to express them.

It is therefore, important to remember that the ascertainment of the meaning of a particular word is a question of fact, but the proper construction of a contract is a question of law.

Very often in the commercial world we come across standard forms of commercial agreements. In such cases the courts are reluctant to disturb an established construction, as it recognizes the desirability of certainty.

In *The Annafield*[17] Lord Denning M.R. said:

"Once a court has put a construction on commercial documents in a standard form, commercial men act upon it. It should be followed in all subsequent cases. If the business community is not satisfied with the decision, they should alter the from."

Implying terms in construction of contracts

In your experience, sometimes, you might have come across instances where courts imply terms in the construction of contracts. However, it is established that in order for a term to be implied certain conditions must be fulfilled. The clearest statement of that is to be found in the judgment of the majority of the Privy Council in *B.P.Refinery (Westernport) Pty Ltd v Shire of Hastings*[18]in which Lord Simon of Glaisdale said:

" …for a term to be implied , the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that 'it goes without saying'; (4) it must be capable of clear expression ; (5) it must not contradict any express term of the contract."

Business efficacy

The expression "*business efficacy"* seems to derive from the well known judgment of Bowen LJ., in *"The Moorcock".*[19] Where he said:

"In business transactions such as this, what the law desires to give effect by the implication is to give such business efficacy to the transaction as must have been intended at all events by both parties who are businessmen…"

17 (1971) P 168
18 (1978) 52 A.L.J.R. 20: 180 C.L.R. 266.
19 (1889) 14 P.D. 64.

Just a few last words!

Cannons of construction

I cannot conclude this paper without touching on what is called 'cannons of construction.'

The cannons of construction are not rules of law; they are guidelines to the interpretation of English language – it is they which were dismissed as "*intellectual baggage"* by Lord Hoffmann in *Investors Compensation Scheme*[20]. However, they still have their supporters. Thus Lord Diplock said of them[21]

"*many of them are rules of composition which any writer seeking clarity of expression is likely to follow, such as expressio unis exclusio alteris, ejusdem generis*

and noscitur a sociis though, unlike lawyers, he does not express them in arcane obscurity of the Latin tongue".

Judges face different challenges when interpreting the terms of a contract. As a result, different canons exist to aid a court in resolving a dispute between the parties to a contract.

As in statutory construction, in a contract dispute the court gives contract terms their plain and ordinary meaning, interpreting them as ordinary, average, or reasonable persons would understand them.

If the language of the contract is clear and unambiguous, there is no room for further interpretation and the court will enforce the contract as written. By doing so, the court gives effect to the parties' intentions in making the contract and avoids adding its own interpretation to the agreement.

If the contract contains ambiguous terms, however, they are strictly construed against the party who drafted the contract. This rule of strict interpretation is often applied in contracts containing *exculpatory clauses*, or provisions that attempt to insulate a party, usually the party who drafted the contract, from liability.

A court may look to other canons of construction or interpretation if it determines that the terms of a contract are ambiguous.

In business situations, the court may consider the course of dealing or course of performance that is, the pattern of conduct observed in previous transactions between the parties.

Such evidence can help the court determine the intent of the parties at the time they entered the contract and provides additional terms that, though they are not expressly contained in the agreement, the court can use to interpret the contract.

Thus, where one party to the contract alleges that the other breached the contract by failing to make payment in the proper manner, and the contract contains no express provisions concerning payment, the court can consider how the parties handled the issue of payment in previous transactions to resolve the issue.

A court can also look to usage of trade to aid its interpretation of an ambiguous agreement. A *usage of trade* is a commercial practice or industry custom having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement. As a result, if a contract is unclear about how shipment of a specific type of goods is to be handled, the court can consider evidence of general industry practice in the area to help

20 Supra

21 Prestcold (Central) Ltd v Minister of Labour (1969) 1 All.E.R. 69

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determine what the parties intended with respect to shipment.

There are so many other aspects relative to the construction of commercial contracts and documents in general, for which I have neither time nor the capacity to deal with it short of attempting to write a book on the subject!

I have tried to capture in this presentation as much as possible the principles involved in the interpretation of commercial contracts, and I hope you will find it helpful in your day to day practice.

I wish you every success in your endeavours to achieve excellence.

Thank you.

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