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ARTICLES

HOW DO THE COURTS INTERPRET COMMERCIAL CONTRACTS?

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THE title to this paper might be thought to suggest that there is something special about commercial contracts. That is not the case; it is often said, with some degree of truth, that commercial contracts are construed in the same way as any other contracts. If there is a distinction to be drawn in this field, it is between written and oral contracts. The meaning of a written contract is a question of law for the judge, and not a question of fact for the jury; the opposite rule applies to an oral contract.[1] That is strange law. But as contract disputes are never now tried by judge and jury, I leave the reader to ponder on some other occasion over the logic of saying that the meaning of a contract is a question of law. The reason that I confine myself here to commercial contracts is that they are virtually the only contracts which in these days anyone can afford to litigate about—with the possible exception of Mr. Forsyth of swimming pool fame.[2]

For anyone who intends to practise commercial law, the interpretation of contracts is a topic of vital importance. Formation of contracts, mistake and misrepresentation, *pacta tertiis nec nocent nec prosunt*, frustration are all interesting topics which were taught in this university with enthusiasm 44 years ago and no doubt still are; but I have rarely ever heard of them since. It is interpretation which is far more important in practice. There is a shortage of academic work on the subject,[3] perhaps because it would be a great labour to assemble the definitive work from a great mass of material.

We must ask ourselves why it is necessary to have any law at all

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[1] *Cf. Torbelt* v. *Faulkener* [1952] 2 T.L.R. 659 (oral contract) and *Pioneer S.S. Co. Ltd.* v. *B.T.P. Tioxide Ltd.* [1982] A.C. 724. See further Lewison, The Interpretation of Contracts, 2nd ed., 1997 pp. 67–68.

[2] *Ruxley Electronics & Constructions Ltd.* v. *Forsyth* [1996] 1 A.C. 344.

[3] But see Lewison, *The Interpretation of Contracts*, 2nd ed., 1997.

on the subject of interpretation of contracts. Why do we not simply read the contract and decide what it means? There are, I think, four answers to that question. First it is desirable, and fairness demands, that different judges, and the same judges in different cases, should reach the same answer on any legal question; that is part of what law is about. Secondly, people who make contracts are entitled to know what the courts will say that they mean, if a dispute should arise. Thirdly, it is in the interest of the parties to a contract, and in the public interest, that judges should impose some restraint to prevent time and money being wasted in considering a mass of irrelevant material.

The fourth reason can be found in *Samples of Lawmaking* by Lord Devlin, where he wrote that a judge sets out "to ascertain the intention of the parties; but before long he has invented canons of construction and other rules which make things easier for himself but much more difficult for the parties who do not know the rules".[4] I have great sympathy with that somewhat cynical sentiment. A judge, after all, has to give a judgment, and judgments have to contain reasons; unfortunately it is not enough for him to say simply "this is what I think the contract means". If you as an advocate can suggest any plausible and legal reason why your client should succeed, you may well be on the road to victory.

Let us now see what rules the courts apply in the interpretation of contracts. I set out my own views on this topic in an article in 1995;[5] I will quote only four principles from what I then wrote. In case it be thought that what was said in a lecture hall at New York University is not in itself law, it should be noted that these principles also feature in three judgments of mine in the Court of Appeal. The first was in *Youell* v. *Bland Welch & Co.*[6] After that there were two successive judgments of mine in the same case, *Mirror Group Newspapers* v. *New Hampshire Insurance Co.* One was given in June 1995,[7] and the second, on 6 September 1996.[8] I enquired why they had not reached the official law reports, and was told that it was not practicable to report complicated cases.

The Intention of the Parties

Rule One is that the task of the judge when interpreting a written contract is to find the intention of the parties. In so far as one can be sure of anything these days, that proposition is unchallenged. But

[4] At p. 31.
[5] (1995) 26 J.Mar.L. & Com. 259.
[6] [1992] 2 Lloyd's Rep. 127.
[7] [1996] 5 Re. L.R. 103.
[8] (1997) L.R.L.R. 24 and [1996] C.L.C. 1728.

as we shall shortly see, the intention of the parties does not necessarily mean what they actually meant. Justice Holmes said as much in a celebrated article: "Nothing is more certain than that parties may be bound by a contract to things which neither of them intended, and when one does not know of the other's assent."[9] That was 102 years ago. The same theme is to be found in the speech of Lord Hope in *Total Gas Marketing Ltd.* v. *Arco British Ltd.*: "I have reached this conclusion with regret. It seems to me most unlikely that the parties to this agreement intended that it should be capable of being terminated by reason only of the non-fulfilment of the condition. . . ."[10] Lord Steyn (*ibid.*) likewise found himself driven to an unattractive conclusion.

The decision in that case is greeted with acclaim by a distinguished commercial lawyer, Mr. Brian Davenport Q.C., in the Law Quarterly Review. In a note headed "Thanks to the House of Lords" he writes: "Those who care about the proper construction of agreements, and statutes, must care that words are given their correct meaning and not some artificial meaning to suit a particular result. Everyone must be grateful to the House of Lords for their decision in this case."[11] The reason for Mr. Davenport's enthusiasm will soon be apparent.

On an allied topic, interpretation of statutes, Justice Holmes said this:

> While at times judges need for their work the training of economists or statesmen, and must act in view of their foresight of consequences, yet when their task is to interpret and apply the words of a statute, their function is merely academic to begin with—to read English words intelligently—and a consideration of consequences comes into play, if at all, only when the meaning of the words used is open to reasonable doubt.[12]

The first place where you look for the intention of the parties is in the language which they themselves used. And it is very often the last place too. But does it not follow that each party should give evidence of what his intention was? Certainly not, says the law, we cannot allow that; subjective evidence of intention is not admissible: see the speech of Lord Wilberforce in *Prenn* v. *Simmonds*.[13] There are at least two reasons for that rule, and perhaps three. The first is that what the judge has to ascertain is the *common* intention, not that held by one party or the other *in pectore*. The second, that each party would be likely to give evidence that *his* intention was that

[9] "The Path of the Law" (1897) 10 Harvard L. Rev. 457
[10] [1998] 2 Lloyd's Rep. 209, 223.
[11] (1999) 115 L.Q.R. 11.
[12] *Northern Securities Company* v. *United States* (1904) 193 U.S. 197.
[13] [1971] 1 W.L.R. 1381, 1385.

which suited *his* case, and nothing or not very much would be gained by listening to self-serving evidence of both of them. And the third possible reason is similar to that which I think I was once taught at this university, that until the Criminal Evidence Act of 1898, those accused of crime were not allowed to give evidence in their own defence, as it was feared that the guilty would feel obliged to perjure themselves in their evidence, and it was better for their bodies to be hanged than that their immortal souls should be in peril.

So it is well established that it is the common intention of the parties that must be sought, primarily in the language which they have used; evidence of subjective evidence is excluded, even if it would show, as Justice Holmes predicated, that they both meant something different. (I am of course not talking of the rare cases of rectification.) Lord Hoffmann recently accepted that subjective evidence of intention should be excluded in *Investors Compensation Scheme* v. *West Bromwich Building Society*;[14] and in the same speech he also accepted the exclusion of evidence of previous negotiations, which again has the authority of Lord Wilberforce in *Prenn* v. *Simmonds*. One notes in passing that the alleged rule against reporting complicated cases apparently does not apply to the House of Lords. Lord Hoffmann treated the exclusion of subjective evidence of intention and evidence of previous negotiations as exceptions for reasons of practical policy. I would prefer to say that the evidence is excluded mainly because it is unhelpful. It does not tell one what one needs to know—the common intention of the parties when the contract was made.

Surrounding Circumstances

My second rule concerns the surrounding circumstances, a phrase which in this context dates back at least to the speech of Lord Dunedin in *Charrington & Co. Ltd.* v. *Wooder*.[15] An alternative word is "background", but that is not so precise. Today many lawyers prefer to speak of "the matrix". There are inestimable benefits to be found in the speeches of Lord Wilberforce on the interpretation of contracts; but I hope that I may be forgiven for saying that his introduction of the word matrix (in *Prenn* v. *Simmonds*) is not one of them, for counsel have wildly different ideas as to what a matrix is and what it includes. Perhaps that is not surprising since the speech of Lord Hoffmann in the *Investors Compensation Scheme* case. He there said:

[14] [1998] 1 W.L.R. 896, 913.
[15] [1914] A.C. 71.

> 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.[16]

It is hard to imagine a ruling more calculated to perpetuate the vast cost of commercial litigation. In the first of the *Mirror Group Newspapers* cases I said that, as it then appeared to me, the proliferation of inadmissible material with the label "matrix" was a huge waste of money, and of time as well. Evidently Lord Hoffmann does not agree.

Others have since questioned that passage in the *Investors Compensation Scheme* case—see the judgments of Saville and Judge L.JJ. in *National Bank of Sharjah* v. *Dellborg*,[17] and of the Lord President and Lord Kirkwood in *Bank of Scotland* v. *Dunedin Property Investment Co Ltd.*[18] I myself returned to the topic in *Scottish Power plc* v. *Britoil (Exploration) Ltd.*[19] I pointed out that the *Investors Compensation Scheme* case was not concerned with a contract made by any ordinary commercial process, as you will see if you look at the report; as I also said, one cannot tell whether matrix was the subject of discussion in that case, and there did not appear to be any dispute as to what material could qualify as matrix. It may have been something of an over-statement on my part, to say that no authority was cited for such a wide meaning of matrix, as Lord Hoffmann had cited his earlier decision in *Mannai Investments Co. Ltd.* v. *Eagle Star Life Assurance Co.*[20] (for another proposition), and in the *Mannai* case he had cited Lord Wilberforce in *Prenn* v. *Simmonds* as authority for the matrix doctrine. But Lord Wilberforce went nowhere near saying that matrix was as wide as Lord Hoffmann makes it. I am told that a distinguished firm of solicitors is telling its clients that the law on the interpretation of contracts is in confusion and needs to be clarified. I am also told, by a young member of my chambers, that whenever the topic arises, which is quite frequently, the *Investors Compensation Scheme* case is again cited.

The surrounding circumstances, as I still call them, admissible for the interpretation of a written contract, must have been known, or reasonably capable of being known, to both parties at the time when

[16] [1998] 1 W.L.R. 896, 912.
[17] 9 July 1997, unreported.
[18] 1998 S.C. 657, 1998 S.C.L.R. 531.
[19] 18 November 1997, 94(47) L.S.G. 30, 141 S.J.L.B. 246, The Times, 2 December 1997.
[20] [1997] A.C. 779.

the contract was made; for each is entitled to know what contract he is entering into; and therefore at that date each must know all facts which will reveal the meaning of the contract. In the *Scottish Power* case I repeated what I had said years before in the *Youell* case as a description of the material that is relevant—"what the parties had in mind, . . . what was going on around them at the time when they were making the contract".[21] Lord Kirkwood in the *Bank of Scotland* case adopted a variant of that: "facts which both parties would have had in mind and known that the other party had in mind, when the contract was made".[22] I would amend my version slightly, so that it reads "what the parties must have had in mind". But it must still be the immediate context, and not facts in the past, distant or even recent.

Unreasonable Results

I turn now to my third rule, which is often the most important of all, and certainly is in the present context. It is that the courts can take into account the consequences of one interpretation or another. I would not describe this as background, or surrounding circumstances, or even matrix (but see the judgment of Mance J. in *Roar Marine Ltd.* v. *Bimeh Iran Insurance Co.*[23]). It is a wholly separate rule, based on obvious common sense. The point is put with admirable clarity and concision by Lord Reid in *Wickman Machine Tools Sales Ltd.* v. *L. Schuler A.G.*: "The fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they should make that intention abundantly clear."[24] When speaking to students I tell them that what Lord Reid said there is something which they should learn by heart. It contains nothing whatever to support a suggestion that the courts, in the interpretation of contracts, may depart altogether from the language which the parties have used. Indeed the contrary view to my mind is a plain inference from what Lord Reid said. What I have quoted earlier from Justice Holmes, writing over a hundred years ago, points in the same direction, as does the passage I have referred to in the *Total Gas Marketing* case in 1998.[25]

But I must now go back to the *Mannai* case. That concerned a unilateral notice by a lessee to his landlord to determine the tenancy

[21] [1992] 2 Lloyd's Rep. 127, 133.
[22] 1998 S.C. 657, 670; 1998 S.C.L.R. 531, 544.
[23] [1998] 1 Lloyd's Rep. 423.
[24] [1974] A.C. 235, 251.
[25] [1998] 2 Lloyd's Rep. 209, 223; see n.10 above.

under an option available to the lessee. Notice was given to determine on 12 January, when it should have said 13 January. By a majority the House of Lords held that the notice validly determined the lease. As will appear, I have no quarrel with that decision. But I must quote this passage from the speech of Lord Hoffmann:

> The fact that the words are capable of a literal application is no obstacle to evidence which demonstrates what a reasonable person with knowledge of the background would have understood the parties to mean, even if this compels one to say that they used the wrong words. In this area, we no longer confuse the meaning of words with what meaning the use of the words was intended to convey. Why, therefore, should the rules for the construction of notices be different from those for the construction of contracts?[26]

So it would seem that the courts may override the words which the parties have used, in the process of interpreting a written contract, despite the powerful authorities which I have mentioned.

For my part, I can see an argument for saying that a notice given unilaterally is a different creature from a contract, which reflects the common intention of at least two parties. If that is the case, then the actual decision in the *Mannai* case poses no problem. But if Lord Hoffmann is right, and if unilateral notices are construed in the same way as contracts, then I respectfully part company with Lord Hoffmann's reasons for the decision which he reached as one of the majority. For present purposes it is enough to say that his remarks as to the interpretation of contracts were *obiter*, and not necessary to the decision.

A fine example of the traditional, and in my view justified, approach to avoiding absurdity is to be found in the case of *Segovia Compania Naviera S.A.* v. *R. Pagnan & Fratelli.*[27] But let us first discuss the geography of the United Kingdom. Does Edinburgh lie to the east or to the west of Bristol? The answer is that Edinburgh lies to the west of Bristol. In the *Segovia* case, a charterparty provided that the charterers could order the vessel to any port in "United States of America east of Panama Canal". You can see what is coming. The charterers ordered the vessel to New Orleans, in the U.S. Gulf. Now New Orleans, like every other port in the U.S. Gulf, lies to the west of the Panama Canal. So, as a matter of fact, does Miami. It was held by Donaldson J. and the Court of Appeal, that the charterparty referred to any port which one would approach from the Caribbean end of the Panama Canal, rather than the Pacific end. That seems to me a wholly legitmate decision on interpretation.

[26] [1997] A.C. 749, 779.
[27] [1977] 2 Lloyd's Rep. 343

The most obvious meaning was rejected, because there would be no rhyme or reason in it; a less obvious but still available meaning of the words used was adopted because it made sense.

Another example is apparently to be found in *Charter Reinsurance Co. Ltd.* v. *Fagan*,[28] which brings to mind Virgil's *Aeneid*, Book 2 line 3. In that case reinsurance contracts required the reinsurers to reimburse the reinsured in respect of their net loss in excess of a specified sum, net loss being defined as "the sum actually paid by the reinsured in settlement of losses or liability. . . ." The reinsured had gone into provisional liquidation, and, on the assumed facts, had not paid—I forbear to say actually paid—anything. You might have thought that the words actually paid were quite plain, and actually meant, actually paid. You might also have thought that there was no obvious absurdity in that interpretation, particularly in the absence of any evidence that the result was absurd, plus the fact that the insurance industry had been happily using the same form of words for 80 years or more. It could also be mentioned that the House of Lords had, as recently as *The Fanti and The Padre Island*,[29] decided that some fairly similar wording ("shall have become liable to pay and shall have in fact paid"), in another kind of insurance contract, should be given its apparent meaning. But you would have been wrong. The judge at first instance, the majority in the Court of Appeal, and the five Lords of Appeal, were all of opinion that the contracts did not require the reinsured to have paid before they could recover from the reinsurer. There was only one dissenter, in the Court of Appeal. He thought, and he actually still thinks, that there was no absurdity in the natural meaning of the words; and even if there had been absurdity, there was no other available meaning and the natural meaning must prevail.

I leave this chapter saying that in my opinion business men would prefer a general rule that words mean what they say in ordinary English, rather than a rule that contracts shall mean what the House of Lords, or some of its members, think they ought to mean. Indeed Lord Mustill said as much, in the *Charter Reinsurance* case:

> There comes a point when the court should remind itself that the task is to discover what the parties meant from what they have said, and that to force upon the words a meaning which they cannot fairly bear is to substitute for the bargain actually made one which the court believes could better have been made. This is an illegitimate role for a court. Particularly in the field of commerce, where the parties need to know what they must do and what they can insist on not doing, it is essential for them to

[28] [1997] A.C. 313.
[29] [1991] 2 A.C. 1.

be confident that they can rely on the court to enforce their bargain according to its terms.[30]

His words should be followed.

Market Practice

My fourth and last rule which the courts apply in interpretation of contracts concerns market practice. One needs to be a bit careful with words here. Custom, or usage, must be notorious, certain and reasonable,[31] and in effect such as is regarded as binding in the trade in question. Mere trade practice is insufficient.[32] It is rare in modern times to find that a contract is varied or enlarged by custom. It might be thought that Hirst J in *The Litsion Pride*[33] relied on market practice for the interpretation of a contract. However, it seems to me that this was a case of words used in a particular sense ("current war risks exclusions"), which it was permissible for market evidence to supply.

What is much more common is for one or both parties to allege that there is a trade or market practice as to how contracts are performed, which is said to show what their meaning is. This gives rise to two problems. First, there is again a strong probability that the expert witness for one side will say one thing, and the expert witness for the other the opposite, each with his supporters and able to quote examples. Leggatt J. in *Vitol S.A.* v. *Esso Australia Ltd.* said this: "It seemed to me that both experts were in an invidious position. . . . Each witness was in fact giving no more than his understanding of the legal requirements of contracts of this nature. Neither witness came within hailing distance of establishing anything in the nature of a custom."[34]

All too often that is the case, and the money and time spent on expert evidence of market practice are entirely wasted. Mance J. took the same view in the *Roar Marine* case, although he took custom and practice together despite the notable difference between them. He said: "For there to be any relevance in custom or practice,

[30] [1997] A.C. 313, 388. *Cf.* Lord Bridge in *A/S Awilco of Oslo* v. *Fulvia S.p.A. di Nav. of Cagliari (The Chikuma)* [1981] 1 W.L.R. 314, and the recent decision in *Kuwait Airways Corporation* v. *Kuwait Insurance Company* (11 March 1999), where Lord Hobhouse of Woodborough said: "But it must in any event be stressed that it is not for the courts to tell the parties what contract they should have made nor, after the event, to evaluate the merits and demerits of their bargain. If, as here, the parties have used plain language to express their intention, that should be an end of it: the courts should enforce the contract in accordance with its terms."

[31] *Chitty on Contracts*, 27th ed. (1994) para. 12-114.

[32] *Ibid.* See also *General Reinsurance Corporation* v. *Forsakringsaktiebolaget Fennia Patria* [1983] Q.B. 856, 874.

[33] [1985] 1 Lloyd's Rep. 437

[34] [1989] 1 Lloyd's Rep. 96, 100.

whether in a strict or informal sense, it must be possible to identify the particular custom or practice with some certainty."[35]

The second problem is that, in my view, it is doubtful whether much of the evidence described as market practice is admissible. Can it qualify as a surrounding circumstance, or matrix? If its effect is merely that some, or many, or even all traders in a particular market interpret the contract in a particular way, that to my mind is not a surrounding circumstance; and in any event the parties to *this* contract may not know how others, or some and if so how many others, would interpret it.

Where however the market practice proved is not direct evidence of the meaning of the contract, but rather evidence of how the market operates, it may well be that such evidence is admissible. For example, it might be proved that insurance brokers commonly produce a slip and insert the wording they require; that they take it to a potential leading underwriter; that he may add to or alter the wording, and quote a rate, and sign for a proportion of the risk; that the broker then takes the slip to other underwriters, in the hope that they too will take a share; and that if the slip becomes over-subscribed it may be signed down by the broker. (I hope that I correctly state the practice.)

That is an example of matters which in my view probably could be proved in evidence—if they were not known to the judge already—and which could, in a given case, have an effect as surrounding circumstances or background. In my article in the British Insurance Law Association Journal[36] I fear that I may have gone too far in limiting evidence of market practice; but still the amount of such evidence which is both relevant and helpful is but a small proportion of the evidence which is in fact tendered for purposes of interpretation. Such evidence of how the market operates may have been what Lord Mustill had in mind when he referred to the wording of a policy being "read against the background of market practice".[37]

Conclusion

There is much else that I could say about the interpretation of written contracts, for example about the rule that you cannot rely on facts arising or coming to the knowledge of the parties after the contract was made, as an aid to its meaning. But here I have sought to set out the principal tools which the courts use for the interpretation of contracts; you are to find the intention of the

[35] [1998] 1 Lloyd's Rep. 423, 429.
[36] British Insurance Law Journal, May 1998, no. 97 p. 5.
[37] *Touche Ross & Co* v. *Baker* [1992] 2 Lloyd's Rep. 207, 210.

parties, and for that purpose you look first at the wording of the contract and see what it says. You do not ask the parties to tell you what they thought it meant. Secondly, you may look at the surrounding circumstances known to both parties, that is what was going on around them when they made the contract. Thirdly, if there is evidence that the ordinary meaning of the words would lead to an absurd result, you must consider whether they can reasonably bear some other meaning. Fourthly, the court may look at evidence of how the market works, if it does not know already, and at any custom which is commonly regarded as binding on everyone in the market. But you may not look at what people in the market think the contract means, however many there be of that persuasion, except perhaps in the case where words are used in a special and unusual sense.