

## **Interpretation of Contracts: are the principles of interpretation now certain?**

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1. English law has been said to appeal to businessmen internationally because it provides relative certainty of outcome in its application to any given factual circumstances.
2. There are a number of aspects to this. They range from clarity and precision of the substantive law, to the application of the doctrine of binding authority (which means that the same issue raised between different parties in different cases will be decided the same way), to the principles on which contracts are interpreted when their meaning is disputed. Another aspect is the avoidance of principles embraced by other legal systems that are thought to bring relative uncertainty to the outcome of cases, in particular obligations of good faith between contracting parties.
3. In this short paper, I will focus mainly on the interpretation of contracts, and then touch briefly on where the English courts have reached with good faith obligations.

### **The Interpretation of Contracts**

4. A very substantial proportion of all legal disputes between commercial parties are disputes about the meaning of contracts expressly made between them; or often standard terms that are incorporated in their contracts. This is true across the range of disputes that are litigated in the Chancery Division: property; finance, commerce, and corporate and quasi-corporate. In what ways, therefore, does the approach taken by English law to interpreting contractual terms promote the certainty that businessmen seek, and are the courts of England and Wales achieving that objective in their current decision making?
5. To illustrate the general approach taken by English law, we can use a typical example of how a contract is negotiated between the parties, perhaps by their CEOs and general counsel, and then reduced into writing and eventually signed. A period of high level discussion may be followed by a more detailed working out of the key terms, by correspondence or at meetings, eventually reduced into non-binding but signed heads of terms, possibly with the approval of both companies' boards. The parties then instruct lawyers, who prepare a draft contract based on the heads of terms and what they have each independently been told about the parties' intentions; the draft passes back and forth in the usual way, with amendments and counter-amendments, leading to a round the table meeting at which the final sticking points are ironed out and a final draft is produced. Both parties then approve and sign it. They then conduct their business in the following months in accordance with their understandings of what it was that was agreed in the contract.

6. A dispute then arises when one party fails to do something that the other party considers that it was obliged to do, or does something that the other party considers that it agreed not to do. The dispute is as to the meaning of particular clauses in the contract, sometimes just one clause. It may be that there is a genuine ambiguity in the language used; perhaps the language is reasonably clear but has been clumsily expressed, thereby admitting a different possible meaning; or although the language is clear the literal meaning might not have been intended, for various commercial reasons; or, as is often the case, something has occurred that was not contemplated by the parties and the contract therefore does not specifically provide for it.
7. The assumption of each party to the contract, when signing it, is that what that party understands to have been agreed is accurately recorded in the language of the contract. So it is natural that one starts with the words that both parties have chosen to encapsulate their agreement. Legal certainty is in principle advanced by looking at the words of the contract and excluding certain extraneous material that would might or might not cast light on what the parties intended their contract to mean. So, in particular, English law excludes from consideration –
  - (a) the subjective views of each of the parties as to what the contract was intended to provide, even if these views were shared with the other party;
  - (b) the negotiations between the parties as to what the contract should provide, even if these were directed to the particular clause that is in dispute;
  - (c) heads of terms;
  - (d) what the parties did in the months following the contract to give effect to it. provide for it
8. The reason why all these matters are excluded, broadly speaking, is that when interpreting the contract the law is not concerned to establish the actual intentions of the parties, or what they thought that the words of the contract mean. Lawyers and even distinguished judges often speak of the process of interpreting a contract as seeking to ascertain from the contract the intention of the parties, but this is not accurate. The only relevant intention of the parties was to reduce what they had agreed into the chosen words of the written contract. It is easy to see that, in many if not all cases, the actual intentions of the parties as to what the contract was to mean may be unclear; or there may not have been a single intention because the parties had different understandings of what was being negotiated; or they had no actual intention at all because the particular circumstances that have arisen were never contemplated. Uncertainty (and delay) would be introduced into the law if inquiry into all these matters were permitted
9. Instead, the law asks a different question, namely: how would the words that the parties have used be understood by a reasonable person aware of the background to the contract considering it at the time that it was made. It does so because it is presumed that the parties reduced their bargain to the words of the contract that they agreed. If that is not in fact the case, and by mistake the

contract does not record what they agreed, the remedy will be rectification of the written agreement.

10. The question that I have just identified as the relevant question clearly imports an objective element into the process. Starting from the words that have been used, how would a reasonable person reasonably understand the contract? But that is very far from saying that the contract simply means what it says, and that effect must be given to the literal words that the parties have used.
11. As Lord Hoffmann memorably explained by reference to Humpty Dumpty and Mrs Malaprop<sup>1</sup>, the difficulty in interpreting contracts is with the inescapable flexibility and imprecision of words and syntax as a means of expressing something. Moreover, sometimes people do not mean what they literally say, or use the wrong word or defective syntax, but in context would nevertheless not be understood as meaning what they have said.
12. So the conventional meaning of the particular words used is the start but not the end of the inquiry. The words are not interpreted in a vacuum. Context is provided by the rest of the contract, the circumstances in which the contract was made, and its commercial purpose, objectively understood, and recourse can be had to these matters. There is a distinction reasonably clearly drawn between these matters – aids to interpretation, if you like – and the four categories of proscribed facts that I identified earlier.<sup>2</sup>
13. The difficulty that the courts face is in deciding to what extent one can give priority to these other factors, in detracting from the literal meaning of the words. How clear do the words literally have to be to preclude an attempt to rely on these aids to construction? Or, put another way, to what extent can these aids justify departing from what are plain words?
14. In many cases, the analysis does begin and end with the ordinary (that is to say, literal) meaning of words in issue. In 1996, in *Melanesian Mission Trust Board v. Australian Mutual Provident Society*<sup>3</sup>, Lord Hope said:

“The approach that must be taken to the construction of a clause in a formal document of this kind is well settled. The intention of the parties is to be discovered from the words used in the document. Where ordinary words have been used, they must be taken to have been used according to the ordinary meaning of those words. If their meaning is clear and unambiguous, effect must be given to them because that is what the parties are taken to have agreed to by their contract. Various rules may be invoked to assist interpretation in the event that there is an ambiguity. But it is not the function of the court, when construing a document, to search for an ambiguity. Nor should the rules which exist to resolve ambiguities be invoked to create an ambiguity which, according to the ordinary meaning of the words, is not there. So the starting point is to examine the words used in order to

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<sup>1</sup> *Mannai Investment Co v Eagle Star Life Assurance Co* [1997] A.C. 749, H.L.

<sup>2</sup> Para 7, above.

<sup>3</sup> (1996) 74 P&CR 297, P.C.

see whether they are clear and unambiguous. It is of course legitimate to look at the document as a whole and to examine the context in which these words have been used. But unless the context shows that the ordinary meaning cannot be given to them or that there is an ambiguity, the ordinary meaning of the words which have been used in the document must prevail”.

15. The formal document in that case was a lease, but nothing particular turns on that, and the same approach would be taken to any commercial contract. Lord Hope’s approach requires one to look at the contract as a whole, and the factual context in which it was made, and in the light of that to give the words used their ordinary meaning unless either (a) there is an ambiguity or (b) the words cannot be given that meaning. Although that decision of the Privy Council, in one of the last appeals from the Court of Appeal of New Zealand, was given before Lord Hoffmann’s famous speech in the *Investors Compensation Scheme* case<sup>4</sup>, Lord Hoffmann was a member of the Board whose decision was pronounced by Lord Hope; and I suggest that there is in reality not much, if anything, between what Lord Hope said and what Lord Hoffmann said the next year in *Investors Compensation Scheme* and then 10 years later in *Chartbrook v Persimmon Homes*<sup>5</sup>. The ordinary meaning of the words is acknowledged by Lord Hope to be a contextual meaning, and in that case the context was very straightforward: an ordinary commercial lease with provisions for adjusting the rent from time to time. Lord Hoffmann’s proposition (5) explains the force of the natural and ordinary meaning of the words (in context), while acknowledging the possibility of identifying from the context that a mistake has been made in expressing the parties’ bargain:

“The “rule” that words should be given their “ordinary and natural 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.”

16. In the two well-known cases referred to above, the House of Lords reached decisions that really exemplify the exceptions identified by Lord Hope: the ambiguity in the syntax in the *Investors Compensation Scheme* case, and the conclusion that the words did not mean (because the parties could not have meant) what the words literally say in the *Chartbrook* case.
17. As a result, possibly, of paying insufficient attention to Lord Hoffmann’s proposition (5), the process of interpreting contracts has on occasions shown a tendency to move away from the words used and more towards the presumed commercial intentions of the parties (N.B. not their actual intentions).

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<sup>4</sup> *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896, H.L.

<sup>5</sup> [2009] 1 A.C. 1101.

18. This is clearly at some risk of reintroducing uncertainty of outcome, which the focus on the words rather than the parties' intentions was supposed to remove. If one pays too much regard to the supposed commercial purpose of a contract (which is a way of identifying the presumed intentions of the parties), is there not a danger of making individual decisions less predictable?
19. The highpoint of that approach can be seen to be the decision in *Rainy Sky S.A. v Kookmin Bank*,<sup>6</sup> where the Supreme Court held that the interpretation preferred by the majority of the Court of Appeal judges did not make good commercial sense and so could not be what the parties meant by the terms of their contract. They held that it did not make good commercial sense that an indemnity, provided by a bond, would not be available in the very circumstances in which it was most likely to be required, namely insolvency of the buyer. Lord Clarke of Stone-cum-Ebony, giving the leading judgment, disavowed any conclusion that the meaning of the words preferred by the Court of Appeal was absurd or irrational and could be rejected on that basis (i.e. it was not a case where the words "could not" be given their ordinary meaning, using Lord Hope's words). He held, rather, that the words were ambiguous (a latent ambiguity arising from the commercial context in which the bonds were issued), had two possible interpretations, and that accordingly the Court should favour that interpretation that was more consistent with business common sense. The conclusion in that case, in my respectful view, stretches the bounds of discerning ambiguity and comes perilously close to doing what Lord Hope said should not be done, namely to find an ambiguity where none really exists. The bond said nothing about insolvency, however sensible it might have been for the builder to have required it to do so.
20. The proposition that where there is a genuine ambiguity the court should decide in favour of the more commercially sensible interpretation is entirely uncontroversial, and has been the law of England and Wales since the days when Wilberforce J held sway in the Chancery Division. The difficult question is in what circumstances the assumed commercial purpose of the contract can itself provide the ambiguity that admits of this canon of interpretation where the terms of the contract itself provide no such ambiguity. In what circumstances are there "genuinely alternative meanings"?
21. It is easy to understand that in some cases the commercial context may give a different colour to the words of a contract, which the words considered in a vacuum do not have. After all, we are all familiar with the case of implied terms, where the contract is held to mean something that is not expressed at all: see *A-G of Belize v Belize Telecom*<sup>7</sup>. It is therefore obviously possible for words that are included in a contract to have a different meaning from their usual and obvious meaning, as a result of the commercial or factual context in which the contract is made. This what Lord Hope means by examining the context in which the words of the contract are used. It is where parties invoke the presumed commercial purpose of a contract that the court is sometimes led

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<sup>6</sup> [2011] 1 WLR 2900.

<sup>7</sup> [2009] 1 WLR 1988.

into difficult territory. Can ambiguity, or other doubt about meaning, arise from what may be assumed to be the commercial purpose?

22. I detect a trend, among judges of the Chancery Division and in the Court of Appeal, moving back towards giving effect to the ordinary meaning of the words, and away from any idea that a presumed intention to achieve a commercially sensible or fair outcome can itself provide the ambiguity (absent

absurdity or a conclusion that an error in language has been made) that allows the court to decide between different interpretations in favour of the more commercially sensible one.<sup>8</sup> After all, a view that it would have made more commercial sense for one party to have agreed something different from what is expressed is no basis at all for refusing to give effect to the words used. In *West v Ian Finlay & Associates*, the Court of Appeal (Moore-Bick, Gloster, Vos LJ) said:

“The first consideration in any construction exercise is to consider the normal meaning of the words.”

It is, inevitably, the first step in any iterative process of identifying the true meaning of a contractual provision; but the emphasis given by the Court in that case was that where the words appear to be clear there has to be found something in the background that compels the conclusion that the words have a different meaning, or that a mistake has been made, before the normal meaning can be displaced.

23. Although *Rainy Sky* is understandably cited by at least one side in just about every case on interpretation of contracts today, I suspect that in cases where it is not possible to say that the apparent meaning is commercially absurd, or that something has obviously gone wrong with the language used, the courts will be cautious in identifying a genuine ambiguity, patent or latent, or other doubt about the meaning of the words that opens the door to the *Rainy Sky* approach to interpretation.<sup>9</sup>

24. In my view, such caution is justified. After all, (1) in *Rainy Sky*, the Supreme Court specifically approved the approach of Longmore LJ, who is a case in 2011<sup>10</sup> had said:

“...when alternative constructions are available one has to consider which is the more commercially sensible”;

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<sup>8</sup> See, e.g., *Scottish Widows Fund and Life Assurance Society v BGC International* [2012] EWCA Civ 607; *West v Ian Finlay & Associates (a firm)* [2014] EWCA Civ 316; *Tindall Cobham 1 v Adda Hotels* [2014] EWCA Civ 1215, and the lecture given by Sir Christopher Nugee to the Chancery Bar Association on 16 January 2015, available at <http://www.chba.org.uk/for-members/library/annual-conference-papers/2015-annual-conference-papers/nugee-j-contractual-interpretation-some-thoughts.pdf>

<sup>9</sup> For a case in which an available alternative interpretation was discerned (on appeal) and preferred, see *Napier Park European Credit Opportunities Fund v Harbourmaster* [2014] EWCA Civ 984.

<sup>10</sup> *Barclays Bank plc v HHY Luxembourg SARL* [2011] 2 BCLC 336, paras [25], [26]

In that case, Longmore LJ emphasised that there were genuinely rival interpretations that were available, and he was certainly not advocating recourse to commercial common sense in a case where there were no other genuinely available meanings. And (2), if a different, commercially more sensible interpretation could itself make a contractual term ambiguous, then in any such case a contract would have to be interpreted contrary to the ordinary meaning of its words, however unambiguously expressed, because the other interpretation makes more commercial sense. Nothing could be more damaging to commercial certainty, and happily that is clearly not the law.

25. Accordingly, if English law does not exactly shut the door on disputes about contractual meaning by applying either a purely literalist or purely commercial approach, the right approach is at last tolerably clear and the outcome therefore reasonably predictable.

### **Implied obligations to act in good faith**

26. That leads me onto my second topic: obligations of good faith in contracts. Of course, parties do, increasingly, include express obligations of good faith, or “absolute good faith” as one sometimes sees, more often than not in relation to particular obligations to be performed by one of the parties rather than applying generally to all parties’ obligations; and more frequently in certain types of contract, such as joint ventures, or conditional contracts of sale and purchase. Where an express term is included, the court has to give a meaning to it, and the meaning will be very context sensitive. It is not possible to generalise about the meaning of such terms, other than to say that they import obligations of commercial honesty and fair dealing, and possibly adherence to an agreed common purpose.<sup>11</sup>
27. But what about when the parties do not expressly state any such obligation. Will an English court say that such an obligation is implicit, on the true interpretation of the contract?
28. Lord Justice Bingham, as he then was, explained the state of the law as it was in 1987 in *Interfoto Picture Library v Stiletto Visual Programmes*, as follows:

“In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must

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<sup>11</sup> *CPC Group Ltd v Qatari Diar Real Estate Investment Co* [2010] EWHC 1535 (Ch): express duty in property JV agreement to act in utmost good faith. Content of the obligation was:

“to adhere to the spirit of the contract, which was to seek to obtain planning consent for the maximum developable area in the shortest possible time and to observe reasonable commercial standards of fair dealing, and to be faithful to the agreed common purpose, and to act consistently with the justified expectations of the parties.” (*per* Vos J.)

recognise; its effect if perhaps most aptly conveyed by such metaphorical colloquialisms as “playing fair”, “coming clean” or “putting one’s cards face upwards on the table”. It is in essence a principle of fair and open dealing....

English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions to demonstrated problems of unfairness.”<sup>12</sup>

and the Judge then gave examples such as unconscionable bargains in equity, contracts where utmost good faith is required and statutory intervention in relation to exemption clauses.

29. Since then, in piecemeal fashion, a number of types of contract have been confirmed to be cases where an obligation of good faith may be implied. These are, by and large, the types of contract that often involve fiduciary obligations or powers, and the courts of Chancery and common law have long dealt with this by imposing a relationship of trust or a duty of loyalty, or something of that nature. An implied obligation to act in good faith to a large extent replicates the content of such relationships.
30. But these cases are exceptional: in generality, there is no implied obligation to act honestly, or to deal fairly or in good faith. Ironically, though England is the home of cricket, its law does not recognise a general obligation to play fair. The metaphor of laying cards face up on the table is very pertinent in this context: as a business person, why would you?
31. Some consternation, then, when that orthodoxy was thought to have been challenged by a first instance decision of the commercial court 2 years ago.<sup>13</sup> Leggatt J gave detailed reasons why the recognition of an obligation to deal with counterparties in good faith was not remotely foreign to English law, and was an aspect of commercial dealings that was reflected in English law’s approach to contracts.<sup>14</sup> However, in that case – essentially a joint venture / franchise case – there was no argument in closing submissions that a term should be implied, generally, that the parties had to deal with each other in good faith. Rather, there were specific implied obligations that were contended for, relating to the particular circumstances of that case, albeit firmly based on principles of commercial fair dealing.
32. In substance, what Leggatt J said was that the court construes contracts against a background of assumed fair dealing and commercial honesty, since that is something that is assumed to underlie all commercial, contractual dealings between parties. He said, in particular:

“...the content of the duty [to act in good faith] is heavily dependent on context and is established through a process of construction of the

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<sup>12</sup> [1989] 1 Q.B. 433 at 439.

<sup>13</sup> *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 [2013] 1 Lloyd’s Rep 526 at [120-131]

<sup>14</sup> “...there is in my view nothing novel or foreign in recognising and implied duty of good faith in the performance of contracts”: *ibid.*, para [145]



contract ...its application involves no more uncertainty than is inherent in the process of contractual interpretation”.

33. What the Judge is really saying is that presumed honesty underscores the approach of the courts to interpreting contracts, and that contracts are interpreted against that background. The particular context of a contract may give rise to a freestanding obligation to act in certain respects in good faith, or to do or not do particular things where that is consistent with honesty and fair dealing. This is not the same, I suggest, as implying a freestanding obligation on each of the parties (or indeed on one party) to perform the contract *in good faith*. Although much cited in argument since 2013, this case has not been held to have established any legal principle different from that which was previously understood.
34. Indeed, some judges have expressly declined to read it as recognising any general obligation of good faith. Norris J in *Hamsard 3147 Ltd v Boots UK Ltd* said:

“I do not regard the decision in *Yam Seng* as authority for the proposition that in commercial contracts it may be taken to be the presumed intention of the parties [i.e. the contract means] that there is a general obligation of good faith”<sup>15</sup>

Henderson J agreed with this statement in *Carewatch Care Services v Focus Caring Services*.<sup>16</sup>

35. The *Yam Seng* decision has, as far as I have been able to ascertain, only been expressly referred to in a judgment of the Court of Appeal in a case called *Mid Essex Hospital Services NHS Trust v Compass Group UK & Ireland*<sup>17</sup> and as an example of the proposition that there is no general duty to act in good faith, but that such a duty may be implied as an incident of certain types of contract. In that case, a hospital trust had discretion under the contract whether or not to exercise its full contractual right to make deductions from payments. It was held that there was no implied term that the paying party would not act in an arbitrary or irrational way when calculating service failures; that a case where a discretion has to be exercised taking into account the interests of both parties was a very different case, where the discretion must be exercised honestly and in good faith. But that is because the relationship between the parties is of a particular kind, where one is entrusted to act in the interests of both. That is a classic example of a case where a quasi-fiduciary obligation will be imposed, and an implied obligation to act in good faith is really coextensive with that. Where that type of or a similar relationship is absent, however, there is no implied obligation to act in good faith.

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<sup>15</sup> [2013] EWHC 3251 (Pat)

<sup>16</sup> [2014] EWHC 2313 (Ch).

<sup>17</sup> [2013] EWCA Civ 200

36. We wait to see what the Court of Appeal may say about *Yam Seng* in later decisions, but do not expect any change from the existing and well-understood law.

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