



HERBERT
SMITH
FREEHILLS

WHAT DOES YOUR CONTRACT MEAN?

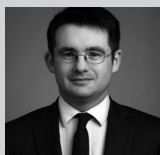
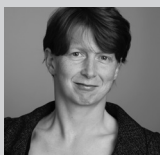
HOW THE COURTS INTERPRET CONTRACTS

CONTRACT DISPUTES PRACTICAL GUIDES
ISSUE 2: JULY 2019

This is the second in our series of contract disputes practical guides, designed to provide clients with practical guidance on some key issues that feature in disputes relating to commercial contracts under English law.

All too often, a term might seem perfectly clear to the parties when the contract is agreed, but a dispute later arises as to how it is meant to apply in the circumstances that have come about.

If the parties cannot resolve the issue, the court may be called on to interpret the contract. Where the parties have not made themselves clear, the result may then be difficult to predict.



Gary Milner-Moore, Sarah McNally and Steven Dalton consider the court's approach to interpreting contracts and some practical steps that can be taken to minimise the risks.

Top tips to make sure your contract means what you want it to mean:

- DO use clear and unambiguous language
- DO stress test the drafting: is it clear what is intended to happen in any potential scenario?
- DON'T be tempted to "compromise" by leaving a term vague rather than resolving the issue
- DO take particular care with defined terms and formulae
- DO use terms consistently throughout the contract
- DO check any amendments or additions carefully
- DON'T look at terms in isolation: think about how they work within the contract as a whole
- DO consider using recitals to clarify the commercial purpose of the transaction
- DON'T assume "commercial common sense" will save you from a bad bargain
- DON'T assume you can rely on anything said in pre-contractual correspondence to clarify a contract term
- DO take care with lists and examples: make clear whether they are meant to restrict the general terms used
- DON'T assume that a clause in one contract will mean the same as the identical clause in another contract

1. An objective approach

In interpreting a contract, the court's overarching aim is to determine the meaning the contract would convey to a reasonable person with all the background knowledge available to the parties at the time the contract was made. This aim is sometimes described as determining the objective intentions of the parties.

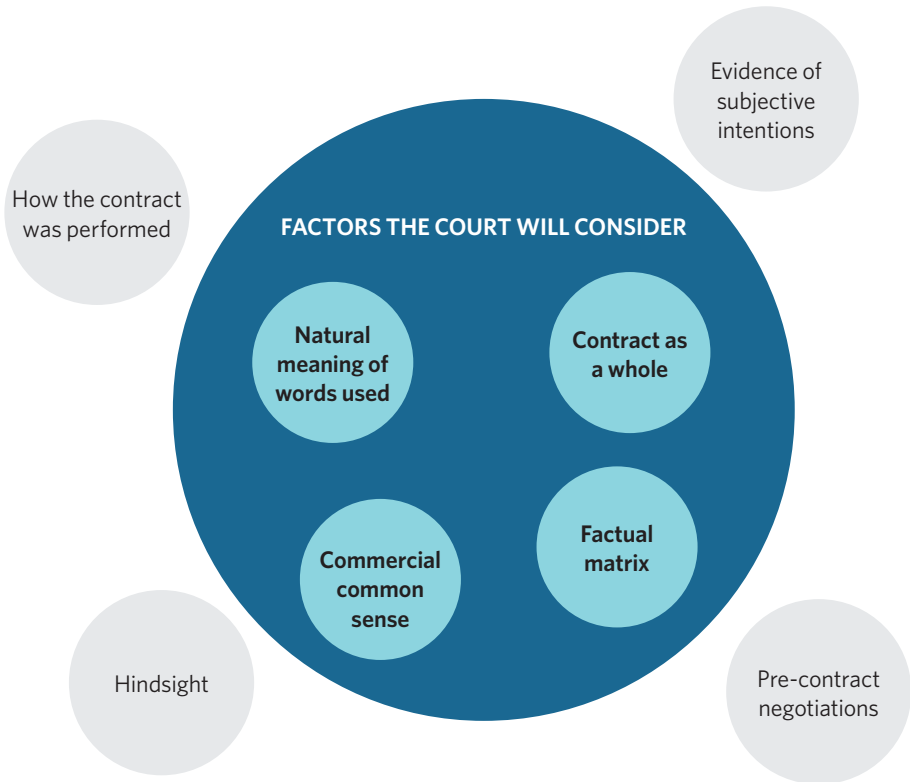
The subjective intentions of the parties are not relevant to this exercise. It is possible for one or both parties to a contract to believe a particular clause has one meaning but the court to determine that it means something else entirely.

As well as considering the actual words used in the clause, the court will take into account the wider context including how the clause fits within the contract as a whole, the background knowledge available to the parties (sometimes referred to as "factual matrix") and considerations of commercial common sense.

The court will not admit evidence of the parties' subjective intentions, including statements made in pre-contract negotiations (unless they go solely to establishing the factual matrix) and evidence as to how the contract was in fact performed. Such evidence may, however, be considered for other purposes, for example if there is a claim for rectification (which is often raised in the alternative to arguments based on interpretation) or estoppel – see section 4 below.

As well as considering the meaning of the express terms of the contract, the court may be asked to imply a term to spell out what the contract does not say expressly but should be understood to mean – see section 9 below.

How the courts interpret contracts



The diagram above shows which factors the court will take into account in interpreting a contract, and which factors must be left out of the equation.

How the various factors interact with one another is considered further below.

2. Natural meaning vs commercial common sense

There has historically been a perceived tension in the authorities as to the respective roles to be played by, on the one hand, the “natural meaning” of the words used in the contract and, on the other, perceptions of “commercial common sense”:

- At one end of the spectrum (sometimes referred to as a literal or textual approach) has been the view that the court must apply the natural meaning of the words unless there is a lack of clarity or an ambiguity in the language used, or it would produce an absurd result. Then, and only then, can the court adopt the construction that is most consistent with commercial common sense.
- At the other extreme (sometimes referred to as a purposive or contextual approach) has been the view that commercial considerations may indicate a lack of clarity or ambiguity in the first place and that any arguable construction must be tested against commercial common sense.

A number of pronouncements from the House of Lords and Supreme Court over the years illustrate the evolution in the court’s approach.

These include the Supreme Court’s decisions in *Rainy Sky* (2011) and *Arnold v Britton* (2015) (see boxed text to the right), which were seen by some commentators as pulling in opposite directions, with the former having given a greater role to commercial common sense in interpreting contracts, while the latter stressed the importance of the natural meaning of the words used. However, another view was that the decisions did not in reality reflect differences of

principle but merely differences in emphasis, resulting from the different circumstances being addressed in the two cases.

In its 2017 *Wood v Capita* decision, the Supreme Court rejected the notion that there is any inconsistency, declaring that “*Rainy Sky* and *Arnold* were saying the same thing”. The decision emphasises that contractual interpretation is a unitary exercise, in which an analysis of the language used (in both the clause under scrutiny and the remainder of the contract) and consideration of the commercial implications are both tools available to be used in ascertaining the objective meaning. It does not matter in which order these tools are used, so long as the court balances the indications given by each.

The appropriate weight to be given to each tool will vary depending on the circumstances, including the contract’s “nature, formality and quality of drafting”. Some agreements can be interpreted principally by textual analysis, eg because they have been professionally drafted and their meaning is clear. For other contracts there may need to be greater attention to the factual matrix, eg “because of their informality, brevity or the absence of skilled professional assistance”. However, these broad categorisations are not intended to set any strict rules as to the approach to be adopted; either tool may be used in any particular case to the extent that it assists in determining the objective meaning.

The passages below and to the right show the evolution in the court's approach to contractual interpretation over the past twenty or so years.

Investors Compensation Scheme v West Bromwich Building Society [1997] UKHL 28: "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."

Chartbrook Limited v Persimmon Homes Limited [2009] UKHL 38:

"...in deciding whether there is a clear mistake, the court is not confined to reading the document without regard to its background or context." And "...there is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed."

Rainy Sky SA v Kookmin Bank [2011] UKSC 50: "... If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other." However, "Where the parties have used unambiguous language, the court must apply it."

Arnold v Britton [2015] UKSC 36:

"...the reliance placed in some cases on commercial common sense and surrounding circumstances ... should not be invoked to undervalue the importance of the language of the provision...".

Wood v Capita Insurance [2017] UKSC 24:

"Textualism and contextualism are not conflicting paradigms in the battle for exclusive occupation of the field of contractual interpretation...". Rather, interpretation is a "unitary exercise" involving "an iterative process by which each suggested interpretation is checked against the provisions of the contract and its commercial consequences are investigated."

"Textual analysis and consideration of commercial implications are both tools that a court can use to determine a contract's objective meaning - though the weight to be given to each will depend on all the circumstances."

3. Badly drafted contracts

It is clear that a court is likely to have greater regard to commercial common sense, and other factors apart from the actual words used, where those words are unclear or ambiguous. As Lord Neuberger commented in *Arnold v Britton* (referred to above), the worse the drafting of the relevant words, the more ready the court will be to depart from their natural meaning - in effect correcting the language through interpretation.

So the best way to guard against disputes about the proper interpretation of a contract is, unsurprisingly, to ensure that all clauses are carefully drafted, looking out for areas of potential ambiguity and paying close attention to correct punctuation and grammatical structure. Particular care should be taken with defined terms and formulae, as these are common areas for problems to arise. When using formulae, consider setting out illustrations or examples as to how the clause is meant to work in a given situation.

References can also cause difficulties; it will generally be better to use defined terms or more detailed drafting rather than referring vaguely to "such" or "the above", and any cross-references to other clauses should be checked carefully in the final version.

Where additions or amendments are made, these need to be checked carefully to ensure they are clear and consistent with other provisions. It is easy for errors or ambiguities to creep in, particularly when there is time pressure.

Chartbrook v Persimmon (referred to above) is an example of ambiguity arising from both a defined term and a formula. The dispute related to the price payable to a land owner under a property development agreement, which turned on the following definition of "Additional Residential Payment", or ARP:

"23.4% of the price achieved for each Residential Unit in excess of the Minimum Guaranteed Residential Unit Value [MGRUV] less the Costs and Incentives[C&I]".

This can be read a number of ways, most obviously depending on whether the C&I should be deducted before or after calculating the 23.4%. The landowner said the meaning was simple: deduct both MGRUV and C&I from the achieved price and then calculate 23.4% of the result. The developer argued that ARP meant the amount by which 23.4% of the achieved price (less the C&I) exceeded the MGRUV, although this would require a departure from the ordinary rules of syntax.

The House of Lords accepted the developer's construction, as otherwise the definition made no commercial sense. Lord Hoffmann described this as "an exceptional case in which the drafting was careless and no one noticed". Since it was clear that something had gone wrong with the language, and it was clear what a reasonable person would have understood the parties to have meant, that was the correct interpretation even if it did not reflect the conventional meaning of the words.

Rainy Sky (referred to above, and see this [post](#)) shows the problems that can arise when references are imprecise. The case concerned advance payment bonds issued by a bank pursuant to shipbuilding contracts. The bank argued that the bonds did not cover refunds to which the buyers were entitled on the insolvency of the shipbuilder.

The relevant term provided that in consideration of the buyers' agreement to make the pre-delivery instalments, the bank undertook to pay the buyers "all such sums" due to them under the contract. The buyers said this referred back to "pre-delivery instalments" earlier in the paragraph (and therefore **included** instalments repayable on insolvency). The bank said it referred back to sums referred to in the preceding paragraph of the bonds, namely instalments paid prior to a termination of the contract or a total loss of the vessel (and therefore **excluded** instalments repayable on insolvency).

The Supreme Court found in favour of the buyers, overturning the Court of Appeal judgment and restoring the first instance decision. Both interpretations were arguable, so the Supreme Court looked to commercial common sense to resolve the question. It concluded that it made no commercial sense for the bonds to cover each of the situations in which the buyers were entitled to a refund of advance payments apart from the shipbuilder's insolvency, which was in fact when the security was most likely to be needed.

"Stand back and think about how each clause would be understood by someone who didn't know what it was aiming to do; if there is any doubt, it needs to be clearer"

4. Exclusion of pre-contract negotiations

It is a long-standing rule that the court will not admit evidence of the parties' pre-contract negotiations for the purpose of interpreting a contract. A caveat to the rule is that such evidence may be admitted for the limited purpose of showing that a relevant background fact was known to the parties, and so should be taken into account as part of the "factual matrix".

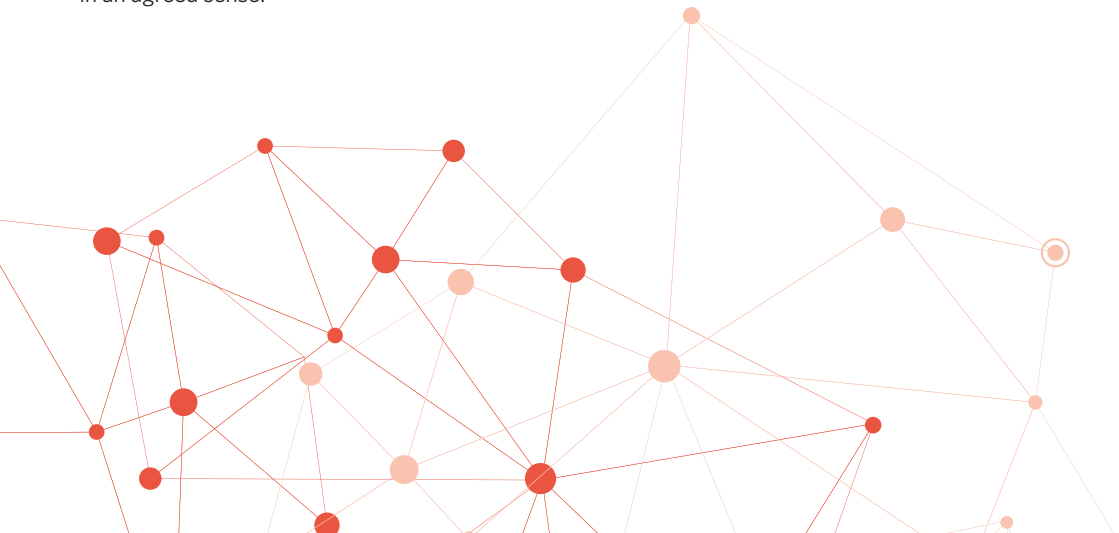
"Everything you want to rely on should be in the contract itself – not in the correspondence"

In essence, the exclusionary rule means that evidence of the parties' subjective aims and intentions, or the terms put forward or rejected in previous drafts, will not be admissible for the purpose of interpreting the contract. This principle extends even to communications that are capable of showing that the parties reached a consensus on a particular point or used words in an agreed sense.

The rule does not, however, exclude such evidence for purposes other than interpreting the contract, eg to support a claim for:

- rectification (which is often raised in the alternative to arguments based on interpretation) – ie that the written contract should be corrected because it does not reflect the terms actually agreed (or possibly the terms one party thought had been agreed, in circumstances where the other party should not be permitted to take advantage of the mistake); or
- estoppel by convention – ie that the parties have negotiated an agreement based on some common assumption, for example that certain words will bear a certain meaning, and should not be permitted to go back on that assumption.

These types of claim are not, however, easy to establish. It is far better to ensure the contract clearly reflects the agreed terms, rather than having to fall back on rectification or estoppel.



In the House of Lords case of *Chartbrook v Persimmon* (referred to above) the developer advanced two alternative arguments, if its primary arguments on interpretation failed.

The first was that the pre-contractual negotiations should be taken into account in interpreting the clause. Their Lordships rejected this argument, confirming the continued application of the rule excluding evidence of pre-contractual negotiations for the purpose of interpreting a contract.

The second was that, if necessary, the clause should be rectified. This was on the basis of pre-contract correspondence which clearly supported the developer's interpretation. Their Lordships accepted that, if the proper interpretation of the clause had been as the land owner argued, it would have been appropriate to grant rectification. Even though the first instance judge had accepted the evidence of those negotiating the contract for the land owner that they did not, in fact, understand the correspondence as supporting the developer's interpretation, what mattered was how the correspondence would be understood by a reasonable observer. That was clearly in accordance with the developer's interpretation.

So if the court had concluded in favour of the land owner's case on interpretation, it would have found that the contract should be rectified to reflect the objective common intention evidenced by the correspondence.

Merthyr (South Wales) Ltd v Merthyr Tydfil County BC [2019] EWCA Civ 526 (see [post](#)) concerned a dispute over the interpretation of an escrow agreement between a local authority and a mining company. The agreement provided for the company to make quarterly payments into the account but also provided that, if a payment was missed, the amount due on the following funding date would increase accordingly, subject to a longstop provision.

The company made no payments and argued that the relevant provisions permitted it not to make any quarterly deposits as long as it paid the full amount by the longstop date. It sought to rely on a passage in its proposal for the escrow arrangement, and the council's report recommending acceptance. These, it said, showed that the object or aim of the relevant clause was to establish an arrangement whereby, if payments were not made on the funding dates, they would simply be rolled forward, with no other consequence of missing a payment.

The court noted the established principle that pre-contractual material can be relied on as evidence of the factual matrix – which includes the genesis and objective aim of the transaction. However, it rejected the company's argument that such material could be relied on to show the genesis and aim of a particular provision in a contract. This would amount to relying on the material to show what the parties intended a particular provision to mean, which is what the exclusionary rule prohibits.

In *Persimmon Homes Ltd v Hillier and Creed* [2019] EWCA Civ 800 (see [post](#)), the claimant purchased the shares in two property development companies from the defendants. In the share purchase agreement the defendants warranted that the target companies held good title to certain properties, but described the site imprecisely.

After completion, the claimant realised that the companies did not own certain freehold interests that were crucial to the development. They were instead held by a third company owned by the defendants, which did not form part of the transaction.

The claimant brought a claim for damages for breach of warranty, on the basis that the warranties should be construed to refer to the whole of the site, or alternatively for rectification.

The claimant failed on the construction argument but succeeded on rectification. The test for rectification on grounds of common mistake is that the parties held a common continuing intention, up to the time of entering into the agreement, which mistakenly was not reflected in its terms. That common continuing intention is not a mere subjective belief but what an objective outside observer would have understood the intention to be.

The Court of Appeal held that the first instance judge was fully entitled on the evidence to conclude that the transaction documents did not accurately reflect the terms agreed between the parties.

5. Limiting the factual matrix

It is sometimes argued that admitting evidence of factual matrix is unfair to third parties who might be affected by a contract, as it increases the risk they may find the contract does not mean what they had thought. The fact that a contract might affect a third party, such as an assignee, is not normally sufficient to prevent the court admitting background facts known to the original parties.

However, where a contract is of a type that is treated as addressed to third parties (eg articles of association), so that their interests ought to be taken into account, the courts may restrict the admissible background to facts which would have been available not only to the contracting parties but also to relevant third parties. The role of the factual matrix may also be more limited in contracts concluded on industry standard forms, given the particular need for commercial certainty in that context.

The Supreme Court considered the approach to the interpretation of tradable financial instruments in *In Re Sigma Finance Corporation* [2009] UKSC 2. Lord Collins stated: "... 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. ...Where a security document secures a number of creditors who have advanced funds over a long period it would be quite wrong to take account of circumstances which are not known to all of them. In this type of case it is the wording of the instrument which is paramount. [It] 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..."

6. Limits of commercial common sense

When the court is interpreting a commercial contract, it will assume that the parties intended their agreement to make sense in the commercial context which prevailed at the relevant time. As discussed in section 1 above, notions of commercial common sense can therefore be relevant in considering the meaning the clause would convey to a reasonable person with the relevant background knowledge.

However, that does not mean that commercial common sense can necessarily be invoked to prevent the court interpreting a clause in a way that makes little commercial sense for one or other party. The fact that a particular interpretation seems unduly unfavourable to a particular party will not generally be sufficient to persuade a court to override what otherwise appears to be the clear meaning of the clause. It may be that the clause was agreed in exchange for a concession elsewhere, or it may simply have been a bad bargain.

In addition, commercial common sense cannot be invoked retrospectively. It is only relevant to the extent it sheds light on how matters would or could have been perceived at the time the contract was made. Of course, while this is the clear principle, it can sometimes be difficult for judges to block out entirely the knowledge gained through hindsight.

“Hindsight may be perfect, but it is not a legitimate tool of contractual interpretation”

The limits of commercial common sense are well illustrated by the Supreme Court decision in *Arnold v Britton* referred to above (see [post](#)). The court interpreted a service charge provision in a number of 99 year leases of chalets in a caravan park in South Wales granted between 1977 and 1991. The court held that the clause required the tenants to pay a fixed sum of £90 for the first year, increasing annually by 10% on a compound basis, even though the practical effect was that the annual service charge would be alarmingly high (over £500,000) by the end of the term.

The court rejected the argument that it was inconceivable that a lessee would have agreed a service charge provision with that effect, at least in the 1970s and much of the 1980s. Annual inflation was well over 10% between 1974 and 1981, and over 15% for six of those eight years. Although it had turned out to be imprudent (at least so far), at the time a lessee could have taken the view that 10% was an acceptable rate. Lord Neuberger set out a number of general principles, including:

- Commercial common sense is not to be invoked retrospectively. The mere fact that a contractual arrangement has worked out badly, or even disastrously, for one of the parties is not a reason for departing from the natural language.
- A court should be very slow to reject the natural meaning simply because it appears to be a very imprudent term for one of the parties to have agreed, even ignoring the benefit of hindsight.

The Supreme Court decision in *Wood v Capita* (see [post](#)) sends a similar message as to the limits of commercial common sense in interpreting a contract.

Under an indemnity clause in a share purchase agreement for a car insurance broker (the Company), the Sellers undertook to indemnify the Buyer against "...all actions, proceedings, losses, claims... suffered or incurred, and all fines, compensation or remedial action or payments imposed on or required to be made by [the Company] following and arising out of claims or complaints registered with the FSA..." relating to misselling.

The question arose whether this indemnity covered compensation the Company was required to pay to customers, where this was the result of the Company self-reporting the misselling, rather than a claim by the customers or a complaint by those customers to the FSA. The High Court held that it did, primarily on the basis that it did not make business common sense for the clause to operate otherwise. The Court of Appeal allowed the Sellers' appeal and the Supreme Court upheld the Court of Appeal decision.

The Supreme Court gave considerable emphasis to the contractual context, and in particular the existence of warranties which, subject to a two year limitation, would have provided compensation for the relevant losses. The court commented:

"Business common sense is useful to ascertain the purpose of a provision and how it might operate in practice. But in the tug o' war of commercial negotiation, business common sense can rarely assist the court in ascertaining on which side of the line the centre line marking on the tug o' war rope lay, when the negotiations ended."

While the agreement may have become a bad bargain for the Buyer, given their failure to bring a claim in time under the warranties, it was not the court's role to construe the indemnity in a way that improved their bargain.

"Don't assume you'll be able to rely on 'commercial common sense' to save you from what turns out to be a bad bargain"

7. The contract as a whole

In interpreting a term in a contract, the court will not look at the clause in isolation; it must be interpreted by reference to the contract as a whole. How does the language used in the clause compare to the language used in other clauses? How is the clause meant to work with the other provisions of the contract? Are there recitals which shed light on its commercial purpose?

The positioning of a term within a clause or within the contract overall may be important. Parties should pay close attention not just to the wording of a clause, but also where it fits within the overall structure and organisation of the contract. If a clause appears in a section of the contract relating to one issue, it may be difficult to persuade a court that it is meant to deal with another issue, even if the wording of the clause might be broad enough to cover that issue.

Headings may also be important as part of the internal context. Where headings are used it is good practice to include a provision stating that they are for convenience only and shall not affect interpretation. But even with such a clause in the boilerplate, it is sensible to make sure the headings are appropriate to the provisions that follow.

If the contract is part of a series of inter-related agreements, then the court will take into account not only the contract in which a clause appears but the overall scheme of the agreements.

“Context is key in contractual interpretation. A clause might mean one thing in one agreement but something quite different in a different context”

The importance of context is well illustrated by the Supreme Court decision in *In Re Sigma Finance Corporation* (referred to above). Sigma was a structured investment vehicle which became insolvent, triggering an “Enforcement Event” under the relevant Security Trust Deed. This started a 60-day “Realisation Period” in which the appointed receivers were to establish separate pools of assets to cover short term liabilities (ie those falling due within a year) and various types of longer term liabilities. The issue on appeal was how Sigma’s assets (of around US\$450 million) were to be distributed in the face of a huge shortfall against total liabilities (around US\$6.2 billion).

Key to the dispute was the last sentence of clause 7.6, which stated: “During the Realisation Period the Security Trustee shall so far as possible discharge on the due dates therefor any Short Term Liabilities falling due for payment during such period...” The courts below had found this had a clear natural meaning, requiring payment of Realisation Period debts as and when they fell due, even though this meant prioritising them over all other debts.

The majority of the Supreme Court said this conclusion attached too much weight to what the courts perceived as the natural meaning of the words of the relevant sentence and too little weight to the context in which it appeared and the scheme of the deed as a whole. In particular, clauses 7.3 to 7.8 were all drafted on the assumption of a situation in which Sigma had enough assets to cover at least its secured creditors; only in clause 7.9 did the deed address the possibility of a shortfall. The majority concluded that, in a situation of insolvency, the relevant sentence did not require payment of Realisation Period debts as they fell due.

8. Tools of construction

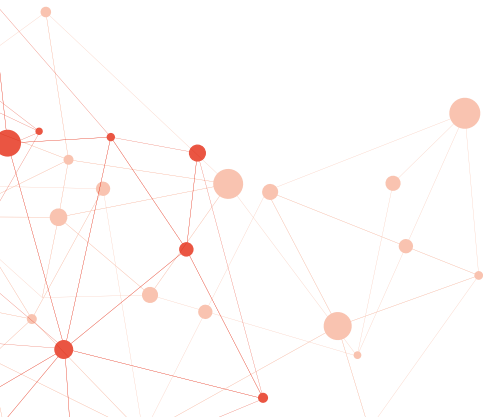
It is a long standing principle of construction that, where there is some doubt or ambiguity as to the meaning of a contract term, it should be construed against the party that has put forward the clause and/or is seeking to rely on it. This is known as the “*contra proferentem*” rule, after the Latin phrase meaning “against the offeror”.

The principle is variously formulated depending on the case. Sometimes it is against the party that has drafted the clause; sometimes against the party who is seeking to rely on the clause to cut back a primary obligation (eg exclusion clauses).

However the principle is expressed, it seems that it now has a very limited role in the interpretation of commercial contracts between parties of equal bargaining power, although it is sometimes still prayed in aid and (less frequently) applied.

In *K/S Victoria Street v House of Fraser (Stores Management) Ltd* [2011] EWCA Civ 904, in a passage that has been cited in numerous subsequent cases, the then Master of the Rolls said the following in relation to the *contra proferentem* rule:

“... such rules are rarely if ever of any assistance when it comes to construing commercial contracts. Quite apart from raising abstruse issues as to who is the proferens ..., “rules” of interpretation such as *contra proferentem* are rarely decisive as to the meaning of any provisions of a commercial contract.



The words used, commercial sense, and the documentary and factual context, are, and should be, normally enough to determine the meaning of a contractual provision.”

However, the rule was applied in *Ace Paper Ltd v Fry* [2015] EWHC 1647. Under an invoice discounting agreement (IDA), Ace had assigned to RBS all its customer debts. The IDA was later terminated by agreement, with RBS confirming that it had no claims against Ace arising under or incidental to the IDA and that, insofar as “any such claims” against Ace “or any third party” might arise in future, “such claims” were “waived and released and transferred/re-transferred” to Ace.

The question was whether that had the effect of re-assigning to Ace a substantial customer debt for which RBS had already paid Ace under the bad debt provisions of the IDA. The High Court held that it did not. Ace’s interpretation was counterintuitive and would require much clearer words than had been used, particularly as the document was drafted by Ace and should be construed *contra proferentem*.

The same may be said in respect of other traditional “canons” of construction. These are now seen essentially as tools the court may use in considering how the agreement would be understood by the reasonable reader with the relevant background knowledge, rather than overriding rules or presumptions. Some of the better known are mentioned below.

Where there is a list of examples, together with general wording, the general wording may be interpreted as limited to other examples of the same type. This is the “*ejusdem generis*” rule, meaning “of the same kind”, though it is not an invariable rule and will depend on the words used and their context. To avoid its application, parties should take care with lists, and may wish to include a boilerplate provision that “including”, and similar words, are not intended to limit the sense of the general words used.

Where particular objects, rights or powers are expressly mentioned, this tends to suggest that other similar objects, rights or powers are not meant to be included. This is known as “*expressio unius*”, a shortened version of a Latin phrase meaning “express mention of one thing excludes the other”. It is not, however, a particularly strong principle, and is not commonly applied.

In general, the court will prefer an interpretation which gives effect to the contract, or the particular clause, rather than one that renders it ineffective or meaningless. Similarly, it will generally prefer an interpretation that does not allow one party to take advantage of its own wrong. And it will not generally infer that a party has given up legal rights to a greater extent than is clearly intended based on the contract wording.

“Traditional rules or canons of construction have only a very limited role in the modern approach to interpreting contracts ”

9. Implied terms

In addition to interpreting the express terms of a contract, the court may in some circumstances imply a term that has not been expressly included.

“The court may imply a term to deal with a situation the parties have not anticipated – but it is best if it doesn’t have to”

Before it will imply a term, the court must be satisfied that the term is:

- (1) necessary to give business efficacy to the contract – ie without it the contract would lack commercial or practical coherence; or
- (2) so obvious that it goes without saying.

While these requirements are technically alternatives, in practice it would be rare for only one of them to be satisfied.

In addition, a term will not generally be implied where it would be inconsistent with the express terms of the contract, or where it is not capable of clear expression, or where it would not be reasonable and equitable.

In practice, the courts tend to be reluctant to imply terms where there is a detailed written contract prepared by legal advisers; the starting point is generally that if the parties intended to include a particular term, they would have done so expressly.

Terms may also be implied by statute or common law, or by reference to an established trade custom or a previous course of dealings between the parties.

The leading modern case on implying contractual terms is the Supreme Court’s decision in *Marks and Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Ltd* [2015] UKSC 72 (see [post](#)).

There was a dispute between M&S and its landlord as to whether M&S could reclaim the proportion of quarterly rent it had paid in advance that related to the period after its lease came to an end following service of a break notice. There was no express provision to that effect, so the question was whether a term should be implied.

The court reaffirmed the traditional, highly restrictive approach to implying terms in commercial contracts – the term must be necessary to give the contract business efficacy or be so obvious that it goes without saying. It rejected any suggestion that this strict test had been watered down by the decision in *Attorney General of Belize v Belize Telecom* [2009] 1 WLR 1988. In particular, that decision should not be taken as suggesting that reasonableness on its own is a sufficient ground for implying a term.

On the facts here, the strict test for an implied term was not met. The fact that M&S had to pay a break premium lay uneasily with the notion that a term should be implied entitling M&S to be paid an apportioned refund the following day.

There was no reason to depart from the starting point that, if the parties had intended there to be such an entitlement, they would have included an express provision.

The decision in *Robert Bou-Simon v BGC Brokers* [2018] EWCA Civ 1525 (see [post](#)) illustrates the strictness of the court's approach to implying terms.

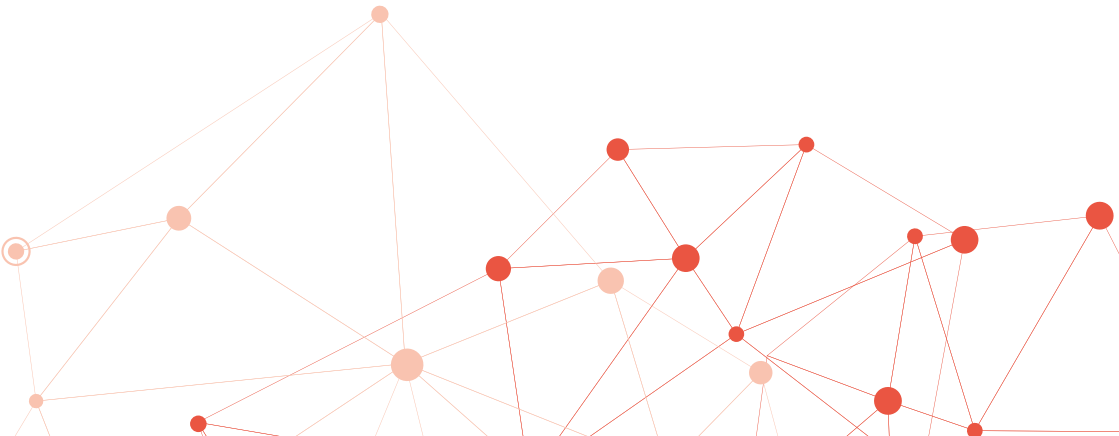
The dispute concerned a loan agreement entered into between a brokerage firm and an intended partner in that firm. An express term provided that, if the individual ceased to be a partner, BCG would write off the outstanding balance of the loan if he had served an initial four year period. In fact, he left within that period but it later transpired that he had never become a partner because the necessary documentation had not been signed.

Overtuning the High Court, the Court of Appeal refused to imply a term requiring the loan to be repaid if the individual left within the initial four year period. The judge had erred in implying a term in order to reflect the merits of the situation as they now appeared, rather than from the perspective of the reasonable reader of the agreement at the time it was entered into.

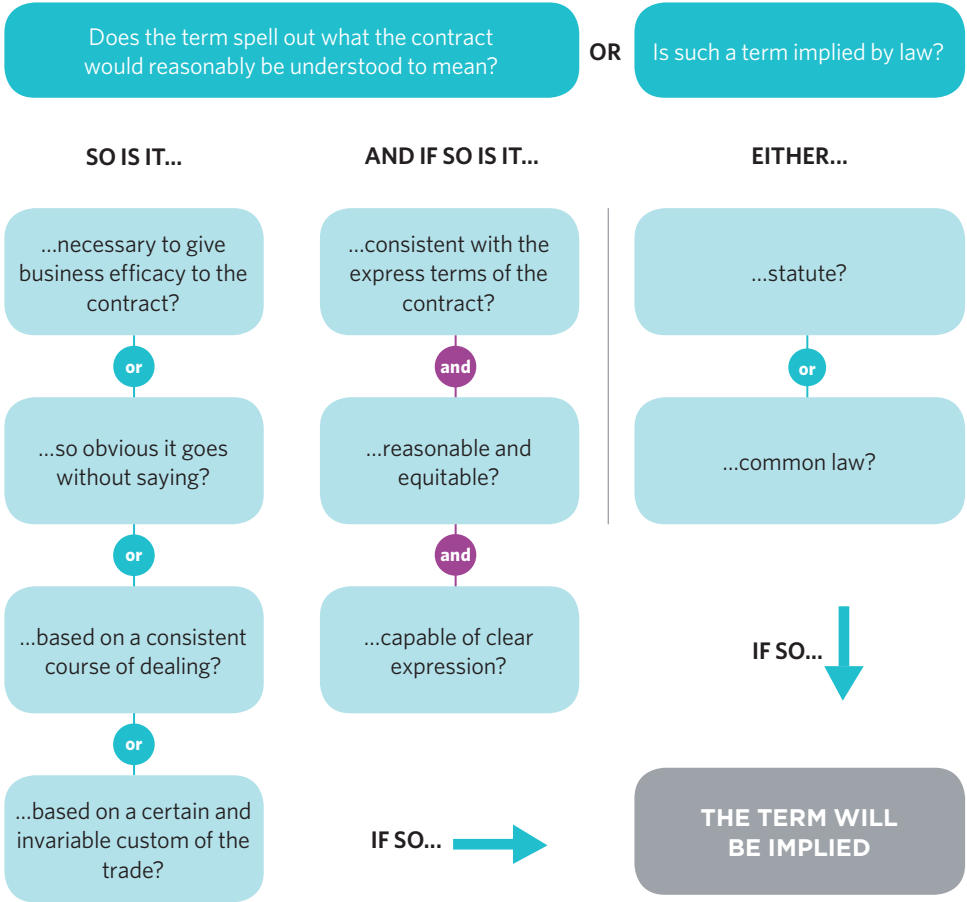
In the court's view, the reasonable reader would consider that the agreement simply would not apply in the situation that arose (ie if the individual never became a partner). It is not appropriate to apply hindsight and imply a term in a commercial contract simply because it now appears to be fair or because it seems likely that the parties would have agreed to it had it been suggested at the time.

The court also commented that the judge embarked upon the task in the incorrect order by construing the agreement to fit the implied term - the question of implied terms can be considered only after the process of construing the express terms of the contract is complete.

The Court of Appeal commented that these circumstances may have given rise to a claim in restitution, but that was not pleaded and the question was not before the court.



Will the court imply a term?



10. Reasonable views may differ

The interpretation of a contract term is notoriously fact-sensitive, depending as it does on not only the words used but also the context in which they appear – both the internal context, within the four corners of the contract, and the external context or factual matrix. As a result, decisions on contractual interpretation generally have little precedent value; the meaning of a clause in one contract may bear little relation to the meaning of even an identically-worded clause in a different contract (subject to an obvious exception for industry standard contracts).

A further difficulty is that reasonable views will often differ not only as to whether language used in a contract is clear and unambiguous, or whether a particular interpretation is arguable at all, but also as to which competing interpretation is most commercially sensible. There are numerous examples of different conclusions being reached by courts at different levels, or dissenting judgments being given, not because of any real difference in principle but because the judges took different views of how the principles should be applied to the particular facts.

As Lord Hoffmann said in *Chartbrook v Persimmon* (referred to above) in the context of correcting mistakes by interpretation: “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 The subtleties of language are such that no judicial guidelines or statements of principle can prevent it from sometimes happening.”

“It will almost certainly be cheaper and easier to invest the time and effort at the drafting stage, to ensure your contract is clear, than to have to call on the court to resolve disputes about its meaning later”

Contacts



Gary Milner-Moore

T +44 20 7466 2454

M +44 7939 125 512

gary.milner-moore@hsf.com

Gary is a partner in the dispute resolution team and deals with a wide variety of commercial disputes. Many are of a complex nature and often they involve an international element and proceedings in a number of jurisdictions.

Gary has worked on cases involving significant and complex litigation or arbitration, as well as those requiring mediation. Clients seek Gary's advice on matters such as commercial contract disputes (including those relating to joint ventures), actions in negligence, claims for breach of directors' duties, fraud cases, and matters involving economic torts and other forms of secondary liability. He also advises on insolvency cases.



Sarah McNally

T +44 20 7466 2872

M +44 7809 200 424

sarah.mcnally@hsf.com

Sarah is a partner in the insurance group and handles all aspects of insurance claims for policyholders with particular expertise in the construction, energy, projects and political and credit risk fields. She is a specialist in M&A related insurance issues and has particular expertise in W&I insurance claims as well as professional negligence claims concerning architects, engineers and brokers.



Steven Dalton

T +44 20 7466 2537

M +44 7809 200 156

steven.dalton@hsf.com

Steven is a commercial and corporate partner specialising in the energy and natural resources sector. He is experienced in acquisitions, disposals and project development. Fluent in Russian, Steven has conducted much of his work in the Commonwealth of Independent States.

HERBERTSMITHFREEHILLS.COM

BANGKOK

Herbert Smith Freehills (Thailand) Ltd

BEIJING

Herbert Smith Freehills LLP
Beijing Representative Office (UK)

BELFAST

Herbert Smith Freehills LLP

BERLIN

Herbert Smith Freehills Germany LLP

BRISBANE

Herbert Smith Freehills

BRUSSELS

Herbert Smith Freehills LLP

DUBAI

Herbert Smith Freehills LLP

DÜSSELDORF

Herbert Smith Freehills Germany LLP

FRANKFURT

Herbert Smith Freehills Germany LLP

HONG KONG

Herbert Smith Freehills

JAKARTA

Hiswara Bunjamin and Tandjung
Herbert Smith Freehills LLP associated firm

JOHANNESBURG

Herbert Smith Freehills South Africa LLP

KUALA LUMPUR

Herbert Smith Freehills LLP
LLP0010119-FGN

LONDON

Herbert Smith Freehills LLP

MADRID

Herbert Smith Freehills Spain LLP

MELBOURNE

Herbert Smith Freehills

MILAN

Studio Legale Associato in association
with Herbert Smith Freehills LLP

MOSCOW

Herbert Smith Freehills CIS LLP

NEW YORK

Herbert Smith Freehills New York LLP

PARIS

Herbert Smith Freehills Paris LLP

PERTH

Herbert Smith Freehills

RIYADH

The Law Office of Mohammed Altammami
Herbert Smith Freehills LLP associated firm

SEOUL

Herbert Smith Freehills
Foreign Legal Consultant Office

SHANGHAI

Herbert Smith Freehills LLP
Shanghai Representative Office (UK)

SINGAPORE

Herbert Smith Freehills LLP

SYDNEY

Herbert Smith Freehills

TOKYO

Herbert Smith Freehills