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Insights

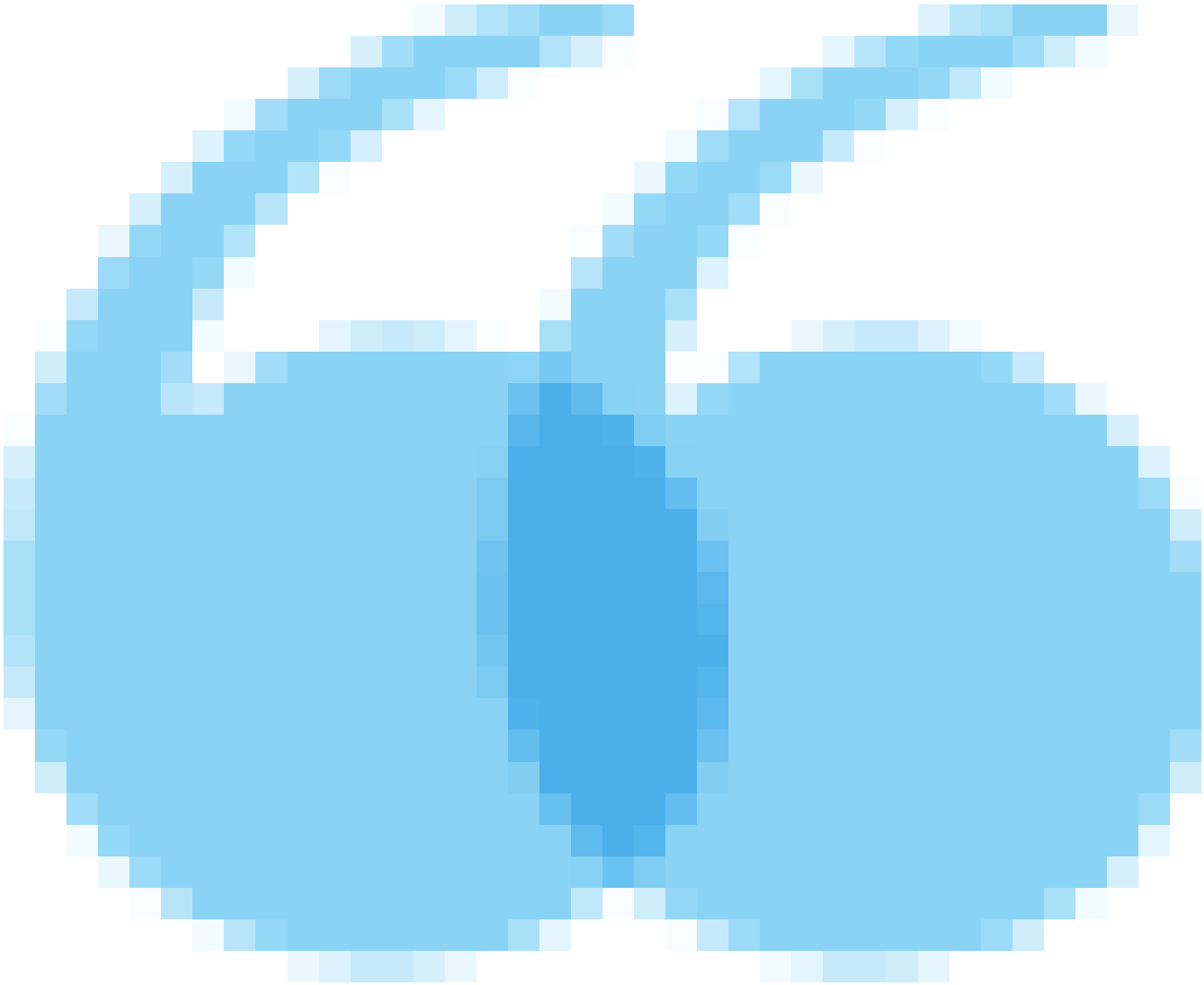
CONTRACT INTERPRETATION – WHO HAS COMMERCIAL COMMON SENSE?

Feb 25, 2021

The dust is slowly settling over the arguments about how contracts should be interpreted. We know that “this is not a literalist exercise focused solely on a parsing of the wording of the particular clause” and that “[t]extualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation” (as stated by Lord Hodge in Wood v Capita Insurance Services Ltd). That means the factual background (matrix of fact) and commercial common sense still have a role to play where the plain meaning of the words is not clear (which is usually the reason why there is a dispute in the first place).

Identifying the relevant factual background presents its own challenges, but I am interested in how you identify what makes commercial sense. We are familiar with the reasonable man on the Clapham omnibus, do we now need to look for his sister, the commercially reasonable business woman on the Waterloo & City line (when not working from home)?

This is not an easy question. As Lord Hoffmann said in Chartbrook Ltd v Persimmon Homes Ltd it is:



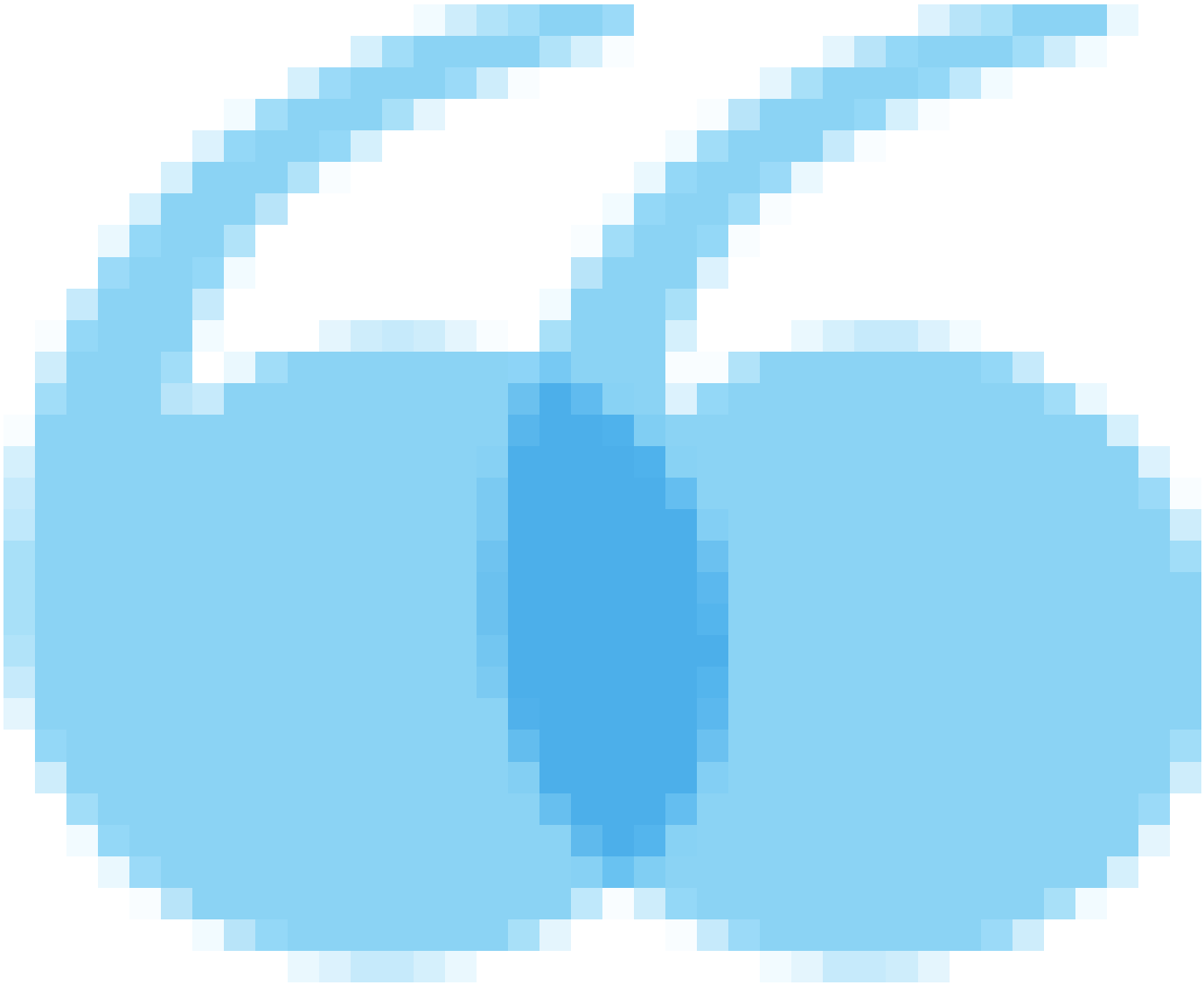
...not unusual that an interpretation which does not strike one person as sufficiently irrational to justify a conclusion that there has been a linguistic mistake will seem commercially absurd to another.

Interpretation is an objective exercise under English law but we know that parties sometimes agree to terms that appear on their face uncommercial but in fact make sense because, for example, the party is investing in entering into a new market or a new relationship, the party's financial position left it with little choice or perhaps it simply made a mistake. Can the courts take account of such matters or does the objective approach mean that they are simply ignored? In any event, how to decide what makes commercial sense?

Do judges have commercial sense?

I think that we have a very able and experienced judiciary in the UK, and TCC judges in particular have a very good understanding of the commercial drivers in the construction industry. But some judges appear to recognise that the traditional legal background does not necessarily make it easy to provide views on commercial matters.

Skanska Rashleigh Weatherfoil Ltd v Somerfield Ltd concerned the interpretation of a letter that in turn referred to a proposed facilities management agreement. Neuberger LJ (as he then was) warned against departing from the natural meaning of the provision in the contract merely because it may conflict with notions of commercial common sense. He stated that:



Judges are not always the most commercially-minded, let alone the most commercially experienced, of people, and should, I think, avoid arrogating to themselves overconfidently the role of arbiter of commercial reasonableness or likelihood

In BMA v African Minerals, the issue was the interpretation of a loan facility agreement. In that case Aikens LJ approved of the comments in the first instance decision of Jackson v Dear, where it was said that commercial common sense is not to be elevated to an overriding criterion of construction and that the parties should not be subjected to "…the individual judge's own notions of what might have been the sensible solution to the parties' conundrum".

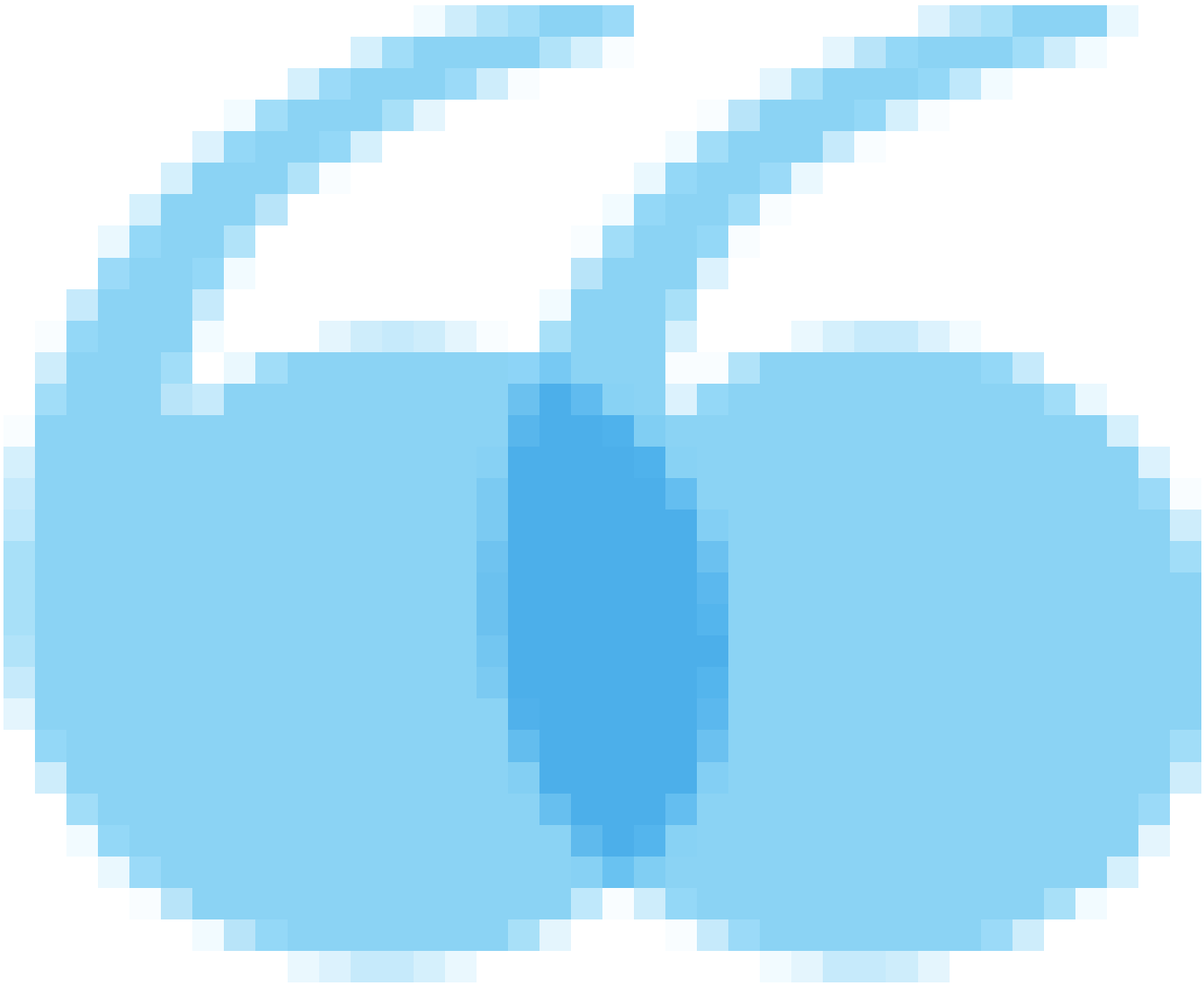
More recently, in S&T (UK) Ltd v Grove Developments Ltd, Sir Rupert Jackson considered arguments as to whether any time had to lapse between the three notices required under the JCT form to deduct liquidated damages for delay. He observed that "[j]udges should not generally impose their notions of commercial common sense upon the parties to business disputes."

It can be argued that the position may well be different in arbitration or adjudication, where the tribunal can consist of an industry person who may have more commercial experience in a particular industry. But even such a tribunal will need some guidance on the right approach.

A possible solution

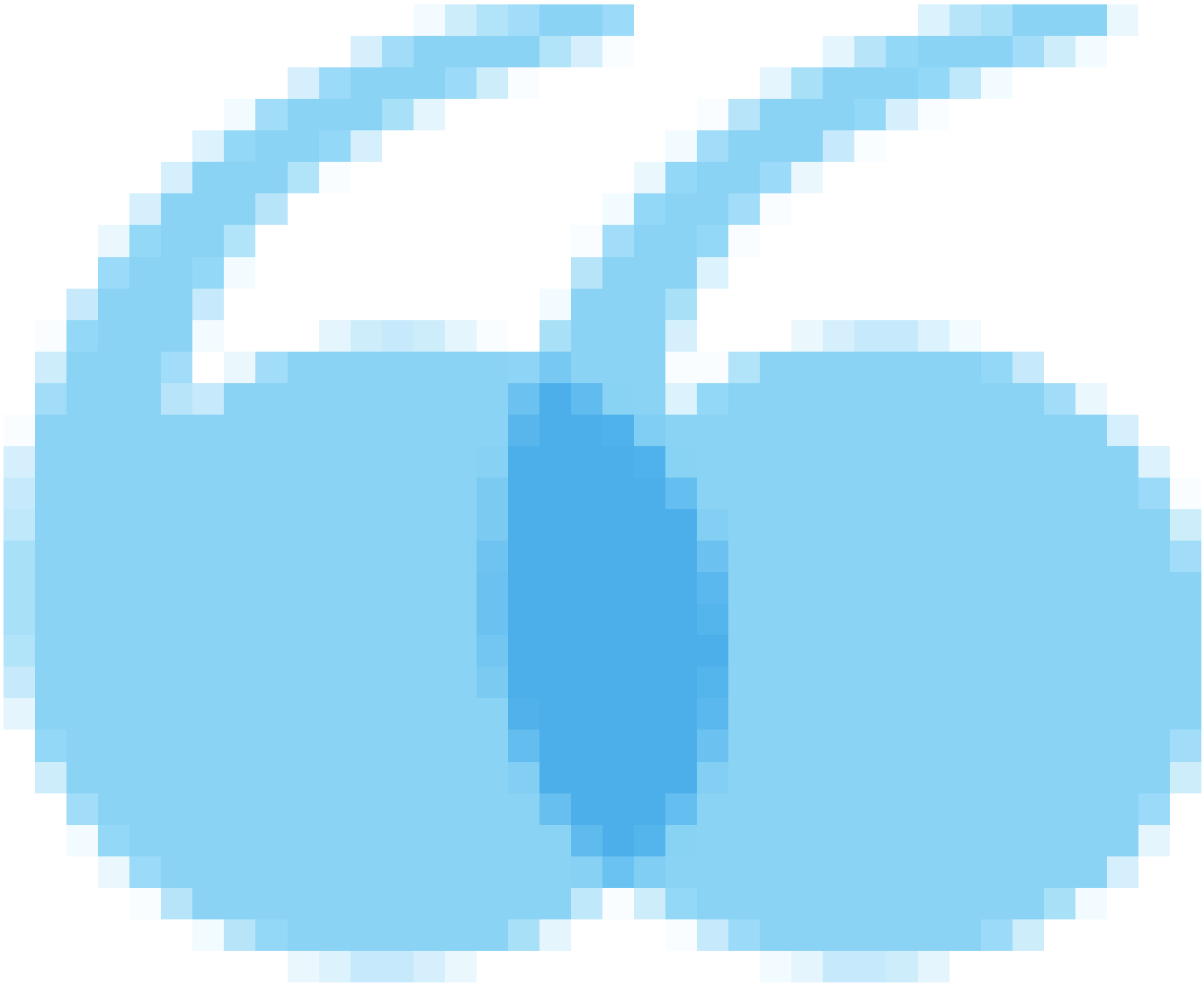
Last year, in Ardmair Bay v Craig, the Court of Session considered the meaning of the phrase “charter arrangements” in a share purchase agreement. Lord Drummond Young, who delivered the opinion of the Court, made some observations about the approach to contractual interpretation as well as a suggestion as to how to determine what makes commercial sense.

He rejected an argument based on Arnold v Britton and pointed out that:



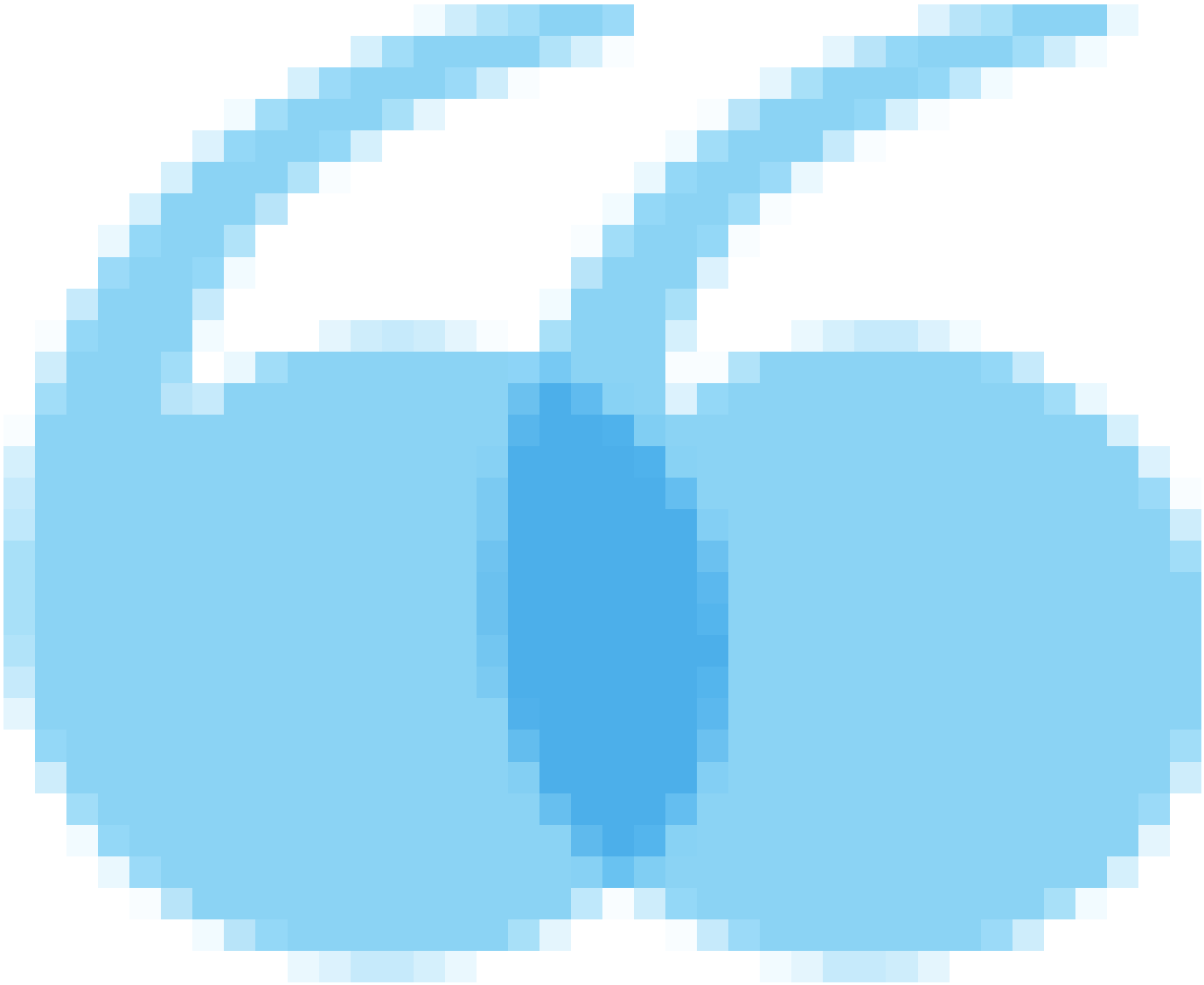
The most extreme problem with a totally literal approach to construction occurs in cases where supervening events are not readily foreseeable, especially the sort of events that are sometimes described as ‘unknown unknowns’

He thought that it was unrealistic to emphasise the parties' control over the language that they use in a contract and that an emphasis on a strictly literal approach may produce a result that is arbitrary or disproportionate, which he saw as undesirable as a matter of commercial common sense. He was in favour of construing contracts purposively and observed that:



The application of commercial common sense is a relatively straightforward process, despite suggestions to the contrary in some academic literature. It obviously involves elements of general common sense as an aid to practical reasoning, such as considering whether a view is widely held by those with knowledge of the particular field in question, and testing a proposition against its converse, to discover whether the converse makes sense; if it does not, that will usually support the proposition

He went on to say that:



At a commercial level, the most important factor is probably the use of elementary microeconomics (the branch of economics that covers the behaviour of individuals and businesses in their commercial dealings with other persons). That will normally involve consideration of the practice followed in a particular trade, and the understanding held by people operating in that trade, for example as to what is commercially important or what would be regarded as commercially undesirable.

I can see the sense at looking at what views are held by people with knowledge of the relevant field, the practices that exist in particular trades and identifying what they would see as commercially important. The construction industry undoubtedly has certain practices that affect or are relevant to the contractual arrangements used. That would be consistent with an objective view of interpretation.

Is economics the answer?

Should we all now spend some time learning about what he referred to as “elementary microeconomics” and use that knowledge to interpret contracts? In this case the court looked at the commercial basis for the transaction and what affected the value of the company, to reach what it described as a “view… based on an objective analysis of the contract, construed in context and in the light of commercial common sense.”

The position may be less clear in other cases. In addition, microeconomics may well be an important factor, but what about behavioural economics? That is a field of economics developed by people such as Richard Thaler and Daniel Kahneman (leading to two Nobel prizes). They have investigated decision making and why people make mistakes, pointing out that people do not always behave rationally as assumed by traditional economists. This seems much more relevant in a contentious situation where a party's commercial judgment is questioned.

I don't think we need to rush to buy economics text books but the Ardmair Bay decision is useful in providing some guidance on how such questions are to be approached and the need to look at what happens in particular trades or sectors. In addition, the decision makes it clear that this is approached on an objective basis, rather than by seeking to identify the specific motives the parties may have when entering into the contract.

However, that could mean that the fact that a party had its own specific good commercial reasons to enter into a transaction, that appears unfavourable, would not be taken into account unless it could be justified on an objective basis. This is where the factual background may become relevant but is that any easier to apply than trying to identify commercial sense? Unfortunately, trying to identify the objective, factual background can raise its own issues. The search for a unified theory of contract interpretation is almost as difficult as the search for a grand unified theory in physics.

This article first appeared on the Practical Law Construction blog dated 23 February 2021.

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