Contractual interpretation: let commercial common sense prevail

In a decision that will have broad application for the interpretation of commercial contracts, the Supreme Court has unanimously held that where the court is asked to construe a provision in a contract that can have more than one possible meaning, the meaning which is consistent with commercial common sense is to be preferred (Rainy Sky S.A. and others v Kookmin Bank [2011] UKSC 50).

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The dispute
The bank issued advance payment bonds to guarantee the obligations of the shipbuilder under a number of shipbuilding contracts in identical terms. The shipbuilding contracts provided that the buyers were entitled to a full refund of pre-delivery instalments in certain circumstances, primarily where:

- The buyers exercised their right to reject the vessel or to terminate, cancel or rescind the contract.
- There was an event of default by the shipbuilder, including insolvency. Insolvency did not, however, entitle the buyers to cancel the contract.

After the shipbuilder entered into a debt workout in Korea, a dispute arose as to whether the buyers were entitled to a refund of their pre-delivery instalments under the bonds in the event of the shipbuilder’s insolvency or only where the buyers terminated, cancelled or rescinded the contract. The wording of the bonds was ambiguous, and it was common ground between the parties that the relevant provisions could be read either way.

The court at first instance found in favour of the buyers, holding that the obligation to repay the instalments in the event of insolvency was covered by the bonds. This decision was reversed by the Court of Appeal, which held that the bank’s construction of the relevant wording (that is, that its guarantee obligations were not triggered by the shipbuilder’s insolvency) would not produce an absurd result, and that the court should not impose its own view of what was commercial over what the parties had agreed, as objectively recorded in the bonds.

The Supreme Court decision
Lord Clarke gave the judgment on behalf of all five Law Lords, allowing the buyers’ appeal, and restoring the first instance decision. He concluded that the buyers’ interpretation of the bonds was that most consistent with their commercial purpose and accordingly was to be preferred.

Lord Clarke considered a number of cases which discuss the correct approach to be taken by the court where a contractual provision can have more than one possible meaning. In broad terms, the cases highlight the two following differing approaches on the part of the judges:

- A literal approach to construing the ambiguous wording, where the court refuses to take into account what would appear to have been the underlying purpose of the provision in question. Adopting the literal approach means that the fact that a term in the contract appears to be particularly unfavourable to one or other party is irrelevant. The term may have been agreed in exchange for some concession elsewhere in the transaction, or it may simply have been a question of one party making a bad bargain.

- A purposive or more liberal approach to construing contractual language where there are competing interpretations. This approach treats the commercial purpose of the contract as more important than the niceties of language. It does not mean that the court should rewrite the language used by the parties in order to make the contract conform to business common sense but, where more than one construction is possible, it does permit the court to choose that construction which seems more likely to give effect to the commercial purpose of the parties’ agreement.

Lord Clarke concluded that the appropriate construction of the ambiguous wording in this case should be that which was most consistent with commercial common sense; in other words, preferring the more liberal approach. He rejected the approach taken by the Court of Appeal that the court must give effect to the most natural meaning of the disputed words, unless this produces a result which is so extreme as to suggest that it was unintended.

Applying the liberal approach to the facts of this case, Lord Clarke held that it made no commercial sense for the parties to have intended that an insolvency event would not lead to repayment of the instalments under the bonds because this would mean that the security that the bonds was intended to provide was not available when it was most needed. Had the parties intended such a “surprising” result, then they should and would have spelt it out clearly in the contracts and the bonds, which they had not done.

**Wider application**

The significance of the Supreme Court’s decision is clearly much wider in scope than, and extends beyond the construction of, refund guarantees and advance payment bonds to the construction of commercial contracts in general. Lord Clarke’s judgment sets out in detail and thereby clarifies the law regarding the approach which should be taken by the courts generally when construing contractual provisions in the event that there is more than one meaning.

While the Supreme Court has upheld the logical and commercial meaning of the ambiguous wording in this case, watertight drafting of commercial agreements remains essential to avoid similar disputes arising in the future. In addition, and when drafting such documents, the commercial intention of the parties must be taken into account because it is now clear that the court can and will consider the particular commercial purpose of a provision when being asked to interpret ambiguous contractual provisions.
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