The interpretation of contracts
A lordly extrajudicial conflict, and its potential significance for New Zealand

BY TIM SMITH AND SAM CATHRO

Those engaged in the ever controversial topic of contractual interpretation will be intrigued by the current spat between Lords Sumption and Hoffman playing out in their recent extrajudicial musings. In the latest Law Quarterly Review, Lord Hoffman has sought to defend the interpretive philosophies that have predominated in the UK (and even more in New Zealand) in recent years from stinging criticisms levelled at both those philosophies - and Lord Hoffman's personal role in expounding them - by Lord Sumption. (See Lord Hoffman, “Language and Lawyers” (2018) 134 LQR 553, responding to Lord Sumption, “A Question of Taste: The Supreme Court and the Interpretation of Contracts” (2016-2017) 8 The UK Supreme Court Yearbook 74, previously given as a speech at Keble College, Oxford (Harris Society Annual Lecture, Keble College, Oxford, 8 May 2017)).

The contextual approach to interpretation that Lord Hoffman championed has permeated the common law system’s most significant decisions on contractual interpretation in recent years - with the UK Supreme Court decision in Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 WLR 896 (ICS), often being seen as the start of a paradigm shift. In that case, Lord Hoffman, giving the leading judgment, applied five “principles” to reach an interpretation of the contract which the Court of Appeal had rejected on the basis that it was “not an available meaning of the words”. Lord Sumption attacked this approach, and claimed that since Lord Hoffman’s departure from the bench, the UK Supreme Court has “begun to withdraw from the more advanced positions seized during the Hoffman offensive, to what [Lord Sumption sees] as a more defensible position”.

So far New Zealand’s highest courts have embraced Lord Hoffman’s contextual approach, and arguably taken it even further, perhaps reaching a high point in the Supreme Court decision in Vector Gas Ltd v Bay of Plenty Energy Ltd [2010] NZSC 5, [2010] 2 NZLR 444 (Vector v BOPE), as discussed below. However, the potential impact of the Sumption-Hoffman debate is, of course, yet to be seen. But the arguments will, no doubt, be fully re-rehearsed in the leading courts in both the UK and New Zealand when the right cases arise. And there are already hints here suggesting a subtly shifting judicial mood abroad.

Lord Sumption’s criticism

Lord Sumption’s chief criticism of contemporary interpretive approaches is that the trend towards admitting contextual evidence as an interpretive tool, and invoking commercial common sense to elucidate meaning, has led courts to depart from the true meaning of the contract. Instead, he says, the contextual approach amounts to the court substituting a meaning which accords with its own view of reasonableness.

Lord Sumption began his criticism boldly, suggesting that judges are out of touch with the reality of business and the real intentions of contracting parties. He asserted:

“Judges are fond of speculating about the motives and practices of businessmen in drafting contracts. It is a luxurious occupation. The rules of admissibility protect them from the uncomfortable experience of being confronted by actual facts.”

He continued “[o]ne would think that the language that the parties have agreed provided the one sure foundation for a hypothetical reconstruction of their intentions.” However, his Lordship suggested that the recent focus on “commercial common
sense”, and the “surrounding circumstances”, in particular, has departed from this “sure foundation”.

Addressing the first of these concepts, Lord Sumption was disdainful of the view that commercial common sense can be a valid interpretive tool. His Lordship disapproved of Lord Diplock’s much-cited pronouncement in Antaios Compania S.A. v Salen A.B. [1984] 3 WLR 592 that “if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense.”

Lord Sumption notes “[a]s a canon of construction, this seems both unnecessary and wrong”, explaining that the focus on commercial common sense here is a means by which the court overrides the language of the contract, rather than interpreting it. In his view, Lord Diplock’s reference to commercial common sense does not illuminate a distinction between a literal interpretation and a commercial one. Rather, it presents a choice between “an approach to contractual construction which elucidates the meaning of the words, and an approach which modifies or contradicts the words in pursuit of what appears to a judge to be a reasonable result.” This seems to be a thinly veiled suggestion that judges use “commercial common sense” as an excuse to substitute their view of a reasonable outcome for the true agreement which is reflected by the language adopted by the parties.

Addressing “the surrounding circumstances”, Lord Sumption specifically attacks Lord Hoffman – and in particular the fourth and fifth “principles” of contractual interpretation Lord Hoffman elucidates in ICS – namely that:

“(4) … T]he meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean… [and]

(5) … if one would 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.”

Lord Sumption suggests that Lord Hoffman’s real conclusion (which can be identified by “[l]ooking through his seductive prose”) is that “the background may be used to show that the parties cannot as reasonable people have meant what they said, so that the court is entitled to substitute something else.”

Lord Sumption goes on to criticise several cases decided by the Supreme Court of the UK, which he suggests exemplify this approach. The Supreme Court’s decision in Rainy Sky SA v Kookmin Bank [2011] 1 WLR 2100 is, in Lord Sumption’s view, the high point of this trend. In that case, the court preferred a construction of a bank guarantee that was consistent with the court’s view of the commercial purpose of the transaction, rather than adopting the meaning Patten LJ in the Court of Appeal had considered was the “natural and obvious construction”. Lord Sumption explains, with reference to the result in that case “[w]e are simply leaving judges to reconstruct an ideal contract which the parties might have been wiser to make, but never actually did.” Speaking in blunt terms, he stated that “[e]xperience has suggested that the loose approach to the construction of commercial documents which reached its highest point in Rainy Sky may have done a disservice to commercial parties by depriving them of the only effective means of making their intentions known”.

Unsurprisingly in light of those comments, Lord Sumption’s view is that the language chosen by the parties ought to be the primary indicator of the contract’s meaning, and that contextual information, or information of what would make commercial common sense, ought to have little weight in the interpretive process. He explains that the language chosen by the parties should speak for itself, and the more care that has gone in to drafting the contract, the less the surrounding circumstances are likely to be useful. The fact that a particular term may appear harsh or unreasonable may not necessarily mean it was unintended. It may instead have been decided in exchange for another concession, or “because the deal was concluded at 3am and one of the parties was more interested in going to bed than in the finer points of drafting”.

**Lord Hoffman’s response**

In response, Lord Hoffman traverses the theoretical justifications for his interpretive approach, beginning with an examination of the way we use language to convey meaning. He dismisses Lord Sumption’s view as “nostalgia” for the old rules of interpretation, and sets out a detailed case for why we must not have an “irrebuttable presumption that the author of a document has used language in its strict and primary sense, irrespective of the strength of background evidence that shows this could not have been the case” (which Lord Hoffman suggests is in reality what Lord Sumption is advocating for). While Lord Hoffman agrees that we should not depart from conventional language merely because to do so would be fair or reasonable, he implores:

“… let us not go back to the dark ages of word magic, of irrebuttable presumptions by which the intentions of a user of language are stretched, truncated or otherwise mangled to give effect to the “admissible”, “strict and proper”, “natural and ordinary” or “autonomous”
meanings of words, even when it is obvious that it was not the meaning the author, actual or notional, could have intended.

A swing back to “plain meaning”?

Regardless of which side of the line one falls, there is force to Lord Sumption's arguments that recently courts have begun to retreat from the contextual approach advocated by Lord Hoffman in ICS and adopted by the Supreme Court in Rainy Sky. For example, in Arnold v Britton [2015] UKSC 36, Lord Neuberger cautioned that:

“... the reliance placed in some cases on commercial common sense and the surrounding circumstances... should not be invoked to undervalue the importance of the language of the provision which is to be construed .... Unlike commercial common sense and the surrounding circumstances, the parties have control over the language they use in a contract. And, again save perhaps in a very unusual case, the parties must have been specifically focusing on the issue covered by the provision when agreeing the wording of that provision.”

And there are hints that a similar shift may also be occurring in New Zealand, shifting slightly away from Vector v BOPE. In that case, McGrath J explained that Lord Hoffman’s principles in ICS were quickly adopted in New Zealand, and Tipping J, in a much cited judgment (with which Wilson J, at least in part, appeared to agree), went further, concluding that evidence of parties’ pre-contractual negotiations is relevant and admissible when that evidence is capable of shedding objective light on meaning (as well as just being evidence of the background and subject matter of the contract). Lord Hoffman had not gone so far in ICS, where his Lordship explained that the “law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent” (in his third principle).

Tipping J in Vector v BOPE also referred to the Supreme Court’s earlier decision in Gibbons Holdings Ltd v Wholesale Distributors Ltd [2007] NZSC 37, [2008] 1 NZLR 277 that post-contractual conduct can also be admissible evidence of the meaning of a contract. Such evidence remains inadmissible in England and Wales (save for specific exceptions).

The Supreme Court also considered that business common sense was relevant to the meaning of the contract. When considering whether the price of gas in the contract was inclusive or exclusive of transmission costs, McGrath J noted that the conclusion that the price was inclusive of transmission costs “would be so extraordinary that it would flout business common sense”. Blanchard J explained that interpreting the price as being exclusive of transmission costs was the “only commercially sensible conclusion”. This was despite the fact that parties had agreed gas was to be supplied on the terms of an earlier agreement, under which the price did include the cost of transmission.

Vector v BOPE has not been overruled, and, given that it now seems to be an established canon (despite the inconsistencies between judgments), it would seem unlikely to be. However, there are now suggestions that it might have represented a high point for the contextual approach in New Zealand. The Supreme Court hinted as much in Firm PI 1 Ltd v Zurich Australian Insurance Ltd t/a as Zurich New Zealand [2014] NZSC 147, [2015] 1 NZLR 432. Citing Vector v BOPE the majority noted that adopting a “purposive or contextual approach is not dependent on there being an ambiguity in the contractual language”. The majority also stated, however, that: “where contractual language, viewed as a whole in the context of the whole contract, has an ordinary and natural meaning, a conclusion that it produces a commercially absurd result should be reached only in the most obvious and extreme of cases.”

Similarly, in Lakes International Golf Management Ltd v Vincent [2017] NZSC 99, [2017] 1 NZLR 935, the Supreme Court declined to look at extrinsic evidence, because the term in question was “crystal clear” on its face, and there was no “genuine issue of interpretation.” In M v H [2018] NZCA 525, the Court of Appeal noted, with reference to Arnold v Britten, that “[t]he text is of central importance” and the “clearer the natural meaning, the more difficult it is to justify departing from it”. Finally, in The Mulhouse Ltd v Rangatira Ltd [2018] NZCA 621, after endorsing the Supreme Court’s comments in Firm PI 1 Ltd, the Court of Appeal explained that “only in a very rare case should a court depart from the plain meaning of a closely negotiated commercial contract to achieve a commercial purpose.” It overturned the approach taken in the High Court on the basis that the commercial purpose referred to was “far from self-evident”.

Counsel will, no doubt, increasingly seek to rely on the comments made by Lord Sumption to bolster the argument that courts should be slow to look outside the words of the agreement to extrinsic material, or to invoke the principle of commercial common sense. The extent to which this results in Lord Hoffman’s seminal judgments in the UK, and Vector v BOPE in New Zealand, becoming increasingly highly distinguished in the pejorative sense remains to be seen.

Tim Smith  tim.smith@bellgully.com is a partner and Sam Cathro  sam.cathro@bellgully.com is a solicitor in the litigation department at Bell Gully, Wellington. Tim appeared as counsel for BOPE in Vector v BOPE in the Court of Appeal.