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CONTRACTUAL INTERPRETATION – RECENT STATEMENTS OF THE LAW RELATING TO CONSTRUCTION, IMPLIED TERMS AND DISCRETION

LITIGATION AND DISPUTE RESOLUTION

The recent decision of the Court of Appeal in *Jackson v Dear [2013] EWCA Civ 89* highlights once more the assimilation by Lord Hoffmann of the processes of both contractual interpretation and implication of terms, in his judgment in *Attorney General of Belize v Belize Telecom [2009] UKPC 11*.

The first instance decision of Briggs J in *Jackson v Dear ([2012] EWHC 2060 (Ch))*, considered Lord Hoffmann's assimilation principally in the context of implied terms. In particular, in 2011, Mr Jackson's fellow directors exercised their powers under Article 88(e) of the Company's articles to remove him as director. There existed a written agreement which provided that the shareholder with all of the voting shares in the company would not only use its votes to nominate and appoint Mr Jackson as a director at the AGM in 2008, but that it would re-appoint him at every AGM thereafter unless there was a termination event under the agreement. Following his removal by his fellow directors, Mr Jackson argued that it was an implied term of the agreement that the fellow directors and the shareholder would procure that he would not be removed as a director between AGMs for as long as he wished to be a director and where no termination event had occurred. Whilst Briggs J agreed, the Court of Appeal considered that the implication of such a term would involve an impermissible re-writing of the parties' contract so as to come up with one notion of what might have been a sensible solution to their conundrum.

The appeal in *Jackson v Dear* was argued against the background of Briggs J's summary of the effect of the most recent authorities on the subjects of contractual interpretation and implication of terms, with which the Court of Appeal concurred, namely: *Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 WLR 896; Chartbrook Ltd v Persimmon Homes Ltd [2009] 1 AC 110; Rainy Sky S.A. v Kookmin Bank [2011] UKSC 50; Attorney General of Belize v Belize Telecom Ltd* (as above); *Mediterranean Salvage & Towage v Seamar Trading & Commerce Inc. [2009] 1 C.L.C. 909;* and *Groveholt Ltd v Hughes [2010] EWCA Civ 538*. Briggs J's summary was as follows:

> *"**Objective Process***
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> *i) Construction [or interpretation] is, in relation to any point at issue the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.*
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> *ii) For that purpose, even though the point in issue may be a narrow one, the interpretation of the relevant provision depends upon an understanding of its context within the agreement as a whole.*
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> *iii) The court's function is to ascertain the meaning of the agreement rather than to seek to improve upon it, or put right any inadequacies of meaning. Nonetheless the court recognises that draftsmen may make mistakes, may use occasionally inappropriate language and may fail expressly to address eventualities which may later occur.*
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> ***Implied Terms***
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> *iv) The implication of terms is no less a part of the process of ascertaining the meaning of an agreement than interpretation of express terms. Implication addresses events for which the express language of the agreement makes no provision.*
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> *v) In such a case the usual starting point is that the absence of an express term means that nothing has been agreed to happen in relation to that event. But implied terms may be necessary to spell out what the agreement means, where the only meaning consistent with the other provisions of the document, read against the relevant background, is that something was to happen.*
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> *vi) Although necessity continues (save perhaps in relation to terms implied by law) to be a condition for the implication of terms, necessity to give business efficacy is not the only relevant type of necessity. The express terms of an agreement may work perfectly well in the sense that both parties can perform their express obligations, but the consequences would contradict what a reasonable person will understand the contract to mean. In such a case an implied term is necessary to spell out what the contract actually means.*
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> ***Commercial common sense***
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> *vii) The dictates of common sense may enable the court to choose between the alternative interpretations (with or without implied terms), not merely where one would "flout" it, but where one makes more common sense than the other. But this does not elevate commercial common sense into an overriding criterion, still less does it subject the parties to the individual judge's own notions of what might have been the most sensible solution to the parties' conundrum".*

The most recent case to consider contractual interpretation and the importation of implied terms in the context of financial instruments, is *SNCB Holdings v UBS AG [2012] EWHC 2044 (Comm)*. This equally helpful decision of Cooke J (decided five days before Briggs J in Jackson v Dear) has largely been overlooked, and it serves as a valuable lesson in how not to pursue such cases. The judgment also contains a useful summary of the current law in relation to contractual interpretation, implied terms, and the exercise of a contractual discretion.

FACTUAL BACKGROUND

The Claimant, SNCB, sought damages from UBS (the Bank) for alleged breach of certain contractual documentation consisting principally of an Amended Deposit Agreement (ADA) and a related security agreement. Under the ADA, SNCB paid the Bank a sum of approximately $40m in return for various payments to be made by the Bank totalling approximately $13m between January 2003-January 2005, and a further sum of approximately $165m in 2031. The Bank was obliged to make repayments in accordance with a Repayment Schedule, subject to the occurrence of a Credit Event in respect of any specified Reference Entity. Should a relevant Credit Event occur, the Bank's future repayment obligations were to be terminated in respect of the portion of the Deposit linked to that Reference Entity and the Bank was then bound, instead of making that repayment, to deliver to SNCB, bonds of the particular Reference Entity with a face value equivalent to a specific Accreted Amount set out in the Repayment Schedule.

The Bank was also obliged to set up a Collateral Account, being a segregated account which would constitute security for its repayment obligations. SNCB argued that the Collateral Account was also security for the obligations of UBS to deliver the Reference Entity bonds on the happening of the Credit Event. The Bank, however, argued that the Collateral Account was simply security for its own default in making payments and was not specifically linked to its delivery obligations in the event of a relevant Credit Event.

Credit Events occurred between March and July 2010, and the particular bone of contention concerned certain Ambac Municipal Bonds held in the Collateral Account with a market value of approximately $9m. SNCB asserted that UBS was required to deliver to it those very bonds in the Collateral Account at the time of the particular Credit Event. In fact, the Bank replaced the bonds in the Collateral Account with cash and subsequently substituted other Ambac guarantee bonds (Ambac Terwin Bonds) with a market value of approximately $2m, served the correct Credit Event Notice on 12 July 2010, and delivered those other bonds to SNCB a month later.

According to the Bank, the contractual documentation clearly meant that when it came to physical delivery of Obligations in the event of a Credit Event, the Delivery Portfolio did not have to consist of bonds held in the Collateral Account but could consist of bonds from elsewhere. If SNCB were right in its argument, the Bank would have been at all times obliged to match the bonds held in the Collateral Account with the specified Reference Entities under the contractual documentation, but that was nowhere stated in the contractual documentation.

According to SNCB, the parties' reasonable expectation and/or presumed intention was that:

- if Obligations of a Reference Entity were held within the Collateral Account at a time when (a) an event had occurred with respect to that Reference Entity which enabled the Bank to serve a Credit Event Notice, or (b) the Bank had expressed the intention of serving a Credit Event Notice, or (c) the Bank was aware it could serve a Credit Event Notice and did subsequently serve a Credit Event Notice, those same Obligations would be delivered to SNCB and other obligations of the Reference Entity not held within the Collateral Account would be delivered to SNCB only if and to the extent that there were insufficient Obligations in the Collateral Account to cover the required Delivery;

- if Obligations of a Reference Entity were held within the Collateral Account at a time when the Bank was considering whether to serve a Credit Event Notice or had expressed to SNCB an intention to serve a Credit Event Notice, the Bank would not remove those obligations from the Collateral Account and/or replace them with cash and/or Obligations of a lesser value at all and/or so as to confer on the Bank a commercial benefit and/or deprive SNCB of the benefit it was entitled to receive, in the form of the value of Obligations held in the Collateral Account that would be required to be delivered to SNCB, if the Bank served a Credit Event Notice; and

- the Bank's right to remove the Collateral from the Collateral Account and/or the Bank's discretion to determine whether Collateral would be in the form of Obligations or cash had to be exercised: (i) honestly and in good faith for a proper purpose having regard to the terms of the Deposit Agreement and/or the purposes and/or the reasonable expectations of the parties; and (ii) not arbitrarily, capriciously or unreasonably.

Before commencing proceedings, SNCB's solicitors sent a 23 page letter to the Bank, raising a number of complaints, challenging the validity of the Credit Event Notice, and challenging the relevant Notice of Portfolio because of the nature of the bonds. However, the only allegation made in the letter which was subsequently repeated in SNCB's Particulars of Claim was that the Bank's exercise of its discretion in replacing the Ambac Municipal bonds in the Collateral Account with cash and then selling them, was impermissible and a breach of contract.

When it came to pleading its case, SNCB set out a number of points on construction of the express terms of the ADA as well as a number of implied terms. For example, the Bank was only allowed to transfer cash into the Collateral Account if on the last business day of each month the mark to market value (MTMV) of the Deposit was more than 100 per cent of the MTMV of the Collateral, and the Bank was unable to transfer sufficient Obligations into the Collateral Account by the last business day of the month. In addition, the Bank was not entitled to remove any Obligations of a Reference Entity held within the Collateral Account at any time after an event had occurred with respect to that Reference Entity which entitled the Bank to serve a Credit Event Notice, or the Bank had formed or expressed an intention to serve a Credit Event Notice in respect of that Reference Entity.

As a result of this multi-faceted approach in a case concerning construction of both express and implied terms, the judge was compelled to comment, before embarking upon his analysis, that not only was there real difficulty in seeking to imply terms of the kind suggested into the type of financial agreements in question, but where two or more implied terms are put forward, which differ in substance, the force of the argument is inevitably diminished that any one of them could necessarily be implied to give effect to the true meaning of the contract and/or fulfil the parties' joint expectations as the only term which "fits". By the end of the trial, SNCB had had several attempts at formulating terms which were said to be implied into the ADA, in its statements of case, its evidence, its written opening, its written closing, and its oral submissions. That did not in itself cast doubt upon the final formulation, but the reason for reconstruction of those provisions was clearly of significance.

The judge added that there was difficulty in SNCB's suggestion that a commercial party to a sophisticated Credit Linked Deposit Agreement of the kind in question could act contrary to the reasonable expectations of the parties and/or abuse its contractual discretion, in such a way as to give rise to a claim for damages, where the express terms of the contract appeared to allow the Bank to do what it had done.

On a plain reading of the contractual documentation, the Bank did not have an obligation to have any or any specific Collateral Securities in the Collateral Account. Instead, SNCB suggested that it was a reasonable expectation of the parties that the Collateral Account would contain Collateral Securities which broadly reflected the Current Percentages applicable to the various Reference Entities prior to a Credit Event, although no good reason was given for such an expectation.

Instead, in its opening, SNCB accepted that the Bank had no obligation to have any specific Reference Entity bonds in the Collateral Account prior to a Credit Event. Indeed, no implied terms were pleaded as to the matching of Reference Entity bonds in the Collateral Account with the Current Percentage selected by the Bank for the credit protection provisions. This concession by SNCB as to the choice which lay with the Bank in selecting the Collateral Securities, completely undercut its argument, because it would have been mere happenstance whether there were Obligations of the Affected Reference Entity in the Collateral Account at the time of Credit Event, and the Delivery Portfolio would have to consist of bonds of the Affected Reference Entity, from outside the Collateral Account and none were held in it. In those circumstances, to seek to import an obligation to deliver bonds of the Affected Reference Entity from the Collateral Account, as SNCB did, was hopelessly optimistic in the absence of an express and clear provision to that effect.

In this particular case, there did happen to be bonds of the Affected Reference Entity in the Collateral Account (the Ambac Municipal Bonds, which retained much of their value, whilst other bonds guaranteed by Ambac such as Terwin Bonds lost 90 per cent of their value as a result of the Ambac default). Therefore, it mattered in this case whether or not the Bank chose to deliver Reference Entity Bonds held in the Collateral Account as part of the Delivery Portfolio or to deliver other bonds of that Entity which were available to it. Regard had to be given to the specific freedom given to the Bank to select and change the make-up of the Collateral Account, without any limitation (save that provided in the ADA) and without reference to the Current Percentage selected for the purpose of the Credit Risk. The Collateral Account had nothing to do with the Credit Risk, since the Collateral was there as security for the Bank's failure, and not as security in relation to the default of any Reference Entity.

According to the judge, it was clear from the ADA that the Collateral Account was to consist of Collateral Securities or cash in US dollars which had to amount in value equivalent to the MTMV of the Deposit (i.e. the Bank's repayment obligations). It was to be a *"first priority continuing security interest"* for those obligations. It was also clear from the ADA that the Bank could transfer collateral in and out of the Collateral Account and had to do so to maintain the appropriate level of security on a monthly basis, providing statements of its contents to SNCB so that it could monitor the position. No distinction was drawn between the senior bonds or the various Reference Entities in the composition of the Collateral and there was no restriction on the use of cash. The central obligation of the Bank in relation to the Collateral was to ensure that it equated to the MTMV of the Deposit, but the Bank otherwise had a discretion to choose the make-up of the Collateral, whether cash or Collateral Securities.

The judge noted that there was recognition in correspondence from SNCB's lawyers in September 2008 of the need for the Bank to maintain switching rights and freedom to deal with Collateral. Indeed, in evidence, SNCB accepted that the Bank was free to put into the Collateral Account any Obligations of any Reference Entity it wished. He concluded, therefore, that the Bank was entitled to replace the Ambac Municipal bonds in the Collateral Account at any stage at its absolute discretion and to sell whatever bonds it had in that Account, provided that the Collateral Account provided security equivalent to one hundred per cent of the MTMV of the Bank's Deposit obligations in Reference Entity bonds or in cash in US dollars. It could replace the Ambac Municipal bonds of higher value in the Collateral Account with lower value Terwin bonds, if it kept to the contractual limits. It did not have to deliver specific bonds from the Collateral Account as the Delivery Portfolio, and he added that it was the service of the Notice of the Portfolio which crystallised the actual bonds of the Affected Reference Entity that SNCB would receive.

Therefore, SNCB's submissions on construction and implication failed, and in reaching his conclusions the judge provided a useful summary of the current law.

THE APPROACH TO CONSTRUCTION

It was difficult for there to be much issue between the parties about the approach to construction of the ADA and Security Agreement, in light of recent decisions of the Supreme Court on the subject: *Chartbrook v Persimmon Homes Limited [2009] 1 AC 1101; Re Sigma Finance Corporation (in administrative receivership) [2009] UKSC 2; Rainy Sky SA v Kookmin [2011] UKSC 50.* In Rainy Sky, the Supreme Court enunciated the following propositions:

- the Court must consider the language used and ascertain what a reasonable person would have understood the parties to have meant, assuming that reasonable person to have all the *background knowledge* which would reasonably have been available to the parties in the situation in which they stood at the time of contracting (see Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 WLR 896);*

- construction is a unitary exercise where regard is to be paid to the overall language and structure of the document concerned and the commerciality of any rival interpretations advanced;

- if there are two possible constructions of a commercial contract, the preferable construction is the one which more closely accords with commercial common sense, as gleaned from the relevant surrounding circumstances;

- if a semantic analysis of the words used in a commercial contract leads to a conclusion which flouts common sense, this would indicate that it is a most unlikely construction which may be rejected;

- the overall scheme of the document is important and individual clauses, sentences and phrases in it must be read in the overall context; and

- many cases stress the importance of context and commercial purpose when construing a commercial contract and the need to test the consequences of competing interpretations against the tenor of the whole document and business common sense.

So far as the *background knowledge* was concerned, sometimes described as "the factual matrix", there are limitations upon what the Court considers admissible or helpful. It is clear that evidence of a party's subjective intentions when concluding the contract, evidence of its belief as to its meaning or of its aim, and evidence of the parties' negotiations leading up to the contract, are not admissible as aids to construction. Equally, evidence of the parties' objectives is inadmissible. The parties may have different subjective intentions, different objectives, different beliefs as to the meaning and aim of the contract and they may negotiate a form of words which is acceptable to both, but to which each ascribes a different meaning. The Court then has to ascertain what is the true meaning of those words in the context of the contract as a whole on the basis of what a reasonable person with the necessary *background knowledge* would have understood the parties to have meant.

THE APPROACH TO THE IMPLICATION OF TERMS

The decision of the Judicial Committee of the Privy Council in *Attorney General of Belize v Belize Telecom Ltd [2009] UKPC 11,* as endorsed and clarified by the Court of Appeal in *The Reborn [2009] 2 Lloyd's Reports 639,* and by Aikens LJ in *Crema v Cenkos [2010] EWCA Civ 1444,* sets out the approach which is to be adopted in relation to implied terms.

Although there had been a concern that Lord Hoffmann in *Belize*, when assimilating the processes of contractual construction and implication of terms, had diluted the requirement of *necessity*[1] for the implication of a term, the Court of Appeal in *The Reborn* had gone to some lengths to explain that Lord Hoffman had not.

Furthermore, it was clear from the authorities that the Court has no power to improve upon the instrument which it is called upon to construe. It cannot introduce terms to make it more fair or more reasonable. Its concern is only to discover what the instrument means and it is the meaning which the instrument would convey to a reasonable person having all the background knowledge which would reasonably be available to the parties, with which the Court is concerned. To this extent, the exercise has the same objective as that of construction.

The question of implication arises when the instrument does not expressly provide for what is to happen when some event occurs. The most usual inference in such cases is that nothing is to happen. If the parties had intended something to happen, the instrument would have said so.

There are, however, cases where the reasonable person to whom the meaning of the instrument is to be conveyed would understand that *the only meaning* which is consistent with the overall provisions of the instrument, read against its relevant background, is that something is to happen which will affect the rights of the parties, even though the instrument does not expressly say so. In such cases, the implication of the term is not an addition to the instrument but spells out the true meaning of the instrument in the situation for which it does not expressly provide.

All the various ways in which the test has been expressed in prior authorities are not to be seen as different or additional tests to the basic question which is *"what the instrument read as a whole against the relevant background would reasonably be understood to mean" in the situation which obtains (Lord Hoffmann paragraphs 21-27 in Belize).* The proposed implied term must spell out what the contract actually means. Therefore, to say that the implied term must be "reasonable and equitable" or "necessary to give business efficacy to the contract" or "so obvious that it goes without saying", that it must be "capable of clear expression", and that it "must not contradict any express term of the contract", is to add nothing to the central idea that the proposed implied term must spell out what the contract actually means. Although these formulations may assist in considering whether or not it does so, there are dangers in taking them as the litmus test.

CONTRACTUAL DISCRETION

As for implied terms limiting the exercise of a contractual discretion, Cooke J referred to the case of *Socimer International Bank v Standard Bank Plc [2008] 1 Lloyd's Reports 558* and, in particular, Rix LJ at page 577, where he stated:

> *"It is plain … that a decision maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith and genuineness and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to Wednesbury unreasonableness …"*

In *Paragon Finance v Nash [2002] 1 WLR 685*, the Court of Appeal stated that the implied term to the effect that the contractual party would not act dishonestly, improperly, capriciously or arbitrarily, was necessary in order to give effect to the reasonable expectations of the parties and is a term about which it could be said that *"it goes without saying"*.

1 An important gloss to be applied (save perhaps in relation to terms implied by law) (see *Mediterranean Salvage & Towage v Seamar Trading & Commerce Inc. [2009] 1 CLC 909*, per Lord Clarke MR).

Cooke J stated that it was clear that "good faith", where it appeared in the contractual provisions, was a limitation on any liability of the Bank for erroneous calculations. There was no duty of care upon the Bank in relation to those functions – merely a duty to act in good faith. In the context of calculating market values for the relevant assets, good faith meant no more than honesty. There was no suggestion that the Bank had acted dishonestly in this case.

CONCLUSION

In conclusion, the judge stated that the Bank was entitled to replace the Ambac Municipal Bonds in the Collateral Account at any stage and to sell whatever bonds it had in that account, provided that the Collateral Account provided security equivalent to 100 per cent of the MTMV of the Bank's deposit obligations in Reference Entity bonds or in cash in US dollars. The Bank could replace Ambac Municipal bonds in the Collateral Account with lower value Ambac Terwin bonds, if it kept to overall contractual limits. It did not have to deliver bonds from the Collateral Account as the Delivery Portfolio, and it was the service of the Notice of Portfolio which crystallised the actual bonds of the Affected Reference Entity that SNCB would receive.

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