PROLOGUE

A. The Nature of the Interpretative Process

'How difficult can it be, Boss?' An expression used by one of my colleagues when we were about to embark upon a transaction seems particularly apposite to the question of contractual interpretation. We may hesitate to offer an opinion on a point of law, but we are all prepared to express a view on what a document means. Surely we can all read English. So what is the problem? **Pr.01**

The problem is that interpretation of contracts is an art, not a science. So said Johan Steyn in the John Lehane Memorial Lecture 2002.[1] It is his fourth general proposition of interpretation. Robert Walker LJ made the same point in *John v PricewaterhouseCoopers*:[2] **Pr.02**

> The process of construction often . . . involves the assessment of disparate (and therefore incommensurable) factors to reach what is ultimately an intuitive (but not irrational) conclusion.

The reason why it is an art, not a science, is because we are ultimately trying to work out what the parties wanted to achieve from what they have said and done. The interpreter puts himself or herself in the position of a reasonable person with all the relevant background information available to the parties at the time the contract was entered into with a view to establishing what the contract means. And that is ultimately a matter of judgement on which two perfectly reasonable people can have quite different views. In the words of Lord Steyn: '[interpretation] is an exercise involving the making of choices between feasible interpretations'.[3] And as Lord Hoffmann said in *Chartbrook v Persimmon Homes*:[4] **Pr.03**

> 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 . . .

---

[1] Steyn, 'The Intractable Problem of the Interpretation of Legal Texts' (2003) 25(1) Sydney Law Review 5, reproduced in Worthington (ed) *Commercial Law and Commercial Practice* (Hart, 2003) 123 at 126. And see also Lord Steyn's comment in *Deutsche Genossenschaftsbank v Burnhope* [1995] 1 WLR 1580 at 1587 that interpretation is often a matter of first impression.

[2] [2002] EWCA Civ 899 at [94]. And see Lewison, *The Interpretation of Contracts* (5th edn, Sweet & Maxwell, 2011) at 2.12.

[3] Steyn, 'The Intractable Problem of the Interpretation of Legal Texts', 123 at 126.

[4] [2009] 1 AC 1101 at [15].

Pr.04 The result is that, however far we try to create a body of law which explains how to interpret contracts, the interpretation of any particular contract will ultimately involve a question of judgement. You can get a long way with principled reasoning, but the final step is a leap of faith. It is important to understand the limits of logic, and where intuition takes over.

Pr.05 We therefore have to recognize that books on interpretation can only carry the putative interpreter so far. Ultimately, we are on our own.

B. The Purpose of this Book

Pr.06 The purpose of this book is, therefore, to try to state the principles which guide anyone who has to interpret contracts.[5]

Pr.07 They are principles, rather than rules, both because they need to be stated at a relatively high level of generality and also because they are by their nature general approaches to the problem, rather than specific answers to it.

Pr.08 There are also related concepts, such as implied terms, rectification, and estoppel by convention, which play a part in the overall question of how contracts are read; and these also need explanation.

Pr.09 And finally, the Epilogue contains a brief discussion of the effect of all this on the way in which contracts should be drafted. This is, after all, the other side of the coin.

C. Why is It Important?

Pr.10 The law of contract is about the voluntary assumption of obligations. Although there are plenty of rules concerned with matters such as the formation and discharge of contracts, in practice much of contract law is about the interpretation of the promises which the parties have made to each other, rather than about particular rules of law.

Pr.11 This point was made by Professor Patrick Atiyah in his *Essays on Contract*[6] when he said:

> [i]t hardly seems open to doubt that construction has become by far the most popular technique for the solution of practically all problems in the law of contract which do not depend on unyielding rules of positive law, such as incapacity, illegality and the requirements of consideration.

[5] The process is sometimes called construction, and sometimes interpretation. In this context, interpretation and construction are synonyms.

[6] Atiyah, *Essays on Contract* (Oxford University Press, 1986).

The reason for this is straightforward. Because contractual obligations are assumed voluntarily, rather than imposed by law, the extent of one person's contractual claim against another depends on what the contract says, rather than on what the law says. Issues do arise in relation to whether or not a contract has been created (for instance, whether the promisee has provided consideration) or whether it is affected by illegality or mistake, but the vast majority of questions in relation to contracts are concerned with what they mean.[7] **Pr.12**

In practice, courts are also often able to avoid dealing with difficult legal issues by interpreting the contract in a particular way. Two examples can illustrate how this is done—*The Didymi*[8] and *Associated Japanese Bank v Credit du Nord*.[9] **Pr.13**

The Didymi[10] concerned a time charterparty. The contract provided for the charterer to pay a particular daily rate of hire, and there was also provision for that rate of hire to be increased if the vessel out-performed certain criteria, and to be reduced if it under-performed. The contract provided for the hire to be 'equitably [increased/decreased] by an amount to be mutually agreed between owners and charterers'. The owners claimed an increase in hire under this provision, and the charterers denied liability on the basis that it was an agreement to agree, and therefore not binding. **Pr.14**

If it had been an agreement to agree, it would not have been binding.[11] But the Court of Appeal managed to avoid the conclusion that this provision had no effect by interpreting it in such a way that it did not amount to an agreement to agree. The court decided that there was a binding obligation to adjust the charter hire 'equitably', and that the required agreement of the parties was simply a mechanism to give effect to that essential term. If the mechanism did not work, because the parties did not agree, then the court could establish what was equitable. **Pr.15**

The interesting thing about this case (and, indeed, many others) is that the court gets round a difficult legal issue (in this case, that an agreement to agree is not binding) by interpreting the contract in such a way that the difficult issue does not arise on the facts (in this case, by deciding that the agreement was not an agreement to agree). A clause which appears to require the parties to reach an agreement is interpreted as being an agreement to do something objective, with the agreement of the parties being merely a mechanism to give effect to it. **Pr.16**

Whether that was an appropriate thing to do in the circumstances is beside the point in this context. What is important is that the court was able to avoid having to deal with a difficult legal issue concerning agreements to agree by interpreting the **Pr.17**

[7] See the comments of Sir Christopher Staughton in: 'How Do the Courts Interpret Commercial Contracts?' (1999) 58 CLJ 303 at 303.

[8] *Didymi Corporation v Atlantic Lines* [1988] 2 Lloyd's Rep 108.

[9] [1989] 1 WLR 255.

[10] *Didymi Corporation v Atlantic Lines* [1988] 2 Lloyd's Rep 108.

[11] *Walford v Miles* [1992] 2 AC 128.

contract in a particular way. This is not uncommon. A few years earlier, the House of Lords had done the same thing in a dispute concerning a lease.[12]

Pr.18 The other example is *Associated Japanese Bank v Credit du Nord*.[13] A bank purchased some machines and then leased them back. The lessee's obligations under the lease were guaranteed by another bank. It subsequently transpired that the machines did not exist and that a fraud had been committed on both banks. The lessor bank sued the guarantor bank under the guarantee.

Pr.19 Steyn J decided that the guarantor was not liable to the lessor. He gave three reasons. The first was that, under the terms of the guarantee, the existence of the machines was an express condition precedent to the guarantor's liability. The second was that, even if there was no express condition precedent, the existence of the machines was an implied condition precedent to the guarantor's obligations. A reasonable man, faced with the suggested term, would, without hesitation, have said that it must be implied: it was so obvious that it went without saying.[14] The third reason was that, if the first two reasons were wrong, the contract was void for mistake in any event.

Pr.20 Steyn J did in fact deal with the difficult question of whether the contract was void for mistake. But he did not strictly need to do so because of the way in which he interpreted the contract—by deciding that the existence of the machines was a condition precedent to the guarantor's liability. Questions of mistake are frequently really about the express or implied allocation of risk between the parties to the contract. What is important is not so much abstract rules of law but the express or implied intention of the parties.

Pr.21 These cases are illustrations of a broad tendency for common law courts to deal with problems that arise in a contractual case by looking more to questions of interpretation than to matters of law. Since contracts involve the voluntary assumption of liability, this is hardly surprising.

D. The Principles

Pr.22 Most of this book consists of the elucidation of ten Principles which, it is suggested, underlie all aspects of contractual interpretation. Like any writing, the Principles need to be read as a whole, and that is why this book is relatively brief.

Pr.23 The Principles are divided into five Parts. Part 1 describes the Guiding Principle—that interpretation is concerned with the objective intention of the parties to the contract. Part 2 is concerned with the materials available to the person interpreting

[12] *Sudbrook Trading Estate v Eggleton* [1983] AC 444.
[13] [1989] 1 WLR 255.
[14] See Principle 8: Implied Terms.

the contract. Parts 3 to 5 are concerned with the words used: Part 3 with what the words mean, Part 4 with adding words, and Part 5 with changing words.

The book is primarily concerned with commercial transactions, rather than consumer ones and, generally, with written contracts, because these are ubiquitous in commercial transactions. **Pr.24**

E. Principles, Rules, and Precedent

One of the reasons for stating the law concerning contractual interpretation by reference to principles, rather than rules, is that it is necessary to state the law at a level of generality sufficient to take account of the fact that interpretation is an art, rather than a science. As Sir Anthony Clarke MR has said:[15] 'It is to my mind possible to over-elaborate the relevant principles [of contractual interpretation]. Indeed there was a tendency to do so during the argument in this appeal.' **Pr.25**

Case law can be authority for the general approach to interpretation, but it cannot lay down what particular words mean, except in the most general way. Words take their meaning from the contract in which they appear and the background facts at the time the contract was entered into. What particular words mean in one contract at one time in one context cannot bind a judge deciding what the same words mean in a different contract, at a different time and in a different context.[16] Cases should be cited for their guidance on matters of principle, not for what they actually decided.[17] **Pr.26**

F. Recent Developments

Over the past twenty years, there has been an unprecedentedly large number of cases at the highest level concerned with the principles of the interpretation of contracts. Much of the credit for this must go to Lord Hoffmann who, in a series of cases, has elaborated what have been described as modern principles for the interpretation of contracts. Some commentators see these cases as having changed the landscape of contractual interpretation; others see them more as changing the emphasis. Some accept it with enthusiasm; others approach it with caution, sometimes bordering on hostility. **Pr.27**

[15] In *Pratt v Aigaion Insurance Co* [2009] 1 Lloyd's Rep 225 at [9]. The need for simple and clear principles is also true of other areas of the law of contract—for instance, what constitutes a repudiation. See *Eminence Property Developments v Heaney* [2010] 2 All ER (Comm) 223.

[16] See Lord Hoffmann's comments in *Bank of Credit & Commerce International v Ali* [2002] 1 AC 251 at [51], and Carter at 13.09.

[17] See Lord Morris's comments in *Schuler v Wickman Machine Tools* [1974] AC 235 at 256.

Pr.28 In *Investors Compensation Scheme v West Bromwich Building Society*,[18] Lord Hoffmann set out five principles of statutory interpretation, which have generally been followed in subsequent cases. He prefaced these principles with a comment that the process of interpreting legal documents has largely been assimilated with 'the common sense principles by which any serious utterance would be interpreted in ordinary life'.[19] Much of the 'old intellectual baggage of "legal" interpretation has been discarded'.[20] The formalistic 'canons of construction' now have a much smaller part to play in what is recognized as being essentially an intuitive exercise.

Pr.29 This is a welcome development. Lawyers should not be allowed to make up their own rules of interpretation which preclude others. It should be possible for any intelligent business person to have a reasonable stab at understanding what a contract means. Lord Hoffmann put this point very clearly in an article written shortly before the *Investors Compensation Scheme* case.[21] He referred to:

> something which laymen find puzzling, and even slightly repellent, about lawyers, namely their claim to use language in a special way which only other lawyers can understand. Contracts are made by businessmen . . . Why, therefore, should any special techniques be required for their interpretation? . . . It is these rules which give rise to public unease about what lawyers are up to.

Pr.30 But the analogy between legal documents and other utterances cannot be carried too far.[22] The process of creating a commercial contract is far removed from everyday utterances—even serious ones. We have different expectations of the former than the latter. Novelists aspire to ambiguity;[23] lawyers eschew it. This creates a tension in the interpretation process, as can be seen when the Principles are discussed.

Pr.31 There is a temptation to see what Lord Hoffmann said in *Investors Compensation Scheme v West Bromwich Building Society*[24] almost as if it were a statutory provision, to be followed to the letter without question. This would be a mistake. As Munby J said, in this context, in *Beazer Homes v Stroude*:[25] 'Utterances, even of the demi-gods, are not to be approached as if they were speaking the language of statute.' Lord Hoffmann would be the first to recognize that what he said has to be read in context—against the background of the cases which preceded it, and in the light of the facts of the case in question.[26]

[18] [1998] 1 WLR 896 at 912–13.
[19] [1998] 1 WLR 896 at 912.
[20] [1998] 1 WLR 896 at 912.
[21] Hoffmann, 'The Intolerable Wrestle with Words and Meanings' (1997) 114 South African Law Journal 656.
[22] See the penetrating observations on this point in Carter at [5.05]–[5.17].
[23] Even to the extent of the titles of their novels, as Ian McEwan's *Enduring Love* (Vintage, 1998) attests.
[24] [1998] 1 WLR 896 at 912–13.
[25] [2005] EWCA Civ 265 at [28], quoted in Mitchell, 61.
[26] It should also be read in the light of the article which preceded it, and on which it is based: Hoffmann, 'The Intolerable Wrestle with Words and Meanings'.

G. The Two Opposing Views

Pr.32 For practically every statement about how to interpret contracts, you will find a contradictory one. There is authority for just about every approach to interpretation.

Pr.33 The law of the interpretation of contracts can be seen, in large part, as an eternal conflict between two different approaches, which are sometimes described as the literal approach and the purposive approach. The way in which contracts are in fact interpreted cannot be understood without an understanding of this conflict.

Pr.34 A book on substantive legal topics can tell you what the answers are, or at least have a good stab at it. That cannot be done with interpretation. It is ultimately a matter of judgement, which will depend on the approach of the judge concerned.

Pr.35 It should therefore come as no surprise that, as David McLauchlan has pointed out,[27] the outcome of cases concerning interpretation of contracts is difficult to predict. Decisions on interpretation by one tribunal are frequently overturned on appeal; and there are very often dissenting judgments within the tribunals themselves. *The Laura Prima*[28] is a good example. Here there were two possible interpretations of a contract. The umpire said that the contract meant A. The judge at first instance said that it meant B. The Court of Appeal reversed the judge and said that it meant A. And the House of Lords reversed the Court of Appeal and said that it meant B.

Pr.36 Another example is the *Mannai* case.[29] There, in an interpretation dispute between a landlord and a tenant, the tenant won by three to two in the House of Lords, but only by four to five overall.

Pr.37 It is therefore important to understand the reasons why different judges take different approaches. There are two main areas of dispute in relation to contractual interpretation:

- how much background information should be available in interpreting a written contract; and
- how much leeway a court should have in twisting the words of the contract to reach what it regards as a 'commercial' result.[30]

Pr.38 At one end of the spectrum are those who would severely limit the background information available and who would frown upon too much word-twisting. If the parties have written their contract, they expect it to be interpreted, not rewritten. At the

[27] McLauchlan, 'Contract Interpretation: What Is It About?' (2009) 31(1) Sydney Law Review 5.
[28] *Nereide v Bulk Oil* [1982] 1 Lloyd's Rep 1.
[29] *Mannai Investment Co v Eagle Star Life Assurance Co* [1997] AC 749.
[30] The Scottish Law Commission has recently published a Discussion Paper on Interpretation of Contracts (Discussion Paper No. 147, February 2011). It contains a useful review of the issues. Earlier discussions of the issues by the Scottish Law Commission are contained in Interpretation in Private

other end of the spectrum are those who believe that words can only really be understood in the context of the entirety of the background facts, and that the court should do its best to resolve a case in a fair and commercial way.

Pr.39 It is rather like the conflict described by Sellar and Yeatman in *1066 and All That*[31] between the Cavaliers (Wrong but Wromantic) and the Roundheads (Right but Repulsive). In this context, the Cavaliers are those who would twist the words to reach the 'right result', the Roundheads those who would apply the words used without mercy.

Pr.40 Very few lawyers fall into either of these extreme camps. Most fall somewhere between. But where the line is drawn on this spectrum will vary depending on the background and nature of the person concerned.

Pr.41 There will always be a tension between accepting what the words say and trying to bend them. It is only by recognizing that fact that it is possible to understand how interpretation disputes are resolved in practice.

Pr.42 It is possible to give guidance as to the principles to be adopted but, ultimately, interpretation is a matter of intuition and judgement and defies logical analysis. It is as important to understand what principles of interpretation cannot do, as to understand what they can.

Law (Discussion Paper No. 101, August 1996) and Report on Interpretation in Private Law (Scot Law Com No. 160, October 1997).

[31] Methuen, 1930.

Part I

THE GUIDING PRINCIPLE

Principle 1: The purpose of contractual interpretation is to establish the intention of the parties to the contract. This is done objectively: what would a reasonable person understand their common intention to be from what they have written, said, and done?

1

PRINCIPLE 1: OBJECTIVE INTENTION

Principle 1: The purpose of contractual interpretation is to establish the intention of the parties to the contract. This is done objectively: what would a reasonable person understand their common intention to be from what they have written, said, and done?

A. Intention

The ultimate purpose of contractual interpretation is to find out what the parties intended. **1.01**

This follows from the basic concept that the law of contract is about the voluntary assumption of liability. In the words of Professor Brian Coote:[1] 'The one characteristic essential to a contract is that it should be a means by which legal contractual liability can effectively be assumed by the party or parties to it.' The law of contract gives effect to promises made for consideration or by deed, and the extent of those promises ultimately depends on what the parties agreed. In practice, most contractual disputes are concerned with establishing the precise scope of the promise. **1.02**

Sir Christopher Staughton, writing extra-judicially,[2] has said, in relation to contractual interpretation, that: 'Rule One is that the task of the judge when interpreting a written contract is to find the intention of the parties. In so far as one can be sure of anything these days, that proposition is unchallenged.' And in *The Starsin*,[3] Lord Bingham said: 'When construing a commercial document in the ordinary way the task of the court is to ascertain and give effect to the intentions of the contracting parties.'[4] **1.03**

[1] Coote, *Contract as Assumption* (Hart, 2010).
[2] Staughton, 'How Do the Courts Interpret Commercial Contracts?' (1999) 58 CLJ 303 at 304.
[3] *Homburg Houtinport v Agrosin* [2004] 1 AC 715 at [9].
[4] See Carter, *The Construction of Commercial Contracts* (Hart, 2013), Chapter 2.

B. Objectivity

1.04 In common law jurisdictions (unlike many civil law ones), the intention of the parties is established objectively. We are not concerned with the parties' actual, subjective intentions, but with the outward manifestation of those intentions. The question is how a reasonable person would interpret their intentions from what they have said, written, and done.[5]

1.05 This is a very important qualification. Although the law is striving to find the intention of the parties, it will not look into their minds. It will only look at what has passed between them. And in doing so, it is not concerned with their actual intention, but with how a reasonable person would understand their common intention from its objective manifestation.

1.06 The principle was expressed by Lord Wilberforce in *Reardon Smith Line v Yngvar Hansen-Tangen*:[6]

> When one speaks of the intention of the parties to the contract, one is speaking objectively—the parties cannot themselves give direct evidence of what their intention was—and what must be ascertained is what intention is to be taken as the intention which reasonable people would have had if placed in the situation of the parties.

1.07 Lord Steyn expressed it this way in *Deutsche Genossenschaftsbank v Burnhope*:[7]

> It is true the objective of the construction of a contract is to give effect to the intention of the parties. But our law of construction is based on an objective theory. The methodology is not to probe the real intentions of the parties, but to ascertain the contextual meaning of the relevant contractual language. Intention is determined by reference to expressed rather than actual intention.

1.08 It is this emphasis on objectivity which enabled Lord Hoffmann, in *Investors Compensation Scheme v West Bromwich Building Society*,[8] to express the principle rather differently:

> Interpretation is 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.

1.09 Here, there is no reference at all to the intention of the parties—just to the meaning of the document. What is important is not what the parties thought, but what they wrote.

[5] See Lewison, *The Interpretation of Contracts* (5th edn, Sweet & Maxwell, 2011) at 2.02, 2.03, and 2.05; McMeel, *The Construction of Contracts* (2nd edn, Oxford, 2011), Chapter 3.

[6] [1976] 1 WLR 989 at 996.

[7] [1995] 1 WLR 1580 at 1587.

[8] [1998] 1 WLR 896 at 912.

C. Is Intention Still Relevant?

1.10 This might suggest that intention is really a chimera. Although we purport to strive for it, we do not really do so. What we really do is look at the document.[9]

1.11 There is some truth in this comment, but it should not be taken too far. To say that subjective intention is irrelevant is not to deny the importance of the objective manifestation of intention. It is important to know what we are ultimately trying to achieve, even if we do not carry it out completely. Even though we adopt an objective test, what we are ultimately trying to elicit is what the parties meant. The common law has this at least in common with the civil law tradition—which tends to adopt a more subjective approach.

1.12 The common law does not carry this to its logical conclusion and try to establish the subjective intention of the parties. But anyone interpreting a contract is still trying to work out what the parties really meant from what they have done.

1.13 Of course, the establishment of intention is sometimes fictional. In some cases, the parties may simply not have considered the matter in hand. David McLauchlan has said that: '*the great majority* of interpretation disputes that come before the courts have the common feature that the parties did not, at the time of formation, contemplate the situation that has arisen'.[10] But even here, it is surely true to say that what we are trying to do is to establish what the parties would have intended if they had set their minds to it. We do this by extrapolation from what they have agreed (and have not agreed) and in the light of the background facts at the time the contract was entered into. It is a difficult matter of judgement, but what the parties would have intended must be what is guiding the person interpreting the contract.

1.14 It is therefore suggested that it is still important to recognize that what underlies the principles of interpretation is a desire to establish the common intention of the parties, albeit objectively. Lord Bingham made the point clearly in *Bank of Credit and Commerce International v Ali*:[11]

> In construing [a] . . . contractual provision, the object of the court is to give effect to what the contracting parties intended . . . To ascertain the parties' intentions the court does not of course inquire into the parties' subjective states of mind but makes an objective judgment . . .

[9] See the comments of Lord Hoffmann in *Attorney General of Belize v Belize Telecom* [2009] 1 WLR 1988 at [16].

[10] McLauchlan, 'Contract Interpretation: What Is It About?' (2009) 31(1) Sydney Law Review 5, part 2. Emphasis in original.

[11] [2002] 1 AC 251 at [8].

D. Why an Objective Approach?

1.15 The objective theory of the common law tradition is frequently distinguished from the more subjective approach of the civil law tradition.[12] One example of the civil law approach that is easily accessible by common lawyers is Article 4.1 of the *Unidroit Principles of International Commercial Contracts* (2010 edition),[13] which says:

> (1) A contract shall be interpreted according to the common intention of the parties.
>
> (2) If such an intention cannot be established, the contract shall be interpreted according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances.

1.16 Here, the objective approach is a fallback mechanism if it is not possible to establish the subjective common intention of the parties. Why does the common law not adopt the same approach? If the law of contract is concerned with the voluntary assumption of liability, why not carry it to its logical conclusion and say that what matters is what the parties actually intended?

1.17 One reason is that the objective approach to interpretation sits well with the objective theory of the common law of contract. Whether there is a contract and, if so, what are its terms, is broadly determined objectively.[14]

1.18 The requirement for objectivity in relation both to the formation of contracts and to their interpretation has been stressed recently by Heydon and Crennan JJ in the High Court of Australia in *Byrnes v Kendle*.[15] After discussing the principle that the purpose of contractual interpretation is to discover the objective intention of the parties, rather than their subjective intentions, their Honours continued:[16]

> These conclusions flow from the objective theory of contractual obligation. Contractual obligation does not depend on actual mental agreement. Mr Justice Holmes said:[17]
>
> > [P]arties may be bound by a contract to things which neither of them intended, and when one does not know the other's assent…

[12] In practice, the divide may be narrower than is sometimes assumed. See Vogenauer, 'Interpretation of Contracts: Concluding Comparative Observations', Chapter 7, in Burrows and Peel (eds), *Contract Terms* (Oxford, 2007).

[13] See Lord Hoffman's comments on this in *Chartbrook v Persimmon Homes* [2009] 1 AC 1101 at [39].

[14] *Chitty on Contracts* (31st edn, Thomson Reuters, 2012), 2-002. The classic case is *Smith v Hughes* (1871) LR 6 QB 597. For a more recent illustration, see *Shogun Finance v Hudson* [2004] 1 AC 919.

[15] (2011) 243 CLR 253 at [98]–[101] following similar statements by the High Court of Australia in *Pacific Carriers v BNP Paribas* (2004) 218 CLR 451 at [22] and *Toll (FGCT) v Alphapharm* (2004) 219 CLR 165 at [35]–[41].

[16] (2011) 243 CLR 253 at [100].

[17] Oliver Wendell Holmes, Jr, 'The Path of the Law' (1897) 10 Harvard Law Review 457, 463–4. Emphasis in original.

> [T]he making of a contract depends not on the agreement of two minds in one intention, but on the agreement of two sets of external signs,—not on the parties' having *meant* the same thing but on their having *said* the same thing.

1.19 This approach to contract formation has been criticized by David McLauchlan. There is a continuing debate about whether the creation of a contract is a purely objective exercise—based on how a reasonable person would view the actions of the parties—or whether the court is more concerned with how a reasonable person in the position of the *promisee* would view what the *promisor* has said and done.[18] But, whatever the outcome of this debate about how a contract is created, it is clear that, when it comes to interpreting the contract, this is done objectively—by reference to a reasonable person having the background knowledge which would reasonably have been available to the parties.[19]

1.20 Why does the law treat the interpretation of contracts in this objective fashion? There are three main reasons.

1.21 In the first place, establishing the subjective common intention of parties to a complex contract can be difficult, if not impossible, to achieve. Even if we can establish the subjective intentions of each of the parties, it is difficult to know which parts of their (frequently opposing) individual intentions were held in common. In addition, many of the issues from which disputes arise will simply not have been considered by the parties when they were drafting the contract.[20] And, in order to get the deal done, the parties may have agreed on the words to be used without necessarily agreeing what they mean. One practical way round these problems is to ask what a reasonable person would have understood the parties to have intended from what they have said and done.

1.22 Lord Wilberforce put the point this way in *Prenn v Simmonds*:[21]

> The words used may, and often do, represent a formula which means different things to each side, yet may be accepted because that is the only way to get 'agreement' and in the hope that disputes will not arise. The only course then can be to try to ascertain the 'natural' meaning. Far more, and indeed totally, dangerous is to admit evidence of one party's objective—even if this is known to the other party. For however strongly pursued this may be, the other party may only be willing to give it partial recognition, and in a world of give and take, men often have to be satisfied with less than they want.

[18] See, for instance, *Chitty on Contracts* (31st edn, Thomson Reuters, 2012) at 5.067 and 5.117; and McLauchlan, 'The "Drastic" Remedy of Rectification for Unilateral Mistake' (2008) 124 LQR 608 at 611; and see McMeel, Chapter 3 and Carter at [2.18]–[2.22].

[19] *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896 at 912 (Lord Hoffmann's first principle). The distinction between the approach to formation and interpretation is clearly drawn in McMeel, Chapter 3.

[20] See *Dumbrell v Regional Group* (2007) 279 DLR (4th) 201 at [50].

[21] [1971] 1 WLR 1381 at 1385.

> So, again, it will be a matter of speculation how far the common intention was that the particular objective should be realised.

1.23 Secondly, and particularly importantly, the objective process is considered to promote certainty[22] and to save time and costs. This is an important theme of contractual interpretation, and appears throughout this book. If the meaning of a contract can only be established by examining the subjective intentions of the parties, the outcome is difficult to predict; and to establish it will involve considerable delay and expense. But if its meaning can be established from its external manifestation—normally the written agreement—it is easier to predict the outcome, and the time and cost of establishing it should be reduced.

1.24 A third reason is that the objective approach protects third parties, such as assignees. They are not parties to the discussions between the parties and could be prejudiced by interpreting a provision differently from how it appears in the document.[23] Again, this is a theme which recurs throughout this book.

1.25 Not everyone is happy with this approach. There are those who consider that it carries the search for objectivity too far. Lord Nicholls is one of those. In 'My Kingdom for a Horse: The Meaning of Words', an article in the Law Quarterly Review in 2005,[24] he asked:

> Why should it be thought [that] evidence of the parties' actual intentions . . . can never assist in determining the objective purpose of a contractual provision or the objective meaning of the words the parties have used?

1.26 The point was taken further by David McLauchlan in 'Contract Interpretation: What Is It About?', an article in the Sydney Law Review in 2009:[25]

> [it] would [be] perverse to exclude evidence that potentially could have allowed [one party to the contract] to get away with repudiating the parties' actual common understanding at the time of the contract . . .

1.27 Even more tellingly, Lord Nicholls has asked: 'Why should the judge have to guess when he can know?'[26]

1.28 These are powerful arguments.[27] They mirror what Lord Bingham said in a different context:[28] 'You need not gaze into the crystal ball when you can read the book.' But

[22] See Lord Goff's comments in *President of India v Jebsens* [1991] 1 Lloyd's Rep 1 at 9.

[23] See the comments of Briggs J at first instance in *Chartbrook v Persimmon Homes* [2007] 2 P&CR 9 at [34]–[38]. The decision was overruled, but not on this point.

[24] (2005) 121 LQR 577 at 581.

[25] (2009) 31(1) Sydney Law Review 5; and see McLauchlan, 'The Contract That Neither Party Intends' (2012) 29 JCL 26.

[26] (2005) 121 LQR 577 at 581.

[27] For a discussion on the approach to this issue in the United States, see Burton, *Elements of Contract Interpretation* (Oxford, 2009), Chapter 1.

[28] *The Golden Victory, Golden Strait Corp v Nippon Yusen Kubishika Kaisha* [2007] 2 AC 353 at [12].

the problem with this argument is that it proves too much. Taken to its logical conclusion it would destroy the objective principle altogether. In relation to any contract, it may be the case that evidence of the parties' subjective intentions would enable the court to get a better understanding of what the parties actually intended. But that would simply replace objectivity with subjectivity. The dangers of this approach are those which have already been discussed: uncertainty, cost, and delay; and potential prejudice to third parties. As is so often the case in English law, pragmatism wins out over theory. Absolute justice gives way to a practical method of enforcing people's bargains more quickly and with a greater degree of certainty than would otherwise be possible.

E. Freedom of Contract and its Limits

One reason why the interpretation of contracts is of such importance in practice is that English law generally recognizes the principle of freedom of contract, and therefore that what the parties have agreed is of paramount importance. **1.29**

This was particularly apparent in the nineteenth century when Sir George Jessel MR said, in *Printing and Numerical Registering Company v Sampson*:[29] **1.30**

> It must not be forgotten that you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this paramount public policy to consider—that you are not lightly to interfere with this freedom of contract.

Inroads were made into this principle in the twentieth century, to such an extent that Professor Atiyah was able to record what he described as 'The Rise and Fall of Freedom of Contract'.[30] **1.31**

But, by the end of the twentieth century, the pendulum had swung back, with the courts being less inclined to override those contractual provisions which they did not like. So, in *Photo Production v Securicor*,[31] Lord Diplock was able to say: **1.32**

> A basic principle of the common law of contract, to which there are no exceptions that are relevant in the instant case, is that parties to a contract are free to determine for themselves what primary obligations they will accept.

[29] (1874–75) LR 19 Eq 462 at 465.
[30] Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford, 1979).
[31] [1980] AC 827, 848.

1.33 This return to the principle of freedom of contract may have had much to do with the fact that Parliament had by now intervened to protect consumers, thereby leaving the courts free to give effect to freedom of contract where that legislation did not apply. In commercial transactions, the courts are now much more willing to accept that the parties should be the final determinant of what is good for them.

1.34 There are now few general exceptions to this basic principle of freedom of contract in commercial transactions. Perhaps the most important one in practice is the doctrine of penalties, by which a court will strike down a provision of a contract which requires a party in breach of the contract to pay an amount which is not a genuine pre-estimate of the loss suffered by the other party.[32]

1.35 The penalty doctrine can now be seen as something of an historical anomaly. If the parties can agree the extent of their primary obligations to perform the contract, why can they not do the same in relation to their secondary obligations to pay damages for breach?

1.36 Under English law, it seems clear that the penalty doctrine is restricted to cases where there is a breach of contract. As Lord Roskill said in *Export Credits Guarantee Department v Universal Oil Products Co*:[33]

> [O]ne purpose, perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant. But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain.

1.37 The position is now different in Australia. In *Andrews v Australia and New Zealand Banking Group*,[34] the High Court of Australia decided that the penalty doctrine could apply even where there was no breach of contract. It is suggested that it is unlikely that an English court would adopt this approach, particularly bearing in mind the uncertainty this would cause in commercial transactions.

F. The Guiding Principle

1.38 The principle that contractual interpretation is about establishing the objective intention of the parties underlies all aspects of contractual interpretation. The other principles in this book are subsidiary to this basic principle, and need to be understood in the light of it. They are essentially ways of achieving this underlying purpose.

---

[32] *Dunlop Pneumatic Tyre Co v New Garage and Motor Co* [1915] AC 79; *Lansat Shipping v Glencore Grain* [2009] CLC 465.

[33] [1983] 1 WLR 399 at 403.

[34] (2012) 290 ALR 595.