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CASE NOTE

Construction of Contractual Terms Applying Commercial Common Sense

Rainy Sky S.A. and others (Appellants) v. Kookmin Bank (Respondent), [2011] UKSC 50

Judgment of the Supreme Court of 2 November 2011 (Lord Phillips (President), Lord Mance, Lord Kerr, Lord Clarke and Lord Wilson)

1. Introduction

This judgment of the Supreme Court concerns the question of the construction of a shipbuilder's refund guarantees given under six shipbuilding contracts. The contracts were between each of the claimants ('the buyers') and Jinse Shipbuilding. Under the contracts, Jinse Shipbuilding agreed to build and sell one vessel to each of the buyers. The buyers were to pay for the vessels in six equal instalments. It was a condition precedent under the contracts that Jinse Shipbuilding would deliver refund guarantees relating to the instalments. Kookmin Bank ('the bank') issued advance payment bonds ('the bonds') to the six buyers. The seventh claimant is the assignee of the benefit of the bonds. After the first instalments had been paid Jinse Shipbuilding encountered financial difficulties and became subject to a debt workout procedure under the Korean Corporate Restructuring Promotion Law 2007.

The buyers wrote to Jinse Shipbuilding notifying it that, pursuant to Article XII.3 of the contracts, this development obliged it to refund all the instalments paid, plus contractual interest. Jinse Shipbuilding denied that it was contractually obliged to refund the instalments. The buyers wrote to the bank demanding repayment. The bank refused to pay, arguing that on their true construction the bonds did not cover refunds to which the buyers were entitled pursuant to Article XII.3 of the contracts. In first instance proceedings, the judge (Simon J) rejected the bank's argument and gave summary judgment for the assignee of the benefit of the bonds. Simon J described the bank's construction of the bonds as having the surprising and uncommercial result of the guarantee not being available to meet Jinse Shipbuilding's obligations in the event of insolvency.

At the Court of Appeal Sir Simon Tuckey agreed with the judge of first instance but the other two judges (Thorpe and Patten LJJ) held the bank's argument to be correct.[1] The buyers appealed to the Supreme Court. Lord Clarke wrote the judgment restoring the judgment of first instance and the other four judges agreed.

2. The Correct Approach to the Construction of Contracts

Lord Clarke said about the correct approach to the construction of contracts:

'The principles have been discussed in many cases, notably of course, as Lord Neuberger MR said in *Pink Floyd Music Ltd v. EMI Records Ltd* [2010] EWCA Civ 1429; [2011] 1 WLR 770 at para 17, by Lord Hoffmann in *Mannai Investment Co Ltd v. Eagle Star Life Assurance Co Ltd* [1997] AC 749, passim, in *Investors Compensation Scheme Ltd v. West Bromwich Building Society* [1998] 1 WLR 896, 912F-913G and in *Chartbrook Ltd v. Persimmon Homes Ltd* [2009] 1 AC 1101, paras 21-26. I agree with Lord Neuberger (also at para 17) that those cases show that the ultimate aim of interpreting a provision in a contract, especially a commercial contract, is to determine what the parties meant by the language used, which involves ascertaining what a reasonable person would have understood the parties to have meant. As Lord Hoffmann made clear in the first of the principles he summarised in the *Investors Compensation Scheme* case at page 912H, the relevant reasonable person is one who has 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.'[2]

The issue between the parties was the role played by considerations of business common sense in determining what the parties meant.[3]

Lord Clarke quoted the following passage from the Court of Appeal's judgment setting out Patten LJ's conclusion with regard to the question of construction:

'In this case (as in most others) the court is not privy to the negotiations between the parties or to the

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1. [2010] EWCA Civ 582.
2. Para. 14 of the Supreme Court judgment.
3. See para. 15 of the Supreme Court judgment.

commercial and other pressures which may have dictated the balance of interests which the contract strikes. Unless the most natural meaning of the words produces a result which is so extreme as to suggest that it was unintended, the Court has no alternative but to give effect it its terms. To do otherwise would be to risk imposing obligations on one or other party which they were never willing to assume and in circumstances which amount to no more than guesswork on the part of the Court.'[4]

Lord Clarke disagreed with this conclusion. He said that it is not necessary to conclude that the court must give effect to that meaning only if the most natural meaning of the words produces a result so extreme as to suggest that it was unintended.[5] He wrote:

'The language used by the parties will often have more than one potential meaning. I would accept the submission made on behalf of the appellants that the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has 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, would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other.'[6]

He went on to say that where the parties have used unambiguous language (i.e. language with only one possible meaning), the courts must apply it.[7] Lord Clarke quoted the following two extracts from the judgment of Longmore LJ in *Barclays Bank plc v. HHY Luxembourg SARL* [2010] EWCA Civ 1248 in which, according to Lord Clarke, Longmore LJ 'neatly summarised the correct approach to the problem':[8]

'25. The matter does not of course rest there because when alternative constructions are available one has to consider which is the more commercially sensible. On this aspect of the matter Mr Zacaroli has all the cards.
...
26. The judge said that it did not flout common sense to say that the clause provided for a very limited level of release, but that, with respect, is not quite the way to look at the matter. If a clause is capable of two meanings, as on any view this clause is, it is quite possible that neither meaning will flout common sense. In such circumstances, it is much more appropriate to adopt the more, rather than the less, commercial construction.'

Lord Clarke then formulated the rule that 'where a term of a contract is open to more than one interpretation, it is generally appropriate to adopt the interpretation which is most consistent with business common sense'.[9]

If the language is capable of more than one construction, it is not necessary to conclude that a particular construction would produce an absurd or irrational result before having regard to the commercial purpose of the agreement.[10]

The bank's construction of the bonds would have led to the surprising and uncommercial result that the buyers would not be able to call on the bonds in the event of insolvency of Jinse Shipbuilding. This would make no commercial sense. If the parties had intended such a result it could be expected that the contracts and the bonds would have spelt this out clearly but they did not do so. The Supreme Court agreed with the judge of first instance and Sir Simon Tuckey that of the two arguable constructions of the bonds, the buyer's construction was to be preferred because it is consistent with the commercial purpose of the bonds in a way in which the bank's construction is not. The appeal was allowed and the judgment of first instance was restored.

3. Comment

It was already well established that the ultimate aim of interpreting a provision in a contract, especially a commercial contract, is to determine what the parties meant by the language used, which involves ascertaining what a reasonable person would have understood the parties to have meant.[11] In *Investors Compensation Scheme v. West Bromwich Building Society,* [1997] UKHL 28, Lord Hoffmann summarised five principles of construction, the first of which is:

'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.'

With regard to the relevant reasonable person having all the reasonably available background knowledge, Lord Clarke approvingly quoted Lord Steyn in *Society of Lloyd's v. Robinson* [1999] 1 All ER (Comm) 545, 551 that although loyalty to the text of a commercial contract, instrument or document read in its contextual setting is the paramount principle of interpretation,

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4. See para. 18 of the Supreme Court judgment.
5. Para. 20 of the Supreme Court judgment.
6. Para. 21 of the Supreme Court judgment.
7. Para. 23 of the Supreme Court judgment.
8. Para. 30 of the Supreme Court judgment.
9. Para. 30 of the Supreme Court judgment.
10. Para. 43 of the Supreme Court judgment.
11. See para. 14 of the Supreme Court judgement and the cases cited there.

when interpreting the meaning of the language of a commercial document the court ought generally to favour a commercially sensible construction. The reason for this approach is that a commercial construction is likely to give effect to the intention of the parties. Words ought therefore to be interpreted in the way in which a reasonable commercial person would construe them. And the reasonable commercial person can safely be assumed to be unimpressed with technical interpretations and undue emphasis on niceties of language.[12]

After a discussion of difficulties in construing the bonds, Lord Clarke wrote that as the language of the bonds is capable of two meanings, it is appropriate for the court to have regard to considerations of commercial common sense in resolving the question of what a reasonable person would have understood the parties to have meant.[13]

This case adds clarity to Lord Hoffman's first principle of construction. It shows that the role to be played by considerations of business common sense in ascertaining the meaning that a commercial document would convey to a reasonable person having all the background knowledge that would reasonably have been available to the parties in the situation in which they were at the time of the contract is an important one. If more than one construction of a clause is possible, the construction that makes commercial sense is to be preferred above the construction that does not.

12. Para. 25 of the Supreme Court judgment.
13. Para. 40 of the Supreme Court judgment.