More Construction Controversy

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This article discusses two important developments in the law of contract interpretation since the authors’ earlier article in (2011) 28 JCL 101. The first is the decision of the High Court of Australia to decline special leave to appeal from the decision of the NSW Court of Appeal in Jireh International Pty Ltd v Western Export Services Inc and also to take the unusual step of publishing the reasons for doing so. The second is the decision of the UK Supreme Court in Rainy Sky SA v Kookmin Bank. While at first sight the two cases seem to be at opposing ends of the literal–contextual spectrum of approaches to contract interpretation, closer analysis reveals that they both affirm principles that are inconsistent with Lord Hoffmann’s well-known restatement in the ICS case insofar as they employ the concept of ambiguity as a gateway or limiting device: in Jireh to limit regard to evidence of surrounding circumstances; in Rainy Sky, to limit regard to considerations of business common sense.

Introduction

In an earlier issue of this Journal we discussed some of the current controversies concerning core principles of the law of contract interpretation in Australia that arose out of observations by Heydon and Crennan JJ in Byrnes v Kendle and the decision of the NSW Court of Appeal in Jireh International Pty Ltd v Western Export Services Inc. We concluded that there was an urgent need for the High Court to issue a definitive statement of the principles of contract interpretation and, in particular, to clarify the extent to which it is permissible to examine the surrounding circumstances when deciding what the words of a contract mean, as well as the current status of the plain meaning rule. Notwithstanding decisions of intermediate appeal courts holding that it is unnecessary to find ambiguity before it is permissible to have regard to surrounding circumstances, their Honours in Byrnes reminded lower courts that in Royal Botanic Gardens and Domain Trust v South Sydney City Council the High Court had stated that Codelfa Construction Pty Ltd v State Rail Authority of New South Wales should be followed until the High Court had ruled on the question whether there are differences between the principles laid down in the latter case and Lord Hoffmann’s restatement in...
Investors Compensation Scheme Ltd v West Bromwich Building Society and, if so, which should be preferred. As is well known, Mason J held in Codelfa, inter alia, that '[t]he true rule is that evidence of surrounding circumstances ... is not admissible to contradict the language of the contract when it has a plain meaning' (except where the words bear a special meaning by trade usage or custom or the interpretation would produce a manifest inconvenience or absurdity). The trouble with the High Court's reaffirmation of Codelfa is that at the same time the court, in Byrnes itself and on several earlier occasions, has been endorsing the first ICS principle under which '[i]nterpretation 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'. We suggested that this principle is inconsistent with Codelfa because, as amplified by Lord Hoffmann, it not only allows but requires consideration of the background to the contract (the so-called 'matrix of facts') as part of the 'single task of interpretation' regardless of whether there is any perceived ambiguity. Further, whereas the Codelfa true rule is based on the notion of a 'plain meaning', under the ICS principles that notion, and the associated plain meaning rule, is relegated to a proposition that where words do have a conventional or ordinary meaning this is simply a strong indication that they were used in that sense.

Two important developments requiring further comment have occurred since we wrote our earlier article. First, the High Court has declined leave to appeal from Jireh v WES and taken the unusual step of publishing the reasons for its decision. As we explained in our earlier article, the primary issue in the NSW Court of Appeal was the consequences of a perceived unambiguous literal meaning and whether the trial judge had erred in having regard to what was considered to be the reasonable commercial operation of the relevant clause. In the High Court, however, the key issue was, somewhat surprisingly, the current status of Codelfa and the admissibility of extrinsic evidence in the absence of a finding of ambiguity in the contractual language.

Second, the regard that can legitimately be had to considerations of business common sense was discussed in the UK Supreme Court's decision in Rainy Sky SA v Kookmin Bank. The Supreme Court emphasised the importance of such considerations and unanimously overturned the majority

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10 (2011) 243 CLR 253; 279 ALR 212; [2011] HCA 26 at [98].
13 Prenn v Simmonds [1971] 1 WLR 1381 at 1384; [1971] 3 All ER 237 at 239 per Lord Wilberforce.
decision of the Court of Appeal that was based on a perceived ‘natural and obvious construction’ of the words in dispute. In doing so, however, the Supreme Court, like its Australian counterpart in Jireh, also had resort to the concept of ambiguity and thus provided some basis for arguing that a partial retreat from the ICS principles is occurring in the country of their origin.

Jireh in the High Court

Reasons for Declining Leave

In refusing the application by WES for special leave to appeal, the High Court said that the Court of Appeal’s decision was correct and that even if the letter agreement ‘should be construed as understood by a reasonable person in the position of the parties, with knowledge of the surrounding circumstances and the object of the transaction, the result would have been no different’.17 For the reasons discussed in our earlier article,18 we respectfully disagree.

Regardless of whether Codelfa or ICS is applied, we prefer the interpretation of the trial judge. His Honour found for WES on the basis that a reasonable person in the position of the parties would have understood the term ‘sales by Jireh . . . to GJGC stores’ to include sales to such stores pursuant to Jireh’s franchising and preferred supplier arrangements where, but for a reorganisation of Jireh’s related companies, the sales would have been made by Jireh directly.

The case also provided a welcome opportunity for the High Court to confront, analyse and choose between the competing principles of interpretation and thus fulfil the primary role of an ultimate appellate court of clarifying the law and providing definitive guidance to lower courts who are dealing with such matters on a daily basis. Instead, the court (a) quoted with apparent approval19 the statement by Macfarlan JA in the Court of Appeal that ‘[a] court is not justified in disregarding unambiguous language simply because the contract would have a more commercial and businesslike operation if an interpretation different to that dictated by the language were

17 (2011) 282 ALR 604; [2011] HCA 45 at [6].
18 (2011) 28 JCL 101 at 116–19. In contrast to the NSW Court of Appeal’s approach, see the decision of the UK Supreme Court in Aberdeen City Council v Stewart Milne Group Ltd [2012] SLT 205; [2011] UKSC 56. The facts of that case bore some broad similarities to the facts of Jireh in that a development company that had purchased land from the council argued that it was not liable to pay the council an uplift in the price after transferring the land to another company within the same corporate group at a price that was far below its open market value and too low for the uplift to become payable. Nothing in the contract seemed to expressly prohibit what the development company had done, but Lord Hope (with whom Lady Hale, Lord Mance and Lord Kerr agreed) found for the council, holding, without drawing a sharp distinction between interpretation and implication, that ‘[t]he context shows that the intention of the parties must be taken to have been that the base figure for the calculation of the uplift was to be the open market value of the subjects at the date of the event that triggered the obligation’ (at [22]). Lord Clarke (with whom the other members of the court also agreed) reached the same conclusion but preferred to resolve the matter on the basis of an implied term, rather than interpretation (at [33]). It will be recalled that, at first instance in Jireh, the trial judge found for WES on the basis of both interpretation and an implied term: see (2011) 28 JCL 101 at 113–14 and 118–19.
adopted’,20 and (b) confirmed, as Heydon and Crennan JJ had in Byrnes, that the lower courts were bound to follow Mason J’s ‘true rule’ as to the admissibility of evidence of surrounding circumstances until that rule is disapproved or revised by the High Court, adding with evident displeasure that ‘[t]he position of Codelfa, as a binding authority, was made clear in the joint reasons of five Justices in [Royal Botanic] and it should not have been necessary to reiterate the point here’,21 and that ‘[w]e do not read anything said in this court’ in the earlier cases that had apparently accepted Lord Hoffman’s first principle in ICS ‘as operating inconsistently with’ the true rule stated by Mason J in Codelfa.22

An initial difficulty with the High Court’s stance is that Macfarlan JA himself did not apply the Codelfa rule. As noted above, the court cited23 the judge’s statement that a court cannot disregard unambiguous language even if it gives the contract an unbusinesslike operation, but it ignored his statement earlier in the same paragraph that the existence of ambiguity is to be determined ‘after considering the contract as a whole and the background circumstances known to both parties’.24 Thus, Macfarlan JA applied a peculiar hybrid approach that is not consistent with either ICS, because a plain meaning must be upheld unless it has absurd consequences, or Codelfa, because it is only after consideration of the factual background that the court can conclude that the language is unambiguous.25 Plainly, since it ignored the relevant passage in Macfarlan JA’s judgment, the High Court did not endorse this hybrid approach.

It is also important to reiterate here the point made in our earlier article26 that, contrary to the impression created by Macfarlan JA, both in the passage quoted by the High Court and elsewhere in his judgment, application of the first ICS principle does not simply entail giving the relevant terms a ‘commercial and business-like operation’. Under that principle, which has been repeatedly endorsed by the High Court,27 even if a particular interpretation would give the contract a ‘commercial and business-like operation’, it does not necessarily follow that that is what a reasonable person would have understood the relevant terms to mean at the time of the contract. After all, the contract may have been a bad bargain or become so as a result of unanticipated events. The test is what a reasonable person would understand the relevant terms to mean, not what a reasonable person would consider gives the relevant terms a ‘commercial and business-like operation’.

20 [2011] NSWCA 137 at [55].
25 Interestingly, at the special leave hearing (Western Export Services Inc v Jireh International Pty Ltd [2011] HCA Trans 297), Jireh’s counsel noted from the outset that ‘[t]his is a case where the Codelfa question simply does not arise’ because Macfarlan JA ‘did take into account surrounding circumstances’ and, ‘more importantly, the surrounding circumstances in this case do not give you any assistance one way or the other in resolving any of these interpretative questions’. In other words, the question ‘Should surrounding circumstances be taken into account?’ was ‘not a live issue in the case’.
27 See cases cited above, n 11.
The latter is merely a factor to consider in determining the answer to the former.

However, of much greater concern is the High Court’s point-blank refusal to entertain a reconsideration of the *Codelfa* ‘true rule’, despite the intermediate appellate court decisions to the contrary and despite the practical difficulties of applying the rule.\textsuperscript{28} Although the special leave decision is technically not binding on them,\textsuperscript{29} and they should arguably continue to follow binding intermediate appeal court decisions,\textsuperscript{30} the emphatic opinion of

\textsuperscript{28} The latter point was persuasively made by Palmer J in *Ray Brooks Pty Ltd v NSW Grains Board* [2002] NSWSC 1049 at [67]:

Before leaving this point of principle [no need to find ambiguity within the four corners of the document before having regard to surrounding circumstances] may I say, with great respect to those who promote the literal approach to construction, that to a trial judge the rationale for that approach does not appear very compelling. Of course, it would be a good thing in terms of saving time, trouble and expense if a trial judge could reject the tender of extrinsic evidence on the basis that the words of the contract are clear and unambiguous. The difficulty is that, in real life, the judge is told by the plaintiff’s counsel in opening that the words of the contract clearly mean X, only to be told by the defendant’s counsel immediately afterwards that the words clearly mean Y. In all but a very few cases, the arguments of both counsel seem respectable. How can a judge confidently reject at the outset extrinsic evidence tendered in aid of construing words said to have at least two meanings on the ground that he or she has already formed the view that the words are clear and could not possibly mean what one or other counsel says they mean when seen in the context of surrounding circumstances? Willy-nilly, the judge has to admit the evidence, hear the disputation arising from it and, at the end of the day, work out whether any of it is of assistance.

\textsuperscript{29} For a discussion of the limited precedential value of the High Court’s decision, see D Wong and B Michael, ‘Western Export Services v Jireh International: Ambiguity as the Gateway to Surrounding Circumstances?’ (2012) 86 ALJ 57. See also *McCourt v Cranston* [2012] WASCA 60 at [22] where Pullin JA said that ‘consideration will have to be given to whether a set of reasons of the High Court dismissing an application for special leave have anything more than persuasive value’. However, after noting that the question did not have to be resolved in the instant case, his Honour immediately added (at [23]):

In view of the pronouncements in *Jireh*, when an issue arises about the proper construction of a contract and there is evidence of surrounding circumstances known to the parties or evidence of the purpose or object of the transaction, that evidence will not be admissible unless the court determines that the contract is: (a) ‘ambiguous’; or (b) ‘susceptible of more than one meaning’.

This view was followed in *Pazi Xerox Finance Ltd v CSG Ltd* [2012] NSWSC 890.\textsuperscript{30} Such as *Franklins Pty Ltd v Metcash Trading Ltd* (2009) 76 NSWLR 603; [2009] NSWCA 407; *Lion Nathan Australia Pty Ltd v Coopers Beer Brewery Ltd* (2006) 236 ALR 561; [2006] FCAFC 144; *MBF Investments Pty Ltd v Nolan* [2011] VSCA 114. However, the High Court’s special leave decision in *Jireh* was cited without any question being raised as to its precedential status in *John Holland Group Pty Ltd v Automotive, Food, Metals, Engineering, Printing and Kindred Industries Union* [2011] VSCA 396 at [54]; [55]; *Retirement Services Australia (RSA) Pty Ltd v 3143 Victoria St Doncaster Pty Ltd* [2012] VSCA 134; *Keswick Developments Pty Ltd v Keswick Island Pty Ltd* [2011] QCA 379 at [97]; *Chu Underwriting Agencies Pty Ltd v Wise* [2012] WASCA 123; and *Spiers Earthworks Pty Ltd v Landtec Projects Corp Pty Ltd (No 2)* [2012] WASCA 53 at [24]. In *Jardin v Metcash Ltd* [2011] NSWCA 409, the NSW Court of Appeal cited *Codelfa*, *Royal Botanic* and *Byrnes* in holding that ‘where the language is susceptible of more than one possible meaning, regard should be had not only to the text but also to the background knowledge which would have been available to the parties and the purpose and object of the transaction’: per Meagher JA (at [70]), with whom Campbell JA (at [38]) and Young JA (at [40]) agreed on this aspect of the case. The Court of Appeal did not cite the High Court’s special leave decision and did not indicate what would be the position if the language was
three Justices of the High Court as to the continuing application of *Codelfa* and *Royal Botanic* is likely to be highly persuasive to lower courts. They have been told in no uncertain terms that, until the High Court determines otherwise, the task of contract interpretation requires a preliminary finding of ambiguity before it is legitimate to have regard to evidence of the surrounding circumstances (which, in the familiar words of Lord Wilberforce, means ‘evidence of the factual background known to the parties at or before the date of the contract, including evidence of the “genesis” and objectively the “aim” of the transaction’). Early indications leave little room for doubt that trial judges and, it appears, also intermediate appellate courts will follow the High Court’s direction in the special leave decision.32

This is not the place to rehearse the many philosophical and practical objections to the plain meaning rule or its chequered history in Australia.33 It suffices to recall the view of Lord Steyn, writing extra-judicially, that:34

> The purpose of interpretation is sometimes mistakenly thought to be a search for the meaning of words. This in turn leads to the assumption that one must identify an ambiguity as a pre-condition to taking into account evidence of the setting of a legal not susceptible of more than one possible meaning. Compare *Balani Pty Ltd v Gunns Ltd* [2011] FCAFC 153 at [28] and *Steggles Ltd v Yarrabbee Chicken Company Pty Ltd* [2012] FCAFC 91 where the Full Federal Court raised but did not discuss the question of the precedential status of the special leave decision in *Jireh*. See also *McCourt v Cranston* [2012] WASCA 60 at [22] (above, n 29).

> Prenn v Simmonds [1971] 1 WLR 1381 at 1385.

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> The starting point is that language in all legal texts conveys meaning according to the circumstances in which it was used. It follows that the context must always be identified and considered before the process of construction or during it. It is therefore wrong to say that the court may only resort to evidence of the contextual scene when an ambiguity has arisen . . . [I]n his important judgment in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, 912–13, Lord Hoffmann made crystal clear that an ambiguity need not be established before the surrounding circumstances may be taken into account.
Enormous energy and ingenuity is expended in finding ambiguities. This is the
wrong starting point. Language can never be understood divorced from its context.

We do, however, take issue with the High Court’s denial that there is anything
in the earlier decisions of the court that had accepted Lord Hoffmann’s first
principle in *ICS*[^35] that is inconsistent with the ‘true rule’ stated by Mason J in
*Codefia*.[^36] In our view, one cannot accept that ‘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’ and at the same time prevent trial judges
having regard to that background knowledge unless there is a preliminary
finding of ambiguity.[^37] At the very heart of Lord Hoffmann’s principles is the
notion that, although words may have an ordinary meaning in one context, the
same words may, when used in another context, convey an entirely different
meaning to a reasonable person with knowledge of the background to the
contract.[^38] Further, parties may use the ‘wrong’ words — words that by their
ordinary or conventional usage cannot bear the meaning contended for — but
nevertheless convey the latter meaning tolerably clearly. Whereas under
Mason J’s true rule it is impermissible to contradict ‘the language’ of the
contract in the absence (presumably) of absurdity, under Lord Hoffmann’s
principles it suffices that a reasonable person with knowledge of the
background would not give that language its ordinary meaning.[^39] Thus, in
ordinary parlance ‘12 January’ does not mean ‘13 January’, but in *Mannai*

[^35]: See cases cited above, n 11 and the full discussion thereof by Campbell JA in *Franklins Pty
[^36]: (2011) 282 ALR 604; [2011] HCA 45 at [5]. See also the strong criticism of the High Court’s
    stance by A Stewart, ‘What’s Wrong with the Australian Law of Contract?’ (2012) 29 JCL
    74 at 82–4.
[^37]: A similar view is expressed in the comprehensive judgment of Campbell JA in *Franklins Pty
    also, eg *Lion Nathan Australia Pty Ltd v Coopers Brewery Ltd* (2005) 223 ALR 560; [2005]
    FCA 1812 at [78]; aff’d (2006) 236 ALR 561; and the view expressed by R D Nicholson J
    in *BP Australia Pty Ltd v Nyran Pty Ltd* (2003) 198 ALR 442; [2003] FCA 520 referred to
    in n 54 below.
[^38]: As Tipping J pointed out in *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] 2 NZLR 444;
    [2010] NZSC 5 at [22]:

    The objective approach [does not] require there to be an embargo on going outside the
terms of the written instrument when the words in issue appear to have a plain and
unambiguous meaning. This is because a meaning that may appear to the court to be
plain and unambiguous, devoid of external context, may not ultimately, in context, be
what a reasonable person aware of all the relevant circumstances would consider the
parties intended their words to mean . . . While displacement of an apparently plain and
unambiguous meaning may well be difficult as a matter of proof, an absolute rule
precluding any attempt would not be consistent either with principle or with modern
authority.

[^39]: As Lord Hoffmann pointed out in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC
    1101; [2009] 4 All ER 677; [2009] UKHL 38 at [37], *ICS* decided two main points:

    first, that it was not necessary to find an ‘ambiguity’ before one could have any regard
to background and, secondly, that the meaning which the parties would reasonably be
taken to have intended could be given effect despite the fact that it was not, according to
conventional usage, an ‘available’ meaning of the words or syntax which they had
actually used.
Investment Co Ltd v Eagle Star Life Assurance Co Ltd\textsuperscript{40} a majority of the House of Lords held that a tenant’s notice to terminate a lease ‘on 12 January’ meant ‘on 13 January’ (the date on which the tenant was entitled to terminate the lease) because in the circumstances a reasonable person in the position of the landlord with knowledge of the terms of the contract would have understood that the tenant wished to determine the lease on 13 January but wrongly wrote 12 January. As Lord Hoffmann pointed out:\textsuperscript{41}

\begin{quote}
words do not in themselves refer to anything; it is people who use words to refer to things. The word ‘allegory’ does not mean a large scaly creature or anything like it, but it is absurd to conclude, as judges sometimes do, that this is not an ‘available meaning’ in the interpretation of what someone has said. This is simply a confusion of two different concepts; as we have seen, a person can use the word ‘allegory’, successfully and unambiguously, to refer to such a creature.
\end{quote}

This is not to say, of course, that the words used by the parties are unimportant. On the contrary, as Lord Hoffmann often explained, there will usually be no answer to the solution derived from giving the words their ordinary or conventional meaning. All of this is clearly brought out in his Lordship’s fourth and fifth principles in ICS, which are essentially amplifications of his first, and guiding, principle:\textsuperscript{42}

\begin{quote}
The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The 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. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax . . .

The “rule” that words should be given their ‘natural and ordinary meaning’ reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless 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 . . .

The inconsistency between ICS and the Codelfa true rule can also be usefully illustrated by considering the impact of the latter on the actual facts of the former.\textsuperscript{43} It will be recalled that the House of Lords substituted the words ‘any claim sounding in rescission (whether for undue influence or otherwise)’ for ‘any claim (whether sounding in rescission for undue influence or otherwise)’ because that was ‘what the parties using [the latter] words against the relevant background would reasonably have been understood to mean’.\textsuperscript{44} Most importantly for present purposes, Lord Hoffmann, speaking for the majority of their Lordships, did not dispute the view of the dissenting
\end{quote}

\textsuperscript{40} [1997] AC 749; [1997] 3 All ER 352 (Mannai Investment).
\textsuperscript{41} [1997] AC 749 at 778; [1997] 3 All ER 352 at 379.
\textsuperscript{42} [1998] 1 WLR 896 at 913; [1998] 1 All ER 98 at 115.
\textsuperscript{43} For a fuller discussion, see D McLauchlan, ‘Plain Meaning and Commercial Construction: Has Australia Adopted the ICS Principles?’ (2009) 25 JCL 7 at 32–3.
\textsuperscript{44} [1998] 1 WLR 896 at 913; [1998] 1 All ER 98 at 115. The relevant background included the legislation establishing and governing the Investors Compensation Scheme, the nature of the
judge, Lord Lloyd of Berwick, that the actual words were unambiguous and that their literal interpretation did not have absurd consequences. Lord Lloyd, who in effect applied the plain meaning rule, regarded the majority’s interpretation as doing ‘violence to the language’. It was ‘not an available meaning of the words’ and it involved impermissible ‘creative interpretation’. There was ‘no principle of construction . . . which would enable the court to take words from within the brackets, where they are clearly intended to underline the width of “any claim”, and place them outside the brackets where they have the exact opposite effect’. His Lordship also thought that ‘it would take a very strong case indeed’ to justify displacing the plain meaning. The consequences of that meaning would have to be ‘extraordinary’, ‘ridiculous’ or ‘very unreasonable’. There were no such consequences in this case, only ‘theoretical anomalies’ and those anomalies fell ‘far short of the sort of absurdity that would justify the rejection of . . . the plain meaning’. This emphasis on plain meaning and the corresponding lack of ambiguity is consistent with the High Court’s reaffirmation of the Codelfa ‘true rule’ in Jireh. Accordingly, there can be little doubt that, if the material facts of ICS arose again today, an Australian court that followed the High Court’s ‘ruling’ in Jireh would take a similar approach to Lord Lloyd and, given the lack of ambiguity, exclude the evidence of the factual background, uphold the perceived plain meaning and decide the case differently to Lord Hoffmann and the majority of the House of Lords.

The Royal Botanic Case

As we have seen, in both Byrnes and Jireh the High Court referred to its earlier decision in Royal Botanic in which it was said that Codelfa should be followed until the court had ruled on the question whether there are differences between the principles laid down in the latter and Lord Hoffmann’s restatement in ICS. There are a number of questionable aspects of Royal Botanic itself and the recent reliance thereon that call for comment.

losses suffered by investors and their potential claims against certain parties, the genesis of the present litigation and the explanatory note to the claim form.

45 Admittedly, Lord Hoffmann did say ([1998] 1 WLR 896 at 913, 914; [1998] 1 All ER 98 at 115, 116) that the clause was ‘badly drafted’ and that the court was ‘inevitably engaged in choosing between competing unnatural meanings’, but he was primarily referring to the strange syntax and the anomalous consequences of the clause if literally interpreted, not ambiguity. He did not think that ‘the concept of natural and ordinary meaning is very helpful when, on any view, the words have not been used in a natural and ordinary way’. See also Lord Grabiner, ‘The Iterative Process of Contractual Interpretation’ (2012) 128 LQR 41 at 52 (‘The provision in ICS was clear but that did not prevent the House of Lords from moving the parentheses to correct an obvious mistake’).

(a) Did *Royal Botanic* affirm the *Codelfa* ‘true rule’?

The full text of the relevant passage in the joint judgment of Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ in *Royal Botanic* is as follows:53

Reference was made in argument to several decisions of the House of Lords, delivered since *Codelfa* but without reference to it. Particular reference was made to passages in the speeches of Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society* and of Lord Bingham of Cornhill and Lord Hoffmann in *Bank of Credit and Commerce International SA v Ali*, in which the principles of contractual construction are discussed. It is unnecessary to determine whether their Lordships there took a broader view of the admissible ‘background’ than was taken in *Codelfa* or, if so, whether those views should be preferred to those of this Court. Until that determination is made by this Court, other Australian courts, if they discern any inconsistency with *Codelfa*, should continue to follow *Codelfa*.

It has been plausibly argued54 that ‘the note of caution sounded by the High Court’ in this passage did not relate to the first ICS principle, ‘which rejected a requirement of ambiguity before examining the surrounding circumstances’, but rather to the second principle, which, as explained in *Bank of Credit and Commerce International SA v Ali*,55 states that the admissible background ‘includes absolutely anything [relevant] which would have affected the way in which the language of the document would have been understood by a reasonable man’. This view gains credence from the fact that in *Maggbury Pty Ltd v Hafele Australia Pty Ltd*,56 which was decided less than three months before *Royal Botanic*, three of the same judges57 who gave the above advice in *Royal Botanic* specifically approved the first ICS principle as well as the statement by Lord Bingham in *Bank of Credit and Commerce International SA v Ali*58 that ‘[t]o ascertain the intention of the parties the court reads the terms of the contract as a whole, giving the words used their natural and ordinary meaning in the context of the agreement, the parties’ relationship and all the relevant facts surrounding the transaction so far as known to the parties’.59

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54 By Campbell JA in *Franklins Pty Ltd v Metcash Trading Ltd* (2009) 76 NSWLR 603; [2009] NSWC 407 at [281]–[285]. Compare, however, the view expressed by R D Nicholson J in *BP Australia Pty Ltd v Nyan Pty Ltd* (2003) 198 ALR 442; [2003] FCA 520 a year after *Royal Botanic* was decided. His Honour held (at [33]) that the approaches in *Codelfa* and ICS are inconsistent because under the former ‘it is necessary firstly to determine whether the contract has a plain meaning or contains an ambiguity’ and ‘if the contract has a plain meaning, evidence of “surrounding circumstances” will not be admissible to contradict the language of the contract’. He therefore felt bound to follow the direction in *Royal Botanic* to apply *Codelfa* until the High Court ruled otherwise. See also *Home Building Society Ltd v Pourzand* [2005] WASC 242 at [28] per McLure JA (the judges in *Royal Botanic* were ‘referring to the well-known passage in the judgment of Mason J in *Codelfa* (at 352)’).
57 Gleeson CJ, Gummow and Hayne JJ.
59 Admittedly, the judges also referred to *Codelfa*, but in *Franklins Pty Ltd v Metcash Trading Ltd* (2009) 76 NSWLR 603; [2009] NSWC 407 at [276] Campbell JA argued that ‘[i]t is notable that the reference to *Codelfa* is not just to p 352 and the statement of the “true rule”, but to the wider discussion’ of modern developments in the law of contract interpretation.
(b) The actual approach in *Royal Botanic*

The recent treatment of *Royal Botanic* as having confirmed that Australian courts must apply the plain meaning rule until the High Court rules otherwise might be seen as even more remarkable when one considers the actual decision and reasoning in that case. This is because not only did the court arguably invent an ambiguity to enable it to resolve the dispute by reference to evidence of the surrounding circumstances — evidence that made it fairly obvious what the parties’ intention was — but also it went beyond what ICS itself considered to be admissible background by having regard to prior negotiations.

In brief, the case concerned the long-term lease of the subsurface of land in the Sydney Domain to enable the construction of a car parking station. The lease gave the lessor the right to fix a new rent every three years subject to various provisions, including one stating that:

in making any such determination the Trustees may have regard to additional costs and expenses which they may incur in regard to the surface of the Domain above or in the vicinity of the parking station and the footway and which arise out of the construction operation and maintenance of the parking station by the Lessee.

The question was whether this meant that the lessor *may only* have regard to additional costs and expenses. The High Court, by a 6:1 majority, gave an affirmative answer.

If one accepts that the task of the court was to determine and give effect to the parties’ objectively determined intention at the time of the contract, this was undoubtedly the right decision. The evidence of the surrounding circumstances showed that the parties contemplated only increases in rent to cover changes in the cost of maintaining the land above the parking station. Thus, the initial rent of a mere $2000 per annum was nowhere near a market rent but rather represented an estimate of the additional maintenance that would be incurred by the lessor as a result of the construction and operation of the car park; the parties were both public authorities motivated by the need to provide a public facility, not profit considerations; the lessee was to incur all of the very substantial cost of construction; the facility would not affect the continued public enjoyment of the domain for recreational purposes; and the concern of the parties in providing for triennial rent reviews was to enable the lessor to recoup increases in maintenance costs.

The last of these ‘surrounding circumstances’ was derived from evidence of the parties’ prior negotiations. Thus, a letter sent on behalf of the lessor setting out the terms on which the lessee would be allowed to construct the car park under the Domain stated:

60 See the excellent explanation and analysis of this case by J W Carter and A Stewart, ‘Interpretation, Good Faith and the “True Meaning” of Contracts: The *Royal Botanic* Decision’ (2002) 18 JCL 182.

61 The non-commercial nature of the transaction was also seen (at [37]) as being reinforced by the absence from the lease of any provisions for dispute resolution in relation to rent reviews that are usually found in long-term commercial leases.

(namely the cost of employing one additional gardener and one person to provide necessary services on weekends and on public holidays and of supplying additional fertilizers) shall have varied from such cost at the commencement of such period, the rental for the succeeding period of three years shall be correspondingly varied by the amount of such variation but shall not in any case be less than [$2000] per annum.

This proposed term was accepted by the lessee and consequently the letter provided powerful evidence of the parties’ actual mutual intention in relation to the ambit of the clause in dispute. It showed what the parties meant by that clause. The problem here, however, is that the High Court has on several occasions⁶³ accepted another of Mason J’s rulings in Codelfa, namely, that evidence of prior negotiations is inadmissible as an aid to interpretation. Of course, this exclusionary rule was also accepted in ICS itself⁶⁴ and later confirmed by the House of Lords in Chartbrook Ltd v Persimmon Homes Ltd.⁶⁵ The great irony, therefore, is that in a case where the High Court left open the question whether ICS ‘took a broader view of the admissible “background” than was taken in Codelfa’ and instructed Australian courts to follow Codelfa ‘if they discern any inconsistency’, it actually resolved the dispute by taking into account evidence that is prohibited by both the ICS and Codelfa principles⁶⁶.

More importantly for present purposes, however, it is questionable whether the words in dispute in Royal Botanic were truly ambiguous. The trial judge had held, and Kirby J dissenting in the High Court agreed,⁶⁷ that to adopt the lessee’s interpretation and treat ‘may have regard to’ as meaning ‘may only have regard to’ would do ‘very great violence’ to the language of the lease. Literally interpreted within the four corners of the document and without regard to extrinsic evidence, the words meant that the lessor was permitted to have regard to additional costs. There was nothing to prevent other factors being taken into account in fixing a reasonable rent. Indeed, it has been cogently argued by Carter and Stewart that if the words were interpreted without regard to the surrounding circumstances there was ‘simply no basis for adopting the lessee’s interpretation’, that ‘[t]he clause was not in any

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⁶³ Most recently in Byrnes v Kendle (2011) 243 CLR 253; 279 ALR 212; [2011] HCA 26 at [98]–[99].
⁶⁴ Lord Hoffmann’s third principle.
⁶⁶ It is not overlooked that in Codelfa (at 352) Mason J held that, while evidence of prior negotiations is inadmissible ‘in so far as [those negotiations] consist of statements and actions of the parties which are reflective of their actual intentions and expectations’, it is admissible (assuming of course the prerequisite ambiguity is present) to the extent that the negotiations ‘tend to establish objective background facts which were known to both parties and the subject matter of the contract’. Similarly, but without the prerequisite of ambiguity, Lord Hoffmann accepted in Chartbrook (at [42]) that evidence of the negotiations is admissible ‘to establish that a fact which may be relevant as background was known to the parties’. It might be argued that evidence establishing the existence of an actual mutual intention on the matter in dispute reached in the course of negotiations is evidence of an objective background fact, but it is highly unlikely that Mason J or Lord Hoffmann had this in mind. See generally D McLauchlan, ‘Contract Interpretation: What Is It About?’ (2009) 31 Syd L Rev 5 at 25–9.
⁶⁷ (2002) 240 CLR 45; 186 ALR 289; [2002] HCA 5 at [48] and [105].
rational sense ambiguous’, 68 and that ‘[t]he majority’s conclusion that the lease was ambiguous was a fiction designed to legitimise the reception of evidence of surrounding circumstances, whereas the proper approach was not to attempt to construe the lease until the surrounding circumstances were understood’. 69 Furthermore, even if the High Court’s decision in Royal Botanic lends support to a ‘broad concept of ambiguity’ that has been mooted by some judges, 70 the contract in Royal Botanic was, in our view, no more ambiguous than the contract in Jireh. In any event, we agree with the conclusion of Carter and Stewart that ‘the sooner that the High Court formally abandons any suggestion that such evidence is admissible only to resolve “ambiguity”, the better’. 71 Royal Botanic provides yet another illustration of why words can never be interpreted divorced from their context. The case also illustrates the wisdom of Lord Hoffmann’s reminder that we must not ‘confuse

69 Carter and Stewart, above, n 68, at 190. We are reminded in this context of Professor Corbin’s wise words (A L Corbin, ‘The Interpretation of Words and the Parol Evidence Rule’ (1965) 50 Cornell LQ 161 at 162):

There are many cases, practically never subjected to criticism, in which the court has considered extrinsic evidence as a basis for finding that the written words are ambiguous; instead of ambiguity admitting the evidence, the evidence establishes the ambiguity. Learned judges have often differed as to whether the written words are ambiguous, each one sometimes asserting that his meaning is plain and clear. All that any court has to do in order to admit relevant extrinsic evidence is to assert that the written words are ambiguous; this has been done in many cases in which the ordinary reader can perceive no ambiguity until he sees the extrinsic evidence.

70 See Vincent Nominees Pty Ltd v Western Australian Planning Commission [2012] WASC 28 at [54] per Beech J, citing the statement by Spigelman CJ in the NSW Court of Appeal in Royal Botanic (South Sydney Council v Royal Botanic Gardens [1999] NSWCA 478 at [35]) that ‘the word “ambiguity” — ironically a word not without its own difficulties — does not refer only to a situation in which the words used have more than one meaning. A broader concept of ambiguity is involved: reference to surrounding circumstances is permissible whenever the intention of the parties is, for whatever reason, doubtful.’ This view has been endorsed on several other occasions: see Burger King Corpn v Hungry Jack’s Pty Ltd [2001] NSWCA 187 at [138]; Ginger Development Enterprises Pty Ltd v Crown Developments Australia Pty Ltd [2003] NSWCA 296 at [20]; BP Australia Pty Ltd v Nyran Pty Ltd [2004] PCAFC 163 at [31]; Club Hotels Operations Pty Ltd v CHG Australia Pty Ltd [2005] NSWSC 998 at [114]; and Wachmer v Jaksic [2007] WASC 313 at [187]. In the later case of Gardiner v Agricultural and Rural Finance Pty Ltd [2007] NSWCA 235 at [12], the Chief Justice reiterated his view that in Codelfa Mason J did not intend to confine the approach to interpretation in the way usually attributed to him. The latter had in mind a wider scope for referring to surrounding circumstances. This is because ‘his reference . . . to the proposition that language may not only be “ambiguous” but also “susceptible of more than one meaning” invoked a concept of “ambiguity”’ extending to any situation in which the scope and applicability of the formulation was, for whatever reason, doubtful’. More recently, in McCourt v Cranston [2012] WASCA 60 at [24] Pullin JA suggested that ‘by using the phrase “ambiguous or susceptible of more than one meaning” perhaps Mason J wished to emphasise that not only a contract open to more than one meaning would allow in evidence of surrounding circumstances but also one where the contract is merely “difficult to understand”’. See further J J Spigelman, ‘From Text to Context: Contemporary Contractual Interpretation’ (2007) 81 AJL 322 and the critical response by D McLauchlan, ‘Plain Meaning and Commercial Construction: Has Australia Adopted the ICS Principles?’ (2009) 25 JCL 7 at 16–17.
71 Carter and Stewart, above, n 68, at 190.
the meaning of words with the question of what meaning the use of the words was intended to convey’.72

**Rainy Sky SA v Kookmin Bank**

As noted at the beginning of this article, the other important recent development is the UK Supreme Court’s decision in *Rainy Sky SA v Kookmin Bank*.73 In outline, the case concerned the proper interpretation of advance payment bonds issued by the defendant bank to each of six claimants who had entered into contracts to buy ships from a Korean shipbuilder on terms requiring payment of the price by instalments at specified times. After instalments had been paid the shipbuilder experienced financial difficulties and became subject to a debt workout procedure. This insolvency event entitled the claimants to demand an immediate refund of their instalments. Demands were made but declined, whereupon the claimants sought repayment from the bank. On the surface they had an open-and-shut claim because para 3 of each bond stated:

> In consideration of your agreement to make the pre-delivery instalments ... we hereby, as primary obligor, irrevocably and unconditionally undertake to pay to you, your successors and assigns, on your first written demand, all such sums due to you under the contract ... 

However, the bank relied on the immediately preceding para 2 of each bond that stated:

> Pursuant to the terms of the contract, you are entitled, upon your rejection of the vessel in accordance with the terms of the contract, your termination, cancellation or rescission of the contract or upon a total loss of the vessel, to repayment of the pre-delivery instalments of the contract price paid by you prior to such termination or a total loss of the vessel ... 

It argued that the expression ‘such sums’ in para 3 was a reference to the sums described in para 2, namely, the pre-delivery instalments paid prior to a termination of the contract or a total loss of the vessel, and hence the bond did not cover the builder’s insolvency, which was not an event giving the buyers a right to cancel. The buyers, on the other hand, argued that ‘such sums’ referred back to the ‘pre-delivery instalments’ in the first line of para 3 so that the bonds guaranteed repayment of pre-delivery instalments in all instances where the builder breached its refund obligation. This interpretation was upheld at first instance by Simon J (who ruled that the bank’s interpretation ‘has the surprising and uncommercial result that the buyers would not be able to call on the bond on the happening of the event which would be most likely to require the first class security’),74 rejected by a 2:1 majority of the Court of Appeal (Patten and Thorpe LJJ, Sir Simon Tuckey dissenting),75 but reinstated by a unanimous Supreme Court in a judgment delivered by Lord Clarke.76

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74 *Rainy Sky SA v Kookmin Bank* [2009] EWHC 2624 (Comm) at [18].
The general issue in the Supreme Court was said to concern ‘the role to be played by considerations of business common sense in determining what the parties meant’. This was because in the Court of Appeal Patten LJ, with whom Thorpe LJ concurred, had rested his decision on the following principle:

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 to 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.

Lord Clarke rejected this principle, saying that ‘[i]t is not in my judgment necessary to conclude that, unless the most natural meaning of the words produces a result so extreme as to suggest that it was unintended, the court must give effect to that meaning’. The true principle is 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’. His Lordship approved the following passage from a judgment of Longmore LJ as ‘neatly’ summarising the correct approach to the construction of commercial contracts:

when alternative constructions are available one has to consider which is the more commercially sensible . . . The [trial] 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 . . . 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 also drew support from and seemed to endorse a principle espoused by Lord Reid, and quoted by Sir Simon Tuckey, that ‘the more unreasonable the result [that a particular construction leads to], the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they shall make that intention abundantly clear’.

Applying this approach to the facts of the present case, Lord Clarke held that ‘of the two arguable constructions of para 3 of the bonds, the buyers’ construction is to be preferred because it is consistent with the commercial

candidly admitted (at [53]) that he found himself ‘in the invidious position of expressing a decisive opinion in a field that is completely foreign’ and that he supported Patten LJ’s judgment ‘[w]ith considerable trepidation’.  
78 [2010] 1 CLC 829; [2010] EWCA Civ 582 at [42].  
purpose of the bonds in a way in which the bank’s construction is not’. 84 His Lordship was also prepared to hold that the latter construction was so absurd as to flout common sense but he said that it was ‘not necessary to go so far’. 85 It sufficed that the buyers’ construction was more commercial than the bank’s.

Unfortunately, however, the judgment gives rise to a number of difficulties and uncertainties. The most important of these concerns the question whether it is necessary to make a preliminary finding of ambiguity before considering the factual background to the contract and attempting to give it the so-called commercial construction. Close analysis reveals some mixed messages in this respect.

On the one hand, the ICS principles are endorsed and apparently applied throughout the judgment. Thus, at the beginning of his analysis of the principles of interpretation Lord Clarke said: 86

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 [1998] 1 WLR 896, 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.

And later he said: 87

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.

On the other hand, his Lordship said that ‘[w]here the parties have used unambiguous language, the court must apply it’, 88 citing in support the pre-ICS decision of the Court of Appeal in Co-operative Wholesale Society
Ltd v National Westminster Bank plc\(^{89}\) where it was held, inter alia, that a court must give effect to unambiguous language even though it has an improbable commercial result. Interestingly, he quoted the statement in the judgment of Hoffmann LJ (as he then was) that one cannot ‘rewrite the language which the parties have used in order to make the contract conform to business common sense’,\(^{90}\) which is exactly what Lord Hoffmann was later to do in Chartbrook!\(^{91}\) Furthermore, Lord Clarke expressly approved\(^{92}\) the approach of Sir Simon Tuckey (who dissented in the Court of Appeal), including the following statement:\(^{93}\)

If the language of the bond leads clearly to a conclusion that one or other of the constructions contended for is the correct one, the court must give effect to it, however surprising or unreasonable the result might be. But if there are two possible constructions, the court is entitled to reject the one which is unreasonable and, in a commercial context, the one which flouts business common sense.

These statements appear inconsistent with the ICS principles and the notion of interpretation being one unitary exercise. They seem to require a preliminary determination of whether the words of the contract are ambiguous. If not, the words must be given their plain meaning no matter how surprising or unreasonable the result (although presumably that would not be so if the absurdity threshold were passed). Thus, only where the words are capable of two interpretations does the court embark on the task of commercial construction.

Although the above statements appear inconsistent with ICS, it is by no means clear that Lord Clarke intended to embrace the old plain meaning rule. Most of his Lordship’s judgment focuses on the principle to be applied when, as was common ground in the case, the words in dispute were capable, or reasonably\(^{94}\) capable, of two meanings. He accepts that ‘[t]he language used by the parties will often have more than one potential meaning’\(^{95}\) and that ‘[o]ften there is no obvious or ordinary meaning of the language under consideration’,\(^{96}\) but we are not told how that initial determination is to be made. Is the existence of ambiguity to be judged solely on the basis of internal linguistic considerations or against the factual background to the contract? We think that the former is unlikely to have been intended, primarily because we judge that his Lordship was not merely paying lip-service to the ICS approach and the notion that ‘the exercise of construction is essentially one unitary exercise’. Further, it would be surprising if he were unmindful that, as Lord Hoffmann confirmed in Chartbrook,\(^{97}\) ICS decided not only that ‘it was not necessary to find an “ambiguity” before one could have any regard to background’ but also that ‘the meaning which the parties would reasonably be taken to have intended could be given effect despite the fact that it was not,

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\(^{89}\) [1995] 1 EGLR 97.
\(^{90}\) [1995] 1 EGLR 97 at 99.
\(^{92}\) [2011] 1 WLR 2900; [2011] UKSC 50 at [22] and [30].
\(^{93}\) [2010] 1 CLC 829; [2010] EWCA Civ 582 at [19].
\(^{94}\) [2011] 1 WLR 2900; [2011] UKSC 50 at [26].
\(^{95}\) [2011] 1 WLR 2900; [2011] UKSC 50 at [21].
\(^{97}\) [2009] 1 AC 1101; [2009] 4 All ER 677; [2009] UKHL 38 at [37].
according to conventional usage, an “available” meaning of the words or syntax which they had actually used’.

The lack of clarity is further exacerbated by the plethora of confusing terminology employed by Lord Clarke and the authorities he cited. Thus, we read at various points, for example, that language may have ‘ordinary’, ‘obvious’, ‘more obvious’, ‘unambiguous’, ‘natural’, ‘no very natural’, ‘most natural’, ‘natural and ordinary’, ‘natural and obvious’ and ‘more than one potential’ meaning. The term ‘natural meaning’ and its variants are particularly troublesome.98 Sometimes the term is used as a synonym for the ‘plain meaning’ of words within the four corners of the document. Indeed, Lord Hoffmann himself used it in this sense in the fifth ICS principle.99

The ‘rule’ that words should be given their ‘natural and ordinary meaning’ reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents . . .

However, more often nowadays the term is used to describe the meaning, or most likely meaning, best supported by consideration of the document as a whole and admissible background evidence. In other words, it is the contextual meaning, the meaning that a reasonable person with knowledge of the background would give to the document. This was the sense in which Lord Wilberforce used the term in the well-known case of Prenn v Simmonds.100 When his Lordship said that the court had to ‘try to ascertain the “natural” meaning’ of the word ‘profits’ he was referring to the natural meaning in the light of ‘the factual background known to the parties at or before the date of the contract’.101 This usage was even more explicit in the judgment of Lord Bingham in Bank of Credit and Commerce International SA v Ali102 when he said, in the passage quoted earlier,103 that ‘[t]o ascertain the intention of the parties the court reads the terms of the contract as a whole, giving the words used their natural and ordinary meaning in the context of the agreement, the parties’ relationship and all the relevant facts surrounding the transaction so far as known to the parties’. It is perhaps unfortunate, however, that more attention has not been paid to Lord Hoffmann’s observation that ‘the notion of words having a natural meaning is not a very helpful one’.104 As his Lordship went on to explain:105

Because the meaning of words is so sensitive to syntax and context, the natural meaning of words in one sentence may be quite unnatural in another. Thus a statement that words have a particular natural meaning may mean no more than that in many contexts they will have that meaning. In other contexts their meaning will be different but no less natural.

100 [1971] 1 WLR 1381; [1971] 3 All ER 237.
103 See text at n 58 above.
There is one further aspect of Lord Clarke’s judgment that requires comment. His Lordship said that it was ‘clear’ that the principle of contract interpretation stated in Patten LJ’s judgment was different from that stated by Sir Simon Tuckey.\textsuperscript{106} He then proceeded to reject the former and accept the latter because it was not ‘necessary to conclude that, unless the most natural meaning of the words produces a result so extreme as to suggest that it was unintended, the court must give effect to that meaning’.\textsuperscript{107} He clearly took the view that, provided the language is reasonably capable of either of the contended interpretations, the court is entitled to prefer the one that is more consistent with business common sense even if it is not ‘the more obvious reading’.\textsuperscript{108} The less obvious reading does not have to produce a result ‘so extreme as to suggest that it was unintended’. However, we do not find it so clear that the two Court of Appeal judges did actually state substantially different principles. In our view, the reasons for their different conclusions had more to do with different readings of the terms of the bonds — different judgments as to the merits of the textual arguments — and different perceptions of what a reasonable person with knowledge of the background would have understood the parties to mean.

Let us consider the key statements in the Court of Appeal judgments in which the different principles were found. Sir Simon Tuckey said, in a passage the first sentence of which we have said is inconsistent with the ICS principles:\textsuperscript{109}

> If the language of the bond leads clearly to a conclusion that one or other of the constructions contended for is the correct one, the Court must give effect to it, however surprising or unreasonable the result might be. But if there are two possible constructions, the Court is entitled to reject the one which is unreasonable and, in a commercial context, the one which flouts business common sense.

Patten LJ said:\textsuperscript{110}

> 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 [to] 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 on the Court.

It seems clear that Patten LJ’s use of the term ‘the most natural meaning’ in the latter passage was intended as a reference not to the literal acontextual meaning, but to the meaning that, of the arguable interpretations, best fits the words used when read in the context of the document as a whole and the immediate surrounding circumstances.\textsuperscript{111} Where, then, is the difference between the two judges? According to Patten LJ, the court will reject an

\textsuperscript{106} [2011] 1 WLR 2900; [2011] UKSC 50 at [20]. Indeed, he later said (at [30]) that the two approaches were ‘significantly different’.

\textsuperscript{107} [2011] 1 WLR 2900; [2011] UKSC 50 at [20].


\textsuperscript{110} [2010] 1 CLC 829; [2010] EWCA Civ 582 at [42].

\textsuperscript{111} Thus, his Lordship cited (at [43]) the very passage in Lord Wilberforce’s judgment in \textit{Prenn v Simmonds} where ‘natural’ meaning is used in this sense (see text following n 100 above). Furthermore, he accepted and applied the ICS approach. The bond had to be interpreted against the background of the terms of the shipbuilding contract, the latter being ‘the only
interpretation that has extreme (absurd?) results. According to Sir Simon Tuckey, the court will reject an interpretation that flouts business common sense. Are these not two different ways of saying the same thing? A result that flouts business common sense is surely extreme or absurd. As noted above, at the end of his judgment Lord Clarke said that he would have been prepared to hold, if necessary, that the interpretation alleged by the bank and upheld by the Court of Appeal ‘would flout common sense’ but he concluded that ‘it is not necessary to go so far’. It sufficed that the buyers’ interpretation was the more commercial interpretation. Thus, we see that a commercially sensible interpretation does not necessarily entail finding that the other contended interpretation flouts business common sense. We can also draw the conclusion that although Lord Clarke indicated that he agreed with the approach of Sir Simon Tuckey, he seems to have gone beyond it to some extent. Sir Simon Tuckey, as we have seen, talks about rejecting a possible interpretation on the ground that it ‘flouts business common sense’, whereas Lord Clarke stresses that it is possible for neither interpretation to flout common sense and for one to be rejected because it is the less commercial than the other.

As mentioned above, the differences between the Court of Appeal judges essentially lay in their analyses of the facts rather than the principles they applied. Much of Sir Simon Tuckey’s judgment was devoted to a discussion of the parties’ competing arguments based on textual analysis of the bonds, although in the end he did not find it necessary to choose between them because textual considerations are but part of the ‘single process of construction’. He simply accepted that both interpretations were possible, at one point describing the bank’s argument based on the purpose of para 2 as at first sight ‘compelling’ and the buyers’ argument about the structure of the bonds as having ‘considerable force’. He also accepted that ‘a judge should proceed with caution before concluding that some suggested contract term is surprising or uncommercial’ but he was satisfied that the trial judge was entitled to so conclude in this case. ‘No credible commercial reason’ had been given for why the parties would have agreed that the bonds covered every situation where the buyers were entitled to a refund from the shipbuilders of the advance payments except the builder’s insolvency. Indeed, ‘[i]t defied commercial common sense to think that [the obligation to refund in the event of insolvency] was the only one which the parties intended should not be secured’. By contrast, Patten LJ, who thought that ‘the obvious purpose’ of para 2 was to provide ‘a clear statement of the builder’s obligations under the contract which are to be covered by the guarantee’, did not regard the

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extrinsic evidence relied on by the parties’ and ‘the genesis of the bond’ (at [45]). Consequently, the court’s essential task was to determine ‘the meaning which the document would convey to a reasonable person reading it with knowledge of the terms of the shipbuilding contract’ (at [50]).

competing interpretations ‘as being in any way evenly balanced’. The buyers’ interpretation was not ‘the meaning which the document would convey to a reasonable person reading it with knowledge of the terms of the shipbuilding contract’. Although security for repayment in the event of insolvency ‘was, objectively speaking, desirable’, it was not ‘the natural and obvious construction of the bond’. It was this view that formed the premise for Patten LJ’s concluding observation that:

This is not a case in which the construction contended for would produce an absurd or irrational result . . . and merely to say that no credible commercial reason has been advanced for the limited scope of the bond does, in my view, put us in real danger of substituting our own judgment of the commerciality of the transaction for that of those who were actually party to it.

Importantly, there is nothing in his Lordship’s judgment to suggest that, if the competing interpretations had been seen as more evenly balanced, so that the bond was reasonably capable of either meaning, he would have thought it inappropriate to favour the more commercial interpretation. Having in effect found that there was no ‘real ambiguity in the language of the bond’, his primary objection to the trial judge’s conclusion that the buyers should have the objectively desirable security for insolvency was that this would, on the basis of the evidence before the court, be to grant relief from a bad bargain. It would rewrite not the language, but the bargain itself. A court is not entitled to reformulate ‘relatively clear’ contractual provisions ‘simply because’ those provisions ‘balance the interests and obligations of the parties in a way which the judge considers to be one-sided or unfair’.

Lord Clarke, however, took a wholly different view of the merits of the parties’ arguments. He disagreed that the bank’s construction represented ‘the natural and obvious construction of the bond’, saying ‘I do not regard the bank’s construction as being the natural and ordinary meaning of the bonds’. In his view, the competing arguments were ‘much more finely balanced than suggested by Patten LJ and the bank’. Indeed, he said that if the case were to be decided solely on the basis of textual analysis he ‘would be inclined to prefer the buyers’ construction to that of the bank’. However, since the relevant language was reasonably capable of two meanings, it was ‘appropriate for the court to have regard to considerations of commercial common sense in resolving the question what a reasonable person would have understood the parties to have meant’ and, as we have seen, his Lordship ruled in favour of the buyers because their interpretation was more consistent with business common sense than the bank’s interpretation.

120 [2010] 1 CLC 829; [2010] EWCA Civ 582 at [51].
121 [2010] 1 CLC 829; [2010] EWCA Civ 582 at [50].
125 [2010] 1 CLC 829; [2010] EWCA Civ 582 at [41].
Conclusion

In the ICS case Lord Hoffmann prefaced his famous restatement of the fundamental principles of contract interpretation with the observation that a ‘fundamental change . . . has overtaken this branch of the law’ in modern times, so much so that ‘[a]lmost all the old intellectual baggage of “legal” interpretation has been discarded’. 130 Included in this discarded baggage were the concepts of ‘plain’, ‘open’ or ‘available’ meanings and the concept of ambiguity (which is the flipside of the other concepts). All of those concepts underlie the plain meaning rule and its corollary that resort to extrinsic evidence as an aid to interpretation is impermissible in the absence of a preliminary finding of ambiguity, but they are fundamentally inconsistent with the ICS principles and the underlying rationale of those principles, as Lord Hoffmann so clearly explained in ICS itself and Mannai Investment. 131 His Lordship rejected any formal requirement of ambiguity since sometimes the reasonable person with knowledge of the background may attribute to the parties a different meaning because, for one reason or another, something must have gone wrong with the language. In any event, to a reasonable person with knowledge of the factual background, ambiguity is not necessarily a binary proposition, either present or absent; there are degrees of ambiguity. The concept is therefore ill-suited to act as preliminary requirement or, in other words, to play a gate-keeping role.

At first sight, the two cases discussed in this article seem at opposing ends of the literal–contextual spectrum of approaches to contract interpretation. In Jireh, the High Court of Australia reaffirmed the Codelfa ‘true rule’, which pre-dates ICS and insists on the need for a preliminary finding of ambiguity before it is legitimate to have regard to evidence of the factual background. In Rainy Sky, the UK Supreme Court seems to have reaffirmed the ICS approach and adopted a liberal view of the role to be played by considerations of business common sense, which, ironically, was the primary issue in the NSW Court of Appeal’s decision in Jireh. 132 What the decisions of the High Court and the UK Supreme Court have in common, however, is that they both affirm principles that employ the concept of ambiguity as a gateway or limiting device: in Jireh, ambiguity is required before regard may be had to evidence of surrounding circumstances; in Rainy Sky, ambiguity is required before regard may be had to considerations of business common sense. Moreover, the High Court and the Supreme Court both employ the concept of ambiguity notwithstanding that both jurisdictions continue to recognise the first ICS principle and, in the case of the United Kingdom, the other ICS principles too.133

As discussed above, the ICS principles (including the first ICS principle) are

132 For discussion of another UK Supreme Court case where considerations of business common sense were decisive and led to an interpretation that was, in our view, open to serious question, see D McLauchlan, ‘A Construction Conundrum?’ [2011] LMCLQ 428.
133 Note, however, that, in Aberdeen City Council v Stewart Milne Group Ltd [2012] SLT 205; [2011] UKSC 56 (see above, n 18), the lack of ambiguity did not prevent Lord Clarke from finding for the council, but his Lordship did so on the basis of an implied term, rather than interpretation (at [33]). Lord Clarke explained that, ‘unlike Rainy Sky, this is not a case in
inconsistent with concepts of ambiguity and plain meaning. In our view, it is the attempt by both courts to graft on to the ICS principles (or, in Australia, the first ICS principle) a conceptually inconsistent principle, based on the concepts of ambiguity and plain meaning, that is the root cause of the difficulties with both decisions identified in this article. In both Jireh and Rainy Sky, it would have been possible to permit trial judges to have regard to, respectively, evidence of surrounding circumstances and considerations of business common sense without imposing a preliminary requirement of ambiguity. The importance of the written word and commercial certainty could instead have been safeguarded by affirming what Lord Hoffmann made abundantly clear — that ordinarily the reasonable person with knowledge of the background will understand the parties to have meant what they said according to ordinary usage, and the court will not lightly accept that words or grammar have not been used in a conventional way, particularly in formal documents. Such a course would, in both cases, have avoided the conceptual inconsistencies that result from trying to marry the ICS principles with a threshold requirement based on ambiguity.

It would, however, be naive to think that all contract interpretation disputes can be easily resolved once the appropriate principles are applied. Rainy Sky is a good example of this. Despite Lord Clarke’s views, we consider that the different conclusions reached by Patten LJ and Sir Simon Tuckey resulted primarily not from substantial differences in the principles applied, but rather from different judicial opinions being reached from the application of very alternative available constructions of the language used. It is rather a case in which, notwithstanding the language used, the parties must have intended that, in the event of an on sale, the appellants would pay the respondents an appropriate share of the proceeds of sale on the assumption that the on sale was at a market price’ (at [31]). Despite the distinction drawn between interpretation and implication, Lord Clarke’s conclusion was still buttressed by resort to notions of business common sense: ‘Rather like counsel for the respondent bank in Rainy Sky, [counsel for the development company] was not able to advance any commercially sensible argument as to why the parties would have agreed a different approach in the event of an on sale. I have no doubt that he would have done so if he had been able to think of one’ (at [32]). The similarity of approach between interpretation and implication when it comes to matters of business common sense (save that it appears ambiguity is unnecessary with implication) lends support to Lord Hoffmann’s view that the implication of terms is itself an exercise in construction:

134 See, eg, Bank of Credit and Commerce International SA v Ali [2002] AC 251; [2001] 1 All ER 961; [2001] UKHL 8 at [39] where Lord Hoffmann emphasised that ‘the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage’ and said that in the ICS case he ‘was certainly not encouraging a trawl through “background” which could not have made a reasonable person think that the parties must have departed from conventional usage’. His Lordship was the dissenting judge in the Bank of Credit and Commerce case, but, in criticising the majority (at [37]) for giving ‘too little weight to the actual language and background’ of the document in question, he was not backtracking from his principles. He was simply unconvinced that there was anything in the background that would lead a reasonable person to think that the parties must have departed from conventional usage of the words.
similar principles. Thus, we believe that, if Lord Hoffmann himself had been sitting in this case, he might have sympathised with the points made by both Patten LJ and Sir Simon Tuckey, depending on his view of the contractual language and the facts. This is because application of his first principle requires a careful balancing of internal textual considerations and external factors. If he had shared Patten LJ’s view concerning the purpose of para 2 and the relative clarity of the language of the bond, he might have insisted on the need for the buyers to establish something akin to or approaching an absurd or irrational result of the bank’s interpretation (because only then would a reasonable person reject that interpretation). On the other hand, if Lord Hoffmann shared the view of Sir Simon Tuckey (and Lord Clarke) that the competing textual arguments were finely balanced, we surmise that he would have agreed that it was entirely appropriate to conclude that that reasonable person would have understood the parties to have meant what was more consistent with business common sense.135

In essence, therefore, we regard *Rainy Sky* as yet another illustration of the valuable point made by Sir Robert Goff (as he then was), writing extra-judicially, nearly 30 years ago:136

a few apparently simple words can give rise to a profound difference of opinion among very experienced judges; and ... all the principles of construction in the world cannot avoid the fact that different people may form different views ... [I]nterpretation of commercial documents will remain until the end of time a topic which can give rise to differences of opinion of this kind. We can only do our best. Accordingly, there can be little doubt that there are many more construction controversies still to come.

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135 Compare the principle applied by Lord Reid in *Wickman Machine Tool Sales Ltd v L Schuler AG* [1974] AC 235 at 251; [1973] 2 All ER 39 at 45, quoted above in the text at n 83, to the effect that the degree of unreasonableness should be assessed with reference to the degree of clarity of the words.