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Interpretation of contracts - liberalism re-affirmed

In Re Sigma Finance Corporation (in administrative receivership) [2009] UKSC 2

Case analysis by Caroline Edwards

On 29 October 2009, the Supreme Court delivered its second published judgment in *In Re Sigma Finance Corporation (in administrative receivership)* [2009] UKSC 2 ("*Sigma*").

What is *Sigma* about?

The Supreme Court's judgment in *Sigma* is the latest in a series of decisions addressing questions of contractual construction arising from the insolvency of structured investment vehicles (SIVs) following the financial crisis brought about by the collapse of the US sub-prime market in 2007. Sigma was a SIV which issued Euro and US Medium Term Notes to investors and used the funds raised to invest in various asset-backed securities and other financial instruments. All Sigma's assets were secured in favour of its investors under the terms of a security trust deed (the "STD"). The STD, in very broad summary, provided that upon the occurrence of an Enforcement Event, a 60 day "Realisation Period" would commence, during which time the Security Trustee was required to establish a Short Term pool and Long Term pools of assets which, following the end of the Realisation Period, would be applied to discharge the Issuer's liabilities to its Short Term and Long Term creditors as and when they matured (there was no acceleration of Short Term and Long Term Liabilities upon the occurrence of an Enforcement Event). Critically, the STD provided (in the final sentence of clause 7.6) that, *"During the Realisation Period the Security Trustee shall so far as possible discharge on the due dates therefor any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer".*

By the time of its collapse, Sigma had issued various Medium Term Notes with differing maturity dates falling both within and after the Realisation Period. A question arose as to whether, on a true construction of the STD, the Security Trustee was required to use the assets of the Issuer: (a) to discharge the first Short Term Liability falling due within the Realisation Period in full, with the remaining assets (if any) being used to discharge subsequent Short Term Liabilities as they fell due within the Realisation Period – the so-called "pay-as-you-go" basis; or (b) to discharge all the Short Term Liabilities falling due within the Realisation Period on a *pari passu* basis; or (c) to discharge all the Short Term Liabilities and Long Term Liabilities falling due both within and after the Realisation Period, with Short Term Liabilities being treated *pari passu* in relation to each other and Long Term Liabilities likewise being treated *pari passu* in relation to each other. It was evident that Sigma's remaining assets (c.US$450 million) fell far short of the liabilities owed in respect of the outstanding Notes (c.US$6 billion). If construction (a) succeeded, there would be sufficient assets to meet the liabilities in respect of the Notes which matured first in the Realisation Period but nothing left to discharge the liabilities in respect of the Notes maturing later in the Realisation Period, and thereafter. If construction (b) succeeded, the liabilities in respect of all the Notes maturing within the Realisation Period would be partially discharged, but again there would be nothing available to meet the liabilities in respect of the Notes maturing after the Realisation Period. If construction (c) succeeded, all the Noteholders would receive something, albeit only a small proportion of the total outstanding. The difference in the financial outcomes for the holders of different Notes produced by the different constructions for which they contended was therefore very significant.

The decision

Mr Justice Sales, at first instance, and Lord Justices Lloyd and Rimer, on appeal, held that on a true construction of the STD, the Security Trustee was required to discharge the Short Term Liabilities on a pay-as-you-go basis i.e. as they fell due during the Realisation Period. However, Lord Justice Neuberger, dissenting in the Court of Appeal, found that the STD required the Security Trustee to discharge all the Short Term and Long Term Liabilities falling due within and after the Realisation Period on a *pari passu* basis. By a majority of 4:1 the Supreme Court overturned the High Court and Court of Appeal decisions, agreeing instead with Lord Justice Neuberger's dissenting view.

In summary, Lord Mance, giving the leading majority judgment, stated that too much weight had been placed by the courts below on the perceived natural meaning of the disputed sentence, which indicated a pay-as-you-go basis, and too little weight on the context in which the sentence appeared and the general scheme of the STD as a whole. Of much greater importance was an understanding of the overall scheme of the document and a reading of its individual sentences and phrases which placed them in the context of that overall scheme. The decisions below had elevated the importance of a minor provision, which appeared to create effective priority for certain creditors, to a level which it was not designed to have. This resulted in a conflict with the basic scheme of the document, which assumed that all secured liabilities would be covered and no issue of priority could arise. The pay-as-you-go clause had been drafted in contemplation of a situation where no question of insolvency would arise: it therefore had to be interpreted in a different context to that for which it was designed. In those circumstances, the basic scheme of the document helped to demonstrate that the pay-as-you-go provision could not be applied in a literal way.

Dissenting, Lord Walker stressed that given that the STD was not intended simply to deal with an insolvency situation, one had to repress the instinctive feeling that *pari passu* distribution was the appropriate result. In that context, he found that the pay-as-you-go provision was wide enough to cover both the possibility that a payment might, for practical reasons, have to be delayed by a few days, and the much more remote possibility (as it would have appeared to the parties at the time) that there would be a permanent deficiency of assets.

The relevant principles of construction

The relevant principals of construction were not in doubt, with Lord Mance citing the chain of House of Lords authority starting with *Charter Reinsurance Co. Ltd. v Fagan* [1997] AC 313 and *Mannai Investment Co. Ltd. v Eagle Star Life Assurance Co. Ltd.* [1997] AC 749, through to *Investors Compensation Scheme Ltd. v West Bromwich Building* Society [1998] 1 WLR 896 and finally the House of Lords judgment in *Chartbrook Ltd. v Persimmon Homes Ltd.* [2009] UKHL 38 ("*Chartbrook*") which had been delivered on the first day of the hearing of the House of Lords appeal in *Sigma*. He referred specifically to the danger, underlined by Lord Mustill in *Charter Reinsurance*, of focusing too narrowly on a critical phrase and set out Lord Hoffmann's oft-cited summary of the principles of contractual interpretation in *Investors Compensation Scheme* (at paragraphs 912G to 913F of Lord Hoffman's judgment), including:

"(4) 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 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 (see Mannai Investments Co. Ltd. v. Eagle Star Life Assurance Co. Ltd. [1997] AC 749).

(5) 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. Lord Diplock made this point more vigorously when he said in The Antaios Compania Neviera S.A. v. Salen Rederierna A.B. [1985] A.C. 191, 201:

'…if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense.'"

It is also worth noting Lord Collins' comments, with which Lord Mance agreed, that because of the nature of the STD, this was, *"… not the type of case where the background or matrix of fact is or ought to be relevant, except in the most generalised way… Where a security document secures a number of creditors who have advanced funds over a long period it would be quite wrong to take account of circumstances which are not known to all of them. In this type of case it is the wording of the instrument which is paramount"*. Lord Justice Lloyd in the Court of Appeal also distinguished between the STD, which he agreed was analogous to a constitutional document and affected the rights of a large number of people who were not a party to it, and an ordinary commercial contract which dealt with the rights and obligations of its parties alone. He considered that this was the reason why none of the parties had sought to imply any term into the STD, *"… which is especially difficult in such cases"*. He also considered this to be a reason why it may be difficult to bring much by way of the surrounding circumstances into the process of construction of such a document. Only one party had sought to refer to any surrounding circumstances – the contents of two offering memoranda which referred repeatedly to the fact that the Notes ranked *pari passu* and which contained no suggestion that Short Term Liabilities might attract special priority during the Realisation Period - but the attempt to rely on these documents in support of a *pari passu* construction was rejected by the Court of Appeal (and not referred to by the Supreme Court).

It is also clear from the judgment that where a lengthy and complex document contains drafting *"infelicities"*, the argument that the clear and natural meaning of the words should prevail because the document was prepared by specialist and skilled lawyers will not necessarily carry any weight. In finding in favour of a construction in which the clear and natural meaning of the relevant words prevailed, the courts below had placed some weight on the fact that the STD was a *"… commercial document prepared by skilled and specialist lawyers for use in relation to sophisticated financial transactions"* (per Lloyd LJ) and that it was *"… a 45-page document reflecting the considered input of (probably) a team of commercial lawyers"* (per Rimer LJ). However Lord Mance considered that the document contained drafting *"infelicities"* (as acknowledged by the courts below), *"… which indicate, at the lowest, the importance of keeping an eye on and making sense of the overall picture"* (¶23).

Finally, it is also worth noting that, not surprisingly, no meaningful assistance was derived from the recent decisions in other SIV cases (*Re Cheyne Finance plc (in receivership) (No. 1)* [2007] EWHC (Ch) 2402 2*, Re Cheyne Finance plc (in receivership) (No. 2)* [2007] EWHC (Ch) 2402 and *Re Whistlejacket Capital Ltd (in receivership)* [2008] EWCA Civ 575) which, in Lord Justice Lloyd's words, involved the construction of documents containing provisions with *"… differences … more notable than the similarities"*.

What does this mean more generally for contractual construction going forward?

The Supreme Court's judgment does not contain any new principles of law, nor represent any departure from the principles of construction enunciated most recently in *Chartbrook*. Indeed Lord Walker, who was a member of the Appellate Committee of the House of Lords (as it then was) who granted permission to appeal, considered that on closer consideration the appeal raised no issue of general public importance - as already noted, there was no doubt about the principles of construction to be applied.

However *Sigma* continues the line adopted in *Chartbrook* of taking a liberal approach to contractual construction. In the words of Lord Hoffman in *Chartbrook, "There is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed"*. We should expect this to be continued. It also demonstrates the difficulties in practice of applying the principles of construction to the facts of a case with any certainty. The disputed sentence, when read alone, made sense as a matter of pure language but all of the judgments acknowledged that it was necessary to construe the language of the relevant provision in the context of the document as a whole. Yet, in doing so, wholly contrasting conclusions were reached. Of the nine judges who considered the *Sigma* case, four found in favour of the pay-as-you-go construction and five found against it. Indeed, in his judgment, Lord Justice Neuberger expressly stated that the fact that three judges for whom he had the highest respect had concluded in favour of the pay-as-you-go

construction caused him to reconsider his own conclusions – *"… in particular to wonder whether I have been persuaded by the commercial merits to adopt an interpretation which is simply not permissible as a matter of language …"* – but ultimately he remained of the view that the *pari passu* construction was the correct one.

Both Lord Mance and Lord Walker considered that it was right to attach importance to the fact that the parties cannot have contemplated that Sigma would not have had sufficient assets to meet its liabilities even to secured creditors, particularly not on the scale which in the event occurred. Yet both arrived at different, and contrary, conclusions. Lord Mance on the one hand considered that it was *"… improbable that commercial parties would contemplate that, after so important an occurrence as an Enforcement Event, priority would be conferred even to a modest extent and in the short-term on a particular group of creditors on the basis of the chance of their indebtedness falling due, or being capable of being made to fall due, during the Realisation Period"* (¶21). Ultimately he considered that there existed a *"clear basic scheme"*, which involved the creation of Short and Long Term pools each with sufficient nominal assets to meet the relevant pools' liabilities as and when they matured, with provision for pro-rating in the event of a shortfall*, "… from which it is improbable that the parties would have wished to depart"* and found in favour of a construction which was consistent with that scheme. Lord Walker on the other hand considered that the fact that the parties cannot have contemplated that there would have been insufficient assets to meet the secured liabilities meant that, *"The fact that the effect of the deed, in a situation which the parties never contemplated, may appear fortuitous or arbitrary does not therefore carry much weight"* and held that, *"It is not for the Court to make a new contract for experienced commercial operators advised by expert lawyers".* Lord Justice Rimer and Mr Justice Sales also considered that the *pari passu* construction involved a rewriting of the parties' contract.

Whilst the judges all seem to have recognised the need to find a construction which did not produce a wholly commercially unreasonable result, there was disagreement as to what constituted a commercially reasonable result. Mr Justice Sales accepted that the pay-as-you-go construction produced a regime for distribution of Sigma's assets which was *"adventitious"* and *"could be regarded as being in a certain sense as unfair"*. However, in his judgment, *"… neither of these features …'flouts business common sense'"* such as to justify a departure from the ordinary and natural meaning of the words of the relevant provision. Lord Justice Neuberger, on the other hand, considered that the pay-as-you-go construction *"… produces an outcome which would surprise (or more than surprise) reasonable people in the commercial world"* and therefore justified such a departure.

As demonstrated by the conflicting decisions on its journey through the courts, what *Sigma* does not seem to provide is any certainty as to the outcome. Perhaps this lack of certainty is accentuated in the context of the voluminous and complex documentation associated with SIVs, not to mention CDOs, ABCPs, and the other complex financial products with which lawyers continue, in the current climate, to grapple – those who have had to consider the meaning of specific provisions within these documents will know only to well the propensity for the documents to contain ambiguities, conflicting provisions, inapt definitions etc. There was a recognition by the Supreme Court and the majority below that the STD contained certain drafting *"infelicities"*. In Lord Justice Rimer's words, *"Documents such as the STD are prepared in many different ways. They often have provisions lifted (sometimes with bespoke amendments) from other documents; they often have different provisions drafted inserted or added to by different lawyers at different times; they often include last-minute amendments agreed in a hurry, frequently in the small hours of the morning after intensive negotiations, with a view to achieving finality rather than clarity…."*. Nevertheless, as *Chartbrook* well demonstrates, these issues of construction and lack of certainty as to outcome are by no means confined to documentation of this nature.

Perhaps the most practical advice can be derived from Lord Justice Neuberger's view (cited with approval by Lord Mance), that, *"Where the interpretation of a word or phrase is in dispute, the resolution of that dispute will normally involve something of an iterative process, namely checking each of the rival meanings against other provisions of the document and investigating its commercial consequences. … What one has to do when assessing each rival interpretation, is to ask whether the words at issue are capable of having the meaning contented for, but even that question cannot be judged free of documentary and commercial context. The more a particular interpretation, which*

accords well with the words in question judged on their own, produces a commercially improbable result and is hard to reconcile with other provisions in the document, the more ready the court will be to give the words another, perhaps linguistically more strained, interpretation, if that other interpretation complies with the other provisions and commercial reality".

Of course, the process described above is only relevant where it is possible to show that there has been some mistake in the language in the first place. It is not enough that the ordinary meaning of the words in question produces an unfavourable result for one of the parties. The High Court's judgment in *HHR Pascal B.V. v W2005 Puppet II B.V.* [2009] EWHC 2771 (Comm) delivered on 5 November 2009 contains a timely reminder that, *"A commercially sensible construction does not mean that the Court disregards express and clear terms in order to give effect to a conception of what might be fair or reasonable..."* (¶35(4)). However, in determining whether something has gone wrong with the language, the court is not confined to reading the document without regard to the relevant background or context. These must always be taken into consideration (see *Chartbrook*, ¶24) and the question of whether or not something has gone wrong will, therefore, in many cases lie at the heart of the debate. As Lord Hoffman observed in *Chartbrook*, *"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 ... the subtleties of language are such that no judicial guidelines or statements of principle can prevent it from sometimes happening."*

What is clear from the decisions in both *Sigma* and *Chartbrook* is that where the court is persuaded that the language permits competing constructions, a literal interpretation of the words alone will not of itself suffice. Each party must be prepared to persuade the court that the other side's construction produces a commercially unreasonable or irrational outcome and that, in contrast, a commercially reasonable outcome is produced by the construction for which they contend.

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