

# *Interpretation of contracts – liberalism re-affirmed*

## *Case Note*

On 29 October 2009 the Supreme Court delivered its second published judgment in *Sigma*, which turned on the construction of a contractual term. Endorsing the liberal approach, the case highlights the practical difficulties of applying construction principles to the facts of a case with any certainty. That said, it is clear that a literal interpretation of the words alone is not good enough - a party must 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 it contends.

*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. The issue was whether Sigma's secured Noteholders should be paid on a "pay-as-you-go" basis, as and when their Notes matured, or on a *pari passu* basis, regardless of the date of maturity of the Notes. Given the very large amounts owed to Noteholders (c.US\$6 billion) when compared to the very limited assets available to meet the liabilities under the Notes (c.US\$450 million), the difference in the financial outcomes for the holders of different Notes produced by the different constructions for which they contended was very significant. The case turned on the construction of a single sentence in the Security Trust Deed (the "STD") which, when read in isolation, indicated that a pay-as-you-go basis was appropriate.

### **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 Sigma's liabilities to the Noteholders on a pay-as-you-go basis. However Lord Justice Neuberger, dissenting in the Court of Appeal, found that the STD required the Security Trustee to discharge all the liabilities to the Noteholders 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 from 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.

*"...an iterative process involving 'checking each of the rival meanings against other provisions of the document and investigating its commercial consequences."*

Per Lord Mance

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.

## Key points from the judgment

- The Supreme Court's judgment does not contain any new principles of law; the relevant principles of contractual construction, most recently enunciated by the House of Lords in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UHKL 38 ("*Chartbrook*"), were not in doubt.
- Even where the disputed wording makes sense as a matter of language in isolation, it is necessary to construe the language of the relevant provision in the context of the other provisions of the document and the overall scheme of the document as a whole.
- Where the ordinary meaning of the words, when read in the context of the rest of the document, produces a result which the court considers the parties cannot have intended, the court will favour a construction which is consistent with the overall scheme of the parties' agreement.
- "*Lord Neuberger was right to observe that the resolution of an issue of interpretation in a case like the present is an iterative process involving 'checking each of the rival meanings against other provisions of the document and investigating its commercial consequences'*" – per Lord Mance (¶12).
- 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. The existence of such "*infelicities*" may instead indicate, "*...the importance of keeping an eye on and making sense of the overall picture*" (¶23).
- Security Trust Deeds and other documents which affect the rights of a large number of people, who are not directly a party, are to be distinguished from ordinary commercial contracts. When construing such documents, the wording is likely to be paramount, with extraneous material by way of "factual matrix" of very little, if any, relevance.

## Conclusion

*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. Whilst 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, completely 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.

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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