"So what! The contract just goes in the bottom drawer."

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Speed read

In-house lawyers have heard that so many times, as have we. It's a perennial problem. But scores of times, as specialists also in handling disputes when contracts go feral, we've found that the contract terms end up being critical.

We lawyers say this, but it can be hard to get the message across, as project managers and others focus on getting the job out the door, cutting time and cost of legal involvement. The "bottom drawer" is the sort of thing that keeps on getting raised. The in-house lawyers, and those external, end up being negatively tarred with the gold plated brush. It's an awkward space for lawyers.

Here's two new salutary cases where messed up drafting - which could happen to anyone who doesn't take care - almost cost a supplier a fortune, and did cost lessees a fortune. One's a simple contract: the other is complex. Both are the sort of problem we've seen numerous times.

The cases are also useful summaries of modern contract interpretation principles, including how business common sense can be utilised to resolve ambiguity. But, more importantly here, where it can't, leading to terrible outcomes for some parties.

These are 2015 examples, to add to cases such as the NZ Supreme Court decision of *Vector Gas v Bay of Plenty Energy,*[1] also an example of a messed up contract, where huge sums were at stake, and of contract interpretation principles.

The Detail

A warranty, good industry practice, or both?

So, here's our first example, about a supplier that designed and built wind farm turbine foundations.

Like many good ICT and construction contracts, the supplier had a contractual obligation to comply with good industry practice and with international standards. It did, and therefore wasn't negligent. Trouble is, the relevant standard had an error and so the foundations wouldn't last for the intended 20 years.

So far so good for the supplier, as it had met the standard and good industry practice. However, in a messy contract, there was also wording by which it could be argued that the supplier contractually committed to provide foundations that worked for twenty years.

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As the English Court of Appeal said:[2]

> *"The court is confronted in this case with contractual documents of multiple authorship, which contain much loose wording. The task of the court is to identify the precise extent of the obligations imposed upon [the supplier]. Ultimately the court must decide which party should pay the bill [of 20 million Euro] for repairing foundation defects in a situation where, (on the judge's findings) there has been no negligence or want of professional skill on either side."*

The trial judge said that the supplier did warrant the foundations would last 20 years. It had to shell out the damages of 20 million euro.

The Court of Appeal reversed this, after interpreting the relevant contract term in context. It was a tortuous and risky path to get to that conclusion. All avoidable.

Supply contracts, as the Court of Appeal said, can *"require the contractor (a) to comply with particular specifications and standards and (b) to achieve a particular result. Such a contract, if worded with sufficient clarity, may impose a double obligation upon the contractor."* The question was whether the words here did this.

Part of the way the courts interpret contracts, applying the *Investors Compensation* line of cases,[3] is to take:[4]

> *"an iterative process. It involves checking each of the rival meanings against the other provisions of the document and investigating its commercial consequences.... In complex documents of the kind in issue there are bound to be ambiguities, infelicities and inconsistencies. An over-literal interpretation of one provision without regard to the whole may distort or frustrate the commercial purpose. .....If there are two possible interpretations of a provision, the court is entitled to prefer the construction which is consistent with business common sense."*

Without going into the fact- specific detail, the supplier got out of jail and the 20 year commitment was read down so that it wasn't a warranty.

To the second case

25 people bought modest chalets in a leisure park on a 99 year lease, with a service charge renewable annually. Here's an example of the clause for calculating the service charge:

> *"To pay the Lessor without any deduction in addition to the said rent a proportionate part of the expenses and outgoings incurred by the Lessor in the repair maintenance renewal and provision of services hereinafter set out the yearly sum of Ninety Pounds and value added tax for [the first three years OR the first year] of the term hereby granted increasing thereafter by Ten Pounds per Hundred for every subsequent year or part thereof."*

Read literally, this is an increase of the service charge at the rate 10% compounding annually, meaning that the starting service charge of £90 per annum becomes £550,000 per annum in 2072!

The UK Supreme Court confirmed that the literal approach should be taken when the contracts are interpreted, so the eye-watering charges applied.[5] In short, the words are clear, there is no ambiguity (enabling a common sense approach to choose between options),

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and the court would not re-write what the parties had expressly agreed, however far-fetched this might appear to be with the benefit of hindsight.

The Supreme Court decision is valuable as it has a good summary of the approach the courts take to interpreting contracts, starting with addressing *"what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean".*[6]

The key point is that the courts won't usually intervene in the case, to interpret applying business common sense, when the words are clear. The court won't play God. As the majority judgment said:[7]

> *"...while commercial common sense is a very important factor to take into account when interpreting a contract, a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed, even ignoring the benefit of wisdom of hindsight. The purpose of interpretation is to identify what the parties have agreed, not what the court thinks that they should have agreed. Experience shows that it is by no means unknown for people to enter into arrangements which are ill-advised, even ignoring the benefit of wisdom of hindsight, and it is not the function of a court when interpreting an agreement to relieve a party from the consequences of his imprudence or poor advice. Accordingly, when interpreting a contract a judge should avoid re-writing it in an attempt to assist an unwise party or to penalise an astute party."*

1. *Vector Gas v Bay of Plenty Energy* [2010] NZSC 5; [2010] 2 NZLR 444.

2. *MT Hojgaard v E.On Climate* [2015] EWCA Civ 407.

3. [2010] NZSC 5; [2010] 2 NZLR 444.

4. *MT Hojgaard* at [83] and [84] citing *Re Sigma* [2010] 1 All ER 571 and *Rainy Sky v Kookmin* [2011] 1 WLR 2900.

5. *Arnold v Britton* [2015] UKSC 36 902.

6. *Arnold v Britton* at [15] quoting *Chartbrook v Persimmon*, one of the leading House of Lords cases.

7. At [20].

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