Commercial common sense in contractual interpretation

CASE COMMENT

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Commercial Common Sense in Contractual Interpretation: Further Views from the Inner House

In recent years there have been a number of cases in both Scotland and England where the use of commercial common sense in interpreting commercial contracts has been discussed.[1] *Hoe International Ltd v Andersen and Another*[2] is the latest offering by the Inner House on the issue. In this case the court made some controversial comments on the use of commercial common sense in interpreting commercial contracts.

A THE FACTS

The defenders had sold a company, Speyside Distillers Co Ltd, to Hoe. A claim was made against Speyside by another company, Chalmers, which appeared to be in breach of a warranty given by the defenders in terms of the share purchase agreement (SPA) providing for the sale of Speyside. Following intimation of the claim against Speyside, Hoe issued a notice to the defenders purporting to intimate a breach of warranty. The SPA made provision for such notice. The issue for the court was whether the notice sent by Hoe was valid in terms of the SPA to intimate the breach of warranty.

The defenders took issue with (i) the content of the notice and (ii) the way in which it was served. The SPA provided that

> the [defenders] are not liable for a claim… unless [Hoe] has given the [defenders] notice in writing of such claim…, giving reasonable details of all material aspects of such claim… known to [Hoe], including [Hoe's] bona fide estimate of the amount thereof and detailing [Hoe's] calculation of the loss alleged to have been suffered by it.[3]

The SPA further provided that Hoe was to notify the defenders in writing as soon as reasonably practicable of any claim.[4] Notices were to be delivered personally or sent by pre-paid first class post or recorded delivery. Notices were to be sent to the defenders' solicitors, marked for the attention of MH.[5]

The notice sent by Hoe stated that it constituted notice as required by the SPA. The notice enclosed a copy of the correspondence that had been received from Chalmers'

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[1] See for instance *Grove Investments Ltd v Cape Building Products Ltd* [2014] CSIH 43; 2014 Hous LR 35 and *@SIPP Pension Trustees Ltd v Insight Travel Services Ltd* [2015] CSIH 91; 2016 SC 243 in Scotland. For English developments see *Arnold v Britton* [2015] UKSC 36; [2015] AC 1619; and *Wood v Sureterm Direct Ltd* [2017] UKSC 24; [2017] 2 WLR 1095.

[2] [2017] CSIH 9; 2017 G.W.D. 6-83.

[3] Para [7].

[4] *Ibid*.

[5] Para [8].

solicitors and the enclosures that had been sent with that correspondence. The notice was sent by DX, marked for the attention of SC.[6]

B COMMERCIAL COMMON SENSE IN THE INTERPRETIVE EXERCISE

In order to determine whether the notice was valid the court had to interpret the SPA, which contained the notice provisions. The bench comprised Lord Drummond Young, Lord Menzies and Lord Malcolm, with Lord Drummond Young delivering the opinion of the court. He noted that the Lord Ordinary had treated as definitive the principles of contractual interpretation summarised by Lord Neuberger in *Arnold v Britton*.[7] That, in the Inner House's view, was an oversimplification of what was said in *Arnold.* Lord Drummond Young noted that the discussion in *Arnold* was not about the general principles that applied to commercial interpretation but a discussion of particular elements that were relevant to the problem before the court in that case, which was an unusual case.[8] Indeed, *Arnold* represented an example, perhaps rare, of a clause which had "true mathematical uncertainty".[9] The Inner House were of the view that Lord Neuberger's comments in *Arnold* were directed towards the relatively extreme case where it is argued that rewriting of a clause is required and not with the ordinary case of construction of a clause containing a degree of ambiguity. The court opined that for the proper approach to ordinary cases of contractual interpretation regard should be had to the factors identified by Lord Hodge in *Arnold* and to Lord Clarke in *Rainy Sky v Kookmin Bank.*[10] This approach could be summed up in the passage from Lord Clarke, which had been cited by Lord Hodge in *Arnold,*

> It is not necessary to conclude that, unless the most natural meaning of the word produces a result so extreme as to suggest that it was unintended, the court must give effect to that meaning.
>
> The language used by the parties will often have more than one potential meaning. I would accept… that the exercise of construction is essentially one unitary exercise of 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.[11]

The Inner House went on to note that if courts adopted an over-strict and over-literal approach to interpretation the result would be much longer contracts, incorporating a large number of terms to deal with what were, realistically, unlikely scenarios. By

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[6] Paras [9]-[12].
[7] *Supra* n 1.
[8] Paras [18] and [20]. For a discussion of *Arnold* see R C Connal "Has the rainy sky dried up? *Arnold v Britton* and commercial interpretation", 2016 Edin LR 20(1), 71.
[9] Para [20].
[10] [2011] UKSC 50; [2011] 1 WLR 2900.
[11] *Rainy Sky* at para [20-21], cited in para [22] of *Hoe.*

contrast, if a contextual and purposive construction and commercial common sense were given proper weight contracts would be shorter and could focus more precisely on the important features of the parties' transaction. The court noted that it might be argued that such an approach would result in more protracted and expensive litigation when a dispute arose, but countered this by pointing out that disputes were the exception. Indeed, any increase in the cost of litigation would be significantly smaller than the increase in transaction costs of long and protracted contract drafting of all commercial contracts.[12]

The court went on to state that evidence about commercial context would not be required in every case. With the common forms of contract it could be expected that the commercial context would be comfortably within judicial knowledge. If there were special or unusual features to the context, notice of those could be given in the parties' pleadings to discover how much of the background was disputed. This would, said the court, go a long way to dealing with lengthy proofs. Furthermore, relying on courts to adopt a sensible commercial interpretation would lead to greater predictability as contracts would be construed according to the standards of a reasonable commercial person.[13]

C THE VALIDITY OF THE NOTICE

In determining whether the content of the notice was sufficient (issue (i)) the court drew on the reasonable recipient test set out in *Mannai Investment Co Ltd v Eagle Star Life Assurance.*[14] The court noted that the purpose of a contractual notice was relevant to interpreting the notice and its validity. In *Hoe* the purpose of the notice was to give the defenders sufficient information to determine whether they wished to take over the defence of Chalmers' claim.[15] The court found that the notice sent by Hoe contained sufficient detail. In providing a copy of the letter of claim against Speyside and the enclosures, Hoe were providing all of the information they had about the claim at the time of sending the notice. While the SPA required a *bona fide* estimate of the claim to be provided the court found that all Hoe could do was pass on the claim against Speyside taking it at face value, until such time as further, and possibly prolonged, investigations could be carried out.[16] This was especially the case given that the SPA required notice to be given as soon as reasonably practicable.[17]

In relation to service (issue (ii)) two distinct purposes were potentially relevant: (1) the purpose of the notice itself; and (2) the purpose of any particular contractual requirement that had not been met.[18] The court opined that it could, in general, be said that the more drastic the consequences of a notice the greater the need for strict compliance with what was prescribed in the contract. The notice in *Hoe*, of a breach of a warranty in an SPA, was at the less drastic end of the scale, such that there was no overwhelming need for rigid formality.[19] The purpose of the notice was to give the

[12] Paras [24] – [25].
[13] Paras [25] – [26].
[14] [1997] AC 749.
[15] Para [47].
[16] Paras [48] – [52].
[17] Para [48].
[18] Para [34].
[19] *Ibid.*

defenders the opportunity to deal with the defence of the claim against Speyside. It was, said the court, of the utmost importance that any notice should arrive in the hands of someone with authority to act. Provided the notice arrived in the hands of such a person other requirements may not be important, especially if they were of an essentially formal nature.[20] The court considered that the fundamental question was perhaps: if a particular formal requirement is not complied with is the would-be recipient prejudiced in a practical sense? If not, the court should be slow to hold that failure to comply with a formal requirement was fatal.[21] The court went on to note that such an approach would also apply where the purpose of the notice was drastic, such as where the court was asked to determine the validity of a break notice in respect of a lease.[22] If there was no prejudice, insisting on strict compliance for its own sake served no useful purpose.[23] The fact that the notice in *Hoe* was marked for the attention of the wrong person and was sent by DX did not prevent the notice from being valid.[24]

D CONCLUSIONS

This case is important in relation to the law regarding contractual notices, as well as interpretation of commercial contracts more generally. In relation to notices, the case suggests a degree of latitude in strict adherence to the terms of the contract in relation to service[25] provided the recipient does not suffer prejudice from a practical perspective. While the issue was different[26] in *West Dunbartonshire Council v William Thompson & Son (Dumbarton) Ltd,*[27] with the notice being addressed to the wrong tenant company, the fact that it was received and opened by a director of the correct tenant company was said to be "nothing to the point".[28] It might be said that these cases are inconsistent with each other. Another view, which was the view of the court in *Hoe,* is that the matter is one of degree. If there are sufficiently serious failings in the form requirements of the notice it will be invalid, even where it gets to the correct recipient. Less serious failings, such as service by a different method to that required by the contract, will not affect the validity of the notice provided it reaches the intended recipient, who suffers no real prejudice as a result.

While one may have sympathy with the law allowing room for argument regarding form requirements where the intended recipient receives the notice[29] and it seems

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[20] Para [35].
[21] *Ibid.*
[22] *Ibid*. Such notices allow one of the parties, usually the tenant to bring the lease to a premature end. This comment seems to contradict the discussion in *Hoe* that the more drastic the consequences of the notice the greater the need for strict compliance with what is prescribed in the contract.
[23] Para [35].
[24] Paras [53] – [56].
[25] There is Scottish authority for taking such a view – referred to in paras [37]-[42]. There is also authority the other way, advocating strict compliance with the requirements of the contract. The position is similar in England where there have been cases going either way – see paras [43] – [44].
[26] As pointed out by the Inner House in *Hoe* as a reason for distinguishing the case: see para [42].
[27] [2015] CSIH 93; 2016 SLT 125.
[28] *Ibid* at [31].
[29] Particularly in a case such as *West Dunbartonshire Council* where the landlord was seeking to increase the rent from £210 per annum to £13,800 per annum on a lease that had

that he is seeking to free himself from the consequences of the notice on a technicality, it is suggested that such as approach leaves room for doubt about what is a sufficiently serious failing. Certainty is of paramount importance in commercial matters. Taking a stricter approach on the issue of validity may result in some decisions that seem unfair on their facts, but which has the benefit of certainty, in knowing that to be valid a notice must comply with the terms of the contract. This is especially the case when it is generally not difficult to consult the contract and comply with the notice requirements. It is suggested that the approach adopted by the Inner House in *Hoe* is likely to lead to more disputes over the validity of notices, in situations where it is beneficial that parties are clear on whether they have or have not validly exercised a right under a contract.

What is striking in relation to interpretation is the approach taken by the Inner House to *Arnold* in order to continue to be able to make significant use of commercial common sense in the interpretive exercise. Many Scottish cases since the decision in *Arnold* have made reference to it, and to Lord Neuberger's comments in particular on the importance of the language the parties used in their contract and a more limited role for commercial common sense, as a summary of the law on contract interpretation.[30] It was not considered to be limited to its unusual facts by other courts, including the Inner House.[31] In this case, the Inner House rears against this understanding of that case. Lord Drummond Young appears to be very intent on courts being able to make use of commercial common sense. [32] Not only that, but he has confidence that judges are able to judge what is commercially sensible, often without evidence on the matter, with the commercial context of common contracts being said to be within judicial knowledge. While judges, particularly in the commercial court, may have a good feel for what is happening in the market and in particular industries, it must be seriously doubted that this is the case for all judges. It seems farfetched to say that a sheriff, often spending significant amounts of time hearing family and criminal matters, is up to speed with the commercial context of common commercial contracts. Indeed, judges are four steps removed from commercial men and women. Commercial clients instruct solicitors. If there is a dispute counsel will often be instructed with the case heard by the judge. One wonders how many judges, so far removed from commercial activities, will feel comfortable with the professed extent of their judicial knowledge.

Finally, it is suggested that the use of commercial common sense is not likely to lead to a reduction in costs for contracting parties. On the contrary, using commercial common sense, to such an extent in the interpretive exercise, is likely to result in more disputes as to the meaning of a contractual provision, with the consequent costs involved in cases ultimately having to be determined by the court. Furthermore, the

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been in place since 1971 and would, as a result of the decision, run until 2031 at a rent of £210 per annum.

[30] See for instance the Lord Ordinary's approach in *Hoe* [2016] CSOH 33; 2016 G.W.D. 7-142; *@SIPP, supra* n 1*; Gyle Shopping Centre General Partners Ltd v Marks & Spencer plc* [2016] CSIH 19; 2016 GWD 10-205; *AWG Business Centres Ltd v Regus Caledonia Ltd and Cheshire West and Chester Council* [2017] CSIH 22; 2016 GWD 9-131; and *Hill v Stewart Milne Group Ltd and Anr* [2016] CSIH 35; 2017 SCLR 92.

[31] *Ibid.*

[32] As well as Lord Drummond Young's comments in *Hoe* see his comments in *Grove, supra* n 1. Grove has been criticised: see the comments in *@SIPP, supra* n 1 and also L Macgregor, "Crossing the Line between Business Common Sense and Perceived Fairness in Contractual Interpretation", Edin LR 2015 19(3) 378.

Scottish judiciary seem at odds as to what is commercially sensible. In *Grove Investments Ltd v Cape Building Products Ltd*[33] the Inner House held that the common law could serve as a benchmark as to what was commercially sensible, with the court characterising contracts as co-operative enterprises, entered into by the parties for their mutual benefit, so that they should be interpreted in such a way that there is no windfall gain or disproportionate loss for either of the parties. Yet, in *@SIPP Pension Trustees Ltd v Insight Travel Services Ltd*[34] a differently constituted bench of the Inner House noted that commercial contracts did not have to be fair and were often hard fought, with each party seeking to achieve their own objective.

Given the approach of the Inner House to the decision of *Arnold, Hoe* creates doubt as to when the court can have regard to commercial common sense and the importance to be given to the words used in the contract.[35] There is the further problem that there is no clear understanding of commercial common sense among the Inner House. This presents those tasked with advising clients on how a court is likely to interpret a contract with an unenviable task.

[33] *Supra* n 1.
[34] *Supra* n 1.
[35] Although some assistance may be derived from the recent Supreme Court decision of *Wood v Capita Insurance Services Ltd, supra* n 1.