MODERN CONSTRUCTION OF COMMERCIAL DOCUMENTS INCLUDING INSURANCE POLICIES

By William Allison

Lord Hoffmann's controversial judgment in *Investors Compensation Scheme Ltd -v- West Bromwich Building Society [1998] 1 WLR 896*, which was recently applied in the Commercial Court case of *Kingscroft Insurance Company Limited & Others -v- The Nissan Fire & Marine Insurance Company Limited (July 1999)* by Mr Justice Moore-Bick, demonstrates the departure by the Courts from the traditional literal approach to the construction of commercial agreements to a more common sense and commercial approach. The background circumstances to a commercial agreement will now be considered in all cases, even where the meaning of the words may appear clear and unambiguous. In some instances, this may result in the Court imposing upon the words of a contract a meaning which is significantly different from the natural and ordinary meaning, so as to achieve a commercial outcome.

It should be noted, however, that in some instances, disputes may still arise where the meaning of the document appears on the face of it perfectly clear. Whilst it is true to say that the clearer the language the parties use in their contracts, the less easy it will be for the Courts to be persuaded that the parties intended it to bear something other than its natural meaning, it may, of course, be the case that the parties have used a word in a private or unusual sense.

The traditional approach to construction adopted by the Courts, as represented in the judgments of Lord Wilberforce in *Prenn -v- Simmonds [1971] 1 WLR 1381* and *Reardon Smith Line Ltd -v- Yngvar Hansen-Tangen [1976] 1 WLR 989*, was to identify the intention of the parties from the document itself. If the words were clear then they would be given their usual and ordinary meaning. Only where there was ambiguity would the Courts look into the factual background of the document (what Lord Wilberforce called the "factual matrix") to determine the proper construction.

We have, however, in recent years, seen a departure by the Courts from a strict literal approach to construction, to a more commercial, but perhaps less certain approach. The case of *Charter Re -v- Fagan [1996] 2 LLR 113* provides a good illustration of how far the Courts are prepared to go in construing the meaning of a contract. The Court was asked in that case to consider the meaning of the words *"actually paid"* in an Ultimate Net Loss clause in a reinsurance contract. Lord Mustill whilst accepting that at first sight the words *"actually paid"* meant that the Reinsurer would have to suffer some *"financial detriment by the transfer of funds"* to the original insured before being able to make a claim under the reinsurance contract, in fact gave the words a wholly different meaning. He concluded that *"actually"* meant *"in the event when finally ascertained"* and *"paid"* meant *"exposed to liability as a result of the loss insured"*. *Lord Mustill accepted that these meanings were far from the ordinary meanings of these* words, but that in the context of this specialised

reinsurance contract the meanings were correct. Whereas the starting point adopted by Lord Mustill was to give the words in a contract their natural meaning, unless the surrounding circumstances dictated otherwise, Lord Hoffmann, in reaching the same verdict, adopted a more liberal approach. He did not start with any preconceptions of what words and phrases should mean and then try to determine whether these should be displaced by context, he rather he approached their meaning in the context of the overall picture. In his judgment he stated:

> *"The notion of words having a natural meaning is not a very helpful one. 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 the statement that words have a particular 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".*

Lord Hoffmann appears to have assumed the role of leading reformer in the field of commercial contract interpretation. In the House of Lords decision in *Investors Compensation Scheme Ltd -v- West Bromwich Building Society and Others [1998] 1 WLR* he controversially re-stated the principles of construction which now govern the interpretation of documents today. He held that the following should be taken into account to determine the proper meaning of a word/document:

(i) Interpretation is the ascertainment of the meaning which a document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties at the time of the contract;

(ii) the background includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man, subject to the requirement that it should reasonably have been available to the parties;

(iii) previous negotiations of the parties and their declarations of subjective intent are inadmissible;

(iv) the meaning which a document would convey to a reasonable man is not the same thing as the meaning of the word; the meaning of the document is what the parties using those words would reasonably have understood them to mean;

(v) whilst applying the rule that words should be given their *"natural and ordinary meaning"*, a Court must accept that in some instances, something must have gone wrong with the language, but should not attribute to the parties an intention which they plainly could not have had.

This approach is not, however, without its critics. Although the majority of the House of Lords agreed with Lord Hoffmann, Lord Lloyd dissented. In agreeing with the approach adopted by the Court of Appeal, he stated:

> *"It is ... from the words used that one must ascertain what the parties meant. Purposive interpretation of a contract is a useful tool where the purpose can be identified with reasonable certainty. But creative interpretation is another thing altogether. The one must not be allowed to shade into the other."*

Judicial reservation as to Lord Hoffmann's approach has also been raised in two Court of Appeal cases following the decision. In *National Bank of Sharjah -v- Delborg (Court of Appeal, unreported, July 1997)*, Saville LJ and Judge LJ expressed concern that in interpreting the meaning of a commercial contract, "absolutely everything" (save for the express exception) should be taken into account in every case and that the surrounding circumstances should be permitted to alter the meaning of words, which on the face of it have an unambiguous and sensible meaning as a matter of ordinary language. These sentiments were echoed by Staughton LJ in *Scottish Power Plc -v- Britoil (Exploration) Ltd (1997)*.

Notwithstanding the apparent weight of judicial opposition from the lower Courts (and one Law Lord), the House of Lords have not had the opportunity to reconsider this issue and accordingly, the principles of construction restated by Lord Hoffmann remain law. They have very recently been applied by Mr Justice Moore-Bick in the Commercial Court in the case of *Kingscroft Insurance Company Ltd and Others -v- The Nissan Fire & Marine Insurance Company Ltd, (unreported 4 August 1999)*. In this case, Mr Justice Moore-Bick was asked to determine the proper construction of two quota share treaties agreed between the Claimants and the Defendant.

The Claimants were members of a pool of insurance companies for whom H S Weavers (Underwriting) Agencies Ltd acted as underwriting agents in the London market between 1963 and 1990. The Weavers pool was made up of two types of company: first the "Stamp Companies" on whose behalf Weavers issued policies and incurred liabilities direct to third parties and second the other companies who were not authorised to carry on insurance business in the UK, who entered into a Whole Account Quota Share reinsurance treaty with the Stamp Companies, which they executed at their principal place of business in their countries of incorporation.

In 1975, Nissan, together with a number of other Reinsurers, was invited to participate in two Facility Quota Share treaties, under which the Weavers pool agreed to cede to the Reinsurers a proportion of its excess of loss business. The dispute before Mr Justice Moore-Bick concerned Nissan's liabilities under these treaties. Nissan claimed it was entitled to avoid the treaties for non-disclosure and misrepresentation. In the alternative, it claimed that the treaties only covered the

liabilities of the Stamp Companies and not the Whole Account Quota Share Reinsurers. The claimants argued the contrary.

The preamble to the Facility Quota Share treaties stated as follows:-

> *"This Agreement made and entered into by and between Walbrook Insurance Company Ltd and other Companies underwritten by H S Weavers (Underwriting) Agencies Ltd, London, England (hereinafter called the "Reinsured") and various insurance companies (subscribing to Schedule "A" attached hereto) (hereinafter called the "Reinsurers").*
>
> *It is understood that the Reinsured issues policies, contracts ..."*

Nissan maintained that the Whole Account Quota Share Reinsurers were not included within the phrase "Companies underwritten by H S Weavers (Underwriting) Agencies Ltd" and therefore were not parties to the treaties. In support of this position, Nissan referred to the fact that the preamble included the words:"... *the Reinsured issues policies* ...". Nissan argued that since the Whole Account Reinsurers did not issue policies, they could not be included as a "*Reinsured*".

Mr Justice Moore-Bick recognised that, whilst the Courts have been prepared to construe the meaning of words which may not obviously be their natural and ordinary meaning, a Court should not be too ready to accept the suggestion that the language chosen by the parties was not intended to bear its natural and ordinary meaning. He noted the criticisms raised by Saville LJ and Judge LJ in the Court of Appeal decision in *National Bank of Sharjah -v- Delborg*. At the same time, however, he accepted that the parties may have intended a meaning quite different from the natural and ordinary meaning of those words. He reiterated that Lord Hoffmann had set out a summary of the principles by which the Court should approach the construction of contractual documents in general and was not confining his remarks to cases where ambiguities or uncertainties are apparent from the document itself.

Mr Justice Moore-Bick applied the above principles to the construction of the Facility Quota Share treaties and determined that the correct approach to adopt was to find a meaning which properly reflected the object which both parties had in mind and the commercial context in which they were made. In determining the construction of the treaties, Mr Justice Moore-Bick followed the criteria set out by Lord Hoffmann. He accepted that strictly speaking, Weavers did not underwrite on behalf of the Whole Account Quota Share Reinsurers, since there were no Underwriting agency agreements in place. He was impressed, however, by the evidence of many of the witnesses that, in a commercial context, the expression *"companies underwritten [for] by Weavers"* is used in a much wider sense. Taking this into account, he concluded that the expression was to be construed as including the Whole Account Quota Share Reinsurers, as well as the Stamp Companies. Mr Justice Moore-Bick

held that it was possible to reach this determination *"without doing any violence"* to the language which the parties had chosen to use, notwithstanding that they should have worded the contracts more carefully. In reaching this conclusion, although he considered the background to the treaties, he did not take account of any knowledge which Nissan itself may have had on the structure of the Weavers pool which was not shared by the market as a whole. Given the subjective nature of this information, it could not properly be considered when determining issues of construction. Leave to appeal has been granted and so it seems likely that the Court of Appeal will have another opportunity to review Lord Hoffmann's principles of construction.

It is clear from the approach adopted by the Court in the *Weavers* case and other cases, that it is now more important than ever for lawyers advising in connection with the construction of a contract, to have a full background knowledge of the circumstances surrounding that contract, which would have been originally known to the parties. It is not possible to advise correctly in the absence of such information, since the Courts will depart from the ordinary meaning and natural meaning of wordings, where the circumstances surrounding the document warrant such an interpretation.

Whilst these principles of construction are likely to result in a more common sense and commercial approach to construction, they may, at the same time, by their very nature, cause some confusion; it may no longer be possible for any party to state with absolute certainty that he knows the meaning of the contract he has entered into. There are no fixed guidelines as to when the Court should depart from the ordinary meaning of the words used in the contract. Clearly, if the agreement makes no commercial sense, the Court should impose a different meaning, but this will leave parties in the hands of the Court to determine the commerciality of their contract. In addition, whilst the background circumstances may demonstrate that the ordinary meaning of the words of an agreement could not have been intended by the parties, at the same time it may allow a party who has made a bad commercial bargain to challenge the proper interpretation of an agreement. It is clearly not the role of the Courts to alter the bargaining position of the parties by way of construction.

It seems inevitable that this approach will result in more disputes coming before the Courts; this in turn will lead to increased costs and delays. Notwithstanding this, it is hoped that the move towards a more commercial approach to construction will avoid interpretations of agreements which offend business efficacy. How and whether the principles of construction will develop from here, however, remains to be seen, but whatever happens, it seems unlikely that this issue will simply disappear.

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