

### Commercial Contracts: The Uncertainty of Construction

Although disputes between contracting parties about the meaning of their documents have always been common, such disputes have been particularly prominent of late in the context of complex debt restructurings.

The modern approach to contractual interpretation is derived from the speeches of the recently retired Lord Hoffmann in the *Investors Compensation Scheme* (1998) and *Chartbrook v Persimmon* (2009) cases. In summary, a Court's task when faced with a dispute over the meaning of a contractual provision is to decide what the "reasonable person", having all the background knowledge available to the parties, would have understood the words to mean at the time the contract was entered into.

Although the negotiating history and the parties' subjective intentions in entering into the contract will not be relevant, the background knowledge which the Court can impute to the reasonable person can include "*absolutely anything*" affecting the way the language would have been understood. Crucially, the Court's task in giving effect to the contract under the modern approach is also not limited by the literal meaning of the words used. Accordingly, if the factual background against which the parties contracted would lead the reasonable person to conclude that "*something must have gone wrong with the language*", the Court is not required to give effect to the literal meaning, and "*there is [no]... limit to the amount of red-ink or verbal rearrangement or correction which the court is allowed*". Instead, the Court will have regard to the commercial purpose of the contract and give effect to the meaning which best furthers that purpose.

The implications of the modern approach for creditors with divergent interests in complex debt structures are clear. According to Lord Neuberger, contractual interpretation is now an "*iterative process*" which requires "*checking each of the rival meanings against other provisions of the document and investigating [their] commercial consequences*". So long as an argument for a particular interpretation of the relevant contract can be made in good faith based on the background material or the commercial purpose, a party is therefore legitimately entitled to raise that argument and the court will be required to decide between the alternatives, even if the literal meaning of the contract is clear and, on its face, unambiguous.

Three recent cases in which Quinn Emanuel have been involved provide particularly good examples of the impact that these principles may have in distressed situations.

- *Sigma Finance (2009)*: Sigma was an insolvent structured investment vehicle ("**SIV**") which issued short term commercial paper and invested the proceeds in asset backed securities of different maturities. Receivers were appointed to realise and distribute Sigma's assets in accordance with the trust deed. The trust deed provided for a 60-day Realisation Period during which the SIV's assets were to be pooled to meet liabilities falling due during and after that period. Given the collapse in the value of the assets backing the structure, however, the effect of this provision was to give debts which fell due for repayment during the Realisation Period priority over longer-dated debts. According to the High Court and the Court of Appeal, the meaning of the trust deed was clear and the Receivers were obliged to give priority to the shorter-dated debt, leaving the creditors who held longer-dated debt with nothing. However, applying the modern approach, the Supreme Court overturned the lower courts' decisions and held that the Receivers were obliged to distribute Sigma's assets amongst all creditors on a *pari passu* basis.

- *Cattles v Welcome Financial Services (2010)*: Cattles ("**C**") borrowed money from the Royal Bank of Scotland ("**RBS**") on the security of a group cross-guarantee and indemnity before on-lending it to its subsidiaries, including Welcome ("**W**"). C owed RBS £2.6 bn, W owed C £2.9 bn and C was liable to RBS for W's debts. On a narrow construction of the

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guarantee, it was arguable that W's debts to C could be paid before RBS's, in which case RBS's realisations from the group's estate would have been reduced. However, according to the High Court and the Court of Appeal, the modern approach required the guarantee to be given a broad construction because its commercial purpose was "*obviously to increase the bank's realisations*".

- *European Directories (2010)*: The European Directories group borrowed money under a €1.5 bn senior facilities agreement. In return, the lenders took guarantees and security from various group companies. A restructuring was proposed pursuant to which the group holding company, DH7, would be placed into administration and DH7's shares in its Subsidiaries would be sold to a new company. In order to complete the restructuring, the administrators would need to transfer the liabilities of the Subsidiaries. They would also need to release the guarantees and security granted by DH7 and its Subsidiaries using a release on disposals clause, but on a narrow construction that clause only permitted the administrators to release DH7's liabilities, not the Subsidiaries'. According to the High Court, the clause only extended to DH7; the purpose of the clause had to be determined from its wording and its scope "*should not be enlarged beyond the ambit of the clause itself*" so as to apply to the Subsidiaries by reference to a priori notions of commerciality. However, according to the Court of Appeal, the clause had to be construed broadly with the result that the administrators' powers extended to the Subsidiaries as well. This was because the commercial purpose of the clause was to maximise the value of the disposal, and in circumstances where a clause was capable of two meanings and neither flouted business common sense, the court should adopt the more commercial construction.

In response to these decisions, many commentators have noted that whilst the lower courts have tended to favour literal constructions and to define purpose narrowly, the higher courts are far more willing to construe documents liberally and will not hesitate to overrule even the most closely reasoned decision where they disagree with the lower courts' views. As a result, there are significant tensions in the case law as to the proper role of commercial purpose in giving effect to a contract, and the true commercial purpose of a given contractual provision may also be highly contentious. In many cases, however, our experience suggests that these difficulties will provide opportunities for creditors with different incentives and conceptions of commercial purpose to challenge majority-led restructurings by advancing rival interpretations of contestable contractual provisions. They also mean that the higher courts will tend to grant permission to appeal more readily than in other types of case, with the result that the commercial backdrop against which the parties might attempt to settle a case is more fluid and unpredictable than it would ordinarily be.