

## Interpreting contracts after *Firm PI 1 Ltd v Zurich Australasian Insurance*

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*In Firm PI 1 Limited v Zurich Australasian Insurance Limited t/a Zurich New Zealand & Anor* [2014] NZSC 147, a majority of the Supreme Court has affirmed the importance of an objective approach to interpretation, and of the need for caution before departing from the natural meaning of contractual language on grounds of “commercial absurdity”.

### The objective approach to contract interpretation

In determining what a contract means, the contract is taken to be an objective record of the parties’ intentions. It is not, however, the Court’s task to decide what those parties *actually* intended but what a reasonable person would take them to have intended in all the circumstances at the time of the contract.

As Lord Wilberforce said in *Reardon Smith Line Ltd v Hansen-Tangen* (*The “Diana Prosperity”*) [1976] 1 WLR 989, 996:

*“When one speaks of the intention of the parties to the contract, one is speaking objectively ... and what must be ascertained is what is to be taken as the intention which reasonable people would have had if placed in the situation of the parties.”*

### Firm PI 1 Ltd – issue and decision

By majority, the Supreme Court dismissed an appeal against a decision of the Court of Appeal finding that insurance for the replacement value of an apartment complex to a limit of \$12.95m was inclusive rather than

exclusive of statutory insurance under the Earthquake Commission Act 1993.

The appeal turned on the particular contract of insurance, which was concluded in July 2009 by the Body Corporate of the complex through its brokers, ACM (now called Firm PI 1 Ltd).

Specifically, the Supreme Court was asked to decide the meaning of clause “MD15” of the policy, which provided that in the event of natural disaster, including earthquake, “the insurer’s liability will be limited to the amount of loss in excess of the Natural Disaster Damage cover.” The question was essentially whether such loss referred to actual loss or loss up to the sum insured limit of \$12.95m. The dispute arose because the replacement value of the buildings insured (estimated at \$25m) exceeded the sum of statutory insurance plus the full reinstatement sum insured of \$12.95m.

A majority of the Supreme Court agreed with the Court of Appeal that the sum insured was intended as *inclusive* of the cover provided by the EQC. The majority noted that while both parties referred to various alleged anomalies or absurdities that would occur if the Court were to accept the interpretation of MD15 advanced by the other, in general these resulted not from the

particular interpretations of the clause, but from the fact of underinsurance.

### The majority on interpretation

In reaching its conclusions as above, the majority summarised the principles of interpretation.

The majority’s summary includes the following key points:

1. The language of a contract must be assessed objectively to establish “the meaning which the document would convey to a reasonable person having 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.” (Para [60])
2. A purposive or objective approach is not restricted to situations of ambiguity, so that every contract must be construed within its overall context, broadly viewed. (Para [61])
3. However, a commercial contract:

*“...will have features that ordinary language (even a “serious utterance”) is unlikely to have, namely that it will result from a process of negotiation, will attempt to record in a formal way the consensus reached and will have the important purpose of creating certainty, both for the parties and for third parties (such as financiers).”*

So, the fact that parties are aware their contract might be relied upon by a third party may justify a more restrictive approach to the use of background in some instances, the parties’ awareness being itself part of the relevant background. (Para [62])

4. The “general structure” of the parties’ bargain can assist to identify its commercial purpose

and an interpretation that flouts common sense is not to be assumed. But, the majority said, that will depend on the extent to which that purpose “can reliably be identified.” (Para [79])

5. The Court may also need to recognise that words are being used in a specialised way, if there is evidence which demonstrates that the parties have adopted such a specialised (or “private dictionary”) meaning.

Interestingly, the majority proceeded mainly by reference to leading English decisions (namely the decisions of the House of Lords in *Investors Compensation Scheme Limited v West Bromwich Building Society* [1998] 1 W.L.R. 896 and *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC 1101, and the decision of the Privy Council in *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988), rather than its own decision in *Vector v Bay of Plenty Energy Ltd*, [2010] NZSC 5; [2010] 2 NZLR 444 (“*Vector*”).

*Vector* is widely considered the leading case on contract interpretation in New Zealand. In it, the Supreme Court affirmed the importance of an objective approach to contractual interpretation, and of looking to the background to establish the commercial context of the contractual language.

### The role of “business common sense”

In *Firm PI 1 Ltd*, in apparent departure from the approach in *Vector*, the majority (McGrath, Glazebrook and Arnold JJ) highlighted the dangers of ‘commercial absurdity’ arguments being used to override the otherwise plain meaning of the contract.

Their Honours noted that:

“...commercial absurdity tends to lie in the eye of the beholder.”

And that:

“The reasons underlying the compromises that typically occur in commercial negotiations may not be

easily perceived or understood by a court, even if they are exposed as part of the relevant background.”

Crucially, their Honours concluded that:

***“Where contractual language, viewed in the context of the whole contract, has an ordinary and natural meaning, a conclusion that it produces a commercially absurd result should be reached only in the most obvious and extreme of cases.”***

### Conclusion

*Firm PI 1 Ltd* has provided important guidance on the role of commercial common sense in contract interpretation.

Two points seem clear:

1. The context provided by the contract as a whole and any relevant background will inform meaning, but “the text remains centrally important”; and
2. There is a need for caution in relying on arguments of “commercial common sense”, particularly when they conflict with the intention naturally to be inferred from the language which the parties have chosen to express their bargain.

Further, the majority’s comments appear to confine commercial absurdity type arguments to “only the most obvious and extreme of cases”.

Accordingly, to the extent *Vector* decided that “commercial common sense” is a touchstone of interpretation, it must be read subject to the majority’s comments in *Firm PI 1 Ltd*.

We note that the majority’s approach aligns closely with that of the English Court of Appeal in *Skanska Rashleigh Weatherfoil Ltd v Somerfield Stores Ltd* [2006] EWCA Civ 1732 at para 22, where Lord Justice Neuberger said:

*“the court must be careful before departing from the natural meaning of the provision in the contract merely because it may conflict with its notions of commercial common sense of what the parties may must or should have*

*thought or intended. Judges are not always the most commercially-minded, let alone the most commercially experienced, of people, and should, I think, avoid arrogating to themselves overconfidently the role of arbiter of commercial reasonableness or likelihood.”*

More recently, in *BMA Special Opportunity Hub Fund Ltd v African Minerals Finance Ltd* [2013] EWCA Civ 416 Lord Justice Aikens said at para 24:

*“The starting point is the wording of the document itself and the principle that the commercial parties who agreed the wording intended the words used to mean what they say in setting out the parties’ respective rights and obligations. If there are two possible constructions of the document a court is entitled to prefer the construction which is more consistent with ‘business common sense’, if that can be ascertained. However, I would agree with the statements of Briggs J in Jackson v Dear, first, that ‘commercial common sense’ is not to be elevated to an overriding criterion of construction and, secondly, that the parties should not be subjected to ‘...the individual judge’s own notions of what might have been the sensible solution to the parties’ conundrum’. I would add, still less should the issue of construction be determined by what seems like ‘commercial common sense’ from the point of view of one of the parties to the contract.”*

With such cautionary statements in mind, *Firm PI 1 Ltd* is a reminder of the importance of ensuring that commercial contracts are drafted as clearly and precisely as possible.