Principles of interpretation of contracts under English law and their application in international arbitration

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ABSTRACT

This article discusses the interpretation of contracts in international arbitration, looking first at the current position on the interpretation of contracts as established by the English courts. It then considers whether an international arbitration tribunal construing a contract is, in fact and/or in practice, constrained by the governing law. It will further consider the influences upon a tribunal in reaching a conclusion as to how a contract should be interpreted and the general approach taken by an international arbitral tribunal to questions of interpretation of contracts. The article concludes that parties are arguably not well-served if they cannot predict with some certainty how a tribunal will approach a particular issue but that this lack of certainty is a trade-off that parties are willing to make in opting for international arbitration.

1. THE SAME ISSUE VIEWED THROUGH DIFFERENT LENSES

Almost invariably, deciding an international arbitration will involve interpreting the provisions of a contract. Interpretation of a contract is simply shorthand for determining what the parties to the contract meant when they chose that language, but, as we know from people’s different reactions to music, drama, and the media, people can reach at very different conclusions when faced with the same experience. The difficulty that participants in international arbitration face where a dispute turns on a question of interpretation is in predicting how a diverse tribunal will approach the issue.

Different approaches to the conduct of arbitrations, different legal backgrounds, and different reactions to the subliminal effects of anchoring, priming, and the ability or otherwise to disregard the precluded evidence or argument means that counsel in international arbitration are shooting in the dark when it comes to advising clients as to how a tribunal may rule. Whilst it is difficult to gather statistics on this issue, the perceived wisdom is that, for a variety of reasons, arbitrations do not settle as frequently as court proceedings.¹ One reason behind this is the unpredictability of

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arbitrations caused by the flexibility of the process, which is also, of course, one of its major selling points. As is well known, all the major international arbitration institutional rules are not lengthy tomes, but slim pamphlets, but this requires the tribunal to actively exercise its discretion to fill in the blanks. It is axiomatic that it is difficult to predict with certainty how discretion will be exercised. Further, although contractual interpretation is key to almost every international arbitration, the extent to which tribunals do have or should have recourse to the principles of contractual interpretation in the governing law in practice is much less evident. Commentators have described the ‘widespread attitude’ among international arbitration practitioners that the governing law does not matter much, if it matters at all. Counsel are therefore left to guess how a tribunal might approach an issue and to hope that their client’s interpretation is to be preferred.

2. THE INTERPRETATION OF CONTRACTS UNDER ENGLISH LAW
When it comes to selecting a governing law of an agreement, parties have an almost unlimited choice. English law is one of the most commonly chosen governing laws in commercial contracts, often, it is said, because it provides relative certainty of outcome in its application to the factual circumstances surrounding the agreement. In the words of Lord Hodge ‘One of the attractions of English law as a legal system of choice in commercial matters is its stability and continuity, particularly in contractual interpretation’. English law is relatively certain for several reasons: it is well-developed and reasonably precise, there is a system of binding authority in place, so the same issue raised between different parties under a different set of facts should be decided in the same way, and there is a clear set of principles to be applied when a clause’s meaning is disputed. Given the popularity of English law, international arbitration tribunals frequently find themselves grappling with principles of interpretation in the face of parties arguing that they are or are not (depending on that party’s position) bound by them.

So, what are the principles of interpretation of contracts under English law? It seems hard to believe that it is 20 years since Lord Hoffman’s seminal judgment in *Investors Compensation Scheme Ltd v West Bromwich Building Society* but before discussing that decision, a principle enunciated by Lord Halsbury a century earlier should be highlighted, namely that the starting point for interpretation is to determine the main purpose of the contract and that provisions should be rejected if they are inconsistent with that purpose. Often when parties are arguing about the meaning of particular clause, the trees are lost in the wood and this basic concept is forgotten. ‘Looking at the whole of the instrument and seeing what one must regard... as its main purpose, one must reject words, indeed whole provisions, if they are inconsistent with what one assumes to be the main purpose of the contract’ (Lord Halsbury)

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Interpretation of contracts under English law

It is impossible to interpret contract clauses in isolation, but tribunals are often effectively urged to do so. Only a full understanding of the complete agreement between the parties will give the tribunal sufficient comfort to rule on the interpretation of a particular clause. The starting point is always the language of the contract. The basic premise under English law that words should be given their ordinary and natural meaning was re-stated in *Pink Floyd Music Limited v EMI Records Limited.*\(^5\) Where there is uncertainty as, by definition, there generally is if a dispute has reached arbitration, then the tribunal will need to consider the principles of contractual interpretation as developed by the English courts. For Lord Hoffman’s judgment in *Investors Compensation Scheme Ltd v West Bromwich Building Society*\(^6\) is broadly seen as giving English judges more leeway in contract interpretation, he opined: ‘the meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean’. A Court of Appeal case shortly after the *Investors Compensation Case* reinforced the need to ‘look at all the relevant background information’ when interpreting a contract.\(^7\) Relevant background information is generally seen as a consideration of what the parties would (or should) have known in the situation they were in at the time of agreeing the contract.

Lord Neuberger in *Arnold v Britton*\(^8\) stated that when interpreting a written contract, the court should be concerned to identify the intention of the parties by reference to ‘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’.\(^9\) According to Lord Neuberger, proper contractual interpretation was achieved by ‘focussing on the meaning of the relevant words, in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party’s intentions’. Lord Neuberger considered that while common or business sense was a factor, it should not undermine the language in the contract. He felt that commercial common sense should not be invoked retrospectively only once it has become clear that the bargain ‘has worked out badly, or even disastrously, for one of the parties’. In the subsequent decision of the Supreme Court in *Wood v Sureterm Direct Ltd*\(^10\) Lord Hodge stated that interpretation is not merely a ‘literalist exercise focused solely on... the wording’ but required consideration of the contract as a whole, taking into account the wider context and commercial purpose of the agreement, and business common sense. He considered that contractual interpretation was an ‘iterative process by which each suggested interpretation is

\(^5\) [2010] EWCA Civ 1429.
\(^6\) *Investors Compensation Scheme Ltd* (n 3).
\(^7\) *NLA Group Ltd v Bowers* [1999] 1 Lloyds’ Rep 109.
\(^8\) [2015] UKSC 36.
checked against the provisions of the contract and its commercial consequences are investigated’.

The approach re-iterated in *Arnold v Britton* and *Wood v Sureterm Direct* will not, of course, be unfamiliar to international arbitration tribunals interpreting contracts under English law. Yet, the extent to which tribunals in fact confine themselves to an approach established by the national courts of the governing law is less clear cut.

### 3. HOW DO INTERNATIONAL ARBITRATION TRIBUNALS APPROACH CONTRACT INTERPRETATION IN PRACTICE?

Contract interpretation is far from an exact science. Arbitral tribunals are occasionally criticized as having too much ‘grey hair’ but this area, perhaps more than any other, is one where experience shows. Yet are tribunals too willing to depart from strict principles of contractual interpretation as laid down by the governing law or are tribunals not, in fact, required to apply those principles anyway? Alternatively, are tribunals unconsciously departing from these strict principles because of the way in which arbitrations are argued?

Taking the first point, whether tribunals are too willing to depart from the strict application of the governing law: this issue is often encapsulated in an often-expressed desire on the part of counsel to ascertain whether an arbitrator will adopt a ‘black letter’ approach or not. The issue really comes down to the old question, whether an arbitrator sees themselves as a private judge or a dispute resolver.

In 2015, Professor Joshua Karton conducted a detailed study into the role of arbitrators adjudicating international commercial disputes. In the study he reviewed published international arbitral awards and interviewed leading commercial arbitrators about their practices. Karton concluded that the practice of interpreting contracts without reference to the governing law’s rules of interpretation is widespread. Karton found that when the governing law did not fit the arbitrators’ preferred method of interpretation, a tribunal would ‘depart from the law or “creatively interpret it” to make it fit’. His findings were supported by patterns of decisions in published awards and the consistency of responses given by the arbitrators he interviewed. As Karton conceded ‘robust generalization’ about international commercial arbitration cannot be made; however, it certainly seems that commercial arbitrators, particularly those in tribunals comprising arbitrators of differing legal backgrounds, see themselves more as dispute resolvers than as private judges and act accordingly. Karton’s research showed that arbitrators’ ‘preferred interpretative method’ was ‘subjective interpretation supported by liberal consideration of extrinsic evidence, but with priority given to the plain meaning of clearly drafted terms’. Certainly, the first part of this approach is not necessarily entirely consistent with the established principles of contractual interpretation under English law. However, the English courts have also emphasized the need for a commercial approach, within reason, so the international arbitrator approach is not necessarily contradictory either. In *Antaios Compania Naviera SA v Salen Rederierna AB*: ‘if detailed semantic and syntactical analysis of a word in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to

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11 Karton (n 2).
business common sense’ (Lord Diplock).\footnote{[1985] AC 191.} This approach is one that will be familiar to all international arbitrators. As one of the (anonymous) arbitrators interviewed by Karton put it: ‘it is fundamental to arbitration that it should solve disputes according to commercial practice and common sense, arriving at a result considered fair in a particular business community.’\footnote{Karton (n 2).} Karton also quotes a leading London-based arbitrator, who, when asked about their approach to interpreting contracts, replied that there are only two rules of interpretation: ‘Common sense is one. Commercial sense is the other.’ In his Bailii lecture in 2016, Lord Justice Thomas, the Lord Chief Justice, noted that in one Court of Appeal case Lord Denning expressed the view that ‘a commercial arbitrator was more likely to be better placed to interpret the contract in a commercial sense than a judge and in a one off case probably more likely to be right than a judge.’\footnote{For the Bailii lecture by the Lord Chief Justice, Lord Thomas, see <https://www.judiciary.uk/wp-content/uploads/2016/03/lcj-speech-bailii-lecture-20160309.pdf> accessed 7 December 2018.} In choosing arbitration, parties are choosing an arbitral approach to deciding disputes. Although that approach may not always adhere rigorously to the governing law, it is, it could be argued, what the parties signed up for in selecting arbitration.

Looking at the second point, does the governing law matter that much anyway? The sentiment ‘I would uphold the law for no other reason than to protect myself’ (attributed to Thomas More) is a pragmatic one but do arbitral tribunals need this protection at all or are they free to enjoy the ‘lawlessness’\footnote{Phillip J McConnaughay, ‘The Risks and Virtues of Lawlessness: A “Second Look” at International Commercial Arbitration’ (1999) 93 Northwestern Law Review 453.} that is often attributed to them? In this regard, arbitrators appointed in an arbitration with its seat in England and determining an arbitration under English law have an additional concern, namely the effect of section 69 of the Arbitration Act 1996. This states that, unless agreed otherwise, a party to a proceeding may ‘appeal to the court on a question of law arising out of an award made in the proceedings’. The effect of adopting the provisions of all the major international institutional rules is to exclude this right to appeal, therefore the issue only arises in a situation in which the seat of the arbitration is in England or Wales, the governing law is English law and the parties have either not adopted institutional rules, or have adopted the LMAA\footnote{London Maritime Arbitration Association.} rules which do not exclude section 69, or have expressly preserved the right to appeal. Further, there are procedural hurdles to clear before the appeal can be heard. The applicant must obtain the agreement of the other parties or, alternatively, the leave of the court. Leave to appeal will only be given if the court is satisfied that the determination of the question will substantially affect the rights of one or more of the parties, that the question was put to the tribunal and that the decision of the tribunal on the question is obviously wrong or the question is one of general public importance and the decision of the tribunal is at least open to serious doubt and it is just and proper in all the circumstances for the court to determine the question. From the above it will come as no surprise that appeals under section 69 are few and far between and successful appeals are extremely rare indeed. Yet the mere existence of the possibility of an appeal under section 69 may mean that arbitral tribunals who have this constraint, approach the issue of the governing law more conservatively than those who are not so constrained.
Addressing the third point above, is there a further argument that tribunals are unconsciously departing from strict principles because of the way in which arbitrations are argued? Even in situations where a tribunal is, for whatever reason, applying the principles of the governing law perhaps more strictly than is usual in international arbitration, the way in which arbitrations are pleaded and the way evidence is introduced in international arbitration may affect the tribunal’s ruling, whether the tribunal is aware of this or not. In interpreting contracts under English law, a tribunal should not consider (absent particular circumstances which are beyond the scope of this article) the subjective views of the parties, negotiations between the parties, and post-contractual behaviour. Yet, how easy is it in fact to ignore these key parts of a commercial relationship once they have been introduced in evidence by the parties?

Although there are reasonably clear rules under English law on what should not be taken into account, research shows how difficult it is to exclude evidence once it has been introduced. In international arbitration there is a tendency to include everything and then reassure the objecting party that the tribunal will ‘give the evidence the weight it deserves’. This approach ignores the effect of anchoring, amongst other things. A frequently cited example of the effect of anchoring is the study in which researchers asked participants whether Mahatma Gandhi died before or after the age of 9 or whether he died before or after the age of 140. The average of answers given to the two questions differed by 17 years, correlating, of course, to the number given in the question, even though the numbers were obviously erroneous. The same effect was reported when asking participants when Albert Einstein first visited the USA. Completely irrelevant anchors such as references to 1215 and 1992 caused anchoring effects which were just as strong as more plausible anchors. In a further study, participants were expressly informed that they were going to be ‘anchored’ but even when they were told about the anchor, they were still unable to avoid its effect. The ability of the judicial mind to disregard evidence has also been tested, with one study finding that only 75 per cent of judges who saw a recall notice (an inadmissible subsequent remedial measure) ruled for the defense while 100 per cent of the judges who had not seen it did so. Similarly, people may not realize the extent to which they can be influenced by seemingly inconsequential details, or ‘primed’ by certain words. For example, if the conversation has been about food our mind will fill in the blank ‘SO_P’ with a U but if we have been talking about cleanliness we will fill in the blank ‘SO_P’ with an A. If we are given a list of words from which to make a sentence, when we walk out of the room we will walk more slowly

17 ‘Anchoring or focalism is a term used in psychology to describe the common human tendency to rely too heavily, or “anchor,” on one trait or piece of information when making decisions. During normal decision making, individuals anchor, or overly rely, on specific information or a specific value and then adjust to that value to account for other elements of the circumstance. Usually once the anchor is set, there is a bias toward that value.’ (ScienceDaily). See <https://www.sciencedaily.com/terms/anchoring.htm> accessed 7 December 2018.
if those words included ‘Florida’, ‘lonely’, and ‘wrinkle’. All these studies cast doubt on an arbitrator’s ability to disregard evidence that, according to the principles of interpretation of the governing law, should not be considered when interpreting the agreement reached by the parties.

The challenge faced by arbitrators is to apply the law to the facts within this complex framework and to do so in such a way as to provide a degree of predictability to counsel as to how the tribunal will approach a particular issue. Arbitrators are not jurists. Arbitrators are primarily chosen for their experience in the relevant industry and less so for their familiarity with the substantive law of the dispute. The tendency to admit all evidence (for fear of a challenge to the award) undermines strict principles of contractual interpretation and the mind’s inability to really disregard information must not be underestimated. The fact that arbitrators are heavily involved with the dispute from inception may also mean that it is more likely that arbitrators seek to ‘make sense’ of a commercial relationship or endeavour to balance, in some way, the competing interests of the parties. All these issues simply underline the differences between international arbitration and national court proceedings.

4. DELIVERING WHAT THE PARTIES WANT

Although parties are not necessarily well-served if they cannot predict with some certainty how a tribunal will approach a particular issue, it appears that the lack of predictability does not overly concern users of international arbitration. International arbitration is in an enviable position. An overwhelming 99 per cent of respondents to the 2018 Queen Mary/White & Case Survey on International Arbitration said they would recommend international arbitration to resolve cross-border disputes in the future. Whilst there are, of course, gripes about delays and escalating costs, on the whole it appears that arbitration is delivering what the parties want and that the approach taken by arbitrators to principles of contractual interpretation is part of this. There are many things that international arbitration awards do not do and that parties do not want international arbitration tribunals to do. Tribunals do not develop the law. Awards are not definitive rulings on the scope and interpretation of contractual clauses, financial instruments, or other legally binding agreements. Awards do not articulate rights or responsibilities. What international arbitration tribunals do, is provide a final binding and, in the vast majority of cases, a definitive determination of a dispute. Quite simply, they provide closure to the parties and they provide this through a flexible process and with party input into arbitrator selection. The trade-off for these positives is that counsel may struggle on occasion to predict how a tribunal might rule. Parties are clearly willing to make this trade-off.

21 As described in Blink by Malcolm Gladwell, researchers gave students a test, requiring them to read five words and make a four-word sentence out of them. The students were then sent to do another test in an office down the hall. Unbeknownst to them, walking the hall was the real experiment. Included in the list were words like ‘worried’, ‘Florida’, ‘old’, ‘lonely’, ‘gray’, ‘bingo’ and ‘wrinkle’. Students who had been primed with these words took significantly longer to walk down the hall than those not primed with the ‘old’ words.