A dispute arose out of six identical shipbuilding contracts. The builder was to obtain refund guarantees to guarantee the buyers' pre-delivery instalments.

The contract gave the buyer the right to a full refund in the event that the buyer exercised its right to reject the vessel or to terminate, cancel or rescind the contract ("X.5 REFUND BY THE BUILDER").

The buyer also had a further right to repayment of instalments in the event of a default by the builder ("Article XII BUILDER'S DEFAULT"), one such default being Insolvency (Article XII.3). Insolvency was not, however, an event entitling the buyers to reject the vessel under Article X.5.

The bank issued six identical refund guarantees at the builder's request. Under paragraph 2, the buyers were entitled to repayment of any pre-delivery instalments if they rejected the vessel. Paragraph 2 referred to a right of refund "upon your rejection of the Vessel in accordance with the terms of the Contract, your termination, cancellation or rescission of the Contract or upon a Total Loss of the Vessel...."

The crux of the dispute was the fact that paragraph 2 made no mention of a right of refund in the event of insolvency. Paragraph 3 set out the bank's guarantee obligation and stated that the bank undertook to pay the buyers "all such sums due to you under the Contract...."

The buyers paid the first instalments under the contracts but the builder subsequently suffered financial difficulties and entered into a debt workout procedure. The buyers sought repayment of the instalments they had paid but the bank refused to pay, arguing that, on a true construction of the guarantees, it had not agreed to payment of refunds arising under Article XII.3, namely, insolvency.

The court had to decide whether the words "all such sums" meant that the instalments had to be repaid in all of the circumstances set out in the shipbuilding contracts or was repayment confined to the circumstances set out in paragraph 2?

In the High Court the judge ruled in favour of the buyers. On appeal the majority of the Court of Appeal overturned this decision.

Lord Patten's conclusion in the Court of Appeal was as follows:

"In this case (as in most others) the Court is not privy to the negotiations between the parties or to the commercial and other pressures which may have dictated the balance of interests which the contract strikes. Unless the most natural meaning of the words produces a result which is so extreme as to suggest that it was unintended, the Court has no alternative but to give effect to its terms. To do otherwise would be to risk imposing obligations on one or other party which they were never willing to assume and in circumstances which amount to no more than guesswork on the part of the Court."

The Supreme Court unanimously overturned that decision. Lord Clarke, giving the judgment, stated that, unlike Patten L.J., he did not consider it necessary to conclude that, unless the most natural meaning of the words produces a result so extreme as to suggest that it was unintended, the Court must give effect to that meaning.

Case law showed that the ultimate aim of interpreting a term in a contract, especially a commercial contract, is to determine what the parties meant by the language used. This involved ascertaining what a reasonable person would have understood the parties to have meant. A reasonable person, for these purposes, is one who has all the background knowledge that would reasonably have been available to the parties at the time of the contract.

As to the role played by the consideration of business common sense in determining what the parties meant, Lord Clarke held that where the parties have used unambiguous language, the Courts must apply it. However, if there are two possible constructions, it is generally appropriate to adopt the interpretation that is most consistent with business common sense and to reject the other. It is not necessary to conclude that a particular construction would produce an absurd or irrational result before proceeding to have regard to the commercial purpose of the agreement.

Applying this to the facts of the dispute, Lord Clarke found that a construction of the Bonds which excluded the builder's insolvency from situations that trigger the builder's repayment obligations made no commercial sense.

Rainy Sky SA & Ors (Appellants) v Kookmin Bank (Respondent) [2011] UKSC 60

Article by Sean Morris (sean.morris@smst.com)