Client Update

English Court of Appeal Considers Contractual Interpretation of Complex Financial Instruments

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On 7 December 2016, the English Court of Appeal delivered its judgment in *Metlife Seguros De Retiro SA v. JP Morgan Chase Bank* [2016] EWCA Civ 1248. The court considered the important questions whether and to what extent the factual, documentary, and commercial context(s) may be relevant to the construction of loan notes in light of the Supreme Court's decision in *Arnold v. Britton* [2015] UKSC 36.

THE ISSUE BEFORE THE COURT OF APPEAL

The dispute between the parties concerned the calculation of the final redemption amount payable to Metlife Seguros De Retiro SA (the "Claimant"), under the terms of structured loan notes (the "Notes") issued by the Defendant, JP Morgan Chase Bank (the "Bank") under a US$3 billion Structured Euro Medium Term Note Programme.

The terms of the Notes provided for the final redemption amount to be calculated according to the Argentinian CER inflation index. However, the method of calculation would be varied if a "*CER Event*" occurred. This was defined in Clause 22 of the Notes to include a number of occurrences, including where "[t]*he Republic of Argentina, or any of its agencies, instrumentalities or entities… by means of any law,* regulation, *ruling, directive or construction, whether or not having the force of law, takes any action which legally or de facto prevents or has the effect of restricting or limiting (i) the calculation or (ii) announcement of the CER or any of the values used to determine the CER.*"

The Bank calculated the final redemption amount using the CER inflation index, and made a payment on that basis. The Claimant claimed that the CER index was inaccurate and had been manipulated by the Argentinian government to produce a lower inflation rate for political purposes. It said that this was a CER Event under the Notes, and that an alternative basis of calculation should be adopted. It

claimed that this alternative calculation would entitle it to a further payment of $75.2m (over and above the US$176,541,651.36 already received from the Bank).

THE DECISION AT FIRST INSTANCE

At first instance, the Claimant put its claim on the basis that, properly construed, the Notes required the CER index to provide a reliable statement of the true inflation rate, failing which a CER Event would be triggered.

The decision at first instance was reached before the Supreme Court judgment in *Arnold v. Britton* [2015] UKSC 36. Burton J dismissed the claim, stating that "*construction must be an exercise of considering the language used and ascertaining what a reasonable informed person would have understood the parties to mean*" but if there are multiple possible constructions, the one which accords more with commercial and common sense should be preferred.

The judge found that the natural meaning of Clause 22 concerned the "*availability*" of CER, i.e. that a CER Event would occur when the government had failed to make the index available at all. An available but unreliable CER index would not trigger a CER Event. In considering the commercial context of the Notes, the judge held that even if the Claimant's construction was correct, there was no known test to determine the *reliability* of the CER.

THE COURT OF APPEAL'S DECISION

The Court of Appeal (Black, Lewison and Hamblen LJJ) unanimously upheld the "*availability*" construction and dismissed the appeal. However, there was a divergence as to their approach to construction.

Hamblen LJ stated that the proper approach to construction was summarised by Lord Bingham in *Dairy Containers Ltd v Tasman Orient CV* [2005] 1 WLR 215, "[T]*he contract should be given the meaning it would convey to a reasonable person having all the background knowledge which is reasonably available to the person or class of persons to whom the document is addressed*."

The Claimant's case on appeal changed from arguing that the CER index had to be reliable to saying that it had to be a "*genuine measurement of inflation*". This argument was rejected by the court as requiring a rewriting of the terms of the Notes. Hamblen and Lewison LJJ (Black LJ concurring) remarked that the inconsistency between the arguments before the Court of Appeal and the court below hampered the Claimant's claim that its interpretation was the clear meaning that would be conveyed to a reasonable person.

Giving the leading judgment, Hamblen LJ held that the "*availability*" construction gives "*CER Event*" a consistent meaning in the Notes, fits the scheme of the contract and makes commercial sense. He noted, for example, that institutional investors such as the Claimant would probably have liabilities linked to the CER index, and any downwards manipulation of the CER index by the government would therefore be of little concern, or may even be beneficial, to them. Hamblen LJ also agreed with the expert witnesses of both parties that financial instruments are generally not linked to concepts such as "*genuine*" or "*true*" inflation, which are difficult or impossible to measure, but to an index which is available to everyone.

Contractual context is particularly important in interpreting financial instruments because, unlike most commercial contracts, they can be traded. Hamblen LJ noted this, and cited *Re Sigma Finance Corp* [2009] UKSC 2, [2010] 1 All ER 571, which provides that a financial instrument "*must be interpreted as a whole in the light of the commercial intention which may be inferred from the face of the instrument and from the nature of the debtor's business*." Although MetLife was in fact the sole purchaser of the Notes and remained the holder of the Notes until maturity, Hamblen LJ noted that it could have traded some or all of the Notes. In those circumstances "*it is the knowledge reasonably available to the class of potential purchasers rather than just MetLife which has to be considered*."

Lewison LJ concurred, but stated that he "*found this a more difficult case than Hamblen LJ*". In his brief judgment, Lewison LJ identified the instrument as falling within a distinct category of "*complex instruments*" that warranted the approach in *Re Sigma*, which gave more weight to considerations of the context in which those words were used. The focus of this approach was to avoid frustrating the commercial purpose of such terms. Lewison LJ observed that the approach in *Re Sigma* had not been overtaken by *Arnold v. Britton,* in which Lord Neuberger said at [15] that the court must focus on "*the meaning of the relevant words… in their documentary, factual and commercial context*." Lewison LJ observed that "[*t*]*he documentary context in this case is of critical importance.*"

While Hamblen and Lewison LJJ agreed that the principles of contractual construction set out in *Arnold v. Britton* must be applied, they each upheld the Bank's construction for slightly different reasons. Hamblen LJ, although addressing in detail the arguments relevant to the commercial context of the Notes, was in favour of the "*availability*" construction chiefly because it "*reflects the contractual wording used*". Lewison LJ, on the other hand, was persuaded by the same construction on the basis that it produced a "*more coherent and workable scheme*".

TAKEAWAYS

The Supreme Court's recent decision in *Arnold v. Britton* has been widely perceived as a change in the approach to contractual construction towards an emphasis on the literal meaning of the express words chosen by the parties. The Court of Appeal's decision in *MetLife*, while consistent with the general approach taken by the Supreme Court, confirms a continued willingness to read the express words of a contract compatibly with the context of the contract as a whole.

Further, the decision suggests that the approach to construing financial instruments has not been affected by *Arnold v. Britton*. Lewison LJ's remark that "[t]*he documentary context in this case is of critical importance*" indicates that the documentary context of similar financial instruments may allow the court to override the literal meaning of the words chosen by the parties more readily than they would in construing another type of contractual instrument.

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Please do not hesitate to contact us with any questions.