Interpreting commercial contracts and excluding consequential losses

The English Court of Appeal has overturned a High Court decision on the interpretation of a consequential loss provision in a drilling contract in Transocean Drilling v Providence Resources [2016] EWCA Civ. 372. The judgment provides useful and more general guidance as to how the court will interpret provisions in commercial contracts. It also serves as a reminder of the importance of clearly drafted contractual provisions.

The facts

The owner of a semi-submersible drilling rig, Transocean Drilling U.K. Ltd, entered into a contract with Providence Resources Plc to drill an appraisal well off the coast of the Republic of Ireland. The contract was an amended version of a standard industry agreement, known as the 'LOGIC' form.

Several months into the contract, drilling operations were suspended as a result of the misalignment of the blow-out preventer. The resulting dispute came before the High Court, where the judge found that the rig had not been in good working condition on delivery. This was a breach of contract by Transocean which, the judge found, caused delays of over 27 days.

The High Court judge also held that Providence was entitled to recover certain wasted costs during the period of delay. These were known as 'spread costs' and included the costs of personnel, equipment and services which Providence had contracted from third parties, but which were left idle during the delays. It was this aspect of the first instance judgment, i.e. whether the spread costs were recoverable, which was the subject of the appeal.

Under the drilling contract, each party had agreed to indemnify the other against its own consequential loss, in effect, excluding liability for 'consequential loss'. The contract contained an extensive definition of 'consequential loss' which included:

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"loss of use (including, without limitation, loss of use or the cost of use of property, equipment, materials and services including without limitation, those provided by contractors or subcontracts of every tier or by third parties)…"

Transocean argued that the spread costs fell within the contractual definition of consequential loss and that they were therefore effectively excluded under the contract. Providence argued that the spread costs fell outside this definition and that they were therefore recoverable from Transocean. The High Court judge agreed with Providence that the costs were recoverable. Transocean therefore appealed.

The judgment of the Court of Appeal

The Court of Appeal reversed the decision of the High Court and, in allowing Transocean's appeal, found that spread costs would indeed fall within the definition of consequential loss. The Court of Appeal decision has ramifications for contractors in the oil and gas industry. However, the court relied on the following principles which are of wider interest and application when construing commercial contracts:

1. The starting point when construing a clause must be the language of the clause itself. In this regard, the Court of Appeal stated that "it should give the language used by the parties the meaning which it would be given by a reasonable person in their position furnished with the knowledge of the background of the transaction". Therefore, the language and context are important.

2. If the parties have used language which is one-sided and genuinely ambiguous, then the court may choose a meaning which is less favourable to the party who introduced the clause or in whose favour it operates. However, if the meaning of the words used is clear and the provision favours both parties equally the court will not apply this 'contra proferentem' principle.

3. When construing a contract there is a presumption that neither party intends to give up its rights. However this presumption does not apply if clear words are used, for example in an exclusion clause, and show that a party did indeed intend to give up its rights.

4. The principle of freedom of contract is, in the words of the Court of Appeal, "still fundamental to our commercial law" and "requires the court to respect and give effect to the parties' agreement". In this regard, the role of the court is "not to reshape the contract, but to ascertain the parties' intention, giving words they have used their ordinary and natural meaning".

The Court of Appeal considered the above in conjunction with the specific words of the consequential loss clause and more generally the scheme for the allocation of risk in the drilling contract. It concluded that the High Court "was making for the parties an agreement which they had not themselves chosen to make" in circumstances where the language of the contract was apt to exclude liability for the wasted costs which Providence sought to recover from Transocean.

Conclusion

The judgment of the Court of Appeal is directly applicable to consequential loss clauses in drilling contracts. However, it is of wider benefit because of the guidance given for interpreting complex contractual provisions. The case serves as a reminder that commercial parties of equal bargaining power are free to determine the terms on which they wish to do business and that, in cases where the parties have used clear and unambiguous language, the courts will be reluctant to interfere.

It is recommended that Members use clear words in all contractual provisions, especially clauses which seek to exclude particular types of loss. If that is done, parties can minimise the risk of the court forcing upon them a particular meaning of a contractual provision that the court considers the parties could or should have agreed, rather than simply giving effect to the intention of the parties.

The Court of Appeal's decision in Transocean v Providence cannot, of course, answer all questions of construction as these will turn on the particular facts and wording in each case. The case should, however, provide some comfort to commercial parties that, under English law, they can use clear language to allocate risk under a contract as they wish.

The UK Defence Club
Thomas Miller Defence Ltd, 90 Fenchurch Street, London, EC3M 4ST
tel: +44 207 283 4646 fax: +44 207 204 2131
email: tmdefence@thomasmiller.com web: www.ukdefence.com