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Objectivity and Subjectivity in Contract Interpretation

*Phillip Hellwege**

Scots law is said to follow an objective approach to contract interpretation.[1] In that respect, therefore, it is thought to be in accordance with English law. Scots lawyers generally believe that this objective approach stands in contrast to the subjective approach prevailing in continental legal systems such as the German one and also subscribed to by international and European instruments of legal unification and harmonization.[2] Objectivity versus subjectivity thus seems to be the great divide in Europe.[3] This understanding is also reflected in the latest publication of the Scottish Law Commission (SLC) on the subject. That Commission is currently reviewing Scots contract law in light of the Draft Common Frame of Reference (DCFR).[4] The first publication within this project is a discussion paper on contract

* Professor of Private Law, Commercial Law, and Legal History in the University of Augsburg.

[1] *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [3] per Lord President Hamilton; *Aberdeen City Council v Stewart Milne Group Ltd* [2010] CSIH 81, at [10]; *Autolink Concessionaires (M6) plc v Amey Construction Ltd* [2009] CSIH 14, at [23]; *Credential Bath Street Ltd v Venture Investment Placement Ltd* [2007] CSOH 208, at [28] and [46] per Lord Reed; *Middlebank Ltd v University of Dundee* [2006] CSOH 202, at [13]; *Emcor Drake & Scull Ltd v Edinburgh Royal Joint Venture* [2005] CSOH 139, at [13]; William W McBryde, *The Law of Contract in Scotland* (3rd edn, 2007) § 8-03; Hector L MacQueen and Joe Thomson, *Contract Law in Scotland* (2nd edn, 2007) § 3.39; Lord Coulsfield and Hector L MacQueen (eds), *Gloag and Henderson: The Law of Scotland* (12th edn, 2007) § 7.02. See also Gerard McMeel, 'Language and the Law Revisited: An Intellectual History of Contractual Interpretation' (2005) 56 *Common Law World Review* 256–86, 262; *idem*, 'Principles and Policies of Contractual Construction' in Andrew Burrows and Edwin Peel (eds), *Contract Terms* (2007) 27–51, 39; Donald Nicholls, 'My Kingdom for a Horse: The Meaning of Words' (2005) 121 *LQR* 577–91; Kim Lewison, *The Interpretation of Contracts* (5th edn, 2011) § 2.03.

[2] MacQueen and Thomson (n 1) § 3.42. See also Gerard McMeel, *The Construction of Contracts: Interpretation, Implication, and Rectification* (2nd edn, 2011) § 2.23; Johan Steyn, 'Written Contracts: To What Extent May Evidence Control Language?' (1988) 41 *Current Legal Practice* 23–32, 23–4; *idem*, 'The Intractable Problem of the Interpretation of Legal Texts' in Sarah Worthington (ed), *Commercial Law and Commercial Practice* (2003) 123–38, 126. Differently David Cabrelli, 'Interpretation of Contracts, Objectivity and the Elision of the Significance of Consent Achieved through Concession and Compromise' 2011 *Juridical Review* 121–41, 128–31.

[3] Martin Hogg, 'Fundamental Issues for Reform of the Law of Interpretation' (2011) 5 *Edinburgh LR* 406–22, 407. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [39] per Lord Hoffmann; McMeel (n 1) 263. For a much more careful assessment, see Andrew Burrows, 'Construction and Rectification' in Burrows and Peel (n 1) 77–99, 78.

[4] SLC, *Eighth Programme of Law Reform* (Scot Law Com No 220, 2010) 2.16–21.

interpretation.[5] The Commission believes that the DCFR adopts a subjective approach,[6] and it is not inclined to propose that Scots law should follow the European trend as it believes that the Scottish approach is preferable.[7]

1. How Subjective are the Subjective Approaches?

A German lawyer will be surprised to read that German law follows a subjective approach to contract interpretation. He will concede that German law does not ignore the parties' true intention altogether. Yet he will stress that interpretation is predominantly an objective enterprise. So how subjective is the German approach?

(1) Nineteenth-century Germany

To answer this question, I start with the interpretation of contracts according to the will theory as it was predominant in nineteenth-century Germany. The interpretation of contracts formed part of a broader subject matter, as it still does today:[8] that of the interpretation of juridical acts including, in particular, declarations of will.[9] According to the will theory, the task of interpreting juridical acts was to identify the true will of the author of that act.[10] And interpreting contracts meant to identify the true joint will of the parties.[11] This looks like a truly subjective approach.

But how does one identify a common will of two or more persons? Nineteenth-century lawyers worked with a number of rules of interpretation.[12] These rules addressed the question of how a judge could identify the parties' true joint will. The exercise of interpretation was thus also referred to as judicial interpretation:[13] the true shared intention was presumed on the basis of objective facts.

[5] SLC, *Review of Contract Law: Discussion Paper on Interpretation of Contract* (Discussion Paper No 147, 2011). On this paper, see Hogg (n 3) 406–22; Phillip Hellwege, 'Der DCFR als Grundlage für eine Revision und Kodifikation des schottischen Vertragsrechts?—Eine erste Bestandsaufnahme am Beispiel der Vertragsauslegung' (2013) 21 *ZEuP* 88–103. There had already been earlier papers on the same subject, see SLC, *Interpretation in Private Law* (Discussion Paper No 101, 1996); SLC, *Report on Interpretation in Private Law* (Scot Law Com No 160, 1997).

[6] SLC, Discussion Paper No 147 (n 5) 3.4.

[7] SLC, Discussion Paper No 147 (n 5) 6.28.

[8] See, for what follows, Phillip Hellwege, *Allgemeine Geschäftsbedingungen, einseitig gestellte Vertragsbedingungen und die allgemeine Rechtsgeschäftslehre* (2010) 104–12, 126–32.

[9] Carl Georg von Wächter, *Pandekten*, vol I (1880) 403. See also Reinhard Zimmermann, 'Die Auslegung von Verträgen: Textstufen transnationales Modellregeln' in *Festschrift für Eduard Picker* (2010) 1353–73, 1355; Stefan Vogenauer, 'Interpretation of Contracts' in Jürgen Basedow, Klaus J Hopt, and Reinhard Zimmermann (eds), *The Max Planck Encyclopedia of European Private Law*, vol I (2012) 973–7, 974.

[10] Heinrich Dernburg, *Pandekten*, vol I (5th edn, 1896) 291; Wächter (n 9) 403; Ferdinand Mackeldey, *Lehrbuch des heutigen Römischen Rechts*, vol I (10th edn, 1833) 253.

[11] Anton Friedrich Justus Thibaut, *System des Pandekten-Rechts*, vol I (2nd edn, 1805) 40.

[12] See Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (paperback edn, 1996) 637–9.

[13] Julius Baron, *Pandekten* (9th edn, 1896) 122.

Most importantly, it was presumed that the true common will was directed at what the parties said.[14] Thus, if the contract was in writing the wording of the document was the starting point. Yet, the parties were allowed to rebut this presumption.[15] Nineteenth-century German lawyers in such situations referred to an authentic interpretation because the parties told the judge what they had truly wanted.[16] Yet it only rarely occurs that parties agree in court about their true intention if it is not reflected in the document. Usually it will only be one of the parties who avers that the true and the presumed intentions do not coincide. However, it was not enough for that party simply to state or prove that its true will was not what it appeared to be. It had to prove that the true common intention of both parties was not reflected in the words of the contract. Again, presumptions based on objective facts were of assistance in that respect, for example what had occurred in prior negotiations.[17]

If the words of the contract were open to more than one interpretation, a number of further rules came into play. If, for example, the parties used a standard contract form, there was a presumption that they intended to give it the usual meaning.[18] Another rule was that contracts were to be construed in a way that they were valid rather than invalid.[19] Again, these rules were a means of presuming the subjective common intention, and each party was able to rebut the presumption.[20] Finally, there was the *contra proferentem* rule.[21]

Now it will be the Scots lawyer who will be surprised: is this the subjective approach to interpretation according to the will theory? The subjectivity in this approach is well concealed. It appears to be a contradiction to claim that one is searching for a subjective intention yet all one does is work on the basis of presumptions which are based on objective findings! The proponents of the will theory were aware of that contradiction. They did not, however, believe that this was a good enough reason to abandon it.[22] Yet the will theory was not uncontested. Its opponents developed the declaration theory.[23] They claimed that the true will can never be of importance as it is not discernible. Instead it is only what has been (objectively) said or written that counts.

For the purposes of the present essay, three characteristics of the controversy between will theory and declaration theory are of importance. First, it was not about practical results. The supporters of both theories accepted the traditional rules of interpretation that had been developed by the lawyers of the *ius commune*

[14] Georg Friedrich Puchta, *Pandekten* (12th edn, 1877) 103; Friedrich Heinrich Vering, *Geschichte und Pandekten des römischen und heutigen gemeinen Privatrechts* (5th edn, 1887) 209.

[15] Wächter (n 9) 403–5; Baron (n 13) 122; Mackeldey (n 10) 253–4; Karl Ludwig Arndts von Arnesberg, *Lehrbuch der Pandekten* (9th edn, 1877) 103–4.

[16] Dernburg (n 10) 292; Mackeldey (n 10) 253.

[17] Wächter (n 9) 403–5; Ferdinand Regelsberger, *Pandekten*, vol I (1893) 642.

[18] Dernburg (n 10) 291.

[19] Thibaut (n 11) 40; Wächter (n 9) 405; Baron (n 13) 122–3; Puchta (n 14) 104; Arndts (n 15) 103.

[20] Dernburg (n 10) 291.

[21] Regelsberger (n 17) 643; Wächter (n 9) 405; Puchta (n 14) 104.

[22] Regelsberger (n 17) 642.

[23] See, eg, Siegmund Schlossmann, *Der Vertrag* (1876) 99.

on the basis of Roman law, and they accepted the results which these rules produced. The controversy was about how to explain these rules of interpretation and how to embed them within a general theory.

The fact that the controversy was not about practical results is shown by two scenarios and these scenarios point to the second characteristic of the controversy: both theories had problems explaining all the results that were generally accepted. (a) Do standard terms form part of the contract if one party had not been aware of them and did not know their content? The proponents of both theories gave a positive answer to that question,[24] yet the will theory had problems explaining the answer. This is shown by the pertinent case law. Thus, there are cases in which courts of first instance held that the standard terms were not incorporated into the contract under such circumstances.[25] The legal literature objected that such findings would undermine commerce, and higher courts thus reversed such judgments.[26] (b) The second scenario is that of both parties agreeing to the meaning of the contract even though it is not reflected in its wording. It is only the will theory that had no problems explaining why the true intention of the parties should prevail.

Finally, the controversy was about the quintessence of contract law. Contract law is about private autonomy. A contract is a means for an individual to regulate his affairs according to his own wishes. This needs to be reflected in the rules on contract interpretation. An approach which only focuses on what has been said and which disregards what was intended thus appears to be out of step with the foundations of contract law.

(2) Modern German law

Scots lawyers believe that modern German law follows a subjective approach. They point to § 133 BGB:[27] 'When interpreting a declaration of will, the true will needs to be discovered irrespective of the literal meaning of the declaration.'[28] Yet, § 133 needs to be read together with § 157 BGB: 'Contracts are to be interpreted according to the requirements of good faith, taking common usage into consideration.'[29] §§ 133 and 157 BGB suggest a difference between the interpretation of declarations of will and of contracts. Yet the line is drawn differently:[30] with regard

[24] O Bähr, 'Ueber Irrungen im Contrahiren' (1875) 14 *Jahrbücher für die Dogmatik des heutigen römischen und deutschen Privatrechts* 393–427, 402; Bernhard Windscheid, 'Wille und Erklärung' (1880) 63 *Archiv für die civilistische Praxis* 72–112, 94.

[25] See, eg, Handelsgericht Elberfeld of 17 August 1850, reported in Wilhelm Koch, *Deutschlands Eisenbahnen: Anlagenheft* (1860) 129.

[26] Levin Goldschmidt, 'Die Haftungspflicht der Eisenbahnverwaltungen im Güterverkehr' (1861) 4 *Zeitschrift für das gesamte Handelsrecht* 569, 597–8; Oberappellationsgericht Berlin of 30 October 1873 (1874) 29 *Seuffert's Archiv für Entscheidungen der obersten Gericht in den deutschen Staaten* 329.

[27] MacQueen and Thomson (n 1) 3.42 no 1.

[28] 'Bei der Auslegung einer Willenserklärung ist der wirkliche Wille zu erforschen und nicht an dem buchstäblichen Sinne des Ausdrucks zu haften.'

[29] 'Verträge sind so auszulegen, wie Treu und Glauben mit Rücksicht auf die Verkehrssitte es erfordern.'

[30] Dieter Medicus, *Allgemeiner Teil des BGB* (10th edn, 2010) nos 322–3.

to declarations which do not need to be communicated to a recipient in order to become effective, the subjective will has greater significance than with declarations which do require such communication. Declarations of the latter type (and every contract is based on at least two of them) serve as an instrument for an individual to promote his right of self-determination. At the same time, however, they also affect the legal position of the person to whom they are communicated. The legal interests of that person need to be protected too.

As a result, German law is not primarily interested in objective or subjective meanings or understandings. It is interested in what the law takes the parties to have intended.[31] German lawyers refer to the normative will and to normative interpretation. Both concepts are keys to understanding German law.

German law has developed a comprehensive normative principle of interpretation which takes account of all conflicting interests involved: a declaration of will is to be understood as a reasonable third person in the position of the recipient would have understood it, in accordance with the principle of good faith, taking common usage into account,[32] and this principle directly applies to the interpretation of contracts. A Scots lawyer will argue that this is the very starting point of the objective interpretation in Scots law.[33] Thus, modern German law and Scots law work with the same formula but seem to understand it differently.

For a German lawyer, the formula is still incomplete. There is a second step to interpretation.[34] It is not enough to find out how a third person would have understood the declaration. That understanding needs to be attributable to the party making the declaration.

A single, comprehensive principle of interpretation versus a number of different rules—this is a great difference between nineteenth-century and modern law. In the nineteenth century a number of different rules of interpretation were applied. They pointed to a specific intention that was to be presumed. Today, the judge uses one basic principle of interpretation. It does not tell him directly what the parties are presumed to have intended. It is only a method for unfolding what the parties are taken to have intended. Nevertheless, the traditional rules of interpretation may still be used insofar as they conform to the single principle of interpretation.[35] Under the surface they still continue to exist although they have lost their independent function. A reasonable third person will, for example, even today usually take the contract to mean what it objectively says. At the same time, however, he is not bound by the objective meaning.

[31] Manfred Wolf and Jörg Neuner, *Allgemeiner Teil des Bürgerlichen Rechts* (10th edn, 2012) 394; Reinhard Bork, *Allgemeiner Teil des Bürgerlichen Gesetzbuchs* (3rd edn, 2011) no 511; Werner Flume, *Das Rechtsgeschäft* (3rd edn, 1979) 293; Reinhard Singer in *J v Staudingers Kommentar zum Bürgerlichen Gesetzbuch* (revised edn, 2012) § 133 no 2.

[32] Medicus (n 30) no 323; Bork (n 31) nos 511, 525; BGH of 24 February 1988, BGHZ 103, 280.

[33] See following text to and references in nn 51–53.

[34] Wolf and Neuner (n 31) 391; Medicus (n 30) no 326; Flume (n 31) 311; Bork (n 31) no 527; Singer (n 31) § 133 no 20.

[35] Flume (n 31) 314–17; Bork (n 31) no 556; Singer (n 31) § 133 no 71.

German lawyers sharply distinguish the object of interpretation from the means used for the purpose of interpretation.[36] The object of interpretation is the declaration of intention or, in the case of contract interpretation, the contractual document. Means of interpretation are all the factors that may be used to understand that declaration or written contract. With regard to those factors, German law does not recognize any restrictions;[37] prior negotiations, subsequent conduct, usages, etc: everything may be taken into account. The only requirement generally accepted by German law is that these factors must point to the intention of the parties at the time when they made their contract[38] and that they were, or could have been, known to both parties.[39]

It would be impossible in each individual case to draw upon all conceivable means of interpretation. This is, in fact, not necessary. The law of evidence works with a number of presumptions. Indeed, if one wants to understand the rules on interpretation it is crucial not to focus exclusively on the substantive law. Scots lawyers are aware of this.[40] If a German court interprets a written contract, two rules of evidence are of great importance:[41] the judge is allowed to work on the assumption that the entire contract is embodied in the document; and he may presume that the words used mean what they say. Any lawyer advising a client should proceed on the same basis. He should tell his client what the contract means by reading it. He should then ask his client whether there are any factors which may point to a different meaning. If such factors (eg prior negotiations) exist, they need to be proved. If that is impossible, the lawyer has to advise his client that the latter is stuck with the presumed meaning. Thus, any lawyer advising a client will filter out both irrelevant and unprovable factors.

In rare cases, the parties may have been in agreement as to the true meaning of their contract although it is not reflected in its wording. In these cases the maxim *falsa demonstratio non nocet* applies, and the contract is interpreted according to the common intention of both parties.[42] The best known application of this rule can be found in a decision of the Reichsgericht of 1920:[43] the parties had entered into a sales contract relating to *haakjærringkjøt*. They believed that the Norwegian word *haakjærringkjøt* meant whale meat whereas, in fact, it means shark meat. The court held that the parties had entered into a contract relating to whale meat as this was what they truly intended.

The other case in which the true intention of a party prevails is when the other party had positive knowledge of what the former truly intended:[44] A wants to sell whale meat but mistakenly uses the word *haakjærringkjøt*. B wants to buy shark

[36] Wolf and Neuner (n 31) 388; Bork (n 31) no 541; Singer (n 31) § 133 no 8.

[37] Bork (n 31) no 549; Singer (n 31) § 133 no 8.

[38] Flume (n 31) 300; Bork (n 31) no 549.

[39] Bork (n 31) no 527; Wolf and Neuner (n 31) 391.

[40] *Gloag and Henderson* (n 1) 7.01, 7.05–21.

[41] Christian Hertel in *J v Staudingers Kommentar zum Bürgerlichen Gesetzbuch* (revised edn, 2012) § 125 nos 92–96.

[42] Wolf and Neuner (n 31) 393; Medicus (n 30) no 327; Flume (n 31) 300–1; Singer (n 31) § 133 nos 6 and 13; BGH of 18 January 2008 [2008] NJW 1658.

[43] RG of 8 June 1920, RGZ 99 147.

[44] See Flume (n 31) 301; Singer (n 31) § 133 nos 6 and 13; BGH of 20 November 1992 [1993] NJW-RR 373.

meat. During the negotiations B becomes aware of A's mistake. The written contract refers to *haakjærringkjøt*. According to German law, the object of the contract is whale meat. This case is distinct from the first one in which the *falsa demonstratio* rule applies. In the first case both parties intended something different from what they said. In the second case both parties had different intentions and B in fact intended what he said. Nevertheless, B is bound to A's subjective will.

A Scots lawyer may not be convinced. How can subjective and objective elements be merged in one theory? A German lawyer will be led by the experience that neither the will theory nor the declaration theory has been able to explain the accepted case law. The normative theory was, therefore, developed as an amalgam of both theories and, as will be seen later,[45] is indeed able satisfactorily to explain the case law. At the same time, it does not neglect the core value of private autonomy since the parties are never held to the objective meaning as such of what they have said or written.[46]

2. How Objective are the Objective Approaches?

The present Scots law is said to follow an objective approach to contract interpretation[47] and the Scottish Law Commission, in this respect, does not see any need for reform.[48] But what is it that makes Scots law so distinctively objective? In fact, there is little which a German lawyer would not subscribe to.

'But commercial contracts cannot be arranged by what people think in their inmost minds. Commercial contracts are made according to what people say...' This is how Lord President Dunedin described the task of interpretation in *Muirhead & Turnbull v Dickson*.[49] If we reduce this dictum to say that the object of interpretation is the declaration then a German lawyer would entirely agree with it.[50] Understood in this way, it does not forbid the person interpreting the contract to go beyond the words when he attempts to understand the declaration.

The crucial issue is what test Scots lawyers apply when assessing what the parties to the contract have said. It is very much the one that we find in German law:[51]

[45] See text following n 92.

[46] cf also Claus-Wilhelm Canaris and Hans Christoph Grigoleit, 'Interpretation of Contracts' in Arthur Hartkamp, Martijn Hesselink, Ewoud Hondius, Chantal Mak, and Edgar du Perron (eds), *Towards a European Civil Code* (4th edn, 2011) 587–618, 588–91.

[47] See text to and references in n 1. On the history of interpretation in Scotland, see Eric Clive, 'Interpretation' in Kenneth Reid and Reinhard Zimmermann (eds), *A History of Private Law in Scotland*, vol II (2000) 47–71.

[48] See reference in n 7.

[49] *Muirhead & Turnbull v Dickson* (1905) 7 F 686, 694 per Lord President Dunedin.

[50] See text to and reference in n 36.

[51] MacQueen and Thomson (n 1) 3.40. See also SLC, Discussion Paper No 147 (n 5) 3.5; *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [3] per Lord President Hamilton; *Forbo-Nairn Ltd v Murrayfield Properties Ltd* [2009] CSIH 94, at [10]; *Middlebank Ltd v University of Dundee* [2006] CSOH 202, at [13]; *Emcor Drake & Scull Ltd v Edinburgh Royal Joint Venture* [2005] CSOH 139, at [13]; *Gloag and Henderson* (n 1) 7.02. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [14] per Lord Hoffmann; McMeel (n 1) 40.

contracts are construed according to 'the position of a reasonable and disinterested third party'. One difference is that German law insists that it needs to be a third person *in the position of the contracting parties.*[52] However, we also find this qualification in Scottish materials.[53]

According to German law, the third person's understanding needs to be attributable to the parties to the contract.[54] Even though Scots law does not appear to have such a general requirement, Scottish courts do very much the same thing as their German counterparts: surrounding circumstances which will function as the backdrop for interpreting the contract are only admissible if they were, or should have been, known to both parties.[55]

Scots lawyers substantiate what needs to be done according to the objective approach:[56] for example, the words have to be read in the context of the entire contract; words are to be understood according to their ordinary meaning; if a technical term is used, it should be given not its ordinary but its technical meaning if the parties have used it as such. Yet Scots lawyers believe that these rules have no independent relevance as they all follow from the objective formula of interpretation.[57] As in German law, these rules only have an indirect effect.[58]

Thus, in principle, the allegedly subjective approach of German law and the so-called objective approach of Scots law appear to be identical. Yet the devil is in the detail and, indeed, there do seem to be differences between the two systems. When assessing these differences it is of primary interest for the purpose of this essay whether they are based on the subjective/objective divide.

[52] See text to n 32.

[53] *Charrington & Co Ltd v Wooder* [1914] AC 71, 82 per Lord Dunedin; *Lloyds TSB Foundation for Scotland v Lloyds Banking Group plc* [2011] CSIH 87, at [10]; *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [41] per Lord Hodge; *Aberdeen City Council v Stewart Milne Group Ltd* [2010] CSIH 81, at [9]; *Credential Bath Street Ltd v Venture Investment Placement Ltd* [2007] CSOH 208, at [18] per Lord Reed; *MRS Distribution Ltd v DS Smith (UK) Ltd* [2004] ScotCS 116, at [13]; Hogg (n 3) 408. See also *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28 per Lord Hoffmann; David McLauchlan, 'Contract Interpretation: What is it About?' (2009) 31 *Sydney LR* 5–51, 6, Nicholls (n 1) 579; Mindy Chen-Wishart, *Contract Law* (3rd edn, 2010) 441; Edwin Peel, *The Law of Contract* (13th edn, 2011) 6-002; AG Guest, 'Express Terms' in HG Beale (ed), *Chitty on Contracts* (13th edn, 2008) 12-043; Lewison (n 1) 2.02.

[54] See text to n 34.

[55] *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [42]–[45] per Lord Hodge; *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118 per Lord Kirkwood; *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28 per Lord Hoffmann; *Emcor Drake & Scull Ltd v Edinburgh Royal Joint Venture* [2005] CSOH 139, at [14]; *Middlebank Ltd v University of Dundee* [2006] CSOH 202, at [27]; SLC, Discussion Paper No 147 (n 5) 5.13. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [14] per Lord Hoffmann; Lord Bingham of Cornhill, 'A New Thing Under the Sun? The Interpretation of Contract and the ICS Decision' (2008) 12 *Edinburgh LR* 374–90, 380; Adam Kramer, 'Common Sense Principles of Contract Interpretation (and how we've been using them all along)' (2003) 23 *Oxford Journal of Legal Studies* 173–96, 178.

[56] MacQueen and Thomson (n 1) 3.41; *Gloag and Henderson* (n 1) 7.02; Discussion Paper No 147 (n 5) 5.13–16.

[57] SLC, Discussion Paper No 147 (n 5) 2.9, 2.11–12; SLC, Discussion Paper No 101 (n 5) 6.30; Scot Law Com No 160 (n 5) 6.3. On the English position see Lewison (n 1) 7.01.

[58] See text to n 35

(1) Surrounding circumstances

The foremost difference turns on the circumstances which may be taken into consideration. German law does not know of any restrictions.[59] Scots law used to be, and still is, more restrictive. It used to be good law that the circumstances surrounding the formation of the contract were admissible in cases of ambiguity.[60] Prior negotiations and subsequent acts could not be relied on. In recent years, English[61] and Scots law have undergone considerable changes.[62] These developments do not need to be retold in this essay.[63] In short, the requirement of ambiguity for surrounding circumstances to be admissible has been abolished.[64] Yet it still seems to be good law that prior negotiations and subsequent acts are inadmissible.[65] The dissatisfaction with this restriction is growing,[66] and the

[59] See text to nn 37 and 38.

[60] See the analysis in SLC, Discussion Paper No 101 (n 5) 2.7–30, 7.1–10; Scot Law Com No 160 (n 5) 2.1–36.

[61] *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28. See also Lord Hoffmann, 'The Intolerable Wrestling with Words and Meanings' (1997) 114 *South African LJ* 656–74.

[62] See esp *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118; *MacDonald Estates plc v Regenesis (2005) Dunfermline Ltd* [2007] CSOH 123, at [132]–[139] per Lord Reed; *Credential Bath Street Ltd v Venture Investment Placement Ltd* [2007] CSOH 208; *Multi-Link Leisure Developments Ltd v North Lanarkshire Council* [2009] CSIH 96, at [23]–[25]. See also *Hardie Polymers Ltd v Polymerland Ltd* [2001] ScotCS 243, at [26]; *Aberdeen City Council v Stewart Milne Group Ltd* [2010] CSIH 81, at [11] stressing that the changes are not as new as they are thought to be.

[63] See, eg, the discussions in SLC, Discussion Paper No 147 (n 5) 4.1–25, 5.1–29; McMeel (n 2) 1.39–46; Ewan McKendrick, 'The Interpretation of Contracts: Lord Hoffmann's Re-Statement' in Worthington (n 2) 139–62.

[64] *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [38] per Lord Hodge; MacQueen and Thomson (n 1) 3.44. See also *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28 per Lord Hoffmann; Burrows (n 3) 81; Sir Jack Beatson, Andrew Burrows, and John Cartwright (eds), *Anson's Law of Contract* (29th edn, 2010) 166; McMeel (n 2) 1.105–106.

[65] *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118 per Lord Rodger for whom the rule is, however, not a strict one and who considered in his opinion the background of the contract, per Lord Kirkwood who discusses exceptions to the rule, per Lord Caplan who simply referred to prior negotiations; *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [39] per Lord Hodge who discusses at [41]–[45] exceptions to the rule; *MacDonald Estates plc v Regenesis (2005) Dunfermline Ltd* [2007] CSOH 123, at [132]–[139] per Lord Reed; *Middlebank Ltd v University of Dundee* [2006] CSOH 202, at [13] per Lord Drummond Young who held that prior negotiations are 'usually' not helpful but then considered documentary evidence from the stage of negotiations; SLC, Discussion Paper No 147 (n 5) 5.17–22; *Gloag and Henderson* (n 1) 7.02–03; McBryde (n 1) 8–28 and 29. On the English position, see *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28 per Lord Hoffmann; *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [28] and [41] per Lord Hoffmann; Lewison (n 1) 3.09; Alan Berg, 'Thrashing Through the Undergrowth' (2006) 122 *LQR* 354–62.

[66] cf the discussion in SLC, Discussion Paper No 147 (n 5) 4.1–19, 7.12–15, 7.18; Laura MacGregor and Carole Lewis, 'Interpretation of Contract' in Reinhard Zimmermann, Daniel Visser, and Kenneth Reid (eds), *Mixed Legal Systems in Comparative Perspective: Property and Obligations in Scotland and South Africa* (2004) 66–93, 83–5; Lord Bingham (n 55) 380–8. See also Kramer (n 55) 177–80; David McLauchlan, '*Chartbrook Ltd v Persimmon Homes Ltd*: Commonsense Principles of Interpretation and Rectification?' (2010) 126 *LQR* 8–14; *idem*, 'Interpretation and Rectification: Lord Hoffmann's Last Stand' [2009] *New Zealand LR* 431–53; *idem* (n 53) 5–51; *idem*, 'The New Law of Contract Interpretation' (2000) 19 *New Zealand Universities LR* 147–76, 170–2; Richard Buxton, 'Construction and Rectification after *Chartbrook*' (2010) 69 *Cambridge LJ* 253–62; Janet O'Sullivan,

Scottish Law Commission suggests that it should be abolished too.[67] Indeed, the better arguments are in favour of admitting prior negotiations and subsequent acts. Let me focus on prior negotiations starting with three observations.

First, in *Bank of Scotland v Dunedin Property Investment Co Ltd*[68] Lord Rodger cited with approval Lord Mustill's dictum from *Charter Reinsurance Co Ltd v Fagan*:[69] 'the inquiry will start, and usually finish, by asking what is the ordinary meaning of the words used'. The German experience shows that admitting prior negotiations within the process of contract interpretation does not conflict with this rule. Usually we will start and finish with what the parties have said, and we will usually understand the words to have been used in their ordinary meaning. When reading the case law we should always be aware of the fact that it is the unusual case that tends to come before the courts.

Secondly, after having read the modern case law I am not convinced that it lends support to the present restrictive approach.[70] For Lord Rodger in *Bank of Scotland v Dunedin Property Investment Co Ltd* the rule was not a strict one.[71] He started with the ordinary meaning. Then he considered prior negotiations and concluded that they supported the ordinary meaning. Others accept exceptions to the inadmissibility of prior negotiations. Prior negotiations are admissible if they were, or should have been, known to both parties and if, objectively ascertained, they shed light on the purpose of the contract, on how the parties used the words, or on what the parties had in mind when entering into the contract.[72] However, these points could simply be understood not as exceptions to the inadmissibility, but as requirements for the admissibility of prior negotiations.

Thirdly, if the objective principle of interpretation requires us to interpret a contract from the perspective of a reasonable person in the position of the parties, it is necessary to admit all surrounding circumstances.[73] Otherwise we would adopt a position which is not that of the parties (unless we presume them to be forgetful).

'Say What You Mean and Mean What You Say: Contractual Interpretation in the House of Lords' (2009) 68 *Cambridge LJ* 510–12; Gerard McMeel, 'Prior Negotiations and Subsequent Conduct—The Next Step Forward for Contractual Interpretation?' (2003) 119 *LQR* 272–97, 282–97; Nicholls (n 1) 577–91; Burrows (n 3) 77–99; *Anson's Law of Contract* (n 64) 167; Chen-Wishart (n 53) 446–7; Stephen A Smith, *Atiyah's Introduction to the Law of Contract* (6th edn, 2005) 145–6; Catherine Mitchell, 'Contract Interpretation: Pragmatism, Principles and the Prior Negotiations Rule' (2010) 26 *Journal of Contract Law* 134–59. See, however, in favour of a more restrictive approach when missives are to be interpreted, Robert Rennie, 'Interpretation of Commercial Missives' 2011 SLT 273–9.

[67] SLC, Discussion Paper No 147 (n 5) 4.1–19, 7.12–15.

[68] *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118. See also *Forbo-Nairn Ltd v Murrayfield Properties Ltd* [2009] CSIH 94, at [11]; *Multi-Link Leisure Developments Ltd v North Lanarkshire Council* [2009] CSIH 96, at [25]; *Autolink Concessionaires (M6) plc v Amey Construction Ltd* [2009] CSIH 14, at [23]; *Middlebank Ltd v University of Dundee* [2006] CSOH 202, at [12].

[69] *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 384 per Lord Mustill.

[70] See also McLauchlan (n 66) 10.

[71] *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118.

[72] *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, [42]–[45] per Lord Hodge; *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118 per Lord Kirkwood. See also *Middlebank Ltd v University of Dundee* [2006] CSOH 202, at [13]–[15], [23]–[29], esp [27]. See also Sir Christopher Staughton, 'How Do the Courts Interpret Commercial Contracts?' (1999) 58 *Cambridge LJ* 303–13, 307–8.

[73] Nicholls (n 1) 580–1; McLauchlan (n 53) 6–7; *Inglis v John Buttery & Co* (1877) 5 R 58, 64 per Lord Moncreiff. See, however, *Inglis v John Buttery & Co* (1878) 5 R (HL) 87; *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [28] per Lord Hoffmann.

Thus, Scots law has two options. It has to change its principle of interpretation so that it reflects these observations. Or it has to admit all surrounding circumstances. At least, the burden of argument is on those favouring a restrictive approach. If their arguments are not convincing the restrictions need to be abolished. What, then, are the arguments brought forward in favour of a restrictive approach?

It is argued that the admissibility of prior negotiations would create increased costs and that it would make the interpretation of contracts more difficult for the parties and their lawyers.[74] However, this is an unproven assumption.[75] If restrictions on the admissibility of surrounding circumstances are to be based upon it, it needs to be proved.[76] Yet, even today lawyers will be confronted with such evidence if their clients understood the contract on the basis of prior negotiations in a certain way. Today lawyers advising clients will filter out inadmissible evidence. Under a different scheme they would filter out irrelevant or unprovable evidence. The work is the same.

It is also argued that admitting all surrounding circumstances would lead to legal uncertainty. Yet if the case law on contract interpretation proves one thing, it is that there is not a lot of certainty in communications between people. Lawyers have to face this problem and should not try to evade it.[77] Furthermore, the context from which evidence is taken does not correlate to its strength: while it may be possible to prove beyond doubt what the parties intended by relying on evidence based on prior negotiations, evidence based on circumstances surrounding the very making of the contract may be doubtful. Finally, parties who do not like a less restrictive approach may contract out of it. In contrast, it is hard to think how parties could contractually agree on a more liberal approach if the law takes a restrictive approach.

Scots lawyers are particularly worried about the position of third parties. Rights under contracts may, for example, be assigned.[78] If surrounding circumstances were admissible, third parties would not be able to assess the right which is assigned to them unless they investigate these circumstances. Yet the Scottish Law Commission has convincingly rejected these arguments.[79] If the expectations of the assignee are not met he should turn to the assignor. If the problem is that assignors regularly exclude their liability, then the interests of assignees are affected not by allowing surrounding circumstances to be taken into account in the process of interpretation but rather by such exclusionary clauses. If assignees agree to such clauses, they accept the risk inherent in them.

[74] *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [40] per Lord Hodge; *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [35] per Lord Hoffmann; Malcolm Clark, 'Interpreting Contracts—The Price Perspective' (2000) 59 *Cambridge LJ* 18–20, 20. See also the discussion in SLC, Discussion Paper No 147 (n 5) 1.18.

[75] See also McMeel (n 66) 289.

[76] In *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [41] Lord Hoffmann took the opposite approach: empirical studies would need to prove that the disadvantages of not admitting prior negotiations are in practice not as great as they are thought to be.

[77] McLauchlan (n 66) 432.

[78] Hogg (n 3) 409, 415–17; SLC, Discussion Paper No 147 (n 5) 1.19.

[79] SLC, Discussion Paper No 147 (n 5) 1.19, 3.12–14, 6.12–17, 7.31–32; cf also *Vectors Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, at [129] per Wilson J.

Sometimes it is held that prior negotiations are only admissible in an action for rectification,[80] though this view is also vehemently rejected.[81] It is based on the assumption that rectification and interpretation should not overlap, as that would make the remedy of rectification superfluous. Yet, rectification may still be attractive to the parties even if prior negotiations are admitted to the process of contract interpretation. If the parties have entered into a long-term contract, it may get harder for them to prove the common intention as time passes. They may fear that it will be more difficult to win a dispute against an assignee. Or they might simply want certainty. Then they should bring an action for rectification.

The Scottish Law Commission has rightly pointed out that there is a problem in drawing the line between admissible and inadmissible surrounding circumstances,[82] a line which a rule-maker simply cannot draw in the abstract. As a consequence, lawyers are forced to argue, under the present regime, whether a specific piece of evidence is admissible or not. They will raise the question of admissibility only if they regard the evidence as relevant. Then, however, it would be arbitrary not to admit relevant evidence.

Finally, the arguments raised against the admissibility of prior negotiations cannot be aligned with the present general approach to contract interpretation prevailing in Scotland. To admit those circumstances which directly surround the formation of the contract also leads to uncertainty. Yet no one argues in favour of a purely literalist approach. To take the perspective of a third person *in the position of the parties* when interpreting a contract is also not in line with the aim of protecting third parties. We would need to take the perspective of a third person in the position of an assignee. Or to put it differently, the very formula of contract interpretation would need to reflect the interests of third parties. Yet no one has ever suggested any modification of that kind. Simply to drop the *parties' position* from the formula would not do, as we do not need to protect just any one, but only those third parties who are potentially affected by the contract. Scots law could, of course, adopt special rules of interpretation with regard to contracts designated to involve third parties.[83] But the position favoured by the proponents of a restrictive approach to the admissibility of surrounding circumstances is neither fish nor fowl. All in all, there are no convincing arguments for not admitting prior negotiations to the process of interpretation.

For the purpose of the present essay, it is of interest that many authors link the question of the admissibility of prior negotiations to the subjective/objective divide. They claim that the admissibility of such evidence would 'clearly add a degree of subjectivity to the process of construction'.[84] This is unconvincing. Subjectivity

[80] *MacDonald Estates plc v Regenesis (2005) Dunfermline Ltd* [2007] CSOH 123, at [118] per Lord Reed. See also *Investors Compensation Scheme v West Bromwich Building Society* [1997] UKHL 28 per Lord Hoffmann; Staughton (n 72) 306.

[81] Burrows (n 3) 77–99; McLauchlan (n 66) 431–53. Compare on the question also SLC, Discussion Paper No 147 (n 5) 1.17, 2.2, 4.20–25, 5.12.

[82] SLC, Discussion Paper No 147 (n 5) 5.29, 7.13.

[83] Canaris and Grigoleit (446) 605.

[84] MacQueen and Thomson (n 1) 3.43. See also Hogg (n 3) 408, 411, 414–15; Robert Hardy, 'The Feasibility Study's Rules on Contractual Interpretation' (2011) 19 *European Review of Private Law* 817–33, 829.

with regard to the interpretation of contracts is about the true will of the parties. Indeed, by taking prior negotiations into consideration the interpreter aims at coming closer to the true intention of the parties.[85] Yet even with prior negotiations being taken into account, the contract is still to be understood as a third person in the position of the parties understands it.[86] Thus, the contextual approach to interpretation does not lead to a subjective objectivity[87] but to an individualized objectivity whereas the literalist approach entails a generalized objectivity.

(2) Known mistakes

Both Scots and German law accept that there is an exception to the objective approach:[88] if one party understood the contract in a particular way and if the other party knew of the first party's understanding, the contract will be interpreted according to the first party's understanding, even though an objective interpretation may call for a different result, and even though the other party may have had a different intention.

In this regard, everything turns on the question which circumstances are to be admitted to prove the other party's knowledge. It is generally recognized that an exception must be made to the rule that prior negotiations are inadmissible: if the other party's knowledge can be proved on the basis of such evidence, this will do.[89] In fact, anything else would hardly be convincing.

Scots lawyers believe that the known mistake rule differs from its equivalent in continental legal systems.[90] In Scots law it is taken to be embedded in an objective setting and is only of subsidiary application. In the continental legal systems it is part of the subjective approach and must therefore be of greater practical importance. Yet we have seen that, with regard to German law, such a difference does not exist.[91]

If we accept the known mistake rule we need to explain it: Scots lawyers concede that it adds a subjective element to contract interpretation and it is perceived as an exception to the objective approach. But why is it an exception to it and not a contradiction? No answer is provided in Scottish text books. German law can explain this rule:[92] (a) contracts are to be understood as a reasonable third person in the position of the parties would understand them. Such a third person has the special knowledge of the parties and this includes the other parties' knowledge of

[85] Lord Hoffmann (n 61) 661; Lord Bingham (n 55) 375–6.

[86] SLC, Discussion Paper No 147 (n 5) 6.26. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [33] per Lord Hoffmann; Burrows (n 3) 82; Lord Bingham (n 55) 379–80; Nicholls (n 1) 583.

[87] This is how Hogg (n 3) 408, 411 refers to the contextual approach.

[88] SLC, Discussion Paper No 147 (n 5) 2.8; Lord Bingham (n 55) 381; *Houldsworth v Gordon Cumming* 1910 SC (HL) 49; *Macdonald v Newall* (1898) 1 F 68; *Hunter v Barron's Trustees* (1886) 13 R 883. However, recently doubt has been shed on whether or not Scots law still follows this exception; see SLC, Discussion Paper No 147 (n 5) 5.29.

[89] SLC, Discussion Paper No 147 (n 5) 2.8; *Houldsworth v Gordon Cumming* 1910 SC (HL) 49.

[90] SLC, Discussion Paper No 147 (n 5) 2.8.

[91] See text to and following n 44.

[92] See also Stefan Vogenauer, 'Interpretation of Contracts: Concluding Comparative Observations' in Burrows and Peel (n 1) 123–50, 141.

the first party's mistake.[93] (b) There is a policy reason underlying the normative principle.[94] With a declaration of will which needs to be communicated to a recipient in order to become effective, we cannot merely look at what the party making the declaration subjectively intended in view of the legal effects of that declaration on the recipient. His interests also need to be protected. Yet that protection would go too far if his understanding of the declaration were to be the decisive factor. That is why resort is had to the third person. If, however, the recipient knew of the first party's intention, he does not require to be protected and resort to a third person is not therefore necessary.

Scots lawyers insist that the parties' individual statements of intention should not guide the process of interpretation.[95] Indeed, 'standing alone such statements are not evidence of the parties' common intention' and they are as a consequence irrelevant.[96] However, the known mistake rule demonstrates that such statements can be relevant: when they make known to the other party, before the contract is concluded, how the first party understands the contract. This can even be aligned with Lord President Dunedin's dictum in *Muirhead & Turnbull v Dickson*.[97] Once the intention is communicated to the other party, the contract will not 'be arranged by what people think in their inmost mind' but by what they have communicated.

(3) *Falsa demonstratio non nocet*

There is case law suggesting that Scots law accepts the *falsa demonstratio* rule.[98] Recent developments have shed doubt on that proposition.[99] Yet the *falsa demonstratio* rule is included in the known mistake rule: if the real intention of one party prevails when it is known to the other party, it follows that the real intention of one party should also prevail if it is shared by the other. Some Scottish authors reduce the question whether Scots law knows the *falsa demonstratio* rule to the subjective/objective divide:[100]

> On one view ... we may even be entitled to create our own personal language ... That, at least, is the conclusion reached from a strong emphasis upon the subjective will of the parties ... There is a different view of contracts, however. If parties choose to frame their agreement in a specific language, then it can be said that they submit to the

[93] See, concerning Art 5:101(2) Principles of European Contract Law, Zimmermann (n 9) 1357.
[94] See text following n 30.
[95] SLC, Discussion Paper No 147 (n 5) 2.7, 3.8; MacGregor and Lewis (n 66) 87.
[96] SLC, Discussion Paper No 147 (n 5) 3.8. See also Staughton (n 72) 305.
[97] See quotation to n 49.
[98] *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118 per Lord Rodger; *Luminar Lava Ignite Ltd v Mama Group plc and Mean Fiddler Holdings Ltd* [2010] CSIH 01, at [42] per Lord Hodge; *Credential Bath Street Ltd v Venture Investment Placement Ltd* [2007] CSOH 208, at [19] per Lord Reed. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [15] per Lord Hoffmann; David McLauchlan, 'Common Intention and Contract Interpretation', [2011] *LMCLQ* 30–50; McLauchlan (n 53) 12; Burrows (n 3) 83–4.
[99] *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [47] per Lord Hoffmann. See, however, *Partenreederei MS Karen Oltmann v Scarsdale Shipping Co Ltd* (*The Karen Oltmann*) [1976] 2 Lloyd's Rep 708 (the so-called private dictionary principle) and the discussion in SLC, Discussion Paper No 147 (n 5) § 4.12. See also Staughton (n 72) 306.
[100] Hogg (n 3) 408–9.

> fundamental purpose of language... Such a view overcomes the difficulty that each of the parties may have had a different understanding of the words being used...

But such thinking along the lines of the subjective/objective divide does not allow us to fine-tune the solutions to problems of contract interpretation. It is certainly correct to say, as is done in the second half of the quotation, that we have to follow the objective meaning of the words if the parties had different understandings. Reading the first half of the quotation we are, however, led to believe that the subjective understanding does not prevail even when the parties were in agreement. But I cannot believe that, if the parties informed the court of their concurrent subjective understanding, they would be held to the objective meaning.[101] Scots lawyers, focusing on the subjective/objective divide and subscribing to an objective approach, are thus in danger of arguing from the top down and on that basis rejecting the *falsa demonstratio* rule. However, we have to think from the top down and the bottom up at one and the same time. Our starting point has, of course, to be the accepted case law. Those charged with reforming the law then have to ask themselves whether that case law is justifiable on policy grounds. A theory of interpretation thus needs to be designed from the bottom up. All policy arguments have to be reflected in that theory. At the same time, all the cases need to be explicable on the basis of that theory, following the top-down approach. If that turns out to be impossible, either the theory or the case law and the policy considerations on which it is based have to be rethought. If, therefore, thinking along these lines, we accept that the known mistake and the *falsa demonstratio* rules are well founded and are part of Scots law, Scots law will have to devise a theory that overcomes the subjective/objective divide.

3. Understanding and Misunderstanding International and European Instruments of Legal Unification and Harmonization

I need to be cautious in the following section of this essay for I do not wish to say that German lawyers understand international instruments correctly whereas Scots lawyers misunderstand them. My point is that they understand them differently, by approaching them with their respective national preconceptions in mind.

Let us take Article II.-8:101 DCFR. Its first paragraph recognizes the *falsa demonstratio* rule, its second paragraph the known mistake rule, and its third paragraph contains the objective formula. German authors read Article II.-8:101 upside down:[102] in most cases the interpretation will turn on the third paragraph. The *falsa demonstratio* rule and the known mistake rule are, in practice, only of secondary importance. Scots lawyers read Article II.-8:101 differently. Coming

[101] Hogg (n 3) 413 no 21.

[102] Zimmermann (n 9) 1356; Stefan Vogenauer in Stefan Vogenauer and Jan Kleinheisterkamp (eds), *Commentary on the Unidroit Principles of International Commercial Contracts (PICC)* (2009) Art 4.1 nn 8–16; Vogenauer (n 9) 976; Martin Schmidt-Kessel in Peter Schlechtriem and Ingeborg H Schwenzer (eds), *Commentary on the UN Convention on the International Sale of Goods (CISG)* (3rd edn, 2010) Art 8 n 11.

from a system which stresses the objective approach to interpretation, they are alarmed by Article II.-8:101(1); they imagine that the DCFR adopts a subjective approach and believe that Article II.-8:101(3) is only of secondary importance.[103]

Scots lawyers will argue that the German reading is in conflict with the order of the paragraphs and that it therefore cannot be right. Yet German lawyers will have a counter-argument. It draws upon the policy consideration underlying the third paragraph.[104] In the process of contract interpretation we cannot look at what the parties intended because often there is no subjective common intention. Nor can we build upon the intention of one party only because the contract also affects the other party and, thus, the other party also needs to be protected. That is why we resort to the reasonable third person. If the other party, however, had knowledge of the first party's intention, or if the parties had a shared intention differing from the literal meaning of the words, the policy reason for resorting to the third party's perspective does not apply. We use the objective formula only in those cases in which the known mistake rule and the *falsa demonstratio* rule do not apply. Moreover, even Scots lawyers, among them Eric Clive who seems to have had a strong influence on the drafting of the provisions relating to interpretation in the DCFR,[105] occasionally concede that the order of paragraphs might have been reversed without changing the content of the article.[106]

There is one point in which the Scottish Law Commission clearly misunderstands the DCFR and that concerns the relationship between Article II.-8:101(1) and (2). The Scottish Law Commission believes that the known mistake rule is an example of the application of Article II.-8:101(1).[107] This, however, is not the case.[108]

4. Conclusion

This essay is dedicated to the memory of Alan Rodger. Having studied in Regensburg, Aberdeen, and Oxford between 1992 and 1998, I became acquainted with Alan Rodger's writings at an early stage and developed a feeling of utmost respect for his learning. When I first met Alan, I was struck by his modesty and by his genuine interest in what a German student and, subsequently, young academic might think and write about Scots law; and I was very grateful for his encouragement. This is why I decided to contribute an essay comparing Scots law with German law to the present collection. Its objective, however, is rather modest. It revisits the subjective/objective divide in contract interpretation. Scots lawyers tend

[103] SLC, Discussion Paper No 147 (n 5) 2.6, 2.8, 2.13, 3.3–4, 6.24. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, at [39] per Lord Hoffmann; Hardy (n 84) 829–30. See also, however, McMeel (n 2) 2.25–28 who follows the German reading of these rules.

[104] See text to and following n 94.

[105] Zimmermann (n 9) 1368; Hellwege (n 5) 100.

[106] Eric Clive, 'Interpretation' in Hector L MacQueen and Reinhard Zimmermann (eds), *European Contract Law: Scots and South African Perspectives* (2006) 176–202, 197–8. See also Zimmermann (n 9) 1356–7; Hellwege (n 5) 103.

[107] SLC, Discussion Paper No 147 (n 5) 7.16.

[108] See text following n 44.

to think along the lines of this divide. Yet a comparison of Scots and German law suggests that this divide is exaggerated.[109] In particular, it does not seem to be very helpful to analyse Scots law in terms of an objective approach. Instead, it is suggested that the Scottish approach to contract interpretation can be reduced to the following points.

First, the object of interpretation is the declaration: what the parties have said or the written contract.[110] This is the objective side to interpretation.

Secondly, the aim of interpreting the declaration is to come as close as possible to the true intention of the parties who have expressed their intentions through that declaration.[111] If we have evidence proving the true common intention of the parties, or if we have evidence that one party had knowledge of the true intention of the other party, then that intention determines how the contract is to be enforced. This is the subjective side to contract interpretation.

Thirdly, however, in most cases, we run into problems identifying the true will of the parties: the common intention is a fiction, as the parties only have their individual wills; the true individual intentions of the parties may not reflect all the problems which may arise; the parties may not even have read the contract and then even the individual intention may be a fiction. In these cases, Scots law, just like German law, holds the parties to what the law takes them to have intended. This is the normative side to interpretation. In deciding what the law will take the parties to have intended, it must be noted that a party's subjective intention or subjective understanding (ie its 'inmost mind') cannot be decisive as it is not discernible to the other party, and the other party's legal position is also affected by the contract. Yet by being guided simply by the objective meaning of what has been said or written, the interpreter will move too far away from what may be the true intention of the parties. Scots law, therefore, regards the position of a reasonable third person in the position of the parties as decisive.[112]

Fourthly, the third person will start and will usually finish with the ordinary meaning of the words that have been used.[113] However, he may also, as a means of interpretation, resort to all facts which could have been known to both parties and which point to a common intention at the time of the making of the contract.[114] The requirement that only those circumstances are admissible which could have been known to both parties, again puts an objective spin on the exercise of interpretation. Yet an individual statement of intention by one party which is known to the other will do.[115] Furthermore, it follows from the normative principle that the interests of third parties are not protected and that there are no

[109] See also Robert Goff, 'Commercial Contracts and the Commercial Court' [1984] *LMCLQ* 382–93, 388.

[110] *Muirhead & Turnbull v Dickson* (1905) 7 F 686, 694 per Lord President Dunedin.

[111] Lord Hoffmann (n 61) 661; McMeel (n 2) 1.61; Mitchell (n 66) 153. See also Canaris and Grigoleit (n 83) 590.

[112] See references in n 53.

[113] *Bank of Scotland v Dunedin Property Investment Co Ltd* [1998] CSIH 118 per Lord Rodger.

[114] See references in n 72.

[115] SLC, Discussion Paper No 147 (n 5) 3.8.

restrictions on the admissibility of surrounding circumstances. If Scots law wishes to protect third parties or if it wishes to put restrictions on the admissibility of such circumstances, it needs to adopt a different normative principle of interpretation. With respect to third parties, it might also adopt special rules relating to contracts typically involving such third parties.

Fifthly, the most difficult part in the process of interpretation is its normative aspect. The traditional rules of interpretation may be of help but they do not call for strict adherence.[116] Basically, everything turns on the facts of the case even in a system in which interpretation is a question of law,[117] and the facts of the case can be so manifold that it is impossible to generalize. As Werner Flume once wrote, 'The art of interpretation . . . can only be experienced through practice'.[118]

And, finally, legislative reform of Scots law is being considered. It follows from what has just been said about the normative side of interpretation that legislation cannot give 'a clear cut answer in difficult cases' as is sometimes demanded.[119] Indeed, legislation may not even give clear answers to fundamental issues: the divergent reading of the provisions of the DCFR by Scots and German lawyers suggest that just about anything may be read into legislative provisions relating to interpretation. Thus, in the field of interpretation, not too much should be expected of legislative reform. If Scots law reformers are looking for a model they may turn to the DCFR. They may consider changing the order of the paragraphs in Article II.-8:101 if they wish to bring out more clearly the normative side to interpretation.

[116] SLC, Discussion Paper No 147 (n 5) 2.9, 2.11–12.

[117] On whether questions of interpretation are matters of law or of fact, see McMeel (n 2) 1.08–15.

[118] Flume (n 31) 317: 'Die "Kunst" der Auslegung kann man nicht in Sätzen erlernen, sondern nur in der Übung erfahren.'

[119] Hogg (n 3) 413.