

THE PRINCIPLES OF CONTRACTUAL INTERPRETATION

BUSINESS AS USUAL

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INTRODUCTION

Both last year and the year before, this presentation focussed on what had become an ongoing controversy concerning the principles of law that should be applied to the exercise of construing a contract. A judicial and academic debate had developed concerning when, and to what extent, it was legitimate to have regard to evidence of matters which were extrinsic to the contract which a court or an arbitrator had to construe on the basis that such material was relevant “background”¹.

Comments had been made by Lord Hoffman to the effect that an agreement had to be construed in its context and that “the background which might be relevant was absolutely anything which might assist the court in the task of construing the agreement”². This comment was seized upon by some commentators and Justice Thomas in the New Zealand Court of Appeal, to justify a broader approach to contractual interpretation which would allow very general reference to extrinsic material to assist in arriving at the meaning of the contract.

In past seminars I have outlined the reaction to the interpretation of Lord Hoffman’s comments and explained how Lord Hoffman himself had placed those comments in their context in a subsequent case. The overall result had been to restate an orthodox approach to the interpretation of contract and retain accepted limits on reference to extrinsic evidence as an aid to interpreting the contract. The spectre which seemed to have arisen of commercial cases concerning the construction of contracts being bedevilled by the need to consider a wide range of evidence falling outside the contract to arrive at a “fair” interpretation of the contract has largely receded.

In the past year there have been a number of cases (as there will be in any year given the fundamental role of contractual obligations in our lives) where the basic principles of contractual interpretation have been applied. In the cases the courts have emphasised the need to concentrate on the central task of construing the agreement reached by the parties objectively in accordance with the natural and ordinary meaning of the words which the parties have used in their agreement.

Comments in *Potter v Potter*³

This emphasis on orthodoxy is underlined by the Court of Appeal in *Potter v Potter*. This decision contains clear statements to the effect that extrinsic material should not be referred to, save in particular limited circumstances and will not be admissible other than to resolve ambiguities.

¹ See the papers – *The Construction of Commercial Contracts* (2002) and *Construing Commercial Contracts – The background, the Purpose or the words?* (2003)

² See *ICS Limited v West Bromwich* [1998] 1 WLR 896

³ [2003] 3 NZLR 145

The case concerned the interpretation of a property sharing agreement entered into by *de facto* partners. The couple agreed to purchase a home and orchard business together. Before settlement, as many couples do, they entered into a property sharing agreement.

One of the parties provided the whole purchase price. The parties separated. The property was sold. The main question was whether the party, who had provided the full purchase price, could claim to be entitled to an interest under a resulting trust over half the purchase price or, claim to be entitled to repayment of half the purchase price on the basis the agreement was a loan. The agreement provided that:

I, John, will:

(a) Provide the half share purchase price payable by Louisa for a half share of Inlet Road in consideration of Louisa entering into this agreement.....

High Court

In the High Court the judge held that the parties were each entitled as tenants in common in equal shares and that each was to be regarded on the terms of their agreement as having provided a half share of the purchase price. On appeal, in simple terms, the argument was that, on the proper interpretation of the agreement, and in the light of extrinsic evidence, there was, as a result of the agreement not being performed, either a resulting trust of half the proceeds of sale in favour of the party who had provide the purchase price or a presumption that the provision of the whole purchase price was a loan of half the purchase price to the other party.

Court of Appeal

The judgment of the Court of Appeal was given by Justice Fisher. The Court initially observed that the resulting trust claim and the loan claim were mutually exclusive. The resulting trust argument was rejected.

On the loan argument the Court of Appeal found that, on the face of the agreement, there was nothing to say that there was any contract of loan of half the sale price by the party paying the whole purchase price. An argument based on the use of the word "provide" in clause 1(a) of the agreement was met by consideration of the agreement as a whole. From this consideration the Court concluded that the agreement clearly meant that the payment of the money was irrevocable (in the same way as the surrender of other property rights by the other party to the agreement was irrevocable). The Court then had to deal with an argument that

the contract should be interpreted as a contract of loan on the basis of extrinsic evidence and made observations of a general nature on this topic.

The appellant sought to rely on certain general statements concerning the construction of agreements in their context in various authorities as the basis on which to admit this background material. A broad approach to extrinsic material was advanced.

Extrinsic material

The Court of Appeal rejected any broad availability of extrinsic material to support a particular interpretation of the contract. It emphasised that the reference to background knowledge by Lord Hoffman in *I C S Limited v West Bromwich*⁴ had to be read in context and subject to the basic proposition in Lord Hoffman's own speech that the law excludes from "admissible background the previous negotiations of parties and their declarations of subjective intent". The Court described Lord Hoffmann's statements on contractual interpretation as a "gloss" on the well known speeches of Lord Wilberforce in *Prenn v Simmonds*⁵ and *Reardon Smith Line Ltd v Yngvar Hansen-Tangen*⁶ (and expressed uncertainty about how long the gloss might endure).

The Court made this general comment about the conduct of commercial litigation in New Zealand:

Wherever the emphasis is placed, the way in which commercial litigation is currently conducted in New Zealand suggests widespread misunderstanding of the limits of extrinsic evidence. It must not be overlooked that the "background knowledge" referred to by Lord Hoffman can be relevant only where stringent requirements are satisfied. Four are of particular importance in the present case.

The judgment then outlines four of the "stringent requirements" which are relevant in the case:

- Background material cannot be used to suggest ambiguity or throw doubt on the meaning of the contract. Interpreting a contract in its objective factual setting does not mean using the background to create doubt about the natural ordinary meaning of the words in the contract. Rules which aim to remove ambiguity cannot be used in this way. (see eg. *Melanesian Mission Trust Board v Australian Mutual Providence Society* [1997] 1 NZLR 391, 395 (PC).
- Extrinsic evidence can only ever be admitted to prove facts which are mutually in the contemplation of the parties at the time of the contract.

⁴ [1998] 1 WLR 896, 913(A) (HL)

⁵ [1971] 1 WLR 1381, 1384-1386

⁶ [1976] 1 WLR 989

- The subjective intention of the parties is always irrelevant and inadmissible.
- Precontractual negotiations, earlier drafts and similar documents are not admissible unless they support objective observable facts as opposed to contentions as to meaning by either party. The aim is to construe the contract which was entered into, not earlier versions of it⁷.

This means that extrinsic evidence which goes beyond the objective general background to the agreement will, in addition to being unhelpful, also be inadmissible. As the Court of Appeal noted there has been no change made by the Privy Council in *Yoshimoto* to the limits of the admissibility of extrinsic evidence.

The Court of Appeal noted that we are back now to the established position of starting and usually ending with the interpretation of the agreement itself (see dictum in *Wel Energy Group Limited v ECNZ*⁸). The Court saw the need to focus the minds of lawyers on the limited ambit of what is relevant on a question of contractual interpretation. It observed that considerable misdirected litigation time might be saved if more effect were given to those limits.

In *Potter v Potter* the Court of Appeal ultimately held that if the principles were carefully applied none of the extrinsic evidence which the appellant sought to rely on was admissible. The Court further held that various objective facts which were within the mutual contemplation of the parties at the time of the contract were admissible but did not support any interpretation other than that which would be reached by analysing the document itself. The plain and ordinary meaning of the agreement was that the payment of the purchase price under the agreement was irrevocable and not a loan. There was no loan of half the purchase price on the true construction of the agreement. The appeal failed.

Recent cases

In the past year, the New Zealand courts (and, no doubt, arbitrators) have had to construe contracts of many different kinds. The decisions continue to reflect some uncertainty about the scope of the relevant background which can be referred to, in order to place an agreement in its factual context but generally emphasise the awareness of the strict limits on the use of extrinsic material and the basic requirement to focus on the meaning of the agreement to be construed. The contracts considered range from property sharing arrangements⁹ to complex commercial property agreements¹⁰, from relatively informal

⁷ See eg Lord Hoffman in the Privy Council in *Canterbury Golf International Limited v Yoshimoto* [2004] 1 NZLR 1

⁸ [2001] 2 NZLR 1 at 18.

⁹ *Potter v Potter* (supra)

¹⁰ See eg *Auckland City Council v Union House Ltd* (unreported) High Court, Auckland, Randerson J, 30 July 2003

commercial arrangements for work on a takeover¹¹ to formal settlement deeds¹², from complex joint venture arrangements in the oil and gas industry¹³ to detailed contractual arrangements governing the selection of Olympic athletes¹⁴. In the last case, the Court of Arbitration in Sport (“CAS”) has recently applied fundamental principles of contract interpretation in deciding on the meaning and application of selection criteria.

The scope for reference to background extrinsic material is inherently somewhat uncertain but the established general principle that extrinsic evidence will not be admitted unless the agreement can fairly be said to be ambiguous remains.

Some practical points

On a practical level, the correct approach to the construction of a contract provides a natural focus on the agreement itself. This has an obvious significance for those who draft contracts and those who become involved in disputes over them - clear focus on the meaning of the bargain is essential. There will always be potential for some argument concerning the relevant admissible background but the proper recognition of the limits on the use of extrinsic material by lawyers and the courts will both maintain focus on the agreement itself and offer the opportunity for the more efficient determination of contractual disputes.

Procedure for rapid resolution

If a dispute concerning a contract arises, which cannot be resolved, the correct approach to what is admissible in such a dispute should mean that the dispute can be decided and the rights of the parties declared rapidly, whether by a court or an arbitrator. Procedural mechanisms are available in the form of summary judgment under HCR 138 or a construction summons in the Commercial List. Express provision is made by section 24C(4) of the Judicature Act 1908 for an application to the Commercial List judge where any dispute has arisen concerning the construction, status or application of a contract or document and the matter is eligible for entry in the Commercial List. The procedure under HCR 446P involves filing a statement of claim and an affidavit with all relevant exhibits. The Commercial List judge has broad procedural discretion to bring the matter to a rapid hearing. Issues concerning the interpretation of documents in their (limited) objective factual background

¹¹ *Jowda Holdings Ltd v Cullen Investments Ltd* (unreported) CA, McGrath J, Fisher J and Rodney Hansen J, 5 June 2003

¹² *Compcorp Ltd v Force Entertainment Centre Limited* [2003] 7 NZVLC 403, 996

¹³ *Greymouth Petroleum Acquisition Company Limited & Or v Ngatoro Energy Limited* (unreported) High Court, Wellington, 30 May 2003 where, in relation to the interpretation of a joint venture operating agreement for an oil-field in Taranaki, the judge appears to adopt a very wide view of the matrix of fact and considered post-contract dealings as admissible to assist in construing the contract.

¹⁴ *Yachting New Zealand v Murdoch; Yachting New Zealand v Cooke & Gair*, Award of Court of Arbitration for Sport, (“CAS”) 2 April 2004

should be capable of determination by those procedures. The problem is that these procedures can be avoided by pleading a case which broadens the scope of the factual inquiry (eg claims based on mistake, rectification, the Fair Trading Act or estoppel). The reality of such claims in the context of a commercial contract is that they often have little or no chance of success but are included to avoid arguing the central issue quickly. Little can be done to prevent this but I would suggest that, in many disputes, parties and their advisers might be better occupied in focussing at an early stage on the merits of the central interpretation issues and, if necessary, having those issues resolved in an efficient manner rather than broadening (and delaying) the litigation.

Conclusion

In the past year we have seen the application of the established principles of contractual interpretation to a range of contractual relationships. There has been an important underlining of the limits on the use of extrinsic evidence as an aid to interpretation. While the precise scope of the relevant background will vary in different contractual contexts, it can and should, be quite confined in most contractual settings. Extrinsic evidence of matters which were within the mutual contemplation of the parties to support a particular interpretation of the contract should only come into play if the contract can properly be described as ambiguous.

It is to be hoped that a clearer attitude to the admissibility of extrinsic evidence may lead to a more efficient disposal of contractual disputes in the courts if such disputes arise.

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