

THE CONSTRUCTION OF COMMERCIAL CONTRACTS

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Introduction

At law school the young lawyer learns about many aspects of contract law - offer and acceptance, the consequence of mistake and misrepresentation, the effects of illegality, the various discretionary powers under our contractual statutes, questions of remoteness of damage etc – but, in practice, the core of a commercial lawyer's work, whether in drafting commercial contracts or in disputes concerning contracts, is the construction (some might say “deconstruction”) of commercial contracts. At the heart of commercial law and commercial disputes lies the network of contracts formed by commercial parties (primarily contracts governing the sale of goods), and central to the work of commercial lawyers is the drafting and interpretation of those contracts. Two of the most common questions commercial lawyers will hear from their clients are:

How should we best put that in writing in our agreement?

And, what does that clause mean?

The range of bargains with which commercial law is concerned is wide. Occasionally contracts will be oral. Some contracts will be partly oral and partly in writing. Most will be written. There will be the agreement in which every single point is hammered out between two well-advised parties after the exchange of many drafts, where the final agreement can be regarded as the private legal universe created by the parties. At the other end of the spectrum, there will be the contract in writing which is on a standard form (with or without amendments) used for convenience and efficiency to get the deal done as quickly as possible. Some contracts may have no element of negotiation at all and will, in reality, be imposed by one party on another by the nature of the market and bargaining strength. In some areas, agreements will be based on international usage or convention or employ particular terms which have settled, well established meanings, which the parties assume will be strictly applied and construed. The ICC clauses for the international sale of goods (INCOTERMS) and the ICC rules governing documentary credits (UCP) are obvious examples. In the area of international trade, by way of example, the lawyer's work is taken up with the network of contracts, many on standard bill of lading and charterparty forms with negotiated amendments, between the commercial parties under which goods are moved and transactions completed.

Principles of construction

The construction of contracts and the principles developed by the courts to assist in that exercise may not interest business people. They usually just want an answer to the questions which they bring to the court. However, in any civilised legal system, principles are required so that those who give the answers, our judges and arbitrators, can give reasons and provide certainty of approach to commercial people. The construction of a contract is a question of law and the courts have developed guiding principles to assist in that process. It is important to note that principles of construction are a

guide for the court by which the court seeks to arrive at the intentions of the parties. Principles of this kind have always been flexible tools for a court. The flexibility and breadth of the principles has been increased by recent decisions.

Historically, the principles of construction focussed on the agreement and drew clear lines against the admissibility of extrinsic material. In the last 50 or so years we have seen a movement in the approach to the interpretation of contracts from a literal approach which focussed solely on the words used by the parties in the contract to a more commercial approach which involves looking rather more at the background¹ to the transaction to ascertain the meaning of the contract in its context. This change came with cases such as *Prenn v Simmonds*² and *Reardon Smith Line Ltd v Hansen-Tangen*³ which permitted reference to the background to the transaction or the “matrix” as an aid to the construction of the terms of the commercial contract (and, of course, an exception to the parole evidence rule⁴). The change was limited but did represent a significant move to examine the meaning of a commercial contract in its context.

Recent judgments in both New Zealand and the United Kingdom have contained statements which permit much more reference to the background to the contract to help the court in finding the meaning of the words used. The result of this is a measure of uncertainty as to what is meant by the commercial background and as to when it is appropriate to examine that background, together with continued judicial amplification of what the applicable principles of construction should be.

In the older cases, the courts emphasised constantly that the aim of a court construing a contract was to arrive at the meaning of the agreement in an objective sense and thereby declare the intentions of the parties. The rules of construction underlined this fundamental aim. Recourse to the background was rare and only appropriate where the agreement was ambiguous or uncertain or the terms of the contract conflicted. If the contract’s meaning was clear without the background, then the courts would declare the meaning of the contract. The recent cases have cast the background in wider terms and general judicial statements support recourse to the background to allow the court to modify the apparent usual meaning of the words used in the contract.

The danger with looking at the background to the transaction and extrinsic material is, of course, that this can get out of hand. The background can be used by an inventive judge with a particular view to justify a finding which he or she believes is just and fair which does real violence to the words used by the parties. There is no general principle of the equitable construction of commercial contracts⁵. The

¹ This was the traditional matrix identified by Lord Wilberforce – the commercial purpose of the contract, in the objective sense, its genesis and background, the market etc – see *Reardon Smith Line Ltd v Yngvar Hansen-Tangen (trading as HE Hansen Tangen)* [1976] 1 WLR 989 (HL) at 996.

² [1971] 1 WLR 1381 (HL)

³ *Supra* at note 1

⁴ For a traditional statement of the parole evidence rule and its exceptions see *GH Treitel Law of Contract* 10th Ed (London: Sweet & Maxwell, 1999) pages 180-183.

⁵ The particular linguistic gymnastics which were carried out to read down exclusion clauses in the United Kingdom courts was strongly criticised before statutory reform gave the court a clear discretion to declare a clause unreasonable – See eg. Lord Wilberforce in *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 at page 843 and Lord Denning MR in *Mitchell (George) Chesterhall Ltd v Finney Lock Seed* [1983] QB 248 at 295-297, noted by Lord Hoffmann in *BCCI* as supporting a changed approach to construction matter.

construction of a commercial contract has always been an objective matter in which the court tries to give to both parties the bargain which they have recorded. The court has to declare the meaning of the bargain rather than rewrite its terms. If bargains were to be consistently reframed by judges, the importance of the contract both for the parties and third parties and markets, who deal on the basis of the terms of the contract not its background, would be lost sight of. The potential difficulty with a wide-ranging ability to look at a range of material falling outside the written contract, which is present in modern decisions, is that this gives considerable leeway to judges to produce what they might see as just results and considerable further ammunition to a party looking to disturb a bargain struck in a changed situation. In short, a broad approach can be an open door to both increased levels of litigation and judicial activism in the area of the interpretation of commercial contracts.

As I hope the short review of the recent authorities which follows will show, while there is uncertainty in the area, I do not believe that the courts have, in reality, shifted the basic focus away from the words used by the parties. Our courts, and the courts of the common law world, will, I believe, remain focussed on the words used by the parties and the task of ascertaining the meaning of the contract in an objective manner from the contract.

Recent cases

Lord Hoffmann has made several general statements concerning the principles of contractual interpretation. He has used interesting literary examples to emphasise that all meaning comes from context and has advocated a wide ranging ability to examine all that can be described as context to ascertain meaning. *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd*⁶, involved a dispute concerning the construction of a notice under a commercial lease where a commercial tenant purported to give a notice to its landlord to end its tenancy. The notice was expressed to take effect on the wrong date. The House of Lords held (with Lords Goff and Jauncey dissenting) that the notice was effective because, in the commercial context, a reasonable recipient of the notice would have been left in no doubt that the tenant wished to determine the tenancy on the right date under the lease but had put the wrong date in the notice. Lord Hoffmann emphasised that sometimes the context of a statement can show that the plain meaning of the words used in a contract may be wrong and found that in the context of this lease a reasonable recipient of the notice would have understood the notice as being a notice to terminate on the correct day in accordance with the lease⁷.

This case can be interpreted simply as involving the interpretation of unilateral notices, where it can be contended that the notice only has to be generally effective as opposed to strictly complying with the contract. However, the broad statements by Lord Hoffmann which apparently allow the background to the contract to be used to “correct” the plain meaning of a contract have attracted both criticism and approval. Some have said that the statements herald a “new” approach to construction.

⁶ [1997] 3 ALL ER 352, [1997] 2 WLR 945 (HL)

⁷ See the use of *Mrs Malaprop* to explain how the context may show that the conventional meaning of the words in an agreement is wrong in the judgment of Lord Hoffmann

After *Mannai* came the statement of general principle concerning the construction of commercial contracts in *Investors Compensation Scheme Ltd v West Bromwich Building Society*⁸ which was adopted by the New Zealand Court of Appeal in *Boat Park Ltd v Hutchinson*⁹. Lord Hoffmann said as follows (with emphasis added):

(1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.

(2) The background was famously referred to by Lord Wilberforce as the 'matrix of fact', but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, ***it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.***

(3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

(4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. ***The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax (see Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd [1997] 3 All ER 352, [1997] 2 WLR 945).***

(5) The 'rule' that words should be given their 'natural and ordinary meaning' reflects the commonsense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord

⁸ [1998] 1 All ER 98, [1988] 1 WLR 896 (HL)

⁹ [1999] 2 NZLR 74 (CA)

Diplock made this point more vigorously when he said in *Antaios Cia Naviera SA v Salen Rederierna AB, The Antaios* [1984] 3 All ER 229 at 233, [1985] AC 191 at 201:

... if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense.

This statement of general principles, made in the context of a dispute about the construction of a claim form, was adopted and applied to the construction of a contract by Justice Thomas in the New Zealand Court of Appeal in *Boat Park Ltd v Hutchinson*¹⁰ and has been repeated in most New Zealand contract interpretation cases since¹¹. It is to be noted that the possible available background on a question of construction under this approach is broad - “absolutely anything” – and seems to be readily available to check or interpret the meaning of the words used in the contract, rather than only being brought into play when there is uncertainty or ambiguity in the contract. The background still does not include the evidence of the subjective intentions of the parties or their negotiations, although the scope of this exception is now said to be “unclear”.

The *Boat Park* case concerned the construction of a contract for the sale of land in which the vendor was to provide a mortgage to the purchaser limited to 75 percent of a registered valuer’s valuation of the property. The purchaser obtained a valuation on the basis that the subdivision proposed for the land had been carried out and claimed that this was the meaning of valuation under the contract. The vendor said “valuation” meant the current valuation of the land at the time of sale. There does not seem to have been a need to adopt the broad statements of Lord Hoffmann in this case. The word “valuation” in the context of a sale of land at a particular point in time, absent express definitions providing for valuation on another basis, would usually refer to the valuation of the land at the time of the contract on the basis of established valuation principles.

The problem with statements of the breadth of those made by Lord Hoffmann is that they can act as an open invitation to avoid construing a contract on its terms and to search amidst the background material to arrive at a meaning which best suits the view taken by the judge of what the obligations between the parties ought to be. The dangers of this approach in a commercial context have been noted by a number of commentators.

¹⁰ *Supra*

¹¹ See eg. J Burrows, J Finn, S Todd (Eds), *Burrows, Finn & Todd Law of Contract in New Zealand*, 2nd Ed (Wellington: LexisNexis Butterworths, 2002) p 172

Reactions to Lord Hoffmann's principles

A strong reaction to the dicta of Lord Hoffmann came from a leading commercial judge (now retired) - Sir Christopher Staughton. In an article entitled "*How do the Courts Interpret Commercial Contracts*"¹², the Judge was critical of the broad statement that "absolutely anything" can be regarded as background (or the matrix) which would have affected the way in which the language of the documents would have been understood by a reasonable man. He was most anxious that the background material be kept to that which could reasonably be examined in the event that there was true ambiguity in the contract. He pointed out that where a contract is made through an ordinary commercial process (which was not the case in the *Investors Compensation Scheme* case) then the background material which should be looked at is considerably narrower than "absolutely anything". The Judge's article sets out what he sees as the key principles which govern the construction of a commercial contract. He emphasised that the inquiry must focus on the language of the written contract used by the parties. In most commercial cases, the process of construing the agreement will begin and end with finding the intention of the parties from an intelligent reading of the English words used in their agreement. That, he emphasised, is what commercial parties expect the courts to do.

Surrounding circumstances can be looked at in the event of ambiguity but that needs to be tempered by the imperative of keeping hearings to what is required to determine meaning. If the surrounding background is to be examined then it must be a background that is common all of to the parties. The Judge also referred to what he termed as the "unreasonable results rule", as a key principle. In determining which of the two competing interpretations is to be preferred, the fact that one interpretation produces a very unreasonable commercial result is a relevant consideration. The basis of this rule is that two commercial parties would, it is presumed, have intended that their contract would produce, on an objective level, a reasonable commercial result¹³.

For Sir Christopher Staughton, the problem with Lord Hoffmann's principles is that they can allow the background to be used to rewrite the contract to produce a result the judge thinks is fair. While he had no quarrel with the *Mannai* decision, if it is treated as the interpretation of a unilateral notice given under a contract, he said that he parted company with Lord Hoffmann if the principles in *Mannai* are to be allowed to come into play in interpreting commercial contracts.

In the *Bank of Credit and Commerce International SA (in liquidation) v Ali and others*¹⁴, the House of Lords considered the interpretation of a commercial release document. Lord Hoffmann (who was in dissent on the decision) moved to explain or qualify aspects of his general statement in *Investors Compensation Scheme*. In *BCCI* he said as follows:

¹² [1999] CLJ 303

¹³ "The fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result, the more unlikely it is the parties can have intended it and if they do intend it, the more necessary it is they shall make that intention abundantly clear" Lord Reid in *L Schuler AG v Wickham Machine Tool Sales Ltd* [1974] AC 235

¹⁴ [2001] UKHL/8, [2001] 1 All ER 961, [2001] 2 WLR 735 (HL)

I should in passing say that when, in *Investors Compensation Scheme Ltd v West Bromwich Building Society*, I said that the admissible background included ‘absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man’ I did not think it necessary to emphasise that I meant anything which a reasonable man would have regarded as relevant. I was merely saying that there is no conceptual limit to what can be regarded as background. It is not, for example, confined to the factual background but can include the state of the law (as in cases in which one takes into account that the parties are unlikely to have intended to agree to something unlawful or legally ineffective) or proved common assumptions which were in fact quite mistaken. But ***the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage***: ‘... we do not easily accept that people have made linguistic mistakes, particularly in formal documents.’ I was certainly not encouraging a trawl through ‘background’ which could not have made a reasonable person think that the parties must have departed from conventional usage¹⁵.

For anyone who favours a more circumscribed approach to the question of construction these words are to be welcomed and were, no doubt, a reaction to the kind of criticism from commercial lawyers found in Sir Christopher Staughton’s article. It still, however, seems to be clear that, on the general principles set out by Lord Hoffmann and in the *Boat Park* decision, the background can be referred to even without ambiguity in the contract.

The danger of the wide ranging approach would appear to have been noted by Justice Fisher in his judgment in *Ancor Packaging (New Zealand) Limited v Forklift Rental Systems Limited*¹⁶. His Honour “balanced” the statement of Lord Hoffmann with a citation from the judgment of Justice Hardie Boys in *Benjamin Developments Limited v Robert Jones (Pacific) Ltd*,¹⁷ which highlighted the problem of using the background material to create ambiguity and resolve it by reference to that material when the contract is clear.

Some recent New Zealand’s decisions

In the New Zealand Courts, we have recently seen two cases concerning the construction of conditions precedent in development contracts. The two cases arise, it must be said, from contracts in which the parties did not clearly specify how conditions which were linked to consent processes under the Resource Management Act 1991 were to work. While the *Boat Park/Investors Compensation* principles were cited in both decisions in the New Zealand courts, there were mixed statements concerning the scope of the principles.

¹⁵ Paragraph 39

¹⁶ High Court Auckland, 13 June 2000, AP 404/26/00

¹⁷ [1994] 3 NZLR 189 at 203

In *Valentines Properties Ltd v Huntco Corporation*¹⁸, the Privy Council overturned the High Court and Court of Appeal on the interpretation of a condition in a construction contract. The case concerned a clause in an agreement which made the agreement conditional upon approval by Valentines of the conditions imposed by the local authority within 5 working days of receipt of the conditions. Valentines received a consent with 14 conditions. It objected to 4 conditions and after 5 working days advised that the agreement was over. During that time, the developers had been negotiating the consent with the council and received a revised consent without the 4 objectionable conditions on the 6th working day after sending the original consent to Valentines. The developers claimed that the agreement was still on foot and sued for damages. The New Zealand courts found that the 5 day period had not begun to run until the objection and appeal process with the council had run. The Privy Council overturned these decisions, basically on a plain reading of the condition which had been agreed by the parties to promote speed and certainty. The Privy Council did not cite the *Boat Park* principles or examine any other points on the principles of construction which had been considered below, such as the relevance of subsequent conduct. The judgment is short and to the point and focuses on the words used in the commercial bargain.

The Privy Council's pointed approach must be contrasted with the academic comment heralding the "new approach" to contract interpretation and with the judgment of Justice Thomas in the *Yoshimoto v Canterbury Golf International Ltd* decision¹⁹. In that case, which has been recently heard on appeal in the Privy Council, the Court of Appeal found that a condition in a contract for the sale of land, under which an instalment of the purchase price was payable provided all "necessary" resource consents to enable the development to proceed had been obtained within 12 months, had been met. "Necessary" was not defined in the contract. The Court found that a consent which was obtained following a notified hearing after the 12 month period was not one of the "necessary" consents contemplated by the parties in their contract at the time of the contract. While Justice Thomas found that the meaning emerged "fairly securely" from the contract and its commercial background (in, apparently, the conventional sense) he took the opportunity to question the scope of the exception relating to the consideration of previous negotiations and draft agreements. It will be interesting to see if the Privy Council picks up the invitation from Justice Thomas to examine the scope of the exclusion. I rather suspect that this case may, like *Valentines*, be treated by their Lordships as a "conventional" construction case to be examined on an orthodox basis.

It is also interesting to read the recent *WEL Energy Group Ltd v Electricity Corporation of New Zealand Ltd*²⁰ case, which concerned the interpretation of a clause which is regularly found in commercial contracts providing for a right of termination on certain specified events. In that case, the Court adopted what might be termed as an orthodox approach to the *Boat Park* principles. At paragraph 23, the Court said:

¹⁸ [2001] 3 NZLR 55

¹⁹ [2001] 1 NZLR 523.

²⁰ [2001] 2 NZLR 1.

It may seem old-fashioned, but the first step in interpreting the words in a document is to read the words concerned. They are the central focus, and the point of departure. *Boat Park* principles do not require anything different. The question is the meaning of the words used, in light of surrounding circumstances. Reference to surrounding circumstances is particularly appropriate where words used give rise to ambiguity or literal meaning gives rise to unreasonable outcomes. One does not start from surrounding circumstances and on that basis invent wording which might have made more sense but which does not exist. The task is interpretation, not reconstruction.

Further comment

There are now considerable areas of uncertainty in the principles governing the interpretation of commercial contracts – the scope of background, when it should be referred to, and whether subsequent conduct can be referred to. This makes for argument on the application of the principles in a given case, before the court can move to apply principles to the particular contract. The result of the recent cases is that there is sufficient support for a reasonably confined approach and also support for a much broader approach. In my view the “new” approach risks a good deal in creating an unwelcome measure of uncertainty and is contrary to the established fundamentals of commercial law.

For commercial parties, contracts are important and they expect their relationship to be governed by the contract. They expect also that the court will grapple first and foremost with the meaning of that document in interpreting their obligations. Where words can only be sensibly read one way and are not ambiguous, why should the background be relevant? Why should one party be allowed to “muddy” the waters by reference to background and have the contract rewritten after the contract has been entered into?

The irony of the “new “ approach is that the most developed commercial contracts, which are the result of protracted negotiations, are perhaps most at risk of reinterpretation by reference to the background. I would suggest that the result of any “new” approach may well be longer hearings with less and less reliable evidence creating more and more uncertainty, rather than some kind of better, purer process. A certain flexibility of approach in this area is inevitable, but I believe it would assist if there was a clear restatement of orthodoxy from the Court of Appeal or the Privy Council. At present the broad principles simply provide significant ammunition to a party which wants to examine a wealth of material to arrive at a “fairer” interpretation of the bargain from its viewpoint. I would expect commercial parties to lose faith in the court process if the approach apparently favoured by Justice Thomas is adopted in many cases.

In most cases, the search for the meaning of a commercial contract should begin and end with the interpretation of words used by the parties in the contractual document. This will not always be an

easy task - words are inherently uncertainty but that is not a reason to be deflected from the primary task of grappling with the meaning of the contract. In difficult cases, the Courts need to be careful not to delve too deeply into the “background” and to become involved in reconstructing or rewriting a bargain in a manner which the Court decides is fair. Ultimately, if a Court does this in one case, a great disservice can be done to commercial law generally. A traditional approach seems more likely to provide commercial parties with what they need – an objective interpretation of their bargain, neither more nor less, after a hearing of reasonable duration at reasonable cost.

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