CONSTRUCTION OF COMMERCIAL CONTRACTS

Harold Werksman, Partner

Holding Redlich, Sydney

EXAMPLES OF AMBIGUITY

Lease

The lessor can raise the yearly rent in long–term lease. In doing so, it 'may have regard to additional costs and expenses which (it) may incur in regard to' the leased premises.

Is this statement ambiguous? Does it mean that the lessor, in raising the rent, can have regard to matters other than the additional costs and expenses? If so, what are they? Or does the clause mean the lessor 'may only' have regard to the additional costs and expenses?

Flagstones

A residential property is shown for sale including valuable flagstones. Prior to sale, they are removed by the seller.

The contract says, 'The buyer accepts the property in the physical state it is in at the date of the contract'.

It also says, 'The seller will transfer the property in the same physical state as it was at the date of the contract'.

Does 'the property' mean the property as it stood at the date of the contract, or the property as it stood at the date of the purchaser's inspection?

This paper will focus upon how a court goes about construing the terms of the contract once the terms have been found. When a contract is wholly in writing, then the parol evidence rules operates.

PRINCIPLES INVOLVED IN DETERMINING THE INTENTION OF THE PARTIES

The court's aim is to objectively ascertain the intention of the parties. In doing so, the court applies the following principles:

Objective Intention from the Language

The overarching principle is that the court derives the objective intention of the parties from the language of the contract itself. So, where a contract contains an 'entire contract clause' or is plainly the entire contract between the parties, and if the contract has words with a plain meaning, evidence as to the circumstances in which those words were chosen would be excluded.

Ordinary Meaning of Words Preferred

Unless it can be shown that the words in the contract were used for some special but atypical meaning, the court will give the words of a document their ordinary meaning. The exception to this rule is where the ordinary meanings themselves create an obviously internally inconsistent meaning. In such a case, a court would have recourse to the surrounding circumstances in which the contract was made so as to give meaning to the chosen words.

Contract Considered as a Whole

In order to determine the meaning to be given to various parts of the contract, the court will consider the contract as a unified and consistent whole. This principle alone may enable the court to iron out ambiguities where, for example, one meaning of a word or phrase is more in harmony with the whole. In those circumstances, this meaning would generally become the preferred meaning.[1]

Contract Unambiguous

If a court finds that the words used are unambiguous, the court must give effect to them notwithstanding that the result may appear capricious or unreasonable and

notwithstanding that the court suspects that the parties intended something different.[2]

On the other hand, if the 'plain meaning' is absurd, a court can construe the contract to make sense.[3] An example of the rule that a court will give effect to the words of a contract, where they are clear and unambiguous, notwithstanding that the result may appear unreasonable, occurred in the case of Hohn & Anor v Mailler (2003) NSW CA 122.

A clause in a lease of agricultural property permitted the lessee to re–enter the land after expiry of the lease to harvest crops sown before the end of the lease. The effect was to extend the lease at no extra rent for a period of approximately one–third of a year. The Court of Appeal said the clause was plain and unambiguous in its terms and it was not part of the court's function to re–make or amend the contract in order to avoid a result which might be viewed as inconvenient or unjust.

THE PAROL EVIDENCE RULE

Extrinsic evidence as to the parties' intentions cannot be admitted to aid in the construction of a contract where the parties have confined the contract wholly to writing.[4]

The purpose of the rule is to observe the finality of the written agreement by excluding evidence that may suggest that the parties had an intention other than the intention which is able to be extracted from the written document. Thus, the rule prevents the court from giving effect to a party's intention at the expense of the intention conveyed by the words of the contract, when those words are understood in their ordinary meaning.

AMBIGUITY

The law regarding the admissibility of extrinsic evidence in relation to surrounding circumstances is not completely settled. In Australia, the ostensible position is that evidence of surrounding circumstances can only be resorted to where this assists the court in resolving an ambiguity in the written document. Whether, of course, the words in the document are considered to be ambiguous is often a matter of much debate.

THE UK POSITION

The position in the United Kingdom is a much broader one and allows the court to approach the question of construction of a contract on the basis that it can have regard to all the background knowledge which would reasonably have been available to the parties. This includes 'absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man'.[5]

On the British approach, the words of a contract, when considered on their own, may not reveal any ambiguity. However, once the surrounding circumstances are considered, it may become clear that the context in which the words were used do create an ambiguity.

So, for example, in looking at a simple sentence such as, 'The cat sat on the mat', a British court could look at the context of that sentence to understand if it created ambiguity. If it came to the conclusion that the sentence referred to the local zoo, it might come to the conclusion that the 'cat' might refer to a tiger, lion or anything but the common variety of household domestic cat.

THE AUSTRALIAN POSITION

The Australian courts have, theoretically at least, adopted the position that evidence of surrounding circumstances can only be admitted if the words of the contract contain, on their face, an ambiguity, i.e., a patent ambiguity.[6] Accordingly, on this view, the court has to find an ambiguity on the face of the document before it can have recourse to surrounding circumstances.

The question of what is in fact an ambiguous in a contract appears to be very broad. In Ginger Development Enterprises Pty Limited v Crown Development Australia Pty Limited (2003) NSW CA 296, the court approved a passage in the Court of Appeal judgment of the Royal Botanic Gardens case which said that the word 'ambiguity' is ironically a word not without its own difficulties. It:

... does not refer only to a situation in which the words used have more than one meaning. A broader concept of ambiguity is involved; reference to surrounding circumstances is permissible whenever the intention of the parties is, for whatever reason, doubtful.

This was before the High Court decision in Royal Botanic Gardens in which the court expressly declined to determine whether the Australian approach was in fact different from the English position.

In practice, however, as Professor Carter notes:

Trial Courts pay little more than lip service to the requirement of ambiguity.

As he points out:

Since virtually every word in the English language is susceptible of more than one meaning if it is not first put in context ...

the exception to the parol evidence rule must apply in virtually every case. The reality is that judges generally interpret the words used in contractual documents by reference to the context in which the transaction has occurred.[7]

APPLICATION OF THE PRINCIPLES

The difference between the two approaches can perhaps be illustrated by the approach taken by the UK Court of Appeal in the two examples I have referred to at the beginning of this paper.

The example of the flagstones comes from a case of Taylor v Hamer, recently decided in the English Court of Appeal. In that case, the facts were briefly that a purchaser inspected a house for sale. There were valuable flagstones in the garden. Prior to the contract being exchanged, the vendor removed the flagstones and placed them in a field outside of the property.

The purchaser's agent conducted an inspection of the property and noticed the flagstones in the adjoining property. The purchaser's solicitor wrote a letter inquiring whether those flagstones had been taken from the property. The answer was:

No and they're not included in the sale.

This was a false answer but the purchaser was not satisfied with damages. He wanted delivery of the flagstones and sought enforcement of the contract.

The contract said that the buyer accepts the property 'in the physical state it is in at the date of the contract.' In construing those terms, the court had regard to the relevant factual background known to, or available to, both parties prior to the contract. This included the fact that the gardens included the flagstones at the time of the purchaser's inspection and that the buyer, to the knowledge of the seller, believed as a result of false answers which had been given to the purchaser's inquiry before that the flagstones in the adjoining field did not come from the property. Further, the buyer, to the knowledge of the seller, believed he was acquiring the property with the flagstones in the garden.

In the circumstances, the court held that the contract included the flagstones. In Australia, however, I think the court would probably determine that the contract was unambiguous and would not allow evidence of surrounding circumstances.

THE ROYAL BOTANICAL GARDENS CASE

The first example I gave at the beginning of this talk comes from Royal Botanical Gardens and Domain Trust v South Sydney Council (2002) 186 ALR 289. In that case, the Trust which had control of the Domain in Sydney, leased a portion to the council for the construction of a car parking station. The council paid the costs of the car park and entered into a 50–year lease at a nominal rent.

The trustees had the power to increase the rent on a regular basis. The terms of the lease said,

The trustees may have regard to the additional costs and expenses which they may incur in regard to the surface of the Domain above or in the vicinity of the parking station and the footway and which arises out of the construction, operation and maintenance of the parking station by the Lessee.

The question which the court had to determine was whether or not the trustees, in raising the rent, could only have regard to the additional costs and expenses, or whether they could have regard to other factors, such as the market rents in the vicinity. The majority of the High Court held the word, 'may', was ambiguous. The majority said:

In a context such as clause 4(b), to specify a particular matter to which a party may have regard, without expressly stating either, i.e., that it is the only such matter or, to the contrary, that the specification does not limit the generality of the matters to which regard may be had, is likely to result in ambiguity. It does so in the present case. (p 292)

The court then had regard to surrounding circumstances, which included the fact that:

• the primary purpose of the lease was to provide a public facility, not a profit;

• the lessee paid the costs of the construction;

• the primary use of the trustees' land was recreation; and

• the parties' concern was to protect the lessor from financial disadvantage from the transaction.

The court accordingly found that the lessor was entitled only to take into account the extra costs and was not entitled to take into account other factors such as market rentals.

The fine distinction as to whether or not an ambiguity exists can be illustrated by the fact that both Kirby J and Callinan J who dissented found that there was no ambiguity in the words contained in the lease, neither did Hodgson J, at first instance.

THE DIFFICULTY IN FINDING AMBIGUITY

A prime example of the difficulty of working out whether a contract is ambiguous occurred in Stadium Australia Management Limited v Sodexho Venues (Australia) Pty Limited (2003) NSW CA 234. This case concerned a catering contract in which a certain guaranteed fee had to be paid, except where 'of the Premier

League matches, all of those played in Sydney are not played at the Stadium' (clause 5.4).

The question was whether clause 5.4 applied when any of the relevant matches were not played at the Stadium, or only when none of the relevant matches were played.

The Arbitrator held that the words of the contract were not ambiguous and rejected evidence of surrounding circumstances. Bergin J granted leave to appeal the Arbitrator's decision because she said that, in her view, the clause was clearly ambiguous. The appeal itself was heard by McClelland J, who said that the meaning of the words were plain. On the other hand, in the Court of Appeal, the majority held that the words were ambiguous.

McClelland J held that of that class of match, all of those played in Sydney must be played at the Stadium, if the guarantee is to operate. His finding was upheld on appeal notwithstanding that the Court of Appeal adopted a very different approach to the question of ambiguity.

WHAT EVIDENCE OF SURROUNDING CIRCUMSTANCES CAN BE ADMITTED?

Evidence can be admitted to establish:

• the 'genesis' of the contract;

• the objective aim of the contract; or

• the meaning of any descriptive term.

PRE–CONTRACTUAL NEGOTIATIONS

According to Mason J in Codelfo, the only material which can be part of the admissible precontractual background are those matters which can be shown to have been known to both parties at the time or, because of their notoriety, can be presumed to be known to both parties. However, statements of the parties' intentions and expectations are not receivable.

In this regard, Mason J said:

Obviously the prior negotiations will tend to establish objective background facts which were known to both parties and the subject matter of the contract. To the extent to which they have this tendency they are admissible. But in so far as they consist of statements and actions of the parties which are reflective of their actual intentions and expectations they are not receivable. The point is that such statements and actions reveal the terms of the contract which the parties intended or hoped to make. They are superseded by, and merged in, the contract itself. The object of the parol evidence rule is to exclude them, the prior oral agreement of the parties being inadmissible in aid of construction, although admissible in an action for rectification.

An example of the use of negotiations is the case of Appleby v Purcell. A lessor was required to remove trees from the demised premises. The lessor simply cut the trees down and left the tree stumps. The lessee claimed that the lease required the entire trees to be uprooted. It was not clear from the lease which interpretation was correct.

An examination of the background facts revealed that the only commercial sense in leasing the land was farming. It was accordingly held that the trees had to be uprooted to allow for farming. Evidence of the negotiations was admissible in so far as they revealed the background facts, namely, the commercial purpose. However, any evidence that during the course of the negotiations the lessor appeared to be accepting a responsibility to uproot the trees would have been inadmissible because this would have demonstrated in intention of the parties which was not reflected in the document. It was only from the commercial purpose of the lease that the court found that the trees had to be uprooted.[8]

RECTIFICATION AND OTHER CLAIMS

As a practical matter, when a court is hearing an argument about the meaning of the words in a contract, it is often faced as well with a claim for rectification of the contract as an alternative. It may also be faced with a concurrent claim for misrepresentation or misleading and deceptive conduct. In respect of those forms of relief, evidence of the mutual subjective intention of the parties which is ordinarily inadmissible to interpret contracts, is admissible. Thus, the court will usually admit evidence of negotiations subject to a later determination as to the relevance of that evidence if it finds that a case for rectification or misrepresentation has been made out. If not, it will exclude the evidence when determining the question of the interpretation of the contract.

POST–CONTRACTUAL CONDUCT

The status of the High Court authorities on whether post–contractual conduct can be admitted into evidence to interpret the meaning of a written contract is unclear (Kirby J in Royal Botanic Gardens at 318). However, the Victorian full Court in FAI Traders Insurance Co v Savoy Plaza Pty Limited (1993) 2 VR 343, rejects the admissibility of post–contractual conduct. A court in New South Wales would follow that line.[9]

The rationale for rejecting post–contractual conduct was explained by Justice Bryson:

The contract cannot mean one thing if it is never acted on, and something else if it is. The meaning of words used in a written agreement is the same, in my opinion, whether the parties did not ever do anything under it, or acted on it every day for many years, and cannot change if evidence of what they did under it becomes unavailable because the contract has been forgotten, or because everyone concerned is now dead. There are also policy considerations which weigh strongly against acting on such evidence; it is an invitation to engage in contrived behaviour, and it would lead to the admission of large bodies of evidence which in their nature require interpretation and are more difficult to interpret than the original agreement…Litigants would be tempted to prove every event in relation to performance and to assert that they all contain grains of confirmation. The parties' later declarations and conduct do not bear directly on the matter in issue, which is what their intentions were at the time when they entered into the agreement.[10]

This is a different situation from the question where interpretation involves identifying the subject matter of the contract. In that case, later conduct and statements of the parties can be admitted. Moreover, subsequent conduct is admissible on the question of whether or not an agreement was, in fact, made.[11]

PRACTICAL POINTS

Because of the difficulty in deciding whether a contract is ambiguous or not, it is very important that the parties pay careful attention to the meaning of the words they are using in the contract.

It may also be of use for parties to include in the preamble to the contract the background circumstances which they consider relevant. Thus, for example, in the Botanical Gardens case, if the parties had included in the preamble the reason why the lease was being entered into, that could have been taken into account by the court, even if it had decided that the contract was not ambiguous.

Accordingly, if you have relevant background circumstances which are important in understand the nature of the obligations contained in the contract, it may well be worth including them as part of the preamble. A clause could then be included in the contract which requires the reader to interpret terms in the contract by reference to the circumstances set out in the preamble.

REFERENCES

1. The Metropolitan Gas Co v The Federated Gas Employees Industrial Union (1925) 35 CLR 449

2. Australian Broadcasting Commission v Australasian Performing Rights Association Limited (1973) 129 CLR 99, 105–106

3. Westpac Banking Corporation v Tanzone Pty Limited (2000) NSW CA 25

4. Codelfa Constructions Pty Ltd v State Rail Authority of NSW (1982) 149 CLR 337

5. Investors Compensation Scheme Limited v West Bromwich Building Society (1998) 1ER 98 at 114

6. Rankin v Scott Fell & Co (1904) 2 CLR 164

7. Carter and Stewart 'Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision' (2002)18 JCL 182 at 187 and 188

8. Appleby v Purcell (1973) 2 NSW LR 879

9. Brambles Holdings Limited v Bathurst City Council (2001) 53 NSWLR 153 at 164

10. Sportsvision Australia Pty Limited v Tallglen Pty Limited (1998) 44 NSWLR 103 at 116

11. Brambles Holdings Limited v Bathurst City Council (2001) 53 NSWLR 153 at 163–4

Harold Werksman's paper was previously presented at a client seminar in March 2004. Reprinted with permission.