Construing Contracts for Arbitrators: Resolving Ambiguous Terms*

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Before embarking upon a resolution of an ambiguous contractual term, an arbitrator should know the fundamentals of contractual construction. This paper looks at those fundamentals and examines what ambiguity is, what evidence may be used and what guidelines may be followed to resolve an ambiguity. This paper focuses on the situation where the parties' agreement is wholly in writing.

Part 1: The Process of Construction

1.1 Construction and Interpretation

The words 'construction' and 'interpretation' are used interchangeably in practice; however, they do have different technical meanings. Interpretation involves the process of determining the meaning of words. Construction involves the process of determining the legal effect of the words.[1]

Originally interpretation was regarded as a question of fact and construction a question of law. This distinction has been criticised by the High Court, which pointed out that interpretation and construction are interdependent – the interpretation given to a word ultimately affects the legal effect of a clause.[2]

1.2 The Parties' Intention

The primary aim of construction is to determine the common intention of the parties manifested by the words of the contract. The parties' actual or subjective intentions are irrelevant. In *Allen v Carbone*[3] the High Court said:

> *"No doubt it is right to say that the intention of the parties to a contract wholly in writing is to be gathered from the four corners of the instrument."*

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1 *Life Insurance Company of Australia Ltd v Phillips* (1925) 36 CLR 60 at 78.

2 *Collector of Customs v Agfa-Gevaert Ltd* (1996) 186 CLR 389 at 396 – 7.

3 (1975) 132 CLR 528 at 531.

Where ambiguity exists a court will have regard to the presumed intention of the parties found by examination of the objective facts surrounding the making of the contract. In *Codelfa Construction Pty Ltd v State Rail Authority of NSW*[4] Mason J said:

> *"Consequently when the issue is which of two or more possible meanings is to be given to a contractual provision we look, not to the actual intentions, aspirations or expectations of the parties before or at the time of the contract, except in so far as they are expressed in the contract, but to the objective framework of facts within which the contract came into existence, and to the parties' presumed intention in this setting."*

By avoiding an examination of the parties' actual intention, the courts have followed an objective approach, involving a 'reasonable intelligent bystander' or, in the field of commerce, the 'reasonable business person'.[5] In *Hospital Products Ltd v United States Surgical Corporation*[6] Gibbs CJ explained:

> *"The intelligent bystander must however be in the situation of the parties, for 'what must be ascertained is what is to be taken as the intention which a reasonable person would have had if placed in the situation of the parties': Reardon Smith Line v Hansen-Tangen [1976] 1 WLR 989 at 996."*

When the parties have consented to reducing their agreement to a particular form of words, the court will focus on the words themselves and, where there is ambiguity, on the objectively known facts surrounding the formation of the agreement.[7]

1.3 The Parol Evidence Rule

When parties reduce their agreement to writing, it is presumed that the writing contains all the terms of their agreement.[8] Where an agreement is wholly written, the parol evidence rule excludes any evidence extrinsic to the contract to contradict, vary, add to or subtract from the language of the document.[9]

The evidence excluded by the parol evidence rule may be categorised as evidence of:

- subjective intentions;
- pre-contractual negotiations; and
- the parties' conduct subsequent to the formation of a contract.[10]

The parol evidence rule preserves the certainty of written contracts by preventing parties from undermining the language contained in a written contract.[11] It saves the court from engaging in a wide ranging inquiry so as to plumb the 'unfathomable depths' of the parties' subjective intentions.[12]

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4 (1982) 149 CLR 337 at 352.

5 E.g. *Schenker & Co Aust Pty Ltd v Maplas Equipment and Services Pty Ltd* [1990] VR 834 at 840.

6 (1984) 156 CLR 41 at 62.

7 In England a court will admit evidence of the objectively known facts regardless of any finding of ambiguity: *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 All ER 98 at 114 – 115.

8 *Major v Bretherton* (1928) 41 CLR 62 at 67 – 8.

9 *Hope v RCA Photophone of Australia Pty Ltd* (1937) 59 CLR 348 at 357, 359 and 366 – 7.

10 *L Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235 at 261; *Codelfa* (above) at 348.

11 Hope (above) at 357.

12 *B & B Constructions (Aust) Pty Ltd v Brian A Cheeseman & Associates Pty Ltd* (1994) 35 NSWLR 227 at 234; *Codelfa* (above) at 352.

1.4 Business Commonsense

When determining the parties' expressed intention, Barwick CJ in *Council of the Upper Hunter County District v Australian Chilling and Freezing Co Ltd*[13] said:

> *"In the search for that intention, no narrow or pedantic approach is warranted, particularly in the case of commercial arrangements."*

In *Antaios Compania Naviera SA v Salen Rederierna AB* Lord Diplock said:[14]

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

In *Vroon BV v Foster's Brewing Group Ltd*[15] Ormiston J warned that there were limits to the business commonsense approach:

> *"I would accept that in commercial transactions the court should strive to give effect to the expressed arrangements and expectations of those engaged in business, notwithstanding that there are areas of uncertainty and notwithstanding that particular terms have been omitted or not fully worked out. Where one should draw the line is difficult to state and equally difficult to apply. The court's desire to give effect to commercial bargains has in recent years been frequently reiterated but occasionally overstated."*

Where a term conveys multiple meanings, a court will construe the term to give it a meaning consistent with commercial commonsense.[16]

Part 2: Ambiguity

2.1 Introduction

The word 'ambiguity' has a number of meanings; however, when a court of construction refers to 'ambiguity' it has one meaning, namely that language conveys to the reader multiple meanings.

Ambiguity abounds in the English language. Lord Simon of Glaisdale spoke of ambiguity as being 'a rich resource in English poetry'. McHugh JA acknowledged that: '... few, if any, English words are unambiguous or not susceptible of more than one meaning or have a plain meaning'. Similarly, Kirby P has said: 'There is now a growing appreciation of the ambiguity of all languages but of the English language in particular'.[17]

Ambiguity may manifest itself in a contract in a number of ways. In *Life Insurance Company of Australia Ltd v Phillips*[18] Isaacs J noted that ambiguity:

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13 (1968) 118 CLR 429 at 437. See also *Cohen & Co v Ockerby & Co Ltd* (1917) 24 CLR 288 at 300.

14 [1985] AC 191 at 201.

15 [1994] 2 VR 32 at 67.

16 *MFI Properties Ltd v BICC Group Pension Trust Ltd* [1986] 1 All ER 974 at 976.

17 *Stock v Frank Jones (Tipton) Ltd* [1978] 1 All ER 948 at 953; *Manufacturer's Mutual Insurance Ltd v Withers* (1988) 5 ANZ Insurance Cases ¶60-853 at 75,343; and B & B Constructions (above) at 234.

18 (1925) 36 CLR 60 at 78.

> *"... may arise from doubt as to the construction in their totality of the ordinary and in themselves well-understood English words the parties have employed. ... Or it may arise from the diversity of subjects to which those words may in the circumstances be applied. ... Or again, it may arise from obscurity as to the full expression in ordinary language of some abbreviated term or arbitrary from that has been adopted."*

2.2 Categories of Ambiguity

The evidence available in interpreting ambiguous contractual language depends upon the type of ambiguity affecting that provision. The law categorises ambiguity as either patent or latent. Patent ambiguity is ambiguity which is apparent from the face of the document, e.g. 'The vendor agrees to sell her land to the Purchaser'. Latent ambiguity is ambiguity which is apparent by reason of matters external to the document, e.g. a gift to 'my Nephew John' is a latent ambiguity, if the donor has two nephews called John.[19]

2.3 Patent Ambiguity

The threshold issue in any dispute concerning a claim that ambiguity exists is a determination whether a term is in fact affected by ambiguity. In *Burns Philp Hardware Ltd v Howard Chia Pty Ltd*[20] Priestly JA said:

> *"What I mean by 'not ambiguous' for present purposes is not having two or more plausible meanings when the context of the words in the document is taken into account in light of the knowledge any ordinary intelligent reader of the document would bring to the reading of it."*

While a lawyer or grammarian may be able to find ambiguity more easily in the words of a commercial contract, it is not on this basis that a court determines whether ambiguity exists. In *Henderson v Woodburn*[21] the court cautioned against looking for ambiguity in contracts. The task in determining whether wording is ambiguous is an objective exercise carried out in the context of the contractual language. If the question of ambiguity were opened up to legal and grammatical analysis this would effectively take the creation of contracts out of the hands of business people and into the hands of lawyers. Such an outcome, while perhaps beneficial to lawyers, would clearly be detrimental to commerce.

The question whether ambiguity exists is not to be answered lightly. In *Cobram Laundry Services Pty Ltd v Murray Goulbourn Co-operative Pty Ltd*[21] the Victorian Court of Appeal upheld an appeal on the basis that it disagreed with the trial judge's decision that a contractual term was ambiguous.[22]

Where ambiguity is patent, the court may have regard to the objectively known facts surrounding the formation of the contract, sometimes called the 'factual matrix'. (See Part 3.)

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19 *Henderson v Woodburn* (1881) 7 VLR 413 at 417; *Larkin v Parole Board* (1987) 10 NSWLR 57 at 70.

20 (1987) 8 NSWLR 642 at 657, see also at 645 per Mahoney JA.

21 (1881) 7 VLR 413 at 417.

22 [2000] VSC 353.

2.4 Latent Ambiguity

When contractual language is affected by latent ambiguity, a court may admit evidence of the parties' actual intentions. Latent ambiguity is an exception to the parol evidence rule.[23] In *Hope v RCA Photophone of Australia Pty Ltd*[24] Starke J described the rule as:

> *"Parol evidence is not, of course, admissible to supply omissions or introduce terms or to contradict, alter or vary a written agreement. On the other hand, it is admissible for the purpose of explaining a latent ambiguity, for example, to identify subject matter to which writing refers, or to show the situation of the parties at the time the writing was made and the circumstances."*

Part 3: The Factual Matrix

3.1 Objective Facts

How does one identify the objective facts, known to the parties, in order to assist in the construction of an ambiguous term? In *Codelfa*[25] Mason J said in a much-quoted passage:

> *"The true rule is that evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning. Generally speaking facts existing when the contract was made will not be receivable as part of the surrounding circumstances as an aid to construction, unless they were known to both parties, although...if the facts were notorious knowledge of them will be presumed."*

Later in his judgment Mason J said that evidence received as an objective background fact for the purpose of construing a contract will be:

> *"...in the common contemplation of the parties yet [will not be] a contractual provision actually agreed upon for the simple reason that it was a matter of common assumption."*

The decisions provide illustrations of what facts are regarded as admissible in questions of construction. Their findings will therefore assist contract professionals identifying relevant admissible matters in disputes in which they may be involved.

3.2 The Cases

3.2.1 Prenn v Simmonds

In *Prenn v Simmonds*[27] the issue was whether the expression "profit of RTT earned during the four years ending 19 June 1963 and available for dividend on the Ordinary Stock Units ...

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23 *Codelfa* (above) at 347; Hope (above) at 359; *Life Insurance Company* (above) at 79; *Thomson v McInnes* (1911) 12 CLR 569 and 578; *Henderson* (above) at 417.

24 (1937) 59 CLR 348 at 359 – 360.

25 *Codelfa* (above) at 352.

26 *Codelfa* (above) at 354.

27 [1971] 3 All ER 237. Applied in *DTR Nominees Pty Ltd v Mona Homes Pty Ltd* (1978) 138 CLR 423 and *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd* (1979) 144 CLR 596.

whether declared or not shall have amounted to 300,000 after payment or provision for income tax and profits tax" meant the separate profits of the holding company Radio and Television Trust Limited, a company controlled by Prenn, or the consolidated profits of the group of companies consisting of the holding company and its subsidiaries. The agreement defined "RTT" as "Radio and Television Trust Limited". In his judgment Lord Wilberforce stated that:

> *"... evidence of negotiations, or of the parties' intentions, and a fortiori of Dr Simmonds' intentions ought not to be received, and evidence should be restricted to evidence of the factual background known to the parties at or before the date of the contract, including evidence of the 'genesis' or 'aim' of the transaction."*

Objective facts held by the court to have been present in the minds of the parties were:

- That under the relevant companies legislation a consolidated profit and loss account of RTT and its subsidiaries had to be placed before shareholders of RTT in general meeting, giving a true and fair view of the profits of RTT and its subsidiaries combined just as if it was an account of a single company;
- Such a consolidated profit and loss account for RTT and its subsidiaries had been prepared for each of three relevant accounting periods immediately before the agreement; and
- There were minutes showing how the decisions as to dividends (on RTT capital) out of the profits (of the group) were made.

In light of the aim of the transaction the reference to "profit" in the passage quoted above was to the consolidated profits of the group and not to the profits of the holding company only. Such a construction was found to be in accordance with commercial good sense, for it was in accordance with accepted business practice that the consolidated account for a group of companies was the significant document showing whether the enterprise was making a profit. Further, it was only the profits of the group which could provide an incentive for Dr Simmonds to remain with the group and would be a measure of his success. No discernible purpose could be discerned from a construction that profit of RTT meant the separate profit of the holding company only. This would in effect have been only such part of the group profits which the board of RTT, effectively Prenn, decided to pass up to the parent company.

Given that the expression "RTT" was expressly defined in the agreement to mean the parent company only, it may be thought that this decision re-wrote the otherwise plain terms of the contract. It should be noted that there were also a number of compelling "linguistic considerations" which favoured the same outcome.[28]

28 *Prenn* (above) at 244 paras c-e.

Just as the task of a court of construction is to ascertain the intention which reasonable people would have if placed in the position of the parties, when one speaks of "aim" or "object" or "commercial purpose", one is speaking objectively of what reasonable people would have in mind in the situation of the parties.[29] Where the contract in question is a commercial arrangement, the court tries to discern what two honest business people would understand the words they have actually used to mean with reference to the subject matter and surrounding circumstances.[30]

3.2.2 Codelfa Construction Pty Ltd v State Rail Authority of NSW

In *Codelfa* the plaintiff (the contractor) was required to give certain undertakings in settlement of injunction proceedings brought against it by residents of Woollahra, New South Wales. The contractor had been carrying out tunneling works for the construction of the eastern suburbs railway in Sydney. Being restrained from working the anticipated 3 shifts per day for 6 days per week, and from working on Sundays, the contractor claimed from the principal (the defendant) additional costs incurred and lost profit by reason of changes in working methods. The claim was put on two alternative bases: either a warranty should be implied in the contract for breach of which the contractor should be entitled to damages, or the contract should be held to have been frustrated by the issue of the injunctions and it should therefore recover on a *quantum meruit*.

The court was not therefore concerned with interpreting the express terms of a contract. In this light, is the decision a "construction of contracts" case at all? Yes. The High Court held that whether or not a term is to be implied into a contract is an illustration of the process of construction, although differing from the more orthodox ascertainment of the meaning of a contractual provision. In enquiring whether a term is to be implied, the court said that it is no more confined than when it construes a contract.[31] In other words, certain objective background facts, to which resort can be had where language is "ambiguous or susceptible of more than one meaning", can be relied upon for the purpose of determining whether a term is to be implied.

Objective background[32] facts to which the court held it was entitled to have regard were:

- that the works would be carried out on a three shift continuous basis 6 days per week and without restriction on Sundays; and
- that notwithstanding the noisy and disturbing nature of the works no injunction would be granted in regard to the noise or other nuisance.

The court held that the existence of these objective background facts was not sufficient to give rise to an implied term of the type contended for by the contractor (essentially one giving an extension of the time to the contractor for completion) since, in the events which occurred, any one of a number of alternative provisions may have been regarded as reasonable. The

29 *Reardon Smith Line* (above) at 996 (see also paragraph 2 above).

30 *Cohen & Co v Ockerby & Co Ltd* (1917) 24 CLR 288 at 300 and *Schenker & Co (Aust) Pty Ltd v Maplas Equipment Services Pty Ltd & Anor* [1990] VR 834 at 840.

31 *Codelfa* (above) at 345 and 353.

32 In the NSW Court of Appeal (at second instance) the expression used was "common beliefs".

court had regard to the existing background facts and the arbitrator's finding that the works could not in fact be carried out by the contractor in accordance with the methods and programmes agreed by the parties, unless the works were carried out on their original basis. The court concluded that the contract had been frustrated. The matter was then remitted to the arbitrator for final determination and quantum assessment.

3.2.3 B & B Constructions (Aust) Pty Ltd v Brian Cheeseman & Associates Pty Ltd – An Application of Codelfa

In *B & B Constructions* disputes arose between a contractor (B & B) and its sub-contractor (Cheeseman) in relation to a resort construction near Coff's Harbour. During the course of the disputes and in order to avoid Cheeseman's financial collapse, B & B made payments called "backcharges" totaling some $385,000 directly to Cheeseman's suppliers and in order for Cheeseman to meet its own payroll obligations. By a "sub-contract amendment advice" these backcharges were recorded by B & B as being subject to deduction from the sub-contract price. A fortnight later a further memorandum (the "further memorandum") was signed by the parties, by which the final value of the sub-contract was fixed at $3.2 million which sum was expressed to include "all variations to date".

B & B contended that given that the further memorandum was to be read with the original sub-contract, the word variations must therefore have the narrow meaning as defined in the original sub-contract, namely, changes in the works themselves and not payments by B & B in the nature of "advances" paid to or on behalf of Cheeseman.

Cheeseman contended that the word meant changes in the sums to be off-set between the parties, having regard not only to variations in the works themselves but also to supervening additional and special arrangements constituted by the further memorandum.

The court found, by reference to the dictionary, that the word "variations" in the further agreement was capable of supporting each of the two meanings contended for by the respective parties.[33]

The objective background facts providing the context in which the further memorandum came into existence was found to include the following:[34]

- The backcharges agreement was made in such a way that the payments would be deducted from the contract price;
- certain "variation amendment advices" issued by B & B to Cheeseman recorded amendments to the sub-contract sum by way of deletion or addition. VA 13 included a deletion in regard to the amounts constituting the backcharges, and also a (more "traditional") variation relating to the deletion of a bowling green from the project;
- a financial summary produced by B & B a week before the further memorandum described the backcharges amount in the verbiage "variations";
- VAs 14-18 further amended the sub-contract sum, and each took account of the amendment made by VA 13 in relation to backcharges;

33 *B & B Constructions* (above) at 237.

34 *B & B Constructions* (above) at 238.

- A written agenda for the meeting which led to the further memorandum being signed showed that the backcharges were included in the variations sought to be included in the discussions between the parties.

Seen in its context the word "variations" in the further memorandum was to be understood as having a broader meaning than one that described mere variations to the works.

The facts of this case are a good example of where an ambiguity does not appear on the face of the document. In such a case, the ambiguity may be demonstrated to exist by evidence of circumstances surrounding the making of the document and the intention of the parties objectively ascertained.[35] A court of construction is always entitled to hear evidence in order to determine whether a word is to be interpreted in its primary meaning or in a secondary or other alternative meaning.

3.2.4 *Royal Botanic Gardens and Domain Trust v South Sydney City Council – Re-affirmation of Codelfa*

The dispute in *Royal Botanic Gardens*[36] concerned whether a lessor was unconstrained in the matters to which it was entitled to have regard when determining the amount of rent payable under a lease.

By a lease dated 15 May 1976 the lessor leased to the lessee an underground car park building and a footway leading to it. The lease was for a term of 50 years, commencing 1 May 1988. The lease provided that the yearly rent could be determined by the lessor at the start of certain periods contained in the total period of the lease.

Clause 4(b)(iv) of the lease provided as follows:

> *in making the determinations of yearly rent [the lessor] may have regard to additional costs and expenses which [it] may incur in regard to the surface of the Domain above or in the vicinity of the [underground car park] and the footway and which arise out of the construction operation and maintenance of the parking station by the lessee.*

The lessee sought a declaration that in determining the yearly rent the lessor was constrained by the above clause only to do so having regard to matters referred to in the clause. The issue for determination was whether the lessor in making a determination, cannot have regard to matters other than the additional costs and expenses stipulated. If the lessor can have regard to such matters, what are they? It appeared to be common ground that a clause such as 4(b)(iv) was likely to result in an ambiguity.

The High Court accepted the Court of Appeal's formulation of the relevant findings, leading to the conclusion that the lease transaction was "non-commercial". They were as follows:

- the parties to the transaction were two public authorities;
- the primary purpose of the transaction was to provide a public facility, not a profit;
- the lessee was responsible for the substantial cost of construction of the facility;
- the facility was to be constructed under the lessee's land and would not interfere with the continued public enjoyment of that land for its primary purpose, recreation;

35 *B & B Constructions* (above) at 238.

36 (2002) 76 ALJR 436; [2002] HCA 5.

- the parties' concern was to protect the lessor from financial disadvantage as a result of the transaction; and
- the only financial advantage to the lessor identified by the parties related to additional expense which it would or might incur immediately or in the future.

The majority of the High Court concluded that clause 4(b) read as a whole contained a statement of the totality of matters to be taken into account in fixing successive rent determinations.

Kirby J was the sole dissenter. He based his conclusion on the further objective background fact, known to the parties, was the promulgation of legislation called the *Domain Leasing Act 1961* (NSW) which imposed statutory obligations upon the lessor and conferred upon the lessor wide powers to ensure that the objects of the statutory trust were advanced. This legislation conferred upon the trustees a power drawn in the widest terms to determine rentals.[37] He concluded that paragraph 4(b) was simply an enabling provision, identifying some factors to which regard may be had in making rental determinations.

Part 4: Guidelines for the Resolution of Ambiguity

The following brief propositions may assist practitioners in devising arguments concerning the meaning of ambiguous terms:

- a construction that makes the transaction futile will be avoided;[38]
- a construction which would deny the objectively construed commercial purpose or commercial good sense will be avoided;[39]
- if it can be shown that one interpretation completely frustrates the object of a written agreement to the extent of rendering it futile, that will ordinarily be a strong argument for the alternative construction, if one can reasonably be found;[40]
- if language is open to two constructions, that will be preferred which will avoid consequences which appear to be capricious, inconvenient or unjust;[41] and
- where a term is ambiguous, it will be interpreted against the person for whose benefit it was inserted. This is likely to apply to the interpretation of exclusion clauses and contracts of adhesion.

37 *Royal Botanic Gardens* (above) at [79].

38 *DTR Nominees* (above) at 429.

39 *Prenn* (above)

40 *B & B Constructions* (above)

41 *ABC v Australian Performing Right Association* (1973) 129 CLR 99 at 109.