

## CONTRACT FORMATION, CONTRACT INTERPRETATION, AND SUBSEQUENT CONDUCT

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### INTRODUCTION

[P]ost-contractual conduct is admissible on the question of whether a contract was formed ...

[P]ost-contractual conduct is not admissible on the question of what a contract means as distinct from the question of whether it was formed.

Although a final ruling by the High Court on the latter is still awaited,<sup>1</sup> the above statements of principle by Heydon JA in *Brambles Holdings Ltd v Bathurst City Council*<sup>2</sup> are supported by the overwhelming weight of Australian authority<sup>3</sup> and indeed they have

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<sup>1</sup> See *Royal Botanic Gardens and Domain Trust v South Sydney Council* (2002) 186 ALR 289, 318 [109].

<sup>2</sup> (2001) 53 NSWLR 153, 163-164 [25]-[26].

<sup>3</sup> On the *admissibility* of subsequent conduct to determine whether a contract was formed, see, for example: *Howard Smith & Co Ltd v Varawa* (1907) 5 CLR 68, 78; *Barrier Wharfs Ltd v W Scott Fell & Co Ltd* (1908) 5 CLR 647, 669, 672; *B Seppelt & Sons Ltd v Commissioner for Main Roads* (1975) 1 BPR 9147, 9149, 9154-9156; *Film Bars Pty Ltd v Pacific Film Laboratories Pty Ltd* (1979) 1 BPR 9251, 9255-9256; *Australian Broadcasting Corporation v XIVth Commonwealth Games Ltd* (1988) 18 NSWLR 540, 547-548, 550; *Terrex Resources NL v Magnet Petroleum Pty Ltd* (1988) 1 WAR 144, 160; *Hughes v NM Superannuation Pty Ltd* (1993) 29 NSWLR 653, 670; *Elmslie v Federal Commissioner of Taxation* (1993) 118 ALR 357, 369; *Toyota Motor Corporation Australia Ltd v Ken Morgan Motors Pty Ltd* [1994] 2 VR 106, 201; *Seven Cable Television Pty Ltd v Telstra Corporation Ltd* (2000) 171 ALR 89, 112 [92]-[93]; *Anaconda Nickel Ltd v Tarmoola Australia Pty Ltd* (2000) 22 WAR 101, 111 [26]; *World Audio Ltd v GB Radio (Aust) Pty Ltd* [2003] NSWSC 855 [85], [111]-[112]; *Baulderstone Hornibrook Pty Ltd v Qantas Airways Ltd* [2003] FCA 174 [36]; *Pacific Premium Funding Pty Ltd v Sierra Holdings Pty Ltd* [2004] NSWSC 713 [45]-[46]; *McKenry v White* [2004] NSWSC 131 [17]-[19]; *Westpoint Constructions Pty Ltd v Lord* [2004] WASC 86 [31]-[34]; *Essington Investments v Regency Property Group* [2003] NSWSC 828 [135]; *Abigroup Contractors Pty Ltd v ABB Service Pty Ltd (formerly ABB Engineering Construction Pty Ltd)* (2005) 21 BCL 12, 24 [63]; *Monarch Building Systems Pty Ltd v Quinn Villages Pty Ltd* [2005] QSC 321 [11], *aff'd* [2006] QCA 210; *Hadley Hall Estate Ltd v HHE Management Ltd* [2005] WASC 442 [32]; *Bell Plastics Sunshyne Pty Ltd v Sunshine Plastics Pty Ltd* [2006] QSC 102 [5]. But cf *Maroubra Pty Ltd v Murchison Queen Pty Ltd* [2002] WASC 98 [64] ('The question of whether post contract conduct is admissible to establish that a contract is made has not been finally resolved in Australia', citing *Royal Botanic Gardens and Domain Trust v South Sydney Council* (2002) 186 ALR 289, 318, overlooking that Kirby J (at [109]) was referring to contract *interpretation* not *formation*) and *Mildura Office Equipment & Supplies Pty Ltd v Canon Finance Australia Ltd* [2006] VSC 42 [185] ("Post-contractual conduct and communications are not admissible in order to establish the existence of a contract"). On the *inadmissibility* of subsequent conduct as an aid to interpretation see, for example: *FAI Traders Insurance Co Ltd v Savoy Plaza Pty Ltd* [1993] 2 VR 343; *Ryan v Textile Clothing and Footwear Union of Australia* [1996] 2 VR 235; *Sportsvision Australia Pty Ltd v Tallglen Pty Ltd* (1998) 44 NSWLR 103; *Baulderstone*

been endorsed on numerous occasions by state and federal courts in recent times.<sup>4</sup> They are also supported by leading texts on the law of contract.<sup>5</sup> They are, therefore, seemingly beyond question. But are they? What is the basis for treating evidence of the parties' subsequent conduct as *admissible* when the issue before the court is one of contract *formation* but *inadmissible* when the issue is one of contract *interpretation*? If the fundamental question of whether a contractual relationship exists at all can be determined by having regard to the parties' conduct subsequent to the alleged point of formation, surely the position should be no different when the perhaps subsidiary questions of interpretation are involved. In both contexts the essential task of the court is to determine and give effect to the intention of the parties. And just as, for example, the parties' conduct may tend to confirm (or deny) that an earlier agreement was intended to be binding, so also it may tend to confirm (or deny) that the parties gave a particular meaning to the terms of an admitted contract at the time it was entered into. For this and other reasons I propose to argue in this article that the distinction is untenable.

### CONTRACT FORMATION AND SUBSEQUENT CONDUCT

Conduct of the parties that is subsequent to the alleged point of contract formation may have probative value in a number of respects. For example, it may bear upon the credibility of their or other witnesses' accounts of what occurred beforehand, or it may serve to confirm matters on which the parties were agreed or not agreed (or thought it important to be agreed). However, the major significance of subsequent conduct is likely to be the light it sheds on the question of the parties' intention to be bound. It may show that the parties were still negotiating on important terms or it may support the inference that both of them, or at least the promisee, accepted that there would be no final commitment until a formal contract was signed. On the other hand, acts of part performance by the parties (but, most helpfully, by the promisor) may provide a strong indication that they did intend to be bound

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*Hornibrook Pty Ltd v Qantas Airways Ltd* [2003] FCA 174 [36]; *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1 [229]; *Danevski v Giudice* (2003) 202 ALR 494, 509 [85]; *Décor Blinds Gold Coast Pty Ltd v Décor Blinds Australia Pty Ltd* [2004] QSC 55 [22]; *Seven Network (Operations) Ltd v TCN Channel Nine Pty Ltd* [2005] FCAFC 144 [83]. But cf *Spinwill Pty Ltd v BAB Pty Ltd* (1994) 36 NSWLR 290 (discussed by the writer in 'Objectivity in Contract' (2005) 24 *University of Queensland Law Journal* 479, 491-492).

<sup>4</sup> See, for example, *John R Keith Pty Ltd v Multiplex Constructions (NSW) Pty Ltd* [2002] NSWSC 43 [227]-[234]; *Rural Insurance (Aust) Pty Ltd v Reinsurance Australia Corp Ltd* (2002) 41 ACSR 30, 36 [34]-[36]; *African Minerals Ltd v Pan Palladium Ltd* [2003] NSWSC 268 [28]-[40]; *ABB Engineering Construction Pty Ltd v Abigroup Contractors Pty Ltd* [2003] NSWSC 665 [37]; *LMI Australasia Pty Ltd v Baulderstone Hornibrook Pty Ltd* [2003] NSWCA 74 [57]; *Gate Gourmet Australia Pty Ltd v Gate Gourmet Holding AG* [2004] NSWSC 149 [170]-[182]; *Vero Insurance Ltd v Walker* [2004] NSWSC 1071 [23]; *Secure Parking (WA) Pty Ltd v Wilson* [2005] WASC 264 [82]; *Hudson Investment Group Ltd v Australian Hardboards Ltd* [2005] NSWSC 716 [278]; *Brooker v Friend & Brooker Pty Ltd* [2005] NSWSC 395 [68]; *Darryll Cullen v ZLB Behring LLC* [2006] NSWSC 265; *Expectation Pty Ltd v PRD Realty Pty Ltd* [2006] FCA 360; *Issac Brott & Co v Levene* [2004] VSC 79 [34]. Interestingly, the latter case was neither an interpretation nor a formation case. The issue was whether a particular term had been agreed to. The Judge's decision that evidence of subsequent conduct was 'not admissible as evidence of the terms of the agreement' (at [37]) is contrary to previous well-established authority that it is permissible to have regard to the parties' conduct to determine whether a previous oral, or partly written and partly oral, contract contained an oral term alleged by one of the parties: see n 147 *infra*.

<sup>5</sup> See, for example, *Chitty on Contracts* (29<sup>th</sup> ed, 2004) vol 1, 768-769 [12-126].

immediately. And, of course, an admission or other unequivocal acknowledgement by the promisor of the existence of a binding contract may be particularly telling.<sup>6</sup>

The above situations, where subsequent conduct is invoked to establish or deny the existence of an *earlier* binding contract, are our primary concern at this stage. Of course, subsequent conduct will often be the foundation for the quite different arguments of mutual abandonment, variation, implied term, or estoppel in relation to an admitted contract. But, more importantly for present purposes, it should be noted that sometimes the appropriate question is whether the so-called subsequent conduct resulted *itself* in contract formation. It is trite law that a contract can arise from conduct. Thus, in the leading case of *Brogden v Metropolitan Railway Co*<sup>7</sup> a binding contract to supply goods on the terms of an unexecuted draft agreement was upheld because the parties subsequently proceeded to deliver and pay for the goods in accordance with the stated terms and to otherwise recognise by their conduct that the document was their contract. Moreover, parties may, through their exchanges and other dealings over a period, 'drift into a contractual relationship'.<sup>8</sup> As McHugh JA usefully pointed out in *Integrated Computer Services Pty Ltd v Digital Equipment Corp (Aust) Pty Ltd*:<sup>9</sup>

[I]n an ongoing relationship, it is not always easy to point to the precise moment when the legal criteria of a contract have been fulfilled. Agreements concerning terms and conditions which might be too uncertain or too illusory to enforce at a particular time in the relationship may by reason of the parties' subsequent conduct become sufficiently specific to give rise to legal rights and duties. In a dynamic commercial relationship new terms will be added or will supersede older terms. It is necessary therefore to look at the whole relationship and not only at what was said and done when the relationship was first formed.

Let us return now to the more straightforward scenario where it is clear that the parties reached an apparent, and sufficiently certain, consensus but there is doubt whether they intended to be bound at that point. Here, as already noted, it is well established that the conduct of the parties subsequent to the time of consensus (and hence alleged contract formation) may be used to assist in determining whether they did or did not originally have an intention to be bound.<sup>10</sup> Thus, in some of the leading cases involving family or domestic agreements, the courts have referred to the subsequent conduct of the parties as a factor which can legitimately be taken into account in resolving the question whether they intended

<sup>6</sup> See, for example, *Port Sudan Cotton Co v Govindaswamy Chettiar & Sons* [1977] 2 Lloyd's Rep 5, 11.

<sup>7</sup> (1877) 2 App Cas 666.

<sup>8</sup> *Ifikhar Husain v O & S Holdings Pty Ltd* [2005] VSCA 269 [51] (Nettle JA).

<sup>9</sup> (1988) 5 BPR 11,110, 11,118.

<sup>10</sup> This is so despite some contrary dicta in the New Zealand Court of Appeal. See *Fraser v Strathmore Group Ltd* [1991] CA 329/90 (Unreported, 4 October 1991) ('While evidence of subsequent inconsistent statements or conduct might bear upon the credibility of witnesses, it offers no assistance in determining objectively whether the parties reached an agreement that can be enforced. To focus on subsequent events is to risk confusing the subjective views of the parties with what is to be determined objectively as to their intentions.');

*Powell v Cromwell Corporation Ltd* [1992] CA 334/91 (Unreported, 20 August 1992) (not 'appropriate to give weight to the evidence of the subjective intentions of the parties nor to their subsequent conduct'). More recent decisions of the Court confirm that subsequent conduct is admissible on the question of whether a contract was formed. See *Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd* [2002] 2 NZLR 433, 444-445 [56]; *Verissimo v Walker* [2006] 1 NZLR 760, 771 [40]-[41].

to enter legal relations. In the well known case of *Jones v Padavatton*,<sup>11</sup> where the question arose whether a mother's promise to pay maintenance to her daughter while she studied for the Bar was a legally binding contract, Fenton Atkinson LJ thought that the subsequent history gave 'the best guide to the parties' intention'.<sup>12</sup> He referred, in particular, to three aspects of the daughter's subsequent conduct which were inconsistent with an intention on her part to enter into legal relations, including her statement in cross-examination that 'a normal mother doesn't sue her daughter in court'.<sup>13</sup> On other occasions, subsequent conduct has been invoked to support the inference that the parties *did* intend to be legally bound.<sup>14</sup>

Subsequent conduct is more commonly resorted to in cases where parties have reached a 'preliminary agreement' (ie, an agreement that is intended to be replaced by later more formal, and usually fuller, written contract) and the question arises whether an agreement was intended to be binding immediately or only upon execution of the formal document.<sup>15</sup> Sometimes the conduct may reveal that, such were the number and importance of issues that remained to be settled between the parties, it would be unreasonable to infer an intention to be bound at the time of the preliminary agreement. But more commonly the conduct may point to a conclusion that the parties (or at least the promisee) actually believed that a firm commitment had not been made. Thus, in the leading New Zealand case of *Carruthers v*

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<sup>11</sup> [1969] 1 WLR 328.

<sup>12</sup> *Ibid* 336.

<sup>13</sup> *Ibid* 337. This was seen as providing 'a strong indication that she had never for a moment contemplated the possibility of her mother or herself going to court to enforce legal obligations ...' It may be observed that the daughter's statement did not unequivocally acknowledge that she had no intention to enter legal relations. There is no necessary inconsistency in saying: 'We intended this agreement to give rise to enforceable legal rights but I did not expect either of us would actually enforce them'. As Salmon LJ pointed out, 'The fact that a contracting party is *in some circumstances* unlikely to extract his pound of flesh does not mean that he has no right to it': at 334 (emphasis added).

<sup>14</sup> *Todd v Nichol* [1957] SASR 72, 75-76; *Parker v Clark* [1960] 1 WLR 286, 293.

<sup>15</sup> See *Australian Broadcasting Corporation v XIVth Commonwealth Games Ltd* (1988) 18 NSWLR 540. In this case Gleeson CJ (with whom Hope JA and Mahoney JA agreed) held that 'it is proper to have regard to communications between the parties subsequent to the date of the alleged contract to the extent to which those communications throw light upon the meaning of the language which is being considered for the purpose of determining whether it expresses an intention one way or the other upon the critical matter. At the least, such subsequent communications will often form part of the context in which the particular exchanges in question are to be evaluated': at 550. However, his Honour said that '[t]he position is by no means so clear ... in connection with internal memoranda, communications by one or other of the parties with some third party, or statements as to subjective intention made by individuals in the course of giving evidence'. The New Zealand Court of Appeal in *Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd* [2002] 2 NZLR 433, 444-445 [56] shared this reservation but 'proceeded on the basis of treating such material as admissible'. In my view, it is difficult to see any principled basis for excluding evidence of any type of subsequent conduct. The issue is one of *weight*, not admissibility. For example, internal memoranda or communications with a third party that emanate from persons in authority will sometimes provide very reliable indications that a party intended to be bound. Similarly, if a promisor says in evidence, 'Yes, I intended to be bound', that surely is an admission which, unless explained away satisfactorily, should be sufficient to resolve the case if the court is convinced that the promisee had the same intention. On the other hand, direct (and likely self-serving) evidence from the promisee as to his or her actual intention will be entitled to little weight and, indeed, will be largely irrelevant given that the critical question, assuming it is not established that the promisor shared the same intention, is whether the promisee was reasonably entitled to infer consensus and intention to be bound.

*Whitaker*,<sup>16</sup> the trial judge found that a preliminary oral agreement on the main terms for the sale of a farm which had been reached prior to the matter being put into the hands of the parties' solicitors was not intended to be binding. This finding was supported by the conduct of the plaintiff purchasers and their solicitor. After the oral agreement had been reached, they continued to inquire of the vendor whether the sale was still going ahead, thus indicating their understanding that a firm commitment had not been made.<sup>17</sup> However, in practice, subsequent conduct has been invoked more frequently to support a conclusion that the parties *did* intend to be bound immediately. Thus, correspondence between the parties or their solicitors,<sup>18</sup> action taken in reliance on the contract or various acts of part performance,<sup>19</sup> and even the issue of a press release,<sup>20</sup> have been taken into account to support conclusions that the contemplated written contract was merely to give more formal expression to mutual commitments already concluded.

### A CONCEPTUAL DIFFICULTY?

It will be apparent from the above examples that the subsequent conduct in question was treated as evidence of the actual intention of one or both of the parties to the alleged contract. There is a widely held view, however, that the test of intention is wholly objective in the sense that the court is unconcerned with the actual intention of the parties. The question is whether a reasonable person would infer intention to be bound at the time the contract was allegedly formed. If this is correct, the subsequent conduct of the parties, which will primarily be significant as an indicator of their actual intention, must be irrelevant.

Remarkably, some recent Australian cases have opted to recognise the strict objective test at the same time as accepting that evidence of subsequent conduct is relevant and admissible. For example, in *Boulderstone Hornibrook Pty Ltd v Qantas Airways Ltd*<sup>21</sup> Finkelstein J adopted the view of Learned Hand J in *Hotchkiss v National City Bank*<sup>22</sup> that '[a] contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties' yet later accepted that it is permissible to 'have regard to the parties' conduct after the date of the putative contract, as that conduct may show what the parties intended at the earlier time'.<sup>23</sup>

<sup>16</sup> [1975] 2 NZLR 667. See also *Barrier Wharfs Ltd v W Scott Fell & Co Ltd* (1908) 5 CLR 647; *Howard Smith & Co Ltd v Varawa* (1907) 5 CLR 68; *B Seppelt & Sons Ltd v Commissioner for Main Roads* (1975) 1 BPR 9147.

<sup>17</sup> *Whitaker v Carruthers* [1975] 1 NZLR 372, 374. See also *Holmes v Australasian Holdings Ltd* [1988] 2 NZLR 303, 310.

<sup>18</sup> See, for example, *Newton-King v Wilkinson* [1976] 2 NZLR 321.

<sup>19</sup> See, for example, *France v Hight* [1987] 2 NZLR 38, aff'd [1990] 1 NZLR 345; *Terrex Resources NL v Magnet Petroleum Pty Ltd* (1988) 1 WAR 144; *Elmslie v Federal Commissioner of Taxation* (1993) 118 ALR 357; *Anaconda Nickel Ltd v Tarmoola Australia Pty Ltd* (2000) 22 WAR 101; *World Audio Ltd v GB Radio (Aust) Pty Ltd* [2003] NSWSC 855.

<sup>20</sup> See *TV3 Network Services Ltd v The News Corporation Ltd* [1996] HC Auckland CP 37/96 (Unreported, Tompkins J, 23 February 1996). In holding that that the plaintiff had established a serious question to be tried on whether a preliminary agreement giving it the exclusive rights to televise Super League games in New Zealand was intended to be binding, the Judge referred to a press release announcing a 'five year agreement reached this week that has granted TV3 exclusive rights to the elite competition from this year' which had been put out by the chief executive of Super League. This was seen as indicating the latter's belief that they had done 'a binding deal'.

<sup>21</sup> [2003] FCA 174 [34].

<sup>22</sup> 200 F 287, 293 (SDNY, 1911).

<sup>23</sup> [2003] FCA 174 [36]. See also the judgments of Einstein J in *John R Keith Pty Ltd v Multiplex Constructions (NSW) Pty Ltd* [2002] NSWSC 43 [227]-[234]; *Rural Insurance (Aust) Pty Ltd v*

There is academic support too for the view that ‘the actual intention of the parties ... is irrelevant to the formation of a contract’<sup>24</sup> but, for the reasons covered in my article in the previous issue of this journal,<sup>25</sup> I believe this is misconceived. The traditional objective approach of the common law does not require a court to ignore the actual intentions, knowledge and beliefs of the parties themselves. Thus, to take a few simple examples, my actual intention *not* to be bound by an agreement that an outside observer would likely view as a contract will prevent formation of a binding contract if the other party shares that intention, knows of it, or ought to know of it. On the other hand, my actual intention *to be bound* will only result in formation of a binding contract if the other party shares that intention or, if she does not, she leads me reasonably to believe that she intends to be bound. In both scenarios, subsequent conduct can in principle have evidential significance. It may provide evidence of some weight tending to prove or disprove the primary allegations concerning intention. Thus, in the first example, my acts of part performance may help the other party to disprove my allegation that I did not intend to be bound. Alternatively, such acts by the other party may corroborate her stance that she did not share my lack of intention to be bound. In the second example, my acts of part performance will be self-serving and therefore ought to be accorded little weight, but such acts by the other party will likely be reliable evidence that she shared my alleged intention to be bound.

Another widely held view concedes that the actual intentions and understandings of the parties are relevant where contract formation is in issue but argues that ‘[o]nce it has been established that a contract has been formed, the actual intentions of the parties as to the meaning or effect of the contract become irrelevant’.<sup>26</sup> This is essentially a generalised version of the argument that is being disputed in this article. How can it be that the parties’ actual intentions are irrelevant when the issue concerns the meaning of a term but relevant when the issue is whether an apparently complete contract is in fact a contract at all? Why is it that one *cannot* contradict the apparent meaning of a term of a contract but one *can* contradict an apparently complete contract? In my view, there is no sensible reason why the interpretation process required to determine whether a contract was formed should differ so fundamentally from the process required to determine the meaning of that contract. The strict objective approach to interpretation which seeks to discover the ‘presumed intent’ of the parties is fair enough when, as frequently happens, they did not contemplate the situation which has arisen, but it is entirely another matter to elevate it to a universal rule and to reject out of hand what may be relevant and reliable evidence from the negotiations or subsequent conduct of the meaning they actually attributed to the words of the contract. Such evidence should be equally as relevant as evidence of their actual intention to be bound to a contract. This is particularly so when it is considered that disputes over the meaning of contractual language will very often call into question whether, due to a lack of consensus ad idem, a binding contract was formed in the first place.<sup>27</sup> Two examples built around the facts of the

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*Reinsurance Australia Corp Ltd* (2002) 41 ACSR 30, 36 [34]-[36]; *African Minerals Ltd v Pan Palladium Ltd* [2003] NSWSC 268 [28]-[36]; *ABB Engineering Construction Pty Ltd v Abigroup Contractors Pty Ltd* [2003] NSWSC 665 [37]; *Gate Gourmet Australia Pty Ltd v Gate Gourmet Holding AG* [2004] NSWSC 149 [170]-[182]; *Hudson Investment Group Ltd v Australian Hardboards Ltd* [2005] NSWSC 716 [278]-[284]. His Honour adopted a strict objective test of intention, treating the actual intention of the parties as irrelevant, whilst at the same time accepting that evidence of their subsequent conduct is admissible.

<sup>24</sup> Hugh Collins, ‘Objectivity and Committed Contextualism in Interpretation’ in Sarah Worthington (ed), *Commercial Law and Commercial Practice* (2003), 189, 190.

<sup>25</sup> D W McLauchlan, ‘Objectivity in Contract’ (2005) 24 *University of Queensland Law Journal* 479.

<sup>26</sup> Kim Lewison, *The Interpretation of Contracts* (3<sup>rd</sup> ed, 2004) 29 [2.05].

<sup>27</sup> See, for example, the first two defences put forward in *Engineering Plastics Ltd v J Mercer & Sons Ltd* [1985] 2 NZLR 72, 77-79.

celebrated American case of *Frigalimint Importing Co Ltd v BNS International Sales Corporation*<sup>28</sup> illustrate this aspect of the argument:

Suppose that Seller (S) and Buyer (B) enter into a written agreement for the sale of a large quantity of ‘chicken’ meeting certain specifications as to weight, packaging and so on. The first shipment meets these specifications but it is rejected by B on the ground that it is stewing chicken. When S sues for damages, B counterclaims arguing that the word ‘chicken’ meant young birds for frying or broiling as opposed to ‘fowl’ which were more mature birds suitable only for stewing. B refers to evidence of the exchanges between the parties before and after the contract suggesting that they contemplated delivery of young chicken (or that, at least, S ought to have known that B intended young chicken). According to the orthodox approach to contract interpretation, such evidence is inadmissible and S will be entitled to succeed if a reasonable third party with knowledge of the factual background other than the negotiations would conclude that a shipment of fowl was performance within the meaning of the word ‘chicken’.

The facts are the same except that B argues in the alternative that, since the parties were not *ad idem*, no binding contract was formed. This defence will succeed if the evidence establishes that S knew or ought to have known that B intended to buy young chicken. For this purpose evidence of the parties’ negotiations and subsequent conduct is clearly admissible.

In the first example, it seems artificial in the extreme to talk about a reasonable third party with knowledge of the background if the most pertinent circumstances, the pre-contract exchanges, are excluded. The position would presumably be different if, for example, S were aware from previous dealings between the parties that when B used the word ‘chicken’ B meant young birds. These previous dealings would be admissible as relevant background in determining the meaning which the words would convey to a reasonable person in S’s position. It is difficult to fathom why negotiations should be treated differently in this regard. More importantly, in the second example, it will usually be a short step from a finding that S ought to have known B’s intention to a conclusion that S led B reasonably to believe that the subject of the sale was young chicken. If so, that surely was *the contract*. We are back then to square one. The answer to the first example must be wrong. B’s counterclaim for damages should succeed!<sup>29</sup>

<sup>28</sup> 190 F Supp 116 (SDNY, 1960).

<sup>29</sup> It might be objected that the answer lies in the application of the parol evidence rule. This rule, which states that parol (extrinsic) evidence is not admissible to add to, vary or contradict the terms of a written contract, applies in the first example (because there is a *prima facie* binding contract *and* the parties intended to record its terms in the document) but not the second (because, *ex hypothesi*, there is no contract). However, as pointed out in *Corbin on Contracts* (1<sup>st</sup> revised ed, 1960) vol 3, 412-413 [579], ‘no parol evidence that is offered can be said to vary or contradict a writing until by process of interpretation it is determined what the writing means. The “parol evidence rule” is not, and does not purport to be, a rule of interpretation or a rule as to the admission of evidence for the purpose of interpretation.’ In other words, a document may have been assented to as a complete record of the terms of an agreement, so that it is a written contract for the purposes of the application of the rule, but it must still be *interpreted*. Therefore, if parol evidence is admitted merely in aid of interpretation, it does not vary or contradict the written terms but goes to determine what the terms are which cannot be varied or contradicted.

## CONTRACT INTERPRETATION AND SUBSEQUENT CONDUCT

Evidence of the parties' subsequent conduct may be relevant to the resolution of an interpretation dispute in a number of ways. For example, it may assist in establishing or verifying the commercial purpose of the contract or the existence of other background facts known to, or reasonably available to, the parties at the time of the contract. But, most importantly, and most contentiously, it may assist in the task of proving the existence of an agreed meaning. The fact that the parties have acted consistently with a particular interpretation, or at least the party now denying that interpretation has so acted, may sometimes provide a reliable basis for an inference that this was the meaning attributed to the words at the time of the contract. As I have argued on previous occasions,<sup>30</sup> there are no convincing reasons of principle or policy why a court should not be able to act on such evidence. Two examples serve to illustrate the argument in a preliminary way.

The first example is modelled on the facts of an early, and seemingly long-forgotten, Australian case<sup>31</sup> decided at a time when it was generally accepted that evidence of subsequent conduct was admissible as an aid to interpretation.

Plaintiff (P) and Defendant (D) are dental practitioners. D has surgeries at venues A and B. When the volume of work expands beyond his ability to cope, D employs P to work at surgery A. The terms of the contract provide for P to be paid a salary plus a quarterly bonus of one half of the receipts of the practice after deduction of a stated sum (the estimated outgoings of surgery A). However, before long the volume of business at surgery A falls away. P is then permitted to attend patients at surgery B. The fees earned by him there are agreed to be, and are later treated as, receipts of the practice at surgery A (for which separate accounts are kept). When the employment is later terminated, P claims that the bonus to which he is entitled is based on the earnings of *both* surgery A and surgery B. In other words, both surgeries constitute 'the practice' referred to in the contract. The question arises whether the parties' subsequent conduct can be taken into account as part of the surrounding circumstances for the purpose of interpreting the words 'the practice'.

The Judge in the case on which this example is modelled had no doubt that the answer must be in the affirmative. He found that 'the inference of a mutual agreement as to the meaning of "the practice" [was] irresistible, in view of the express agreement and the usage with respect to the fees earned at [surgery B]'.<sup>32</sup> In other words, the subsequent conduct of the parties in agreeing that the fees earned at surgery B were to be treated as receipts of surgery A was only explicable on the basis that, when they referred to 'the practice' in the employment contract, they meant surgery A. They tacitly admitted that this was the meaning they attributed to the words at the time of the contract. Or, as the Judge put it, this was 'what the parties really intended when they signed the document'.<sup>33</sup> Accordingly, the

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<sup>30</sup> D W McLauchlan, 'Subsequent Conduct as an Aid to Interpretation' (1996) 2 *New Zealand Business Law Quarterly* 237; 'Subsequent Conduct and Contract Interpretation—An Update' (1997) 3 *New Zealand Business Law Quarterly* 147; 'The New Law of Contract Interpretation' (2000) 19 *New Zealand Universities Law Review* 147, 172-176.

<sup>31</sup> *Cocks v Maddern* [1939] SASR 321.

<sup>32</sup> *Ibid* 327.

<sup>33</sup> *Ibid*.



conduct was seen as reinforcing the same inference drawn from reading the contract as a whole in light of the other surrounding circumstances and ‘justice require[d] that the parties be held to the bargain in the sense to which they have agreed’.<sup>34</sup>

This reasoning seems entirely in accordance with common sense, yet the recent authorities noted at the beginning of this article suggest that it is contrary to principle! Admittedly the case for allowing use of subsequent conduct in the example is particularly strong because it involves mutual conduct providing unequivocal support for the contention that the parties used the words in the particular sense. However, in my view, there is no reason to limit the use of conduct to situations where both these requirements are satisfied. Suppose that, in the example, the only conduct was an initial demand by P for a bonus based on the receipts of surgery A alone. Where the conduct involves only one party and there *may* be other explanations for it, these are matters going to *weight* rather than admissibility.

My second example involves the exact facts that came before the New Zealand Court of Appeal in *Edwards v O’Connor*,<sup>35</sup> a remarkable case where the Court did not even countenance basing its decision on the proven actual mutual intention of the parties, let alone having regard to the subsequent conduct of the parties which strongly confirmed the existence of that intention.

The defendant enters into a written contract for the sale of her fishing business to the plaintiffs. The latter allege that it was agreed that if Individual Transferable Quota (ITQ) were eventually allocated to the defendant it would pass to them. In particular, it was agreed prior to signing the written contract that the terms ‘fishing licence’ and ‘goodwill’ included quota. There is conflicting evidence, but the trial Judge prefers the plaintiffs’ version. The Judge refers to the subsequent conduct of the defendant to confirm his conclusion. This includes: a letter from the defendant’s solicitor requesting immediate payment of the balance of the price for the ITQ; a conversation between the defendant’s agent and the plaintiffs to like effect; and evidence of a conversation between the defendant and a third party in which the former acknowledged that the quota passed with the boat and bemoaned the fact that the plaintiffs were acquiring it for a modest sum.

On the basis of the trial Judge’s findings of fact, this is an easy case. The evidence of the prior negotiations and the subsequent conduct combine to establish that the *actual mutual intention* of the parties at the time of the contract was that ‘fishing licence’ and ‘goodwill’ included quota.

Unfortunately, in the case itself, the Court of Appeal, although finding for the plaintiffs, did not regard the case as nearly so straightforward. The trial Judge, Smellie J, having found that it had been orally agreed that quota would pass to the plaintiffs, had ruled that the contract was partly written and partly oral.<sup>36</sup> However, the Court of Appeal, whilst not doubting the Judge’s finding on the credibility issue, rejected that conclusion. It held that the written sale and purchase agreement was intended to contain all the terms of the contract. In reaching this conclusion the Court relied particularly on the fact that the evidence accepted by Smellie J was to the effect that the words ‘fishing licence’ and ‘goodwill’, which were contained in the writing, were agreed to include quota. Accordingly, ‘the only reasonable inference [was] that the parties were content to focus on the written agreement and it was

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<sup>34</sup> *Ibid.*

<sup>35</sup> [1991] 2 NZLR 542.

<sup>36</sup> [1989] 3 NZLR 448.

their intention that it should contain all the terms of their agreement'.<sup>37</sup> As a result, of course, the parol evidence rule applied and the issue became solely one of interpretation. It seems that counsel's response to this analysis in the course of argument was the entirely sensible one that, if there was not a partly written and partly oral contract, the only alternative was that there had been an actual agreement between the parties as to the meaning of the terms 'fishing licence' and 'goodwill'. In other words, 'the parties had made their own dictionary'.<sup>38</sup> Although the Court did eventually find for the plaintiffs, this argument was not accepted, seemingly because evidence of negotiations or other manifestations of the parties' actual intention was inadmissible. Thus, in a remarkable tour de force, the Court relied on the negotiations to establish that there was a written contract for the purposes of the parol evidence rule but then shelved that evidence when it came to the interpretation of that contract. The case was decided on the basis of the orthodox objective approach derived from *Prenn v Simmonds*<sup>39</sup> and *Reardon Smith Line Ltd v Yngar Hansen-Tangen*.<sup>40</sup> In other words, a reasonable person with knowledge of the factual background and the aim of the transaction would infer that quota was covered. But why does a court have to look for a presumed intention when their actual intention that quota was to pass is established? Is our law of contract really so silly? The telling admissions in the subsequent conduct did not even rate a mention in the Court's discussion of the interpretation issue! At the very least, resolution of the case was made much more complicated than it need have been.

### THE HOUSE OF LORDS' DECISIONS

Prior to 1970, there was ample authority for the proposition that, where a written contract contains an ambiguity, evidence of the parties' subsequent conduct is admissible as an aid to interpretation. This was subject to the qualifications that the evidence must be received with caution and that it must unequivocally support the interpretation suggested. The authorities included: the Privy Council decision in *Watcham v Attorney-General of the East Africa Protectorate*;<sup>41</sup> a line of New Zealand cases<sup>42</sup> culminating in *New Zealand Diving Equipment Ltd v Canterbury Pipe Lines Ltd*,<sup>43</sup> a decision of the Court of Appeal; and some, albeit less conclusive, decisions of the High Court of Australia.<sup>44</sup> However, in 1970 the House of Lords ruled against the admissibility of evidence of subsequent conduct (unless it were being used to found an estoppel or a new contract) in *James Miller & Partners Ltd v Whitworth Street Estates (Manchester) Ltd*<sup>45</sup> and reaffirmed that view four years later in *L Schuler AG v Wickman Machine Tool Sales Ltd*.<sup>46</sup>

In my view, it is particularly unfortunate that their Lordships chose to veto the use of subsequent conduct as an aid to interpretation in these cases, because neither concerned a

<sup>37</sup> [1991] 2 NZLR 542, 548.

<sup>38</sup> *Ibid.*

<sup>39</sup> [1971] 1 WLR 1381.

<sup>40</sup> [1976] 1 WLR 989.

<sup>41</sup> [1919] AC 533.

<sup>42</sup> See, for example, *South v Palmer* (1987) 16 NZLR 596; *Karepa v Saunders* [1930] NZLR 242, 255; *Whitley and Co Ltd v Green* [1935] NZLR 360, 364; *O'Donnell v Walter Buchanan Ltd* [1947] NZLR 906, 911; *Thames Borough v Thames Valley Electric Power Board* [1957] NZLR 523, 529 (Court of Appeal).

<sup>43</sup> [1967] NZLR 961.

<sup>44</sup> See, for example, *Thornley v Tilley* (1925) 36 CLR 1; *White v Australian and New Zealand Theatres Ltd* (1943) 67 CLR 266.

<sup>45</sup> [1970] AC 583.

<sup>46</sup> [1974] AC 235.

typical interpretation dispute where subsequent conduct may be relevant.<sup>47</sup> In such a dispute, as in the examples discussed in the previous section, the parties will be joining issue on the question of the proper meaning of a particular term in their contract and there will be evidence of subsequent actions which arguably provide a reliable guide to, or confirmation of, the meaning they attributed to the term at the time of the contract.

#### A. *James Miller v Whitworth Street Estates*

This case concerned a dispute under a building contract entered into between an English company and a Scots company. One of the issues before the House of Lords concerned the proper law of the contract. Was it the law of England or the law of Scotland? It was accepted that, at least initially, the answer depended on the intention of the parties, and that this intention might either be expressed in the written contract or inferred from the terms of the contract and the relevant surrounding circumstances.<sup>48</sup> The contract did not contain an express choice of law clause so the question was whether an intention could reasonably be inferred. It was held in both the Court of Appeal and the House of Lords (by a majority) that English law was the proper law. In the Court of Appeal, reliance was placed, *inter alia*, on the subsequent conduct of the parties. They had on two occasions acted on the basis that English law applied. However, the reasoning was somewhat unconvincing in that no attempt was made to explain that the relevance of this conduct was that it was merely indicative of the parties' intention *at the time of the contract*. The Court simply observed that the parties acted on the basis that English law applied<sup>49</sup> as if this were sufficient on its own to establish the parties' intention. This failure to justify its reasoning may partly explain the antipathy of the House of Lords towards relying on subsequent conduct when the focus of the court's inquiry is the parties' intention at the time of the contract. It may also explain Lord Reid's simplistic, yet often quoted, observation that '[o]therwise one might have the result that a contract meant one thing the day it was signed, but by reason of subsequent events meant something different a month or a year later'.<sup>50</sup>

The difficulty with Lord Reid's observation, when read in isolation, is that it misses the point of tendering evidence of subsequent conduct, namely, to persuade the court that the

<sup>47</sup> The same applies to the decisions of the Privy Council which soon endorsed (albeit *obiter* and without discussion) the position taken by the House of Lords: see *Ashton v Commissioner of Inland Revenue* [1975] 2 NZLR 717, 722; *AMP Society v Allan* (1978) 52 ALJR 407, 411; *Narich Pty Ltd v Commissioner of Pay-roll Tax* (1983) 58 ALJR 30, 32. The former concerned whether a contract had the purpose or effect of avoiding tax within s 108 of the *Land and Income Tax Act 1954*. The other two cases raised questions of construction or categorisation rather than interpretation. In other words, they concerned the proper nature or classification of certain contracts rather than the meaning of individual terms. Thus, in *AMP Society v Allan* the issue was whether, construed as a whole, the terms of the contract created a relationship of employment or agency. In *Narich* a similar issue arose as to whether a person was an employee or independent contractor. There was no doubt in either case that the written terms represented the parties' intentions and their Lordships said in *AMP* that it was only 'proper to consider the subsequent actings ... for the limited purpose of seeing whether they have had the effect of varying the written agreement': at 411. (Even this statement now requires qualification in view of *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710, 730 [48]: see generally, G McMeel, 'Prior Negotiations and Subsequent Conduct—The Next Step Forward for Contractual Interpretation?' (2003) 119 *Law Quarterly Review* 272, 291-293; A Berg, 'The Cuckoo in the Nest of Corporate Insolvency: Some Aspects of the *Spectrum* Case' [2006] *Journal of Business Law* 22.)

<sup>48</sup> [1970] AC 583, 603, 611.

<sup>49</sup> [1969] 1 WLR 377, 381, 384.

<sup>50</sup> [1970] AC 583, 603. However, Lord Reid did say (at 603) that 'counsel sought to use the [subsequent conduct] to show that there was an agreement when the original contract was made ...'

particular interpretation which that evidence supports was the meaning attributed to the words at the time of the contract. In other words, that meaning *is* the true meaning. Nevertheless, one can understand what Lord Reid was driving at because, in the context of the case before him, the subsequent conduct was indeed irrelevant. The respondent was seeking to use that conduct to infer an intention at the time of the contract which simply did not exist. Not only was there no term in the contract relating to proper law but also the parties had given no thought to the matter at the time of the contract and hence had no actual intention.<sup>51</sup> Accordingly, the question to be decided became: what intention could be reasonably imputed to the parties in light of the terms of the contract and the surrounding circumstances at the time of formation? For the purpose of resolving this question the parties' subsequent conduct was quite rightly treated as irrelevant. The only basis for allowing resort to such conduct is that it may provide an indication of the meaning which, at the time of entering into the contract, the parties actually attributed to its provisions. But in *James Miller* there was, *ex hypothesi*, no relevant provision and no actual intention.

### ***B. Schuler v Wickman Machine Tool Sales***

In this case Schulers had appointed Wickmans as their United Kingdom distributor for panel presses made by them. Clause 7(b) of the contract made it 'a condition' of the agreement that Wickmans send their representatives to visit certain motor manufacturers at least once in every week to solicit orders for the panel presses. When Schulers later terminated the contract they sought to justify their actions on the ground that the designation of clause 7(b) as a condition meant that they were entitled to terminate the contract for any breach, however minor. This argument was rejected in majority decisions of both the Court of Appeal and the House of Lords.

In the Court of Appeal the majority judges derived support for their conclusion from the subsequent conduct of the parties.<sup>52</sup> There had been several communications between them which pointed to an understanding that breach of the visiting obligation was governed by a later clause in the contract which gave Schulers a right to terminate for a material breach if Wickmans failed to remedy the breach within 60 days of notice being given. However, the House of Lords, while upholding the decision of the Court of Appeal that Schulers were not entitled to terminate for any breach of clause 7, held that the subsequent conduct should not have been taken into account.

The reasons of principle put forward by some of their Lordships in support of their opposition to the use of subsequent conduct as an aid to interpretation will need to be examined later, but there are two features of the case which should be noted at this juncture. First, although the subsequent conduct did point to an understanding that Wickmans would have 60 days from notice being given to remedy a breach of the visiting obligation, there was no suggestion that the parties had actually directed their minds to the possible legal significance of the term 'condition' in clause 7. Secondly, and most importantly, an arbitrator had made certain undisputed findings of fact which, surprisingly, none of the Judges referred to when discussing the issue of subsequent conduct. Lord Denning MR said:<sup>53</sup>

The arbitrator ... found that Schulers intended the use of the word 'condition' in clause 7(b) to have the effect that a failure by Wickmans to make a single

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<sup>51</sup> See the speeches of Lord Reid (at 603) and Lord Guest (at 608).

<sup>52</sup> *Wickman Machine Tool Sales Ltd v L Schuler AG* [1972] 1 WLR 840, 851, 857.

<sup>53</sup> *Ibid* 849.

visit by the scheduled representative would entitle Schulers to treat the agreement as at an end. But the arbitrator also found that Wickmans did not share Schulers' intention and would not have signed the agreement had they supposed that the use of the word 'condition' had that effect. So the evidence was not helpful, save to show that we must go by the reasonable interpretation of the words, and not by any supposed common intent ...

Since these findings of fact were unchallenged, they effectively negated any possible relevance of subsequent conduct to the interpretation of the contract. If the parties did not, in Lord Denning's words, have a 'common intent', there was no way that the subsequent conduct could alter that fact (unless, of course, it gave rise to an estoppel or binding variation). As pointed out above, the main relevance of subsequent conduct when the issue is one of interpretation is that it may provide evidence of a meaning actually attributed to a particular term at the time of formation of the contract. But, on the facts of *Schuler*, it must be taken that the appellants actually had an intention inconsistent with that allegedly revealed by their subsequent conduct. And, so far as the respondent Wickmans are concerned, although they did not share Schulers' intention, there is no indication that they had addressed the matter let alone intended the meaning which the subsequent conduct allegedly supported. In essence, therefore, the Court of Appeal's reasoning suffered from much the same problem as its reasoning in *James Miller*. The Judges tended to suggest that the parties' conduct provided some kind of *ex post facto* dictionary to interpret the contract which is quite independent of their intention at the time of the contract.

#### THE POSITION IN PRINCIPLE

In my view, common sense suggests that where an interpretation dispute arises the court should be able to have regard to relevant evidence of the parties' subsequent conduct. The fact that the parties have acted consistently with a particular interpretation, or at least the party now denying that interpretation has, may provide a reliable basis for an inference that this was the meaning attributed to the words at the time of the contract. But what is the position as a matter of legal principle? Unfortunately, this question does not admit of a short answer because there is so much inconsistency and confusion in the cases concerning the principles of contract interpretation. As will be apparent from the discussion thus far, the argument for taking into account subsequent conduct assumes that it is a legitimate function of the court in an interpretation dispute to determine, where possible, 'the sense in which the parties used the language they have employed'.<sup>54</sup> Accordingly, if the evidence establishes that the parties did actually focus their minds on the language in dispute and gave it the meaning now alleged by one of them, the court will give effect to their intention. Another view, however, is that the only role of the court is to decide the *presumed* intention of the parties and hence that evidence of the actual intention and understanding of the parties is not receivable.<sup>55</sup>

The answer to the question whether evidence of subsequent conduct ought *in principle* to be admissible as an aid to interpretation largely depends, therefore, on one's understanding of the underlying general principles of contract interpretation and the proper role of the court when resolving an interpretation dispute. Without wishing to deny the existence of shades of opinion in between, there are, for present purposes, three competing schools of thought. First, there is the traditional conservative (or 'literal') approach. The

<sup>54</sup> *Watcham v A-G of the East Africa Protectorate* [1919] AC 533, 538.

<sup>55</sup> See, for example, *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337, 352; *McLaren v Waikato Regional Council* [1993] 1 NZLR 710, 725: 'The subjectively considered intentions and meanings of the parties before, during and after the contract are irrelevant.'

second is the qualified contextual approach reflected in Lord Hoffmann's restatement of the fundamental principles of interpretation in *Investors Compensation Scheme Ltd v West Bromwich Building Society*,<sup>56</sup> sometimes referred to as 'commercial interpretation'<sup>57</sup> or 'commonsense interpretation'.<sup>58</sup> Thirdly, there is the liberal contextual approach which rejects artificial limits on the aids to interpretation available to a court. As we shall see, only the latter allows for reception of evidence of subsequent conduct.

### A. The Traditional Approach

Adherents to this approach, brought up on the staple diet of strict objectivity, supplemented by the plain meaning and parol evidence rules, accept the following principles as articles of faith.

First, the court's task when adjudicating upon issues of contract interpretation is to determine the meaning of the words the parties have used. 'It is not an inquiry into intention, but into meaning as a guide to intention.'<sup>59</sup>

Secondly, where contractual language has a plain meaning (a 'proper signification'<sup>60</sup> or a 'fixed meaning not susceptible of explanation'<sup>61</sup>), the court must give effect to that meaning. The words must be taken as representing the intention of the parties. The general rule is that parol evidence is not admissible to show that the parties meant something different from what they said. Only in exceptional circumstances, such as where the words bear a special meaning by trade usage or custom or the interpretation would produce a manifest inconvenience or absurdity, will departure from the plain meaning be justified.

Thirdly, where the terms of the contract are ambiguous the court may have regard to the surrounding circumstances, the so-called 'matrix of facts',<sup>62</sup> but such circumstances are 'restricted to evidence of the factual background known to the parties at or before the date of the contract, including evidence of the "genesis" and objectively the "aim" of the transaction'.<sup>63</sup>

Fourthly, evidence of the parties' negotiations or other direct evidence of their intentions is inadmissible. In so far as the negotiations 'consist of statements and actions of the parties which are reflective of their actual intentions and expectations they are not receivable'.<sup>64</sup> The court can only look to 'the objective framework of facts within which the contract came into existence, and to the parties' presumed intention in this setting'.<sup>65</sup> Interpretation of a contract requires 'a purely objective assessment' of the contractual terms.<sup>66</sup>

Those who adhere to the above principles will not, or logically cannot, accept that evidence of the parties' subsequent conduct can be received as an aid to interpretation, except perhaps to the limited extent that it sheds light on the contract's purpose and factual background. They will say that the court's task is to determine the meaning of the language

<sup>56</sup> [1998] 1 WLR 896, 912-913.

<sup>57</sup> *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749, 770 (Lord Steyn).

<sup>58</sup> *Ibid* 780 (Lord Hoffmann).

<sup>59</sup> *Blakeley and Anderson v De Lambert* [1959] NZLR 356, 367 (Adams J). See also *L Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235, 263.

<sup>60</sup> *Allgood v Blake* (1873) LR 8 Ex 160, 163.

<sup>61</sup> *Bank of New Zealand v Simpson* [1900] AC 182, 189.

<sup>62</sup> *Prenn v Simmonds* [1971] 1 WLR 1381, 1384 (Lord Wilberforce).

<sup>63</sup> *Ibid* 1385.

<sup>64</sup> *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337, 352 (Mason J).

<sup>65</sup> *Ibid*.

<sup>66</sup> *McLaren v Waikato Regional Council* [1993] 1 NZLR 710, 731 (Fisher J).

at the time of the contract and ‘subsequent conduct is equally referable to what the parties meant to say as to the meaning of what they said’.<sup>67</sup> Further, evidence of the parties’ conduct, in so far as it may reflect their actual intentions, is no more relevant than evidence of their prior negotiations or other direct evidence of intention which cannot be received. ‘[I]t might, indeed, be most misleading to let in subsequent conduct without reference to these other matters.’<sup>68</sup> While subsequent conduct may provide the basis for finding an estoppel or a new contract, it cannot affect the interpretation of the contract. Indeed, reliance on previous authority such as *Watcham v Attorney-General of the East Africa Protectorate*<sup>69</sup> is ‘nothing but the refuge of the desperate’.<sup>70</sup>

### ***B. The Qualified Contextual Approach: Lord Hoffmann’s Restatement***

Under Lord Hoffmann’s now famous restatement of the fundamental principles of interpretation in *Investors Compensation Scheme Ltd v West Bromwich Building Society*<sup>71</sup> the task of a court is to ascertain ‘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’. He stresses that the meaning of a document<sup>72</sup>

... 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 ...

As his Lordship explained in his instructive speech delivered less than a month earlier in *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd*:<sup>73</sup>

We start with an assumption that people will use words and grammar in a conventional way but quite often it becomes obvious that, for one reason or another, they are not doing so and we adjust our interpretation of what they are saying accordingly. We do so in order to make sense of their utterance: so that the different parts of the sentence fit together in a coherent way and also to enable the sentence to fit the background of facts which plays an indispensable part in the way we interpret what anyone is saying. No one, for example, has any difficulty in understanding Mrs Malaprop. When she says ‘She is as obstinate as an allegory on the banks of the Nile’, we reject the conventional or literal meaning of allegory as making nonsense of the

<sup>67</sup> *L Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235, 269 (Lord Simon of Glaisdale).

<sup>68</sup> *Ibid* 268. Indeed, according to Lord Wilberforce, ‘[i]t is one and the same principle which excludes evidence of statements, or actions, during negotiations, at the time of the contract, or subsequent to the contract, any of which to the lay mind might at first seem to be proper to receive’: at 261.

<sup>69</sup> [1919] AC 533.

<sup>70</sup> *L Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235, 261 (Lord Wilberforce).

<sup>71</sup> [1998] 1 WLR 896, 912-913.

<sup>72</sup> *Ibid* 913.

<sup>73</sup> [1997] AC 749, 774-775.

sentence and substitute 'alligator' by using our background knowledge of the things likely to be found on the banks of the Nile and choosing one which sounds rather like 'allegory' ...

It is of course true that the law is not concerned with the speaker's subjective intentions. But the notion that the law's concern is therefore with the 'meaning of his words' conceals an important ambiguity. The ambiguity lies in a failure to distinguish between the meanings of words and the question of what would be understood as the meaning of a person who uses words. The meaning of words, as they would appear in a dictionary, and the effect of their syntactical arrangement, as it would appear in a grammar, is part of the material which we use to understand a speaker's utterance. But it is only a part; another part is our knowledge of the background against which the utterance was made. It is that background which enables us, not only to choose the intended meaning when a word has more than one dictionary meaning but also, in the ways I have explained, to understand a speaker's meaning, often without ambiguity, when he has used the wrong words.

Lord Hoffmann's principles are obviously far more liberal than the traditional approach to contract interpretation. The most notable features of those principles, particularly for the purposes of a comparison with the latter approach, are as follows. First, the essential task of a court is to determine the meaning of the *document*—the meaning that a reasonable person with knowledge of the background to the contract would give to the document. Secondly, for this purpose, the background or matrix of facts is *always* admissible as an aid to interpretation. Thirdly, the so-called plain meaning rule is relegated to a proposition that where words do have a natural or ordinary meaning this is simply a strong indication that they were used in that sense.

Although the two approaches have the point in common that plain meanings will not prevail where they produce results that are absurd or a commercial nonsense, in other respects they are very different. The starting point of a court applying the traditional approach is the meaning of the *words*. The court must ask: do the words in issue, read only in the context of the document as a whole, have a plain meaning and, if the answer is yes, is that meaning so absurd that the parties cannot possibly have intended it? Thus, the court starts from the premise that it is only permissible to depart from a plain meaning in cases of manifest absurdity. By contrast, under Lord Hoffmann's principles, the immediate and primary task of the court is to determine the meaning of the document and 'the meaning of the document is what the parties using [the words in issue] against the relevant background would reasonably have been understood to mean'. We must not 'confuse the meaning of words with the question of what meaning the use of the words was intended to convey'.<sup>74</sup> In order to displace an alleged plain meaning it is sufficient that the words would have conveyed a different meaning to a reasonable person with knowledge of the background. Lord Hoffmann essentially rejects the notion of plain meaning. Language is fallible and does not define itself. As he pointed out in *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd*:<sup>75</sup>

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<sup>74</sup> *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749, 779.

<sup>75</sup> *Ibid* 778. In the same case Lord Steyn said: 'In determining the meaning of the language of a commercial contract ... the law ... generally favours a commercially sensible construction. The reason for this approach is that a commercial construction is more likely to give effect to the intention of the parties. Words are therefore interpreted in the way in which a reasonable commercial person



[W]ords do not in themselves refer to anything; it is people who *use* words to refer to things. The word ‘allegory’ does not mean a large scaly creature or anything like it, but it is absurd to conclude, as judges sometimes do, that this is not an ‘available meaning’ of the word in the interpretation of what someone has said. This is simply a confusion of two different concepts; as we have seen, a person can use the word ‘allegory’, successfully and unambiguously, to refer to such a creature.

Thus, on the facts of *Mannai Investment* his Lordship felt able to hold that a tenant’s notice to terminate a lease ‘on 12 January’ meant ‘on 13 January’ (the date on which the tenant was entitled to terminate the lease) because that was the objective meaning of the words. It was the objective meaning because a reasonable person in the position of the landlord with knowledge of the terms of the contract would have understood that the tenant wished to determine the lease on 13 January but wrongly wrote 12 January.

Nevertheless, Lord Hoffmann’s principles are quite conservative in some respects, particularly in so far as they accept that ‘for reasons of practical policy’ evidence of ‘the previous negotiations of the parties and their declarations of subjective intent’ is inadmissible.<sup>76</sup> Most importantly for present purposes, although the issue is not addressed directly, allowing evidence of subsequent conduct to be received as an aid to interpretation would be logically inconsistent with those principles. It would be inconsistent in three respects. First, the main relevance of subsequent conduct is that it may provide a reliable guide to the meaning that the particular parties actually attributed to the words in dispute when the contract was signed, whereas Lord Hoffmann’s first principle seems, at least on the surface,<sup>77</sup> to reject the view that it is a legitimate function of the court in an interpretation dispute to determine, where possible, the sense in which the particular contracting parties used the language in question. The task of the court is to determine the meaning that the document would convey to a *reasonable person* with knowledge of the background.

Secondly, under the same principle, this reasonable person only has available ‘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*’.<sup>78</sup> Thirdly, and more importantly, if evidence of the parties’ subsequent conduct is admissible, how can it be that evidence of negotiations or other pre-contract indicators of their actual intentions is inadmissible? As Lord Simon of Glaisdale pointed out in *L Schuler AG v Wickman Machine Tool Sales Ltd*:<sup>79</sup>

[S]ubsequent conduct is of no greater probative value in the interpretation of an instrument than prior negotiations or direct evidence of intention: it might, indeed, be most misleading to let in subsequent conduct without reference to these other matters.

Further, in the same case Lord Wilberforce said:<sup>80</sup>

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would construe them. And the standard of the reasonable commercial person is hostile to technical interpretations and undue emphasis on niceties of language’: at 771.

<sup>76</sup> [1998] 1 WLR 896, 913.

<sup>77</sup> Cf, however, D W McLauchlan, ‘Objectivity in Contract’ (2005) 24 *University of Queensland Law Journal* 479, 493-494 and text herein at n 108.

<sup>78</sup> Emphasis added.

<sup>79</sup> [1974] AC 235, 268.

<sup>80</sup> *Ibid* 261.

It is one and the same principle which excludes evidence of statements, or actions, during negotiations, at the time of the contract, or subsequent to the contract, any of which to the lay mind might at first sight seem to be proper to receive.

This is why, as I have previously argued,<sup>81</sup> rejection of the English rule that evidence of subsequent conduct is inadmissible as an aid to interpretation must lead to a reconsideration of other related aspects of the traditional approach to issues of contract interpretation. It is not sensible for a court to allow evidence of subsequent conduct and at the same time continue to accept some of the other restrictions on the admissibility of extrinsic evidence, especially the rule that evidence of the parties' negotiations is inadmissible which is based on the notion that 'the interpretation of contracts is not a matter for evidence of the intentions or understandings of the parties'.<sup>82</sup>

### ***C. The Liberal Approach***

The liberal approach to the interpretation of contracts, which I have discussed elsewhere,<sup>83</sup> naturally shares a great deal in common with Lord Hoffmann's restatement and is more in the nature of a refinement of it. Thus, both reject the existence of a plain meaning *rule*. No words have a settled or fixed meaning independent of their users or the context. Where the words of a contract do have an ordinary meaning this is simply a strong indication that it was the meaning adopted by the parties. Further, in most cases application of the two approaches will not lead to different results. This is because in the great majority of interpretation disputes the parties will not, at the time of formation, have contemplated the situation that has arisen, so that the court can only seek to resolve the dispute by reference to their presumed intention.<sup>84</sup> In other words, the task is to ascertain the meaning that the document would convey to a reasonable person with knowledge of the background.

Where the two approaches part company is that the liberal approach overtly recognises that sometimes the parties, at the time of the contract, do contemplate the situation that later arose and do give thought to the impact of the words they have chosen in that situation. Starting from the premise that the basic object of the law of contract is to give effect to either an actual or objective consensus ad idem, the task of a court in an interpretation dispute according to the liberal approach is to seek, wherever possible, to give effect to the meaning which the parties attributed to the words in dispute when the contract was entered into; or, more particularly, the meaning which the parties actually attached to the words or the

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<sup>81</sup> D W McLauchlan, 'Subsequent Conduct as an Aid to Interpretation' (1996) 2 *New Zealand Business Law Quarterly* 237, 259.

<sup>82</sup> *Port of Wellington Ltd v Longwith* [1995] 1 ERNZ 87, 92 (Court of Appeal).

<sup>83</sup> D W McLauchlan, 'The New Law of Contract Interpretation' (2000) 19 *New Zealand Universities Law Review* 147.

<sup>84</sup> See E A Farnsworth, *Farnsworth on Contracts* (1990) vol 2, §7.9, 254: 'In many disputes arising out of contemporary business transactions ... the parties gave little or no thought to the impact of their words on the case that later arose. Perhaps the contract is embodied in a printed form that neither party prepared; perhaps its clauses have been lifted from a form book; perhaps the deal is a routine one struck by minor functionaries ... The court will then have no choice but to look solely to a standard of reasonableness. Interpretation cannot turn on meanings that the parties attached if they attached none, but must turn on the meaning that reasonable persons in the positions of the parties would have attached if they had given the matter thought. If the contract is on a widely used standard form, the use of this purely objective test has the advantage of promoting uniform interpretation, without regard to the chance circumstances of the parties.'

meaning which one party attached where that party reasonably believed that the other party or parties accepted this meaning. This is so regardless of whether those words on their face are ambiguous or have a plain meaning. On this approach, just as 'parties may agree for the purposes of a particular transaction that black shall mean white and vice versa' so as to give rise to an estoppel by convention,<sup>85</sup> such agreement prior to their contract will also establish their meaning for the purposes of an interpretation dispute. In determining meaning in accordance with this principle parol evidence must necessarily be admissible of all relevant surrounding circumstances, including the negotiations and other communications between the parties. It follows too that the usual statement that an interpretation exercise involves an inquiry into the meaning of what the parties said, not what they meant to say, is seriously misleading. The initial task facing the court is to answer the question: what, if any, was the meaning attributed to the words by the parties to the contract? This is surely just another way of saying: what did the parties intend the words to mean?

The answer to the problem of subsequent conduct is easy for those who adhere to these principles.<sup>86</sup> Evidence of such conduct should always be admissible, although its probative value is another matter altogether. The conduct may be evidence, of more or less weight, that *at the time of the contract* the parties attached a particular meaning to the words in question, or that one of them attached that meaning and reasonably believed that the other did so too. Although it will rarely, if ever, be conclusive, the conduct may, when taken in conjunction with other evidence of their intention and the surrounding circumstances, sometimes tip the evidential balance in favour of a conclusion that a particular meaning was indeed adopted at the time of the contract.

It will be noted, therefore, that when evidence of subsequent conduct is used as an aid to interpretation (as opposed to the basis for alleging a variation or estoppel) its purpose is to elucidate, not alter, meaning. As Thomas J pointed out in the leading New Zealand judgment on the subject:<sup>87</sup>

[The evidence] is admitted for the purpose of persuading the Court that it provides a reliable guide to the meaning which the parties attributed to the contract when it was signed. The proper construction is assisted and not changed by the subsequent conduct. In this manner, the Court's ability to give effect to the mutual intention of the parties is undoubtedly furthered.

On the other hand, evidence of subsequent conduct will be largely irrelevant to the interpretation of the contract if in fact the parties did not contemplate the situation that has arisen and did not adopt a shared meaning at the time of the contract.<sup>88</sup> And, as I have already stressed, in most interpretation disputes that will indeed be the case, so that the court's task is to determine the presumed intention of the parties.

### **MUST THE SUBSEQUENT CONDUCT BE UNEQUIVOCAL?**

If the argument in the latter part of the previous section be accepted, it follows that there is no reason why the subsequent conduct should be required to support *unequivocally* the suggested interpretation before it is able to be received. Otherwise, evidence of such

<sup>85</sup> *National Westminster Finance NZ Ltd v National Bank of NZ Ltd* [1996] 1 NZLR 548, 550.

<sup>86</sup> *A-G v Dreux Holdings Ltd* (1996) 7 TCLR 617, 631 (Thomas J): 'the issue is reasonably straightforward'.

<sup>87</sup> *Ibid* 641.

<sup>88</sup> As Thomas J has pointed out, 'the parties cannot be thought to have acted on a shared meaning of the contract at the time it was completed if, in fact, there was no shared meaning at that time': *ibid* 638.

conduct would hardly ever be admissible. It will rarely provide unequivocal support for the suggested interpretation<sup>89</sup> because the party affected will be able to point to other possible explanations for the conduct, such as inadvertence or a mistaken interpretation of the contract, and hence argue that it does not necessarily reflect an understanding held at the time of the contract. Nevertheless, many of the older authorities holding that evidence of the parties' subsequent conduct is admissible as an aid to interpretation insist that not only must the evidence be received with caution but also it must unequivocally support the interpretation suggested. The objections to this requirement can be illustrated through a consideration of the New Zealand Court of Appeal's decision in *New Zealand Diving Equipment Ltd v Canterbury Pipe Lines Ltd*,<sup>90</sup> arguably the leading Commonwealth authority on the present subject prior to the decisions of the House of Lords in the early 1970s.

The case concerned a written contract for the provision of diving services by the plaintiff company for the purpose of construction of a sewer pipeline. The contract stated that the company was to be paid at certain hourly rates per diver 'on the job or in the water'. A dispute arose concerning, inter alia, whether these ambiguous words covered the period between the divers' embarkation and disembarkation at the wharf, as the plaintiff contended, or only the period between their arrival at and departure from the diving site, in which case the defendant had been overcharged. The Court of Appeal unanimously held that on the true construction of the words in light of the surrounding circumstances the plaintiff's contention was correct. More importantly for present purposes, it was also held that, in principle, evidence of the parties' subsequent conduct is admissible to aid the interpretation of an ambiguous contract provided that it constitutes an unequivocal indication of the meaning which the parties attached to the disputed words at the time of the contract. However, only a majority found that the latter requirement was satisfied on the facts.

The relevant conduct was that, for three months prior to the dispute arising, the plaintiff had rendered detailed accounts to the defendant on the basis that it was entitled to charge for the time taken to journey to and from the diving site. These accounts were carefully checked and approved by the defendant's project manager and duly paid. It was held by McGregor and McCarthy JJ that this conduct amounted to an acceptance by the parties that 'the true basis for calculation of the hourly diving rates was time from wharf to wharf'<sup>91</sup> and reinforced the other factors pointing to the meaning intended by the parties. McCarthy J acknowledged that the requirement that 'the acts or conduct relied on must unequivocally support the construction said to be demonstrated by them ... is a hard test to satisfy' and that 'an examination of the cases shows that it is not often thought to be satisfied' but concluded that 'if it is not satisfied here, then I doubt whether it will ever be'.<sup>92</sup>

However, these observations did not persuade the third judge, Turner J. His Honour accepted that 'the subsequent conduct of a party to a contract may constitute an unequivocal indication of the meaning which at the time of entering into the contract that party attributed to its provisions'<sup>93</sup> but continued:<sup>94</sup>

The conduct is then used as a dictionary; but what it is used for is to show what the party himself supposed the meaning of the words used to be. If it

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<sup>89</sup> See *Offshore Mining Co Ltd v A-G* [1988] NZCA 116/86 (Unreported, Cooke P, 28 April 1988); *A-G v Dreux Holdings Ltd* (1996) 7 TCLR 617, 640 (Thomas J).

<sup>90</sup> [1967] NZLR 961.

<sup>91</sup> *Ibid* 978 (McGregor J).

<sup>92</sup> *Ibid* 980.

<sup>93</sup> *Ibid* 985.

<sup>94</sup> *Ibid* 985-6.

can then be proved that the other party attributed the same meaning to the term in the contract then, in cases where the words are ambiguous, the Court will use the dictionary furnished by the conduct of the parties. But it must be noticed that it is what was actually in the mind of the party which is the subject of inquiry. It is not sufficient to prove (as would be sufficient in the case of a submission of estoppel, which cannot be made here) that the conduct relied upon is such as would be accepted by a reasonable observer as indicating the meaning which the party attributed to the contract—the whole basis of the doctrine lies in the conduct proved being an unequivocal indication of *what was actually in the mind of the party when he contracted*.

His Honour was not satisfied that the defendant's project manager represented the mind of the company. Further, it could not 'be said with sufficient certainty that [the company's principals] ever adverted to the point'.<sup>95</sup> The failure of the company to dispute the accounts was consistent with a conclusion that, 'never having previously adverted at all to the construction of the words "on the job or in the water", it ultimately became concerned at the size of the accounts presented to it, and scrutinised the accounts item by item accordingly; and then at last perceived that the phrase presented an ambiguity of which something could be made'.<sup>96</sup>

It is difficult to fault the logic of Turner J's approach and conclusion. Strictly speaking, the subsequent conduct did not *unequivocally* support the interpretation said to be demonstrated by it. There were other possible explanations for that conduct. However, his Honour's approach has the effect that evidence of subsequent conduct will rarely be admissible. For it will almost always be open to the party adversely affected by the subsequent conduct to say, for example: 'My conduct was based on ignorance. I never adverted to the meaning of the contract. I simply assumed that the performance requested was required by the contract.' Alternatively, in situations where it is established that the party did refer to the terms of the contract and did act in accordance with the meaning alleged by the other party, the conduct will not be an unequivocal indication that this meaning was shared at the time of the contract, for that conduct will be consistent with the existence of a mistaken interpretation of the contract. Thus, the party may be able to say: 'Yes, I did act in accordance with the plaintiff's interpretation but that does not mean that it was my understanding at the time of the contract. In fact, I had given no thought to the matter then and I now allege my later conduct was mistaken.' Or yet another explanation may be that the conduct was an act of grace, an indulgence or concession 'to promote good relations or to avoid argument'.<sup>97</sup> If this analysis is accepted, it would seem that the only conduct that would be admissible is that amounting to an admission—an express or perhaps implied acknowledgement of the meaning that the party attached to the words at the time of the contract.

The lesson to be learned from the *New Zealand Diving* case is that a requirement that the subsequent conduct must provide unequivocal support for the meaning alleged is unduly restrictive. In my view, the fact that there may be other explanations for the subsequent conduct should merely be a factor affecting the *weight* of the evidence rather than a basis for it being discarded or rendered altogether inadmissible. So too should the fact that the

<sup>95</sup> Ibid 986.

<sup>96</sup> Ibid.

<sup>97</sup> *St Edmundsbury and Ipswich Diocesan Board of Finance v Clark* [1973] 3 All ER 902, 915 (Megarry J). His Honour continued, 'Life would become intolerable if everyone insisted to the ultimate on the strict letter of his rights; and the danger of applying the doctrine [in *Watcham v Attorney-General*] to cases of obligation is that it would encourage such an insistence.': at 916.

conduct is that of a mere employee, as opposed to a senior manager or director, of the party affected.<sup>98</sup> Thus, in the kind of situation which came before the Court in the *New Zealand Diving* case the parties' conduct, although not conclusive, might legitimately be seen as reinforcing the inferences drawn from evidence of the other surrounding circumstances that they did indeed attach a particular meaning to the words at the time of the contract (or one of them did and reasonably believed that the other did so too).

## THE ARGUMENTS FOR EXCLUDING SUBSEQUENT CONDUCT

Over the years numerous reasons of principle or policy have been put forward as justification for excluding evidence of subsequent conduct. However, none stand up to close scrutiny. Some have already been addressed in the course of my earlier analysis and therefore require only relatively brief discussion here.

### A. *Inconsistency with Objective Approach to Interpretation*

As we have already seen, the orthodox view is that the task of a court when resolving an interpretation dispute is to ascertain the meaning that the document would convey to a reasonable person having knowledge of the background circumstances. For this purpose the court can only look to 'the objective framework of facts within which the contract came into existence, and to the parties' presumed intention in this setting',<sup>99</sup> and evidence of negotiations or other exchanges 'which are reflective of their actual intentions and expectations' is inadmissible.<sup>100</sup>

This is the most commonly expressed reason for excluding subsequent conduct. Thus, in *McLaren v Waikato Regional Council* Fisher J said:<sup>101</sup>

It seems clear that a distinction must be drawn between establishing the contractual communications which passed between the parties and placing the correct construction upon those communications once they have been ascertained ... Whether something was stated during contractual negotiations is a pure question of fact. As with all questions of fact, there is the potential for an issue of credibility. If credibility is in

<sup>98</sup> See *Re Canadian National Railways and Canadian Pacific Ltd* (1978) 95 DLR (3d) 242, 262 (Lambert JA): 'In the case of evidence of subsequent conduct the evidence is likely to be most cogent where the parties to the agreement are individuals, the acts considered are the acts of both parties, the acts can relate only to the agreement, the acts are intentional and the acts are consistent only with one of the alternative interpretations. Where the parties to the agreement are corporations and the acts are the acts of employees of the corporations, then evidence of subsequent conduct is much less likely to carry weight. In no case is it necessary that weight be given to evidence of subsequent conduct. In some cases it may be most misleading to do so and it is to this danger that allusions are made throughout the recent English cases ... In England the risks have been considered sufficiently grave that the possibility of illumination from the use of subsequent conduct has been ruled out. In Canada, they have not, but those risks must be carefully assessed in each individual case before determining to give weight to subsequent conduct.'

<sup>99</sup> *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337, 352 (Mason J).

<sup>100</sup> *Ibid.*

<sup>101</sup> [1993] 1 NZLR 710, 731.

issue, the subsequent conduct of the parties may be relevant. In that context it will be helpful to know whether the post-contract conduct of a party was consistent or inconsistent with an alleged recollection that a certain term had been communicated between the parties. But as I see it, the use of post-contract conduct for that purpose has nothing to do with the construction of the contract ...

The construction of a contract is a different subject entirely. It requires a purely objective assessment of whatever had been communicated as the express terms of the contract. It is fundamental to the law of contract that what the parties privately thought about the matter then and subsequently is irrelevant ... Since the subjective intentions of the parties—whether before or after the date of the contract—are irrelevant, general principle would exclude the post-contract conduct of either or both parties as a legitimate aid to construction ... The application of contract law to objectively considered expressed intentions is demanding enough. Experience in contract litigation suggests that to add an inquiry into the unexpressed thoughts of the parties would be a time-consuming journey into the inherently unreliable.

Similarly, in *FAI Traders Insurance Co Ltd v Savoy Plaza Pty Ltd*<sup>102</sup> Brooking J questioned why ‘evidence of subsequent conduct [should] be admissible where direct evidence of intention is not?’<sup>103</sup> His Honour proceeded to hold that ‘[t]he view which a party to a contract takes of its effect has no bearing on its construction’.<sup>104</sup> Even an admission by a party as to its interpretation ‘while theoretically available for use, is not admissible because it could not be given any weight at all by the court in construing the contract. It could be given weight if the question for the court was that of the subjective intention of the parties, for a party knows what he intended, but that is not the question ...’<sup>105</sup>

Three points need to be made here. First, as already discussed, this line of argument falls to the ground if the liberal approach to interpretation is accepted and it is legitimate for a court to seek to give effect to the meaning actually attached to the words by the parties or the meaning attached by one party which that party reasonably believed the other accepted. On this approach, the question *is*, contrary to the view of Fisher J, one of fact and there *is* ‘the potential for an issue of credibility’. Subsequent conduct *may* therefore be helpful in determining whether the meaning alleged was indeed attached to the words at the time of the contract.

Secondly, it must be stressed that there is nothing in this article to suggest that a court should be able to interpret a contract in accordance with ‘unexpressed thoughts’ or ‘what the parties privately thought’ about the matter in question. The liberal approach to contract interpretation does not seek to allow or encourage, in the words of Kirby P (as he then was), ‘curial exploration of the unfathomable depths of subjective intentions’.<sup>106</sup> Neither the thoughts nor the acts of one party preceding the execution of a written contract and not communicated to the other party are relevant to the interpretation of a contract. Plainly, ‘the general principle [is] that nothing is relevant to the interpretation of a contract, unless it is known, or at least capable of being known, to both parties at the time when the contract was

<sup>102</sup> [1993] 2 VR 343.

<sup>103</sup> *Ibid* 350.

<sup>104</sup> *Ibid* 351.

<sup>105</sup> *Ibid*.

<sup>106</sup> *B & B Constructions (Australia) Pty Ltd v Brian A Cheeseman & Associates Pty Ltd* (1994) 35 NSWLR 227, 234.

made'.<sup>107</sup> (It would be entirely another matter, of course, if that unexpressed intention were proven to have been shared by the other party and hence there happened to be an actual consensus ad idem on the point.)

Thirdly, for the reasons discussed in my article in the previous issue of this journal,<sup>108</sup> accepting and giving effect to evidence of the actual mutual intention of the parties is not in any event inconsistent with an objective approach. I suggested, for example, that when Lord Hoffmann's speech in the *Investors Compensation Scheme* case is read as a whole, his 'reasonable person having all the background knowledge which would reasonably have been available to the parties'<sup>109</sup> is a reasonable person *in the situation of the parties*, or what amounts to the same in practice, a reasonable person *in the situation of the promisee*. This reasonable person is necessarily aware of communications between the parties and would not, for example, deny shared understandings as to the meaning of their words. Nor would he deny a meaning which, though not shared by the promisor, the promisee reasonably believed the promisor intended to accept. Thus, according to Lord Hoffmann, when Alice is told by Humpty Dumpty that the word 'glory' means 'a nice knock-down argument', Alice 'would have had no difficulty in understanding what he meant'.<sup>110</sup> The objective meaning of the word 'glory' is 'a nice knock-down argument'.

### ***B. Contract to be Interpreted at Time of Formation***

Lord Reid's observation in *James Miller & Partners Ltd v Whitworth Street Estates (Manchester) Ltd*<sup>111</sup> that subsequent conduct must be excluded because '[o]therwise one might have the result that a contract meant one thing the day it was signed, but by reason of subsequent events meant something different a month or a year later' has been widely accepted. Thus, in *McLaren v Waikato Regional Council* Fisher J said that 'the contract is to be construed as at the date upon which it was made' and that '[s]hort of a valid variation of the original contract, its proper construction could not be changed by subsequent conduct'.<sup>112</sup> In *Sportvision Australia Pty Ltd v Tallglen Pty Ltd* Bryson J went so far as to say that 'the consideration stated by Lord Reid is of overwhelming and unanswerable importance'.<sup>113</sup> His Honour continued:<sup>114</sup>

The contract cannot mean one thing if it is never acted on, and something else if it is. The meaning of the 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 ... 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.

<sup>107</sup> Staughton LJ, 'Interpretation of Maritime Contracts' (1995) 26 *Journal of Maritime Law and Commerce* 259, 263.

<sup>108</sup> D W McLauchlan, 'Objectivity in Contract' (2005) 24 *University of Queensland Law Journal* 479.

<sup>109</sup> [1998] 1 WLR 896, 912.

<sup>110</sup> *Ibid* 914.

<sup>111</sup> [1970] AC 583, 603.

<sup>112</sup> [1993] 1 NZLR 710, 731.

<sup>113</sup> (1998) 44 NSWLR 103, 114.

<sup>114</sup> *Ibid*.



This argument stands in stark contrast to some important recent extra-judicial observations by Lord Nicholls of Birkenhead. His Lordship described Lord Reid's statement as 'puzzling', pointing out that:<sup>115</sup>

Evidence of the parties' subsequent conduct is sought to be used as a means of identifying the meaning borne by the language of the contract from its inception. The fact that this evidence only came into being after the contract was made can hardly be a good reason for declining to admit it.

As this passage implies, Lord Reid's statement misses the point of tendering evidence of subsequent conduct, which is to persuade the court that the particular interpretation which that evidence supports was the meaning attributed to the words at the time of the contract.<sup>116</sup> In other words, that meaning *is* the true meaning. When subsequent conduct is used as an aid to interpretation (as opposed to the basis for alleging a variation or estoppel) its purpose is to elucidate, not alter, meaning. There can be no question of subsequent conduct leading to a contract having 'different meanings at different times'. The most that the conduct can do is to persuade the court that the alleged meaning was in fact the meaning accorded to the contract at the time it was signed.<sup>117</sup> The fact that without such evidence the court *may* have been inclined to reach a different conclusion is simply irrelevant. Such are the realities of the judicial process. Many a deserving claimant has been denied for want of a clinching piece of evidence!

### C. Penalising a Mistaken Party

It has been said that to allow use of subsequent conduct might entail a party being penalised 'for a mistaken view of his or her objectively considered rights'.<sup>118</sup> However, if the subsequent conduct was in fact based on a mistaken interpretation of the contract, there can be no penalty. By definition, the existence of mistake means that the interpretation put forward by the other party, which is allegedly supported by the subsequent conduct, is wrong. The true meaning of the contract will prevail. Of course, the very purpose of

<sup>115</sup> Donald Nicholls, 'My Kingdom for a Horse: The Meaning of Words' (2005) 121 *Law Quarterly Review* 577, 589. Compare, however, Hugh Collins, 'Objectivity and Committed Contextualism in Interpretation' in Sarah Worthington (ed), *Commercial Law and Commercial Practice* (2003) 202: 'It is usually stated that the meaning of the document is to be ascertained by reference to the circumstances at the time of the formation of the contract, that is when the parties have committed their agreement to paper. That emphasis upon the moment of formation is why the subsequent conduct of the parties is, in principle, irrelevant ...'

<sup>116</sup> However, as explained earlier (see text at n 50), Lord Reid's statement needs to be read in the context of the facts and issue before their Lordships, a context which, on any view, plainly made the conduct in question irrelevant.

<sup>117</sup> In *FAI Traders Insurance Co Ltd v Savoy Plaza Pty Ltd* [1993] 2 VR 343, 353 Nathan J said that 'a homely analogy is in order. A meat pie does not become an apple tart merely because it is served for dessert. A lease does not change its character or ingredients simply because the parties conduct themselves as if it were of a different character and contained different ingredients.' However, to continue the homely analogy, the Judge ends up with egg on his face. He misses the point of tendering evidence of subsequent conduct, which is to prove that the words in question were given a particular meaning at the time of the contract. His argument assumes that what is being served for dessert is in fact a meat pie. Whereas the argument for a particular interpretation based on subsequent conduct will not seek to change the ingredients but to establish what they were in the first place.

<sup>118</sup> *McLaren v Waikato Regional Council* [1993] 1 NZLR 710, 731 (Fisher J).

admitting evidence of subsequent conduct is to assist in determining what that meaning was, which will in turn determine whether there was or was not a mistake. And the fact that a *possible* explanation for the conduct is the existence of a mistake will simply be an important factor to be taken into account in assessing the weight of the evidence.

In *FAI Traders Insurance Co Ltd v Savoy Plaza Pty Ltd*,<sup>119</sup> where the question arose whether a covenant in a lease obliging the tenant to pay taxes, rates and other charges covered insurance premiums which, during the first 13 years of the term, the tenant had paid, Brooking J made a slightly different point:

Since the relevance of the conduct is said to be the view it manifests concerning the interpretation of the contract, it is presumably open to one side to show that the conduct did not in fact proceed from the suggested view of the contract advanced in the litigation. So in the present case it would presumably be open to the tenant to explain away its payment of the insurance premiums by showing that the payments had been made because of a mistaken belief that the lease contained an express covenant to insure or to pay insurance premiums, or simply because some officer of its had passed the invoices for payment as a result of merely assuming them to be in order. That the meaning to be given to a lease might depend upon the acceptance or rejection of this kind of evidence strikes me as remarkable.

In my view, this is a simplistic response to the argument for admitting evidence of subsequent conduct. As I have said, the relevance of such conduct is that it may provide evidence of the meaning attached by the parties to the words of the contract at the time that contract was entered into. The mere fact that a plausible explanation for the subsequent conduct *could be* the existence of a mistaken interpretation or assumption will, by itself, be an important factor affecting the weight that can be attached to the conduct. It will then be incumbent on the proponent of the particular interpretation to prove from other sources that the meaning alleged was held by the parties at the time of the contract. It will be a rare case where the meaning will depend on the acceptance or rejection of evidence that there was an *actual* mistaken interpretation or assumption. Of course, if the court were to *reject* the allegation of mistake this would most likely be because it is otherwise satisfied that the intention which the conduct apparently exhibits was the meaning attached to the words at the time of the contract. If the argument were *accepted* this could only be because the court is satisfied that the parties did not attach the particular meaning allegedly supported by the subsequent conduct at the time of the contract. Therefore, acceptance or rejection of a party's contention that the conduct was based on a mistaken interpretation will not determine meaning. Rather it is the judge's conclusion based on the evidence as a whole as to whether a particular meaning was adopted at the time of the contract that will do so. The subsequent conduct will be one factor, varying in weight according to the nature of the conduct and the other circumstances, to be considered in reaching that conclusion.

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<sup>119</sup> [1993] 2 VR 343, 350-351.

#### ***D. Uncertainty as to Nature of Admissible Conduct***

Brooking J suggested various other reasons why a principle allowing evidence of subsequent conduct ‘would be uncertain in its operation and mischievous in its effect’. He said:<sup>120</sup>

The present case affords a good example. This is a lease of a valuable building for a term of 71 years ... Is there any limit to the conduct to which regard may be had as an aid to interpretation? Does it include mere statements as opposed to acts? Is the conduct of one party admissible or must the conduct be the concurring conduct of all? Is the conduct of a party which favours the view on construction which he supports admissible even if it is not concurred or acquiesced in by the other?

The questions posed by the Judge can be shortly answered. There is no reason to limit the kind of conduct to which regard might be had, provided it is potentially relevant to the parties’ meaning at the time of the contract. Such conduct might include statements and acts. The fact that the conduct is that of one party only rather than ‘the concurring conduct of all’ is a matter going to weight. Further, such conduct would be entitled to little weight if it were the self-serving conduct of the party who is putting forward the particular interpretation which it allegedly supports.

#### ***E. Impact on Third Parties***

Brooking J was also concerned that a principle allowing evidence of subsequent conduct might unfairly prejudice third parties who rely on the contract. He thought that ‘a prospective purchaser of the term [might have] to ascertain its provisions not simply by examining the instrument but also by calling for evidence of what has been done under it’.<sup>121</sup> Such concern for the rights of third parties is a standard response from those who are opposed to liberalisation of the law relating to contract interpretation. In my view, the concern is greatly exaggerated. The extent to which the law protects third party purchasers or assignees is in any event extremely murky, and as a result a full response would raise wider issues that go beyond the scope of this paper. Nevertheless, the following points are offered by way of rebuttal.

First, even assuming that the concern for the position of third parties is legitimate, it is difficult to see why that justifies potentially imposing on the parties, in a dispute between them which affects their interests only, a contractual obligation which is contrary to their actual intentions.<sup>122</sup>

Secondly, third parties are always vulnerable to an unexpected interpretation based on the surrounding circumstances at the time the original parties entered into the contract. This point has recently been made by Lord Nicholls of Birkenhead in the article referred

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<sup>120</sup> Ibid 350.

<sup>121</sup> Ibid.

<sup>122</sup> See the observation of Thomas J in *Yoshimoto v Canterbury Golf International Ltd* [2001] 1 NZLR 523, 545 [81]: ‘Nor, thirdly, is this a case where third parties might seek to rely on the literal wording of the contract, not knowing of the evidence external to the contract which would change its apparent meaning. Why third parties may be thought to be entitled to hold the parties who are privy to the contract to a meaning which is not their meaning is difficult to see.’

to earlier.<sup>123</sup> While conceding that third parties are unlikely to be aware of pre-contract negotiations or subsequent conduct, his Lordship argues:<sup>124</sup>

But that does not make good this ground of objection. When interpreting contracts courts already take into account ‘objective’ background matters known to the contracting parties but not necessarily known to others.

Thirdly, where a third party, to the actual or constructive knowledge of the parties, reasonably expects to be able to take the contract at face value and acts in reliance thereon, his or her legitimate concerns can be met through application of the doctrine of estoppel. Of course, where the third party is an assignee of a chose in action, it is already the position that the assignment operates ‘subject to equities’ and hence the assignee takes subject to any defence the promisor would have had in an action brought by the assignor, and indeed that is why the assignee will ordinarily obtain appropriate undertakings from the assignor.<sup>125</sup>

#### ***F. Other Policy Considerations—Uncertainty, Unnecessary Time and Cost***

In *Sportsvision Australia Pty Ltd v Tallglenn Pty Ltd*,<sup>126</sup> Bryson J expressed strong opposition to receiving evidence of subsequent conduct based on the uncertainty and wasted time and cost it would cause. His Honour said:<sup>127</sup>

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; to be picked over for assertions that they show something about the original agreement: an expanded inquiry on an inherently less reliable body of material than what the parties recorded at the time they came to agreement. It would be necessary to infer their earlier intentions from their later actions and intentions, using some form of the presumption of continuance. Litigants would be tempted to prove every event in relation to performance and to assert that they all contained grains of confirmation.

A quite different view, however, is expressed by Lord Nicholls of Birkenhead in the course of his recent extra-judicial observations. His Lordship said that where the pre-contract negotiations (and by inference subsequent conduct):<sup>128</sup>

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<sup>123</sup> Nicholls, above n 115, 587.

<sup>124</sup> Although his Lordship only refers expressly to pre-contract negotiations in the passage quoted in the text, it is clear from the article as a whole that he would regard it as equally applicable to subsequent conduct. See further n 128.

<sup>125</sup> The position is much the same in New Zealand for third party beneficiaries who seek to enforce contracts under the *Contracts (Privity) Act 1982*. By s 9 of the Act, promisors can ordinarily invoke any defences that would have been available in an action brought against them by the promisees.

<sup>126</sup> (1998) 44 NSWLR 103.

<sup>127</sup> *Ibid* 116. See also *FAI Traders Insurance Co Ltd v Savoy Plaza Pty Ltd* [1993] 2 VR 343, 352 where Nathan J said that to allow evidence of subsequent conduct ‘would lead to an endless parade of evidentiary arguments concerned, not only with what the parties in fact did, but why they did it’.

<sup>128</sup> Nicholls, above n 115, 587. Although Lord Nicholls only refers expressly to pre-contract negotiations in the passage quoted in the text, it is clear from the article as a whole that he would

... furnish a clear insight into the intended meaning of the disputed provision, admission of that evidence can hardly promote uncertainty. Rather the reverse. It is the exclusion of that evidence which generates uncertainty by enabling one party to contend for a meaning he knows was not intended. Since the extrinsic evidence is not admissible he is able to advance a case which otherwise would be untenable.

In his view, 'Judges are well able to identify, and disregard, self-serving subsequent conduct.'<sup>129</sup>

I agree with his Lordship but, even if his view were regarded as unduly optimistic, it is difficult to believe there would be any greater uncertainty than already exists. Contract interpretation cases tend to be the most intractable of all contractual disputes and their outcome is notoriously difficult to predict.<sup>130</sup> The division of opinion they give rise to is extraordinary.<sup>131</sup> The courts routinely disagree not only on the correct approach but also on such elementary questions as whether particular words have a plain meaning<sup>132</sup> and what is the 'commonsense' or 'commercially realistic' interpretation.<sup>133</sup>

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regard it as equally applicable to subsequent conduct. His Lordship said that 'it is surely time the law recognised what we all recognise in our everyday lives, that the parties' subsequent conduct, that is, their conduct after they had reached agreement, may be a useful guide to the meaning they intended to convey by the words of their contract. Such conduct, for what it may be worth in the particular case, is one of the matters the court should be able to take into account when deciding what, in the events which have happened, is the meaning the words would reasonably convey to a reader. Judges are well able to identify, and disregard, self-serving subsequent conduct': at 589. See also Johan Steyn, 'The Intractable Problem of the Interpretation of Legal Texts' (2003) 25 *Sydney Law Review* 5, 10: 'The decision in the *Investors Compensation Scheme* case raised questions about two sacred cows of English law, namely that the court is not permitted to use evidence of (1) pre-contractual negotiations of the parties or (2) of their subsequent conduct in aid of the construction of written contracts even if the material throws light on the subjective intentions of the parties ... In England the rule about prior negotiations may for the moment be relatively safe. I am less confident about the life expectancy of the rule excluding subsequent conduct. Business people and, for that matter, ordinary people, simply do not understand a rule which excludes from consideration how the parties have in the course of performance interpreted their contract. The law must not be allowed to drift too far from the intuitive reactions of justice of men and women of good sense: the rule about subsequent conduct may have to be re-examined.' For a different view, see Alan Berg, 'Thrashing through the Undergrowth' (2006) 122 *Law Quarterly Review* 354.

<sup>129</sup> Nicholls, above n 115, 589.

<sup>130</sup> Who could have predicted the outcome of, to name just a few cases, *Valentines Properties Ltd v Huntco Corp Ltd* [2001] 3 NZLR 305 (Privy Council); *Royal Botanic Gardens & Domain Trust v South Sydney City Council* (2002) 186 ALR 289; *Haines v Carter* [2003] 3 NZLR 605 (Privy Council); *Yoshimoto v Canterbury Golf International Ltd* [2004] 1 NZLR 1 (Privy Council); or indeed *Investors Compensation Scheme Ltd v West Bromwich Building Soc* [1998] 1WLR 896?

<sup>131</sup> See further D W McLauchlan, 'A Contract Contradiction' (1999) 30 *Victoria University of Wellington Law Review* 175, 189-90.

<sup>132</sup> See, for example, *Cook v Financial Insurance Co Ltd* [1998] 1 WLR 1765 (House of Lords); *Melanesian Mission Trust Board v AMP Society* [1997] 1 NZLR 391 (Privy Council); *Sunflower Services Ltd v Unisys New Zealand Ltd* [1997] 1 NZLR 385 (Privy Council).

<sup>133</sup> See, for example, *Deutsche Genossenschaftsbank v Burnhope* [1996] 1 Lloyd's Rep 113 (majority of House of Lords accepting an interpretation which was rejected by the Court of Appeal and castigated by Lord Steyn as contrary to 'business common sense': at 124); *Lim v McLean* [1997] 1 NZLR 641 (majority of Privy Council upheld an interpretation which the two dissenting judges (at 649) and three Court of Appeal judges thought made 'no sense commercially'); *Centrax Ltd v Citibank NA* (Unreported, English Court of Appeal, 4 March 1999) (Waller LJ, dissenting, could see 'nothing irrational' in an interpretation which Roch LJ, with whom Ward LJ concurred, described as a 'commercial absurdity' and as 'flout[ing] common sense'); *Sinochem International Oil (London) Co Ltd v Mobil Sales and Supply Corp* [2000] 1 Lloyd's Rep 339. The Judges who

Bryson J's concerns about unnecessary time and cost in the process of civil litigation are also unconvincing. The reality is that many interpretation disputes will also be accompanied by alternative claims which will inevitably involve a consideration of prior negotiations and subsequent conduct, so that excluding such evidence for the purpose of the interpretation dispute will not have the effect of reducing the length and cost of civil trials. Thus, evidence of subsequent conduct will often be invoked to support an alternative claim for rectification, estoppel by convention, variation, or even implied term. A further related consideration is that, as Thomas J pointed out in *Attorney-General v Dreux Holdings Ltd*,<sup>134</sup> 'the Courts are already influenced by evidence of subsequent conduct'. After noting that such evidence is often adduced to support alternative causes of action, his Honour said that 'it would be unrealistic to suggest that the Courts are not influenced by this evidence in arriving at a construction of the contract',<sup>135</sup> and he later concluded that 'if, as is to be accepted, the Courts are influenced by the extrinsic evidence in this manner it is appropriate to make that influence overt'.<sup>136</sup>

A similar argument has been endorsed by Lord Nicholls of Birkenhead in his recent article. His Lordship said:<sup>137</sup>

In my days at the Bar the practice was that when the parties' pre-contract negotiations furnished some insight into their actual intentions, one or other of the parties would include a rectification claim in the proceedings. By this means, whatever the outcome of the rectification claim, the evidence of the parties' actual intentions would be before the court. The hope was that, either consciously or subconsciously, the judge's thinking on the interpretation issue would be influenced by this evidence.

No one was deceived by this transparent ploy. I understand this still goes on. There is nothing improper about this, so long as the rectification claim has a seriously arguable factual basis and is brought in good faith. But the continuing vitality of this practice does suggest something is amiss. If evidence of intention, when admitted for the rectification purpose, may in practice affect how a judge views the outcome of the interpretation issue, why is it not openly admissible for this purpose?

Although this passage refers only to prior negotiations, his Lordship clearly regarded the point as equally applicable to subsequent conduct. Thus, later in the article, he said:

As with pre-contract negotiations, so with post-contract conduct, I suspect that in practice judges from time to time do have regard to post-contract conduct when interpreting contracts. In the ordinary course in these cases some evidence of what happened post-contract will be before the court. When being told of the point of interpretation in issue the judge normally learns something of how the point arose.<sup>138</sup>

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heard the latter case were evenly split as to which interpretation made better commercial sense. Thorpe LJ (dissenting) could see 'nothing objectionable or non-commercial' (at 346 [36]) in the interpretation favoured by the trial Judge whereas the majority Judges regarded that interpretation as 'capricious and cumbersome in its operation and effects': at 345 [26].

<sup>134</sup> (1996) 7 TCLR 617, 643.

<sup>135</sup> *Ibid* 643-644.

<sup>136</sup> *Ibid* 644.

<sup>137</sup> Nicholls, above n 115, 578.

<sup>138</sup> *Ibid* 589.

### ADDITIONAL ARGUMENTS FOR ADMITTING SUBSEQUENT CONDUCT

There are numerous positive reasons, in addition to those already covered, why the Australian courts should reconsider their opposition to allowing subsequent conduct as an aid to contract interpretation.

First, the English position has been expressly rejected in both Canada<sup>139</sup> and New Zealand.<sup>140</sup> This alone provides good reason for further reflection.

Secondly, the fact that Australia has implemented the United Nations Convention on Contracts for the International Sale of Goods<sup>141</sup> provides a substantial and independent reason why the High Court should be wary of endorsing the state and federal court rulings against the admissibility of evidence of subsequent conduct. Thus, included amongst the new rules governing international sales contracts are provisions for the interpretation of contracts which reflect the liberal approach referred to in this article. Under Article 8(1) statements made by a party 'are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was'. Article 8(2) provides that, if the latter provision is inapplicable, a party's statements 'are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances'. Most importantly for present purposes, Article 8(3) provides:

In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties.

The need for harmonisation of the interpretation rules for domestic contracts with the Convention's rules for international sales is obvious. It would be decidedly odd, for example, if it were the law of Australia that evidence of subsequent conduct were admissible to aid the interpretation of international sales contracts but not other sales contracts, or indeed commercial contracts generally. A seller in Sydney would surely be more than a little bemused to learn that the outcome of interpretation disputes might hinge on whether her buyers were in Brisbane or Auckland!

<sup>139</sup> Canadian Courts refused to follow the House of Lords' decisions in *Manitoba Development Corporation v Columbia Forest Products Ltd* [1974] 2 WWR 237, 245 (Manitoba CA); *Re Canadian National Railways and Canadian Pacific Ltd* (1978) 95 DLR (3d) 242, 262 (British Columbia CA); and *Montreal Trust Co of Canada v Birmingham Lodge Ltd* (1995) 125 DLR (4<sup>th</sup>) 193, 203 (Ontario CA). The English position was preferred in *Paddon-Hughes Development Co Ltd v Chiles Estate* [1992] 3 WWR 519, 523-524 (Alberta Queen's Bench) but later decisions of the same Court have taken a different view: *Scurry-Rainbow Oil Ltd v Galloway Estate* [1993] 4 WWR 454, 485; *Erewhon Exploration Ltd v Northstar Energy Corporation* [1994] 3 WWR 488, 523-524.

<sup>140</sup> See *Valentines Properties Ltd v Huntco Corporation Ltd* [2000] 3 NZLR 16, 27 [19] (Court of Appeal): 'the meaning may be illuminated by the subsequent conduct of the parties'. As pointed out by Wild J in *Greymouth Petroleum Acquisition Co Ltd v Ngatoro Energy Ltd* [2003] HC Wellington CP 162/02 (Unreported, 30 May 2003) [38], this view survived the reversal of the Court of Appeal's decision by the Privy Council ([2001] 3 NZLR 305).

<sup>141</sup> *Sale of Goods (Vienna Convention) Act 1987* (Vic); *Sale of Goods (Vienna Convention) Act 1986* (Qld); *Sale of Goods (Vienna Convention) Act 1986* (SA); *Sale of Goods (Vienna Convention) Act 1986* (WA); *Sale of Goods (Vienna Convention) Act 1987* (Tas); *Sale of Goods (Vienna Convention) Act 1987* (ACT); *Sale of Goods (Vienna Convention) Act 1987* (NT).

Thirdly, the publication in recent times of various influential international restatements of contract law adds further weight to the above argument based on the implementation of the international sales convention. Both the *Unidroit Principles of International Commercial Contracts* (1994 and 2004 revision) and the *Principles of European Contract Law* (1999) refine and expand the principles contained in the convention. The *Unidroit Principles* provide that contracts are 'to be interpreted according to the common intention of the parties' or, if that cannot be established, 'according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances'. Most importantly for present purposes, both sets of principles state that 'regard shall be had' to prior negotiations and subsequent conduct.<sup>142</sup> There is much to be said for the view that, unless there are compelling reasons for doing otherwise, domestic contract law should, in our increasingly global economy, be guided by established international practice.<sup>143</sup>

Fourthly, returning to more technical arguments, it is well established that it is permissible to have regard to the parties' conduct, not only to imply a term to cure alleged uncertainty<sup>144</sup> or otherwise make the contract work,<sup>145</sup> but also to determine whether a previous oral, or partly written and partly oral, contract contained an oral term alleged by one of the parties. The court can 'take into account what was done later as a basis for inferring what was agreed when the contract was made'.<sup>146</sup> Indeed, it has been said that '[c]ommon sense suggests that [the parties'] subsequent conduct is the best evidence of what they have agreed orally but not reduced to writing, though it is not evidence of what any written terms mean'.<sup>147</sup> One might also argue that common sense suggests that, if subsequent conduct may be used to establish the existence of an oral term, it should also be able to be used to show that the parties gave a particular meaning to a term contained in the written part of the contract. Why should the party alleging the particular meaning be in a worse position than if the term had remained oral?

Fifthly, it is also well established that in a suit for rectification of a written contract the court may have regard to the subsequent conduct of the parties in determining whether there is sufficient proof of an antecedent common intention not reflected in the document. Thus, it has been held that 'both on principle and on authority ... the fact that a party has acted as if the document stood in the form into which it is sought to be rectified is strong evidence of the existence of an intention on the part of that party to contract in those terms'.<sup>148</sup> Again the question must be asked: if subsequent conduct may be strong evidence of intention for

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<sup>142</sup> See *Unidroit Principles of International Commercial Contracts*, art 4.3 (2004); *Principles of European Contract Law*, art 5.102 (1999).

<sup>143</sup> See the observations to similar effect by the New Zealand Court of Appeal in *A-G v Dreux Holdings* (1996) 7 TCLR 617, 627, 642.

<sup>144</sup> *Foley v Classique Coaches Ltd* [1934] 2 KB 1, 10.

<sup>145</sup> *Liverpool City Council v Irwin* [1977] AC 239, 253. See also, for example, *Council of the City of Sydney v Goldspar Australia Pty Ltd* [2006] FCA 472 [164].

<sup>146</sup> *Ferguson v John Dawson & Partners Contractors Ltd* [1976] 1 WLR 1213, 1229 (Browne LJ).

<sup>147</sup> *Mears v Safecar Security Ltd* [1983] QB 54, 77 (Stephenson LJ). See also *Port Sudan Cotton Co v Govindaswamy Chettiar & Sons* [1997] 2 Lloyd's Rep 5, 11; *Wilson v Maynard Shipbuilding Consultants AB* [1978] QB 665, 675; *Hill v National Bank of New Zealand Ltd* [1985] 1 NZLR 736, 739-740; *McLaren v Waikato Regional Council* [1993] 1 NZLR 710, 731; *National Bank of New Zealand Ltd v Murland* [1991] 3 NZLR 86, 93; *Victor Hydraulics Ltd v Engineering Dynamics Ltd* [1996] 2 NZLR 235, 242; *Carmichael v National Power Plc* [1999] 1 WLR 2042, 2051 (House of Lords).

<sup>148</sup> *Westland Savings Bank v Hancock* [1987] 2 NZLR 21, 31 (Tipping J). His Honour went on to cite *M'Cormack v M'Cormack* (1877) 1 LR Ir 119 and *Dormer v Sherman* (1966) 110 SJ 171 'in support of the proposition that subsequent conduct is both relevant and highly persuasive as to what a party's intention was at and leading up to the execution of the instrument in question'.



purposes of rectification, why is the position different in the context of interpretation? Why should not evidence of conduct be equally available to prove that certain words included in the contract by common consent (so that there is no question of rectification) were given a particular meaning by the parties at the time of the contract?

This brings us back full circle to the even more basic question posed at the beginning of this article. If, as is well established, evidence of subsequent conduct is admissible for the purpose of determining whether parties intended to enter into a contractual relationship at all, why should the position be different when, it having been found or admitted that a contract did exist, an issue arises as to what the words of the contract were intended to mean? For the reasons I have discussed, there is no satisfactory answer to that question.

## CONCLUSION

Shortly after the House of Lords reaffirmed the inadmissibility of evidence of subsequent conduct in *L Schuler AG v Wickman Machine Tool Sales Ltd*,<sup>149</sup> Lord Denning MR, perhaps still smarting from being reversed on this point in the latter case, declared that the outcome was ‘contrary to the rule in every other civilised system of law, including the other countries of the Common Market’.<sup>150</sup> Five years later he took another swipe at their Lordships, saying:<sup>151</sup>

For many years I thought that when the meaning of a contract was uncertain you could look at the subsequent conduct of the parties so as to ascertain it. That seemed to me sensible enough. The parties themselves should know what they mean by their words better than anyone else.

Some leading Law Lords, albeit writing extra-judicially, have now endorsed this view. Thus, Lord Steyn has doubted ‘the life expectancy of the rule’, saying:<sup>152</sup>

Business people and, for that matter, ordinary people, simply do not understand a rule which excludes from consideration how the parties have in the course of performance interpreted their contract. The law must not be allowed to drift too far from the intuitive reactions of justice of men and women of good sense: the rule about subsequent conduct may have to be re-examined.

More recently, Lord Nicholls of Birkenhead has said, inter alia, that ‘it is surely time the law recognised what we all recognise in our everyday lives, that the parties’ subsequent conduct, that is, their conduct after they had reached agreement, may be a useful guide to the meaning they intended to convey by the words of their contract’.<sup>153</sup>

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<sup>149</sup> [1974] AC 235.

<sup>150</sup> *Port Sudan Cotton Co v Govindaswamy Chettiar & Sons* [1977] 2 Lloyd’s Rep 5, 11.

<sup>151</sup> *Amalgamated Investment & Property Co Ltd v Texas Commerce International Bank Ltd* [1982] QB 84, 119.

<sup>152</sup> Johan Steyn, ‘The Intractable Problem of the Interpretation of Legal Texts’ (2003) 25 *Sydney Law Review* 5, 10. Interestingly, some 15 years earlier, Lord Steyn said (‘Written Contracts: To What Extent May Evidence Control Language?’ (1988) 41 *Current Legal Problems* 23, 30) that ‘[e]vidence of the subsequent conduct of the parties could only become admissible as relevant to construction if the objective theory to the interpretation of contracts was abandoned’, a view that, it will be apparent from this article, I do not share.

<sup>153</sup> Nicholls, above n 115, 589. For the full text of this quote see n 128 above. See also R M Goode, *Commercial Law* (3<sup>rd</sup> ed, 2004) 91-92. The rule that it is ‘impermissible to construe a contract by

It is to be hoped that, when the opportunity arises, the High Court of Australia will take heed of these views as well as the principled arguments for implementing them that have been advanced in this article. Lest there be any misunderstanding or misrepresentation of those arguments, certain key points must be reiterated:

- When subsequent conduct is used as an aid to interpretation its purpose is to establish meaning *at the time of the contract*, not to alter it.
  
- Subsequent conduct will be largely irrelevant to the interpretation of the contract if in fact, as in most interpretation disputes that come before the courts, the parties did not contemplate the issue that has arisen, and therefore could not have adopted a shared meaning of the relevant term at the time of the contract. At best, the conduct may be one factor to be considered by the court in determining the parties' presumed intention.<sup>154</sup>
  
- Because there will usually be other possible explanations, subsequent conduct will rarely be sufficiently unequivocal to establish the meaning contended for. Rather it is the court's conclusion based on the evidence as a whole as to whether a particular meaning was adopted at the time of the contract that will do so. The subsequent conduct will be one factor to be considered in reaching that conclusion. Sometimes, the conduct, when considered together with other factors, may be of sufficient weight to satisfy the court that the alleged meaning was in fact the meaning accorded to the contract at the time it was signed.
  
- Allowing resort to subsequent conduct does not therefore involve penalising a party for a mistaken view of the contract.

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reference to the negotiations that led up to it or the conduct of the parties after conclusion of the contract' is 'a rigid rule' that 'has little to commend it, and is believed to be widely ignored in practice'.

<sup>154</sup> It may assist, for example, in establishing the commercial purpose of the contract or that certain important background facts were known to the parties at the time of the contract.