CONTRACTUAL INTERPRETATION – CODELFA UPDATE AND RELATED MATTERS

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[1] EVIDENCE OF SURROUNDING CIRCUMSTANCES AS AN AID TO CONSTRUING A CONTRACT. IS SUCH EVIDENCE ADMISSABLE ONLY WHERE THE LANGUAGE IS AMBIGUOUS?

Primary Australian authority – Codelfa Construction Pty Ltd v. State Rail Authority of New South Wales[1]

1. The High Court's decision in Codelfa Construction Pty Ltd v. State Rail Authority of New South Wales is the primary Australian authority on the admissibility of evidence of surrounding circumstances in the construction of contracts.

2. Mason J. stated:-

> "*The true rule is that evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning*"[2].

3. In the pages leading up to the above passage (pages 347-352) Mason J. (with whom Stephen (page 344) and Wilson JJ. (page 392) agreed on this issue), referred with approval, to a number of English[3] and Australian cases[4] regarding the admissibility of evidence of surrounding circumstances. He set out a number of passages from those cases, none of which made any reference to ambiguity being a pre-requisite to the admissibility of such evidence.

4. For example, he referred[5] to the following passage from the joint judgment[6] in DTR Nominees Pty Ltd v. Mona Homes Pty Ltd[7]:-

> "*A court may admit evidence of surrounding circumstances in the form of 'mutually known facts' 'to identify the meaning of a descriptive term' and it may admit evidence of the 'genesis' and objectively the 'aim' of a transaction to show that the attribution of a strict legal meaning would 'make the transaction futile' ...* ".

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1 (1981-1982) 149 CLR 337.
2 Page 352.
3 In particular Prenn v. Simmonds [1971] 1 WLR 1381 at pages 1383-1385; Reardon Smith Line v. Hansen-Tangen [1976] 1 WLR 989 at 995-997.
4 DTR Nominees Pty Ltd v. Mona Homes Pty Ltd (1978) 138 CLR 423 at 429; Secured Income Real Estate (Australia) Limited v. St Martins Investments Pty Ltd (1979) 144 CLR 596 at pages 605-606.
5 Page 351.
6 Stephen, Jacobs JJ and himself.
7 (1978) 138 CLR 423 at 429.

5. The difference between the passage on page 352 of Mason J's judgment, and the lead up pages 347-352 has lead to some uncertainty about what is the law in Australia on this issue.

6. Refer by way of example to the Victorian Court of Appeal decision in Murray Goulburn Co-operative Co Limited v. Cobram Laundry Service Pty Ltd[8]. Chernov JA's judgment (with whom Brooking and Batt JJA agreed) proceeds[9] on the basis that under Codelfa, evidence of surrounding circumstances is not admissible unless there is an ambiguity in the wording of the document.

7. On the other hand in Maggbury Pty Ltd v. Hafele Australia Pty Ltd[10] Gleeson CJ, Gummow and Hayne JJ adopted Lord Hoffman's statement in Investors Compensation Scheme Limited v. West Bromwich Building Society[11], and said nothing about ambiguity being a pre-requisite to the admission of evidence of surrounding circumstances:-

> "*11 Interpretation of a written contract involves, as Lord Hoffmann has put it (11): 'the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract'* ".

8. Further, footnote (11) to the above passage referred to the Investors decision as well as the House of Lords decision in Bank of Credit & Commerce International SA v. Ali[12]. The footnote also referred to Codelfa stating "*see also the remarks of Mason J. in Codelfa Construction Pty Ltd v. State Rail Authority (NSW) (1982) 149 337 at 350-352*".

9. In the recent case of Franklins Pty Ltd v. Metcash Trading Limited[13] the New South Wales Court of Appeal[14] observed that the above passage from Maggbury supported a conclusion that the members of the High Court were there adopting a position that it was not necessary to find an ambiguity in the language of the contract before the surrounding circumstances could be looked at.

10. In Royal Botanic Gardens & Domain Trust v. South Sydney City Council[15] the High Court was called upon to construe a lease, the relevant term of which was ambiguous[16]of the joint judgment of Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ, the judges had this to say about whether the House of Lords "*took a broader view of the admissible "background" than was taken in Codelfa*":-

> "*[39] Two further matters should be noticed. First, reference was made in argument to several decisions of the House of Lords, delivered since Codelfa but without*

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8 [2001] VSCA 57.
9 Refer paragraphs 11, 19, 29 and 33.
10 (2001) 210 CLR 181 at 188 [11].
11 [1998] 1 WLR 896 at 912.
12 [2002] 1 AC 251 at 259.
13 [2009] NSWCA 407.
14 Campbell JA at [274]-[276], with whom Giles JA at [63] and Allsop P at [14]-[18] agreed.
15 (2002) 240 CLR 45; (2002) 186 ALR 289.
16 Paragraph 39.

> *reference to it. Particular reference was made to passages in the speeches of Lord Hoffmann in Investors Compensation Scheme Limited v. West Bromwich Building Society and of Lord Bingham of Cornhill and Lord Hoffmann in Bank of Credit & Commerce International SA v. Ali, in which the principles of contractual construction are discussed. It is unnecessary to determine whether their Lordships there took a broader view of admissible "background" than was taken in Codelfa or, if so, whether those views should be preferred to those of this court. Until that determination is made by this court, other Australian courts, if they discern any inconsistency with Codelfa, should continue to follow Codelfa*".

11. In an article by JW Carter and Andrew Stewart regarding the Royal Botanic decision[17], the learned authors expressed some frustration at the High Court's failure to clarify this issue:-

> "*The High Court's decision in Royal Botanic does little to settle the controversy – indeed it may have just the opposite result – which surrounds the reception of surrounding circumstances as an aid to interpretation. Yet it seems almost bizarre that at the beginning of the 21st century there still should be uncertainty as to such a basic issue of contract law*"[18].
> ...
> "*It is therefore most unfortunate that the court in Royal Botanic Gardens decided to leave this fundamental issue of principle unresolved*"[19].

Position now clarified – evidence of surrounding circumstances is admissible without having to demonstrate ambiguity in the language

12. Since Royal Botanic, there have been a number of decisions by the High Court which support a conclusion that under Australian law, it is not necessary to find an ambiguity in the wording of the contract before evidence of surrounding circumstances can be looked to.

13. Before referring to these decisions, it should be pointed out that in none of them, has the High Court expressly rejected the statement about ambiguity by Mason J. at page 352 of Codelfa. Rather, in each case the Court has re-stated the principle relating to the admissibility of evidence of surrounding circumstances, without including any reference to the necessity for there to be an ambiguity. So to that extent, the departure from Mason J's statement at page 352 is implicit rather than express.

14. Campbell JA made this point in Franklins Pty Ltd v. Metcash Trading Limited[20]:-

> "*[286] However, later decisions of the High Court have given clear guidance concerning when and how surrounding circumstances may be used as an aid to construction of a contract. In doing so, the High Court has not considered whether there were indeed an internal tension in the judgment of Mason J. in Codelfa, nor have the judges stated in so many words that any part of Codelfa is no longer to be followed. Rather, by restatement of principle, the Court has made irrelevant any future consideration of*

17 "Interpretation, Good Faith and the "True Meaning" of Contracts: The Royal Botanic Decision", (2002) 18 JCL 182.
18 Page 186.
19 Page 187.
20 [2009] NSWCA 407 at [286].

whether there was any internal tension in Mason J's judgment in Codelfa, or precisely how his Honour's 'true rule' should be applied".

15. Campbell JA then[21] referred to each of the cases and set out the relevant passages. The cases and the passages are summarised below.

- Pacific Carriers Limited v. BNP Paribas[22]:-

> **[22]** What is important is not Ms Dhiri's subjective intention, or even what she might have conveyed, or attempted to convey, to NEAT about her understanding of what she was doing. The letters of indemnity were, and were intended by NEAT and BNP to be, furnished to Pacific. Pacific did not know what was going on in Ms Dhiri's mind, or what she might have communicated to NEAT as to her understanding or intention. The case provides a good example of the reason why the meaning of commercial documents is determined objectively: it was only the documents that spoke to Pacific[5]. The construction of the letters of indemnity is to be determined by what a reasonable person in the position of Pacific would have understood them to mean[6]. That requires consideration, not only of the text of the documents, but also the surrounding circumstances known to Pacific and BNP, and the purpose and object of the transaction[7]. In *Codelfa Construction Pty Ltd v State Rail Authority of NSW*[8], Mason J set out with evident approval the statement by Lord Wilberforce in *Reardon Smith Line Ltd v Hansen-Tangen*[9]:
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> In a commercial contract it is certainly right that the court should know the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating.

- Toll (FGCT) Pty Ltd v. Alphapharm Pty Ltd[23]:-

> **[40]** This Court, in Pacific Carriers Ltd v BNP Paribas[6], has recently reaffirmed the principle of objectivity by which the rights and liabilities of the parties to a contract are determined. It is not the subjective beliefs or understandings of the parties about their rights and liabilities that govern their contractual relations. What matters is what each party by words and conduct would have led a reasonable person in the position of the other party to believe. References to the common intention of the parties to a contract are to be understood as referring to what a reasonable person would understand by the language in which the parties have expressed their agreement. The meaning of the terms of a contractual document is to be determined by what a reasonable person would have understood them to mean. That, normally, requires consideration not only of the text, but also of the surrounding circumstances known to the parties, and the purpose and object of the transaction[7].

- Agricultural and Rural Finance Pty Ltd v. Gardiner[24]:-

> **[38]** Further, the loan agreements and the indemnity agreements must be construed in their commercial context. Each was an important constituent document in a publicly marketed investment scheme. It is not readily to be supposed that documents of that kind are to be given meanings other than the meaning ordinarily conveyed by the words used. As Spigelman CJ recorded,[20] the availability of the taxation advantages said to attach to investment in the scheme was seen by the promoters of the scheme and the Australian Taxation Office as depending upon such matters as whether those who invested were engaging in a commercial venture attended by risks of the kind ordinarily encountered in business and, in particular, whether the loans could be described as "non-recourse". That being the position, there is even less reason to suppose that the liability of the Borrower to repay money lent should depend upon the unfettered discretion of the Lender. Yet in effect that is the construction urged by the Borrower. It is a construction that should be rejected.

- International Air Transport Assn v. Ansett Australia Holdings Limited[25]:-

> **[8]** In giving a commercial contract a businesslike interpretation, it is necessary to consider the language used by the parties, the circumstances addressed by the contract, and the objects which it is intended to secure.[4] An appreciation of the commercial purpose of a contract calls for an understanding of the genesis of the transaction, the background, and the market.[5] This is a case in which the Court's general understanding of background and purpose is supplemented by specific information as to the genesis of the transaction. The Agreement has a history; and that history is part of the context in which the contract takes its meaning.[6] Before considering that history, it is necessary to explain, by reference to the text, how the
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> issue of construction arises.

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21 Paragraphs [287]-[291].
22 (2004) 218 CLR 451 at [22].
23 (2004) 219 CLR 165 at [40].
24 (2008) HCA 57 at [38].
25 (2008) 234 CLR 151 at [8].

Franklins Pty Ltd v. Metcash Trading Limited

16. The New South Wales Court of Appeal decision in Franklins Pty Ltd v. Metcash Trading Limited[26] is the one decision where a Court has addressed expressly the question whether it is necessary for a Court to find the language of a contract ambiguous before considering evidence of circumstances surrounding the entry into the contract.

17. Campbell JA's judgement provides an extremely thorough and detailed analysis of the relevant English decisions[27], High Court decisions[28], Federal Court and New South Wales Supreme Court decisions[29]. He concluded at paragraph [305] that it is not necessary to find ambiguity in the words of a written contract before the Court can look at surrounding circumstances as an aid to construction.

Victorian cases

18. There are two recent Victorian Supreme Court decisions which make it reasonably clear that, consistent with the post Royal Botanic High Court decisions referred to above, ambiguity is not a pre-requisite to the admissibility of evidence of surrounding circumstances. Whilst neither case raised the question directly, the authorities referred to and the other references footnoted, strongly suggest this conclusion.

19. In 3143 Victoria Street Doncaster Pty Ltd v. Retirement Services Australia (RSA) Pty Ltd[30] Pagone J. said:-

> **[8]** Darnley sought to rely upon evidence that the parties, when formulating their agreement in 2000, intended that RSA would provide a qualified nurse to staff a nursing station and reception area and provide respite services as part of the obligations which found expression in cl 7(a) of the Management Agreement. The Management Agreement should be construed to give effect to the commercial purpose it was designed to achieve.[6] In that task it is permissible to have regard to the surrounding circumstances known to the parties and to the purpose and object of the transaction. In *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd*[7] it was said in the joint judgment of the High Court:
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> > This Court, in *Pacific Carriers Ltd v BNP Paribas*, has recently reaffirmed the principle of objectivity by which the rights and liabilities of the parties to a contract are determined. It is not the subjective beliefs or understandings of the parties about their rights and liabilities that govern their contractual relations. What matters is what each party by words and conduct would have led a reasonable person in the position of the other party to believe. References to the common intention of the parties to a contract are to be understood as referring to what a reasonable person would understand by the language in which the parties have expressed their agreement. The meaning of the terms of a contractual document is to be determined by what a reasonable person would have understood them to mean. That, normally, requires consideration not only of the text, but also of the surrounding circumstances known to the parties, and the purpose and object of the transaction.[8] (footnotes omitted)

26 [2009] NSWCA 407. Campbell JA at [239]-[305]; Allsop P at [14]-[18]; and Giles JA at [63].
27 Refer [262]-[273].
28 Refer [274]-[292].
29 Refer [299]-[304].
30 [2010] VSC 317 at [8].

20. In Thoroughvision Pty Ltd v. Sky Channel Pty Ltd[31] Croft J. said:-

> **[37]** Having referred to the provisions of the MOU giving rise to the present disputes and other relevant provisions of the MOU, the Arbitrator considered the approach to contract construction with respect to the MOU. In view of the importance of the Arbitrator's approach in this respect, both for the purposes of s 38(5) and s 42 of the Act, I set out the Arbitrator's statement of his approach to construction:[98]
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> > High Court authority makes it clear that I must construe the terms of the MOU objectively, and without regard to the subjective beliefs, intentions and expectations of the parties, but in the light of surrounding circumstances which are either known to the parties or notorious. Also relevant is what is, objectively, the "genesis" and "aim" of the transaction: *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 at 348-352; *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451; *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165 at [35]-[40]. The question is what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean: *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC 1101 at [14].
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> > The MOU is a complex, formal document intended to create substantial rights and obligations between sophisticated commercial bodies. It bears the hallmarks of detailed negotiation between parties and careful drafting by experienced and skilled lawyers. In construing contracts one should "not easily accept that people have made linguistic mistakes, particularly in formal documents": *Chartbrook* at [14] citing *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 at 912-913. In the present case, neither side contended that something has gone wrong with the language or that this is a case of "correction of mistakes by construction": *East v Pantiles (Plant Hire) Ltd* (1981) 263 EG 61. Nor, contrary to what may have been said in one of the notices of dispute, was any implied term advanced. No claim for rectification is made.
> >
> > The relevant language of the MOU consists of ordinary English words and not technical terms.
> >
> > The hypothetical reasonable person, while not a racing expert, is to be credited with a general awareness of the way horse racing is conducted in Australia and the televised broadcasting of such races.
> >
> > Evidence of broadcasts by Sky at the time of the MOU is apparently no longer available. The Sky Parties tendered DVDs of recent broadcasts (18 and 21 November 2009) which were said to "reflect the style and content of broadcasts on the Sky Channels as at the time of entry into the MOU". There was some disputation as to whether the DVDs were fairly reflective as alleged. I do not think such evidence assists. The rights and obligations of the Sky Parties under the MOU were not linked to, or conditional on, an analysis of the nature of the programmes which Sky was broadcasting in early 2007. Rather, the MOU uses non-technical language to define rights and obligations in a way which would be understandable to a hypothetical reasonable observer with the most rudimentary understanding of horse racing in Australia.
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> **[38]** Neither TVN nor the Sky parties submitted that the Arbitrator's statement of the law with respect to the principles of construction to be applied with respect to the MOU were erroneous. TVN submitted that the statement was brief, probably incomplete, and did not focus on certain aspects of particular pertinence in the case, but conceded that there was no detectable error in the statement. In any event, I find no error in the statement of the law in this respect.[99] Issues were, however, raised by TVN in relation to the application of the Arbitrator's stated approach to contract construction with respect to the MOU as applied to particular issues considered by the Arbitrator.

21. Importantly, footnote 99 of paragraph [38] of Croft J's decision cites the following:-

> 99 It is a statement consistent with current authority and commentaries: see, for example, Carter, Peden and Tolhurst, *Contract Law in Australia* (5th ed, Lexis Nexus Butterworths, 2007), particular at [12-13]-[12-15]; Lewison, *The Interpretation of Contracts* (4th ed, Sweet and Maxwell, 2007) at para 314 (see also the First Supplement to the 4th Edition, para 3.14); and see Spigelman, "From Text to Context: Contemporary Contractual Interpretation", (2007) 81 *ALJ* 322.

All of those references support the conclusion that ambiguity is not necessary to enable evidence of surrounding circumstances to be admitted in evidence.

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31 [2010] VSC 139 at [37]-[38].

[2] WHAT EVIDENCE IS ADMISSIBLE BY WAY OF SURROUNDING CIRCUMSTANCES?

22. In determining what evidence is admissible way of surrounding circumstances, it is essential to keep in mind the purpose to be served by its admission. The purpose is to assist the Court in its task of determining what the parties intended by the language used in the written contract.

23. Under our objective theory of contractual interpretation, that does not allow evidence of the parties' actual subjective intentions[32].

24. Ultimately, the evidence admissible depends upon the particular contract and the circumstances of the case. However the cases do provide guidance along the following lines:-

actual knowledge by both parties

(1) the circumstances (including knowledge of facts or law[33]) must be known to both parties. Their knowledge can be established by direct proof of such knowledge or that knowledge can be inferred because of the notoriety of the facts in the market in which the parties are operating. The evidence is not admissible if only one party has knowledge of it. Knowledge means actual[34] knowledge and does not include constructive or imputed notice of such fact or circumstance[35];

relevance

(2) the circumstance must be relevant to a fact in issue[36];

types of evidence admissible

(3) the evidence of surrounding circumstances includes evidence of the genesis, the background and context of the transaction, and its aim or objective. It may also include evidence of the market in which the parties are operating[37];

prior negotiations – draft agreements exchanged between the parties

(4) the admissibility of evidence of negotiations between the parties prior to entry into the contract depends upon whether such evidence goes to establishing the objective background evidence

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32 Note the possible exception to this, referred to by Mason J. in Codelfa at page 352, final paragraph. Refer to a discussion of this exception in the article by FM Douglas Modern Approaches to the Construction and Interpretation of Contracts (2009) 32 Australian Bar Review 158 (at page 3 of the Lexis Nexis produced copy).

33 Maggbury Pty Ltd v. Hafele Australia Pty Ltd & Anor. [2002] 210 CLR 181 at [11].

34 ie. directly proved, or alternatively inferred on the basis of the notoriety of the fact or circumstance.

35 Refer Codelfa, Mason J. at page 352, second paragraph. The wording there used by Mason J. "*as we have seen*" was said by Macfarlan JA (with whom Young JA and Sackville AJA agreed in Movie Network Channels Pty Ltd v. Optus Vision Pty Ltd [2010] NSWCA 111 at [98]-[99]), to be a reference to the previous page of Mason J's judgment (page 351, first complete paragraph) where he referred to a passage from Reardon Smith Line v. Yngvar Hansen-Tangen [1976] 3 All ER 570 at 575. Refer also Movie Network Channels Pty Ltd v. Optus Vision Pty Ltd at [97]-[106]. Refer also QBE Insurance Australia Limited v. Vasic [2010] NSWCA 166 at [24]-[35].

36 This is obvious and therefore unnecessary for a Court to state. However the point was expressed by Allsop P. in Franklins Pty Ltd v. Metcash Trading Limited [2009] NSWCA 407 at [24]. The necessity to make this point may stem from Lord Hoffmann's statement in Investors Compensation Scheme Limited v. West Bromwich Building Society [1998] 1 WLR 896 at 912H-913A, that surrounding circumstances evidence "*includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man*". Note that Lord Hoffmann, in his judgment in the subsequent case of Bank of Credit & Commerce International SA (in liquidation) v. Ali & Ors. [2001] 1 All ER 961 at [39] slightly corrected what he said in the Investors case (as set out above) stating that when "*I said that the admissible background included 'absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man', I did not think it necessary to emphasize that I meant anything which a reasonable man would have regarded as relevant*".

37 Mason J. in Codelfa at pages 350-351. Refer also DTR Nominees Pty Ltd v. Mona Homes Pty Ltd (1978) 138 CLR 423 at 429. Franklins Pty Ltd v. Metcash Trading Limited [2009] NSWCA 407 at [24].

relied upon, in which case it is admissible, or goes to an understanding of the actual intentions of the parties, in which case it is inadmissible. Drawing the distinction will often be difficult[38].

Surrounding circumstances must be known to both parties

25. The question whether, in order to be admissible, the surrounding circumstances evidence must be known to both parties, has been the subject of recent decisions handed down by the New South Wales Court of Appeal in Movie Network Channels Pty Ltd v. Optus Vision Pty Ltd[39] and QBE Insurance Australia Limited v. Vasic[40].

26. In both cases the Court of Appeal has reaffirmed the statement by Mason J. in Codelfa:-

> "*Generally speaking facts existing when the contract was made will not be receivable as part of the surrounding circumstances as an aid to construction, unless they were known to both parties, although, as we have seen, if the facts are notorious knowledge of them will be presumed*"[41].

27. In both cases it was argued that Mason J's statement in Codelfa no longer represented the law in Australia. Reliance was placed upon Lord Hoffmann's judgment in Investors Compensation Scheme Limited v. West Bromwich Building Society[42] and the High Court's adoption thereof in Maggbury Pty Ltd & Anor. v. Hafele Australia Pty Ltd & Anor.[43].

28. In the Investors case Lord Hoffmann said:-

> "*(1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.*
> *(2) The background was famously referred to by Lord Wilberforce as the 'matrix of fact', but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by the reasonable man*"[44].

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38 Mason J. in Codelfa at page 352, second full paragraph on that page. Prenn v. Simmonds [1971] 1 WLR 1381 at 1384-1385. Kimberly Securities Limited v. Esber [2008] NSWCA 301 at [4]-[6] and [28]-[32]. Franklins Pty Ltd v. Metcash Trading Limited [2009] NSWCA 407 at [24]. Chartbrook Limited v. Persimmon Homes Limited & Anor. [2009] 4 All ER 677 at [27]-[46]. Refer also Catherine Mitchell Contract Interpretation: Pragmatism, Principle and the Prior Negotiations Rule (2010) JCL 134.

39 [2010] NSWCA 111.

40 [2010] NSWCA 166.

41 Page 352.

42 [1988] 1 WLR 896 at 912.

43 [2002] 210 CLR 181 at [11].

44 [1988] 1 WLR 896 at 912-913. Note that the exception referred to in sub-paragraph (2) of the quote was a reference to the exclusion of prior negotiations of the parties and their declarations of subjective intent.

29. Part of Lord Hoffmann's statement was referred to by members of the High Court in Maggbury's case:-

> "*11 Interpretation of a written contract involves, as Lord Hoffmann has put it (11): 'the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract'*[45]".

30. In both the Movie Network and QBE Insurance cases the Court rejected the contention that Gleeson CJ, Gummow and Hayne JJ's adoption in Maggbury, of Lord Hoffmann's reference to "*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*", should be understood as reflecting an intent by their Honours to allow evidence of surrounding circumstances which is known only by one of the parties and/or to impute knowledge to the parties under the concept of constructive knowledge as opposed to actual knowledge. The Court has reaffirmed that there must be direct proof of actual knowledge by both parties or that such actual knowledge can be inferred because of the notoriety of the fact or matter in the market in which the parties are operating[46].

31. The Court of Appeal in each case strongly re-affirmed the correctness of the statement by Mason J. in Codelfa.

32. In the QBE Insurance Australia case[47] Allsop P explained the rationale for this limitation upon the admissibility of evidence of surrounding circumstances:-

- at paragraph [22]:-

  > "*That a fact represents a part of the history as to why one party came to a contract does not make it admissible. A reasonable person who is hypothesised to understand the words of the contract is placed in the position of the contracting parties, or, if relevant, their agents – not one or some only of them. That requires the fundamental element of mutuality of known facts and background. To permit, under the guise of the reasonable person, background facts known only to one person to be attributed to the reasonable person would tend to re-introduce the subjective understanding of one party by permitting or requiring the contract to be interpreted by reference to one party's knowledge only*";

- at paragraph [35]:-

  > "*It is clear from the binding Australian authorities that the scope of the surrounding circumstances, knowledge of which is to be attributed to a reasonable person in the situation of the contracting parties (not one or some only of them), it is to be understood by reference to what the parties knew in the context of their mutual dealings. As Lord Wilberforce said, this does not involve a species of constructive notice. Constructive notice implies a degree of enquiry by reference to some external standard. Just because*

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45 Para 11. The judgment of Gleeson CJ, Gummow and Hayne JJ.

46 Movie Network Channels Pty Ltd v. Optus Vision Pty Ltd [2010] NSWCA 111. The outlining of the argument put is at [40]-[43] and [58] and [59]. The decision of the Court on the issue is at [97]-[106] (Macfarlan JA, with whom Young JA (131) and Sackville JA (153) agreed). QBE Insurance Australia Limited v. Vasic [2010] NSWCA 166. The outlining of the argument is at [20]. The decision of the Court is at [20]-[35] (Allsop P, with whom Giles and Macfarlan JJA agreed).

47 At [22] and [35].

> *something is available to be found does not make it relevant, if the parties did not know of it. The reasonable person may be taken to know of things that go beyond those that the parties thought to be important or those to which there was actual subjective advertence by the parties. Further, the circumstances may include such things as the legal context to the transaction, especially if a market is involved. Nevertheless, the scope of the relevant material is necessarily bounded by the objective task of the reasonable person giving meaning to the words used by the parties in the circumstances in which the contract came to be written, by reference to what the parties knew in the sense stated by Lord Wilberforce in Reardon Smith, by Mason J. in Codelfa and by the High Court in the various cases since Codelfa. This is how I read the reasons of Macfarlan JA in Movie Network Channel v. Optus, with which I agree*".

QBE Insurance Australia Limited v. Vasic (2010) NSWCA 166

33. QBE Insurance Australia Limited v. Vasic was an insurance case. The two insureds owned and managed a country property. They permitted licensed shooters on the property for the purpose of hunting.

34. The relevant coverage clause under the policy of insurance was for:-

> "*Legal liability to third parties for bodily injury and/or property damage caused by an occurrence in connection with the insureds' activity of allowing licensed shooters on their properties for the purpose of hunting only*".

35. On 3 June 2003, the plaintiff (a 16 year old boy) and his father attended the insureds' property for the purpose of hunting for feral animals.

36. They paid the insureds an amount of money for accommodation and hunting.

37. The accommodation consisted of the old shearers quarters.

38. In the early hours of 4 June 2003 there was a fire in the shearers' quarters and the plaintiff was seriously injured.

39. The plaintiff sued the insureds in negligence and they sought indemnity from the insurers (QBE and MMI).

40. The insurers denied liability on the basis that coverage did not include any event outside hunting.

41. They relied heavily upon the wording '*for the purpose of hunting only*'. They argued that the coverage did not include injury sustained by fire in the accommodation, but only injury sustained during hunting.

42. The trial judge rejected the insurers' argument holding that once it was established that the licensed shooters attended the property with the purpose of hunting only, then there was no reason to limit coverage by reference to the activities of the licensed shooters rather than the activity of the insureds in allowing them onto the property.

43. The trial judge relied[48] upon the following surrounding circumstances in support of this construction:-

(1) the remote physical location of the insureds' property. It was not unreasonable to contemplate that hunters who went to remote areas such as this for hunting would need to stay on the properties where they were hunting;

(2) hunting was an activity which could occupy many hours in a day, involve walking across country in often difficult conditions. It was an intrinsic part of such an activity that the participants would need to rest or sleep, shelter, and eat or drink. The construction advanced by the insurers would require a moment by moment analysis of each of these activities to establish whether they were part of the activity of hunting;

(3) that a change in the wording of the policy was nothing more than a clearer definition of the nature of the activity covered.

44. The insurers sought[49] to rely upon four documents by way of surrounding circumstances, three of which were relevant (documents 2, 3 and 4):-

(1) document 2 – a proposal form issued by Wesfarmers Federation Insurance Limited to the insureds dated 29 January 2010, in respect of the property;

(2) document 3 – the policy wording in respect of the Wesfarmers policy for the period 21 July 2002 to 21 July 2003; and

(3) document 4 – a statement of Robert Gregory Low, insurance broker.

45. Documents 2 and 3 were the proposal and policy wording of a separate policy that the owner insured took out with Wesfarmers in 2001. The point which the insures sought to make in reliance upon the Wesfarmers proposal and policy documents, was that they revealed a policy which the insureds had taken out, in order to cover a gap in their insurance, namely covering rural landowners for their liability for negligence to licensed shooters while out hunting on their properties.

46. The fourth document was a statement by Robert Low (7 June 2010). He was an insurance broker with considerable experience, who said that he developed the wording in the Wesfarmers policy. He explained the purpose of the gap cover under the Wesfarmers policy was to cover occurrences such as that which saw the plaintiff severely injured when the fire took place in the shearers quarters on the insureds' property.

47. Both the trial judge and the Court of Appeal held that the documents were not admissible by way of evidence of surrounding circumstances, on the basis that there was no evidence that the insurers were

48 Refer to paragraph [17] of the judgment where the Court sets out paragraphs [64]-[66] of the trial judge's decision.
49 Refer paragraph [10].

ever aware of the Wesfarmers policy held by the owner insured. It was not a policy which played any role in the genesis of the QBE policy which was the subject of the proceedings.

48. As for Mr Low's statement, it was also inadmissible on the basis, inter alia[50], that his knowledge and intentions were not known by either of the parties at the time the insureds took out the policy with the insurers.

[3] PRIOR NEGOTATIONS

49. The admissibility of evidence of prior negotiations (including the exchange of draft agreements between the parties), depends upon the purpose served by such evidence. To the extent that such evidence goes to establishing the objective background evidence relied upon, it is admissible. To the extent that such evidence goes to an understanding of the actual intentions of the parties, it is inadmissible. In Codelfa Mason J. stated:-

> "*Obviously the prior negotiations will tend to establish objective background facts which were known to both parties and the subject matter of the contract. To the extent to which they have this tendency they are admissible. But in so far as they consist of statements and actions of the parties which are reflective of their actual intentions and expectations they are not receivable*".

Royal Botanic Gardens & Domain Trust v. South Sydney City Council

50. In Royal Botanic Gardens & Domain Trust v. South Sydney City Council[51] the majority[52] admitted into evidence a large amount of antecedent material, including details of the historical legislative paths of both the Council and the Trust, and also substantial material regarding the dealings and negotiations between the antecedents of the parties, both at the time of the construction of the car park in 1955, and at the time of entry into the lease in 1976 (which lease was backdated to 1958). This included considering relevant minutes, letters and proposals for the terms and conditions of the agreement for lease and the lease[53].

51. The case involved the construction of a lease. Within the area of the demised land the Council had constructed an underground car park which it operated and maintained. The lease was for a period of 50 years and had commenced in 1958 (albeit that a deed of lease was not executed until May 1976).

52. The litigation turned upon the correct construction of clause 4(b)(iv) of the lease which provided that:-

> "*(iv) in making any such determination the Trustees may have regard to additional costs and expenses which they may incur in regard to the surface of the Domain above or in vicinity of the parking station and the footway and which arise out of the construction operation and maintenance of the parking station by the Lessee*".

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50 It was also inadmissible in any event as it was no more than an expression of the subjective aims and intentions of a person who was not even a person representing a party – refer paragraph [23] of the judgment.
51 (2002) 240 CLR 45; (2002) 186 ALR 289.
52 Gleeson CJ, Gaudron, McHugh, Gummow, Hayne and Callinan JJ.
53 Refer paragraphs [18]-[29].

53. The Council (the lessee) argued that in determining any increase in yearly rent for the following three year period, the Trustees were constrained by clause 4(b) only to do so by reference to the matters set out in sub-clause 4(b)(iv), namely, having regard to additional cost and expense which they may incur in regard to the surface of the Domain above or in the vicinity of the parking station and the footway and which arise out of the construction, operation and maintenance of the parking station by the Lessee.

54. The Trust (lessor) argued that the Trustees were not restricted to the matters identified in clause 4(b)(iv) in fixing the yearly rental.

55. The impetus for the litigation was the very substantial increase in rental demanded by the Trust in the recent years leading up to the litigation, ie. $175,000 per annum during 1988-1991 and $500,000 per annum during 1992-1994. The Council sought declaratory relief regarding the construction of clause 4(b).

56. The majority held that clause 4(b) contained a statement of the totality of the matters to be taken into account in fixing successive rent determinations.

57. Although the majority decision has been the subject of some trenchant criticism regarding the admission of substantial evidence of prior negotiations between the parties[54], the majority's decision in admitting such evidence should be viewed as having been admitted on the basis that it tended to establish the objective background facts which were known to both parties, as opposed to being evidence reflective of their actual intentions.

Chartbrook Limited v. Persimmon Homes Limited & Anor.

58. In the recent decision of Chartbrook v. Persimmon Homes Limited & Anor.[55] Lord Hoffmann has reaffirmed the inadmissibility of evidence of prior negotiations insofar as such evidence goes to understanding the parties' actual intentions.

59. His judgment on this issue was strictly obiter dictum. However His Honour took the opportunity[56] to consider the arguments for and against retention of the prior negotiations rule. No doubt he did so in light of various academic writings wherein it has been argued that the rule ought not be retained[57].

60. Lord Hoffmann's justification for retention of the rule included:-

    (1) that to depart from the rule excluding such evidence, would mean a departure from a long and constant line of authority[58];

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54 Refer JW Carter & Andrew Stewart Interpretation, Good Faith and the "True Meaning" of Contracts: The Royal Botanic Decision (2002) 18 JCL 182 at 189-190.
55 [2009] 4 All ER 677.
56 At [27]-[47].
57 Refer [32] of the judgment.
58 Paragraphs [30-[32].

(2) to depart from the rule would be inconsistent with the English objective theory of contractual interpretation[59];

(3) if evidence of prior negotiations directed to the parties' actual intentions were admitted, it would add to the cost of legal advice and litigation concerning disputes over contractual interpretation[60];

(4) the present rule concerning prior negotiations strikes a reasonable balance in that, whilst it excludes such evidence insofar as it shows the actual intentions of the parties, such evidence is admissible to establish the objective background circumstances surrounding the entry into the contract, and it is also admissible to support claims for estoppel or rectification, which causes of action are "*safety nets*" to a contractual claim[61].

61. Catherine Mitchell's article Contract Interpretation: Pragmatism, Principle and the Prior Negotiations Rule[62] provides a very helpful and interesting discussion of Lord Hoffmann's judgment in Chartbrook.

62. She argues that evidence of prior negotiations directed to showing the parties' actual intention should be admitted. She argues that such evidence is probative of the question which the Court is determining, namely what did the parties mean by their contract. By admitting such evidence the Court is more likely to achieve the correct answer. She also points out that should the parties so wish, they can agree to contract on the basis that evidence of prior negotiations not be admitted in evidence in the event of litigation or arbitration. She also argues that having regard to the numerous exceptions to the prior negotiations rule, doing away with the rule would provide a more coherent contract law.

[4] SUBSEQUENT CONDUCT AS AN AID IN THE INTERPRETATION OF A CONTRACT

63. The question whether subsequent conduct may be used as an aid in the interpretation of a written contract has been the subject of divergent authorities amongst the intermediate Appellate Courts in Australia[63].

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59 Refer paragraph [33].

60 Refer paragraph [41].

61 Refer paragraphs [41]-[42]. Note that there are a number of other exceptions under which evidence of negotiations are permissible. Catherine Mitchell summarises them at page 2 of her article. She states that such evidence is admissible (1) for the purpose of deciding what was agreed in an oral contract; (2) in a case for rectification of a written document; (3) if one party is trying to establish additional obligations by way of collateral contract; (4) where the contract is not incorporated into a final document; (5) if the contract terms have to be constructed from the parties' behaviour, oral negotiations, dealings and so on, then prior negotiations must be relevant, as must subsequent conduct; (6) she refers to The Karen Oltmann exception ie. if agreement was reached during negotiations on the meaning to be attached to an ambiguous term, or the negotiations show a particular interpretation was placed on the words by the parties, evidence of that negotiated or accepted meaning is admissible. She notes that in Chartbrook, Lord Hoffmann doubted the legitimacy of this exception (refer paragraphs [43]-[47]. It is not clear from Catherine Mitchell's article, whether she has included as an exception, the exception referred to by Mason J. in Codelfa at page 352, final paragraph where he stated that if it transpires that the parties have refused to include in the contract, a provision which would give effect to the presumed intention of persons in their position it may be proper to receive evidence of that refusal.

62 (2010) 26 JCL 134.

63 Refer to the large list of cases referred to by Campbell JA in Franklins Pty Ltd v. Metcash Trading Limited [2009] NSWCA 407 at [330].

64. The law in Victoria is that the conduct of the parties subsequent to the making of a contract is not relevant to the interpretation of the contract. This was laid down in the case of FAI Traders Insurance Co Limited v. Savoy Plaza Pty Ltd[64].

65. However in the New South Wales case of Spunwill Pty Ltd v. Bab Pty Ltd[65], the FAI decision was not followed. Santow J. held that whilst the general rule was that subsequent conduct may not legitimately be employed as an aid to construction, the rule was not absolute and that evidence of actual intention was admissible in limited circumstances where it was evidence of a "*shared subjectiveness*", viz. of matters in common contemplation or of common assumption[66].

66. In the recent New South Wales Court of Appeal decision in Franklins Pty Ltd v. Metcash Trading Limited[67], the Court of Appeal has, by reference fundamentally to the High Court decision in Agricultural & Rural Finance Pty Ltd v. Gardiner[68], held that the law binding in Australia is that it is not legitimate to use as an aid in the construction of a contract anything which the parties said or did after it was made.

67. The judgment of Campbell JA in particular[69] provides very thorough consideration of the relevant cases, and his decision, along with the other members of the Court would appear to have now clarified the position which was hitherto unclear.

68. However the Court noted that there are circumstances in which subsequent conduct is admissible as an aid in construing a contract[70]:-

(1) in ascertaining whether there was a contract formed and when it was formed;

(2) revealing probative evidence of antecedent surrounding circumstances, viz. events occurring after the time of the execution of the contract being admissible as retrospectent evidence probative of surrounding circumstances at the time the written contract was executed; and

(3) revealing probative evidence of facts relevant to rectification, estoppel or any other legal, equitable or statutory rights or remedies that may impinge on an otherwise concluded, construed and interpreted contract.

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64 [1993] 2 VR 343 at 347-50, 352-353 and 353-355.
65 (1994) 36 NSWLR 290.
66 Refer in particular to page 309F-312A.
67 [2009] NSWCA 407. Refer in particular to the judgment of Campbell JA at [306]-[330]. Refer also Allsop P at [6]-[13] and Giles JA at [58].
68 (2008) 83 ALJR 196.
69 Refer [306]-[330].
70 Refer [6]-[13] per Allsop P; and [323]-[327] per Campbell JA.