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How to *Vector* change

Interpreting a written contract should be easy. We can all read. We have a reasonable level of comprehension. A contract is recorded in writing so that everyone knows what their obligations are, and thus can perform them.

So why do so many cases before the Court call into question the meaning of a written contract?

One reason is, of course, buyers remorse. The deal was not quite as good as first thought, so it would benefit one party to have the contract mean something a little different from that originally envisaged. Less cynically, there is always the prospect that the parties were talking past each other, rather than to each other, with a confused and non-mutual appreciation of what was intended. This is more likely the more complicated the contract, and the more specialised the terminology.

When such an issue comes before the Court, the approach the Court takes is to try to ascertain the intent of the parties, by reference to the words used in the written document.

This is probably what you would expect. What you may not expect is that classically, any evidence about what each party thought they meant, is excluded. The Court looked at the words used, and would not hear evidence about what the parties actual intent was. This surprising outcome was called the Parole Evidence Rule. The name is historic, and was seen not principally as a rule of evidence, but a rule of how Courts would approach questions concerning the construction of contracts.

While surprising, the rule had a very significant practical benefit. Because the evidence of the parties' intentions was not considered, the evidence did not have to be called. This significantly shortened the time taken at trial. Instead of the Plaintiff saying what he thought he meant, and the Defendant saying what he thought he meant (always likely to be different), with each of them also being cross-examined and re-examined, the Court simply looked at the words in the document itself.

There would, of course, always be legal submissions around the meaning of the written words, but that was going to happen anyway.

In its judgment, the Court did not have to review evidence of what the parties thought, but could rather more simply declaim what (in the Court's opinion) the contract meant.
On the other hand, there was always the prospect that the Court could conclude that the intention of the parties (as presumed by the Court, from the words used in the contract) was contrary to the actual intent of the parties.

The simplicity of the "presumed intent" approach was eroded as a result of a series of decisions that allowed the Court to take into consideration the factual matrix behind the making of the particular contract at issue.

The role of the Court (often considering factors that neither party envisaged when the contract was drawn up) was to give the contract a 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" (see *Investors Compensation Scheme Ltd v West Bromwich Building Soc* [1998] 1 WLR 896 at 912).

These "factual matrix" decisions opened the evidential floodgates. "Background knowledge" covers a wide variety of factual issues – relative bargaining strength, general and specific economic circumstances and terms of art in a particular industry. "The situation in which they were at the time of contract" opens the prospect of prior negotiations, between the parties and possibly with other parties, which failed (and the reasons why this occurred). It also allows evidence of what the parties subjectively thought they meant, via the back door of an explanation of why they thought that – referring to their background knowledge and circumstances. Contractual interpretation cases had to extend the amount of evidence submitted at trial, and made the role of a Judge far more complex.

At the start of the present decade that complexity came home in a quite spectacular way, as a result of the Supreme Court case of *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5. As a Supreme Court decision, it remains the last word in the approach to be taken by a Court when interpreting contracts. The case is at its heart quite simple. The two protagonists entered into a written contract (evidenced in an exchange of letters between lawyers) for the supply of gas at a price of $6.50 per gigajoule.

The issue was whether that price was inclusive or exclusive of transmission costs. Earlier in the negotiations, the price had been expressed as being exclusive of any transmission costs, which would be "passed through at cost". The final agreement was silent on the transmission costs. Unsurprisingly, one party decided the contract was meant to be inclusive of transmission costs, and the other that transmission costs were excluded. On its face, the contract did not deal with the issue, one way or the other. The financial consequences were a difference of $3.5 million.

The Court at first instance concluded the contract was for a price that excluded transmission costs. The Court of Appeal disagreed, and found that the price was inclusive of transmission costs. The Supreme Court restored the first instance decision. The price was exclusive of any transmission costs.

Unfortunately, the decision by 5 judges in the Supreme Court was delivered separately by each of the judges. The decisions do not agree between them whether there was any ambiguity in the written words used, or whether the words on their face are sufficiently clear to exclude

evidence of the factual matrix. While the result was unanimous, the reasons why (and thus the approach any other Court is to take) are unclear.

Justice Blanchard upheld the old rule, but only to the extent of excluding evidence of the subjective intent of a party. Written communications in the course of the negotiations were accepted by him.

Justice Tipping rejected the old rule and would allow any evidence of prior discussions leading up to the formation of the final contract, if it shows objectively what the parties meant by the words they used.

Justice McGrath rejected both prior approaches and would not allow the old rule to be eroded by reference to documents used during negotiations. But he did accept that a separate cause of action was available – estoppel by convention – because that cause of action would allow access to the prior negotiations to establish a common intent as to the use of the words, which the defaulting party could not then disclaim. The defendant was estopped from denying the meaning of the words used. Thus, he put the remedy outside the question of interpretation of contract, and relied on an equitable remedy. At a practical level, this approach encourages litigators to plead a separate cause of action, so they can call all possibly relevant evidence.

Justice Wilson upheld the old rule, but would erode it where this was needed to resolve an ambiguity in the wording, or where the plain meaning made no commercial sense. The ambiguity exception would allow access to all relevant evidence in order to determine such ambiguity. He would also allow estoppel by convention (as a separate and additional cause of action).

Justice Gault agreed with Justice Blanchard, but in his short decision appears to allow unlimited access to extrinsic evidence, without qualification.

These differences in reasoning do not assist commercial parties attempting to resolve a contractual dispute. It means any litigation will have to involve all available evidence, with the risk that the Court may exclude it, based on the old rule and a selective use of the reasoning in the *Vector* case – a waste of time and money.

Consequently, every prudent litigator will have to ensure everything possibly relevant is admitted, given the risk of a Judge being swayed by some fact or event that may bear on a disputed interpretation. Further, the decision encourages parties to plead multiple causes of action, which also leads to longer and more complex trials, and more prospects for appeals.

It would be difficult now to maintain that any evidence should be excluded under the old rule. But the principles that should be applied are in a state of flux. Every Court in New Zealand is bound by the *Vector* decision, but it is unclear what it does mean.

Academic commentators have suggested that the old rule is now dead, and at a conceptual level, there is good reason not to mourn its passing. Why should parties end up with a contract that neither intended, based on a theoretical view of a Court as to what they did intend, when they can not give evidence of what was in fact intended?

At a practical level, there is merit in the economics of short trials, excluding subjective evidence that tends to unravel over long periods of expensive court hearing time. But that may overstate the position, and not take account of the prospects for settlement of disputes where both sides know that all the relevant evidence can be put before the Court, particularly if this leads to a consistent interpretation.

Further, one issue does not seem to have been addressed in the debate.

The Evidence Act 2006 restated the rules of the admissibility of evidence, in favour of admitting any relevant evidence. While this deals with the law of admissibility of evidence, and the Parol Evidence Rule was regarded as a rule of interpretation of contracts, it is submitted that they do overlap. The evidence available would seem to be something governed by the statute, and therefore gives the Court another reason to admit and consider it.

Consequently, it is reasonable to conclude that the direction (or Vector) of change is in favour of admissibility of all available evidence of the parties actual intent (even if subjectively framed).

Long trials will therefore be a feature of contract interpretation disputes, with the consequent cost burden on litigants. This may lead to the rather perverse outcome of less contractual interpretation issues coming before the Courts – not because there are less of them, but because the cost of litigating them has become prohibitive.

About the author

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