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Significant contractual interpretation case in the Supreme Court: a preview

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In a forthcoming decision, the Supreme Court has signalled that it may clarify the position on significant issues of contractual interpretation. Those issues include whether evidence of the parties' conduct before and after contractual formation can be used to interpret contracts. The Supreme Court will also consider on what basis the courts should imply terms into contracts. The decision will likely be of broad interest to the commercial community. This article considers the potential implications of the Supreme Court's decision.

The case

In April 2020, the Court of Appeal gave judgment in *Bathurst Resources Limited v L&M Coal Holdings Limited* [2020] NZCA 113, [2020] NZCCLR 26. The case concerned the obligation of Bathurst Resources Limited (Bathurst) to pay L&M Coal Holdings Limited (L&M) under a contract granting mining rights. Bathurst was unsuccessful in the Court of Appeal and sought leave to appeal to the Supreme Court.

The Supreme Court, in granting leave to appeal, indicated it wished to hear argument on the admissibility of the parties' conduct before and after the conclusion of the contract, as well as the distinction between interpretation and implication and the appropriate test for the latter. The Supreme Court also indicated that it would not revisit the general principles of contractual interpretation set out in *Firm PI 1 Limited v Zurich Australian Insurance Limited* [2014] NZSC 147, [2015] 1 NZLR 432. We consider the state of the law on those issues in the section following.

Contractual interpretation – principles

General approach

In *Firm PI 1 Limited,* the Supreme Court outlined the proper approach to the interpretation of contracts as follows:

…the proper approach is an objective one, the aim being 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". This objective meaning is taken to be that which the parties intended. While there is no conceptual limit on what can be regarded as “background”, it has to be background that a reasonable person would regard as relevant. Accordingly, the context provided by the contract as a whole and any relevant background informs meaning.

The Supreme Court also emphasised three considerations central to the interpretation of contracts:

1. **Objectivity**: The Court stated that contracts in New Zealand are to be interpreted objectively, without regard to the subjective intentions of the parties to that contract. In this context, the objective meaning is the meaning that would be conveyed 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 contract
2. **Text**: While assessment of contractual context is an element of interpretation, when the language in dispute "has an ordinary and natural meaning, that will be a powerful, albeit not conclusive, indicator of what the parties meant"
3. **Third-parties**: When third parties (such as financiers) are impacted by the contract, a court will be more reluctant to consider extrinsic evidence shared between the contracting parties, as that evidence may not have been available to those third parties.

Pre-contractual negotiations

Evidence of contractual negotiations has historically been excluded from the interpretation process for both principled and practical reasons.

- On a principled level, the objective approach to interpretation is at odds with pre-contractual negotiations. Those negotiations represent the subjective intentions of the contracting parties, and often speak more to the aspirations of those parties than the realities that are codified in the final contract

- Further, allowing the consideration of pre-contractual negotiations will often result in the introduction of vast amounts of new evidence to disputes, most of which will either be irrelevant or unhelpful.

The Supreme Court reviewed the rule excluding evidence of pre-contractual negotiations in *Vector Gas Limited v Bay of Plenty Energy Limited* [2010] NZSC 5, [2010] 2 NZLR 444. All five justices delivered separate judgments, taking different positions on the role (if any) of such evidence when interpreting a contract. Various cases since *Vector Gas* have allowed the consideration of pre-contractual evidence, primarily when it shows objectively the meaning the parties intended their words to convey. However, until the Supreme Court delivers a more coherent judgment on the issue, the legal status of pre-contractual negotiations in interpretation remains unclear.

Subsequent conduct

Much like evidence of the contracting parties' conduct prior to the contract, evidence of conduct after the contract has historically been excluded from the interpretation process. This position was changed by the Supreme Court in *Gibbons Holdings Limited v Wholesale Distributors* [2007] NZSC 37, [2008] 1 NZLR 277.

In that case, the Court endorsed the consideration of subsequent conduct when it supports an objective interpretation of the contract, although the Court was split on whether that conduct needed to be shared or mutual between the contracting parties.

Accordingly, as with pre-contractual negotiations, the law is unsettled on the extent to which the parties' conduct after contractual formation can be considered in interpreting the terms of a contract.

Implication

In certain situations, the courts can imply terms into the contract to make the contract work as the parties must have intended.

The traditional test for the implication of terms required that, for a term to be implied, the following conditions (which may overlap) need to be satisfied:

- It must be reasonable and equitable
- It must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it
- It must be so obvious that “it goes without saying”
- It must be capable of clear expression
- It must not contradict any express term of the contract.

This test is well known to lawyers as the "*BP Refinery* test", which arises from the decision of the Privy Council in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 266 (PC).

However, a later decision of the Privy Council – *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10, [2009] 1 WLR 1988 – sought to reshape the *BP Refinery* test as simply a way of expressing the same question the Court must ask itself when it interprets contract. The Board said that: "[t]here is only one question: is that what the instrument, read as a whole against the relevant background would reasonably be understood to mean?"

So far, the courts in New Zealand have tended to apply both approaches, often in tandem. There has been a significant volume of commentary about whether the tests in fact differ and, if so, which ought to be preferred.

Bathurst

Facts of the case

Bathurst concerned an arrangement between Bathurst and L&M, under which Bathurst acquired coal mining rights on the West Coast of the South Island from L&M.

The sale agreement underlying this arrangement (Agreement) provided that Bathurst would make two performance payments of USD40 million to L&M, each payment becoming due once a certain amount of coal had been "shipped" from the area being mined (the first payment following the first 25,000 tonnes of coal (First Performance Payment)).

At the time of the dispute, over 25,000 tonnes of coal had been mined by Bathurst and distributed to domestic purchasers. However, Bathurst had discontinued substantive mining activity in the area, and denied any liability for payment of the First Performance Payment.

In the High Court, Bathurst was found liable to pay the First Performance Payment. It appealed to the Court of Appeal.

First argument – definition of "shipped"

As outlined above, under the Agreement the First Performance Payment was due once 25,000 tonnes of coal had been "shipped". Though this amount of coal had been mined and distributed, Bathurst argued that the term "shipped" referred to the export of the coal (as a majority of the coal was initially intended to be exported). Because most coal had been used domestically

(and therefore had not travelled by ship), Bathurst argued that the threshold for the First Performance Payment had not yet been met.

Bathurst's argument had been rejected in the High Court, where "shipped" was instead interpreted to mean "transported". Among other things, this finding was based on evidence of Bathurst's conduct subsequent to the contract (including its financial statements and correspondence), which demonstrated that Bathurst did not consider there to be a distinction between domestic and export use of coal when considering the First Performance Payment.

Though the Court of Appeal endorsed the High Court's interpretation, and much of its reasoning, it disclaimed any reliance on Bathurst's subsequent conduct as described above. Following the Supreme Court in *Gibbons Holdings*, the Court considered it unable to give any weight to that evidence, as it related to the conduct of Bathurst alone (ie it was not mutual or shared conduct).

Second argument – royalty payments

Bathurst also argued that it was excused from paying the First Performance Payment on the basis that it was instead making royalty payments for the coal it was mining.

Under the Agreement, Bathurst was required to pay 10% of its sale revenues to L&M for the duration of the Agreement "in the event that the [First Performance payment] does not occur" (Royalty Clause). The parties later amended the Agreement to add a clause (Amendment Clause) stating that:

For the avoidance of doubt, the parties acknowledge and agree that a failure by [Bathurst] to make, when and as due, a Performance Payment is not an actionable breach of or default under this Agreement for so long as the relevant royalty payments continue to be made under the Royalty Deed.

The Amendment Clause was introduced by the parties to minimise the risk that Bathurst went into default under the Agreement, as a default would need to be disclosed to the ASX, which could limit Bathurst's ability to raise capital.

Bathurst argued that that its continued payments under the Royalty Clause entitled it to avoid payment of the First Performance Payment. This position was entrenched by the Amendment Clause, which stated that non-payment was not an actionable breach of the Agreement. However, as mining under the Agreement had largely ceased at this point, Bathurst's royalty payments were nominal.

The Court of Appeal did not accept Bathurst's interpretation of the Royalty Clause. In the Court's view, the Royalty Clause only clarified the royalty rate payable in the event that the First Performance Payment was not made and did not prevent L&M from suing Bathurst for recovery of the First Performance Payment. The Court noted that this interpretation aligned with the background to the Amendment Clause, as Bathurst would only be concerned about an ASX announcement if it was possible to default on the First Performance Payment.

Following a review of the text and its surrounding context, the Court then considered the Amendment Clause. It concluded that L&M would not have allowed Bathurst to avoid payment of the First Performance Payment with no real consequence, particularly given Bathurst's weak negotiating position at the time of the amendment. Accordingly, the Court interpreted the Amendment Clause's reference to continued "relevant royalty payments" to require royalties "from continuing mining and sales at a level not materially less than had resulted in the US$40m payment being triggered in the first place". This interpretation was the only "commercially realistic [option] to L&M for the delay in receipt of the performance payment". As Bathurst was not paying royalties to this extent, it was not entitled to rely on the Amendment Clause to avoid the First Performance Payment.

What do we expect the Supreme Court to do?

It is difficult to determine exactly what the Supreme Court might do. The trend of the most recent cases has emphasised the centrality of the words actually used by the parties in the contract in the interpretive exercise. Relatedly, those cases also give less emphasis to the parties' conduct before and after the contract was agreed. We expect the Supreme Court's judgment to follow that trend.

However, equally, we do not expect the Supreme Court entirely to abandon what several of its own judgments have tentatively established as part of New Zealand law – which is that, in appropriate cases, evidence of the parties' conduct before and after contract can be admitted to aid in the interpretation exercise. We expect, however, that the Court will attempt to rein in some of the excessive reliance placed by litigants from time to time on evidence of the parties' conduct, which adds significantly to discovery and trial costs.

It is more difficult to predict what the Supreme Court may do in relation to the test for implied terms. On one hand, the *BP Refinery* test is long enduring. And the Supreme Court of the United Kingdom recently upheld the *BP Refinery* test as the appropriate test for implication of terms. On the other hand, there are commentators who argue vigorously for the lack of any distinction between interpretation and implication. Practically, too, lawyers are often guided by an intuitive understanding of how a contract should work and will find a result that makes sense, before putting that result in whatever framework applies. On that view, whether a term should be implied is more properly a matter of interpretation.

We do not expect the Supreme Court to abandon the *BP Refinery* test, but it is possible that it will emphasise key aspects of that

test. In addition, given the practice of New Zealand courts often to apply both tests in tandem, the Supreme Court might seek to achieve coherence by emphasising the need to cross-check the *BP Refinery* test against what a reasonable person would understand the instrument to mean against the relevant background. There are also a range of other alternatives, including that the Supreme Court could radically recast the test for the implication of terms. Precisely when the Supreme Court lands is, as mentioned, difficult to predict.

Whatever the outcome in *Bathurst*, it can be expected to be an influential and potentially leading decision for contract law in New Zealand.

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