BUDDLE FINDLAY

Supreme Court delivers significant contractual interpretation decision: RIP Vector v Bay of Plenty

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The Supreme Court has clarified significant issues of contractual interpretation in its decision handed down yesterday in *Bathurst Resource Ltd v L&M Coal Holdings Ltd* [2021] NZSC 85. As we outlined in our preview of the case, the appeal provided the opportunity for the Supreme Court to clarify whether evidence of the parties' conduct before and after contractual formation can be used to interpret contracts, as well as on what basis the courts should imply terms into contracts. The Court reached a unanimous position on law as it should apply to those issues, although the Court was split 2:3 on the result on the facts of the case.

The status quo ante

As we outlined in our preview of the case, the law in relation to the three issues mentioned in the introductory paragraph was in an unsatisfactory state of confusion.

To recap:

- **Pre-contractual negotiations**: The Supreme Court last authoritatively considered the admissibility of parties' pre-contractual conduct in interpreting contracts in *Vector Gas Limited v Bay of Plenty Energy Limited* [2010] NZSC 5, [2010] 2 NZLR 444. The case produced five different judgments, each taking different positions on the role (if any) of such evidence when interpreting a contract. In practice, the lower courts tended to admit pre-contractual conduct in interpreting contracts when that conduct could show objectively the meaning that the parties intended their contractual words to convey.
- **Subsequent conduct**: Likewise, in *Wholesale Distributors Ltd v Gibbons Holdings Ltd* [2007] NZSC 37, [2008] 1 NZLR 277, the Supreme Court permitted the admission of the parties' conduct after contractual formation when interpreting the terms of contracts, although the Court was split on whether that conduct needed to be shared or mutual between the contracting parties.
- **Implication**: There were two tests competing for supremacy in determining whether to imply a term into the parties' contract.
  - the first is the well-known "*BP Refinery* test", which arises from the decision of the Privy Council in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* [1977] UKPC 13, (1977) 180 CLR 266 (PC). Under that test, there are five conditions to the implication of a term, which are as follows: (1) it must be reasonable and equitable; (2) 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; (3) it must be so obvious that "it goes without saying"; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.
  - the second was Lord Hoffmann's approach in *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10, [2009] 1 WLR 1988. While not expressly disavowing the *BP Refinery* test, Lord Hoffmann sought to reshape the *BP Refinery* test as simply a way of expressing the same question the Court must ask itself when it interprets contracts. 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?"

The unhappy co-existence between these two tests – as well as the more fundamental question about whether they even differed, lead to doubt about how lower courts should imply terms into contracts.

The new position in *Bathurst*

The minority, comprising Winkelmann CJ and Ellen France J, and the majority, comprising Glazebrook, O'Regan and Williams JJ, were all agreed on the applicable principles, which we summarise below.

Conduct before and after contract

The Supreme Court considered that issues of the admissibility of evidence of the parties' conduct before and after contract was an issue for the law of evidence, rather than the law of contract (at [54]-[55]). From that starting point, the Supreme Court summarised the position on the admission of evidence to interpret a contract as follows (at [62]):

"Applying s 7 [of the Evidence Act 2006] in the context of contractual interpretation, evidence is prima facie admissible if it has a tendency to prove or disprove anything of consequence to determining the meaning the contractual document would convey to a reasonable person having all the background knowledge reasonably available to the parties in the situation in which they were at the time of the contract."

The Supreme Court emphasised that s 8 of the Evidence Act 2006 (Act) will be important in the analysis. In particular, s 8(1)(b) of the Act requires a Judge to exclude evidence if its probative value is outweighed by the risk that the evidence will "needlessly prolong the proceeding". The Court said that s 8(1)(b) of the Act "addresses the policy concerns that the admission of extrinsic material will involve unnecessary expenditure of time and resources for the parties and the courts". That can be taken as a clear signal that parties will not be permitted to adduce significant volumes of material that is only marginally relevant at best to the interpretation of contracts.

The Court considered that the application of the provisions of the Act would preserve the distinction between interpretation, rectification and estoppel when deciding questions of admissibility. Those provisions keep the focus on the relevance of the evidence to the legal test for the purposes of interpretation, which is the objective interpretation of the contract (at [80]).

The Court offered the following guidance on certain specific, and well-trodden issues:

- **Prior negotiations (including draft contracts, communications, and oral negotiations)**:
  - if the evidence shows what a party intended the words to mean, and that this was communicated, it may tend to show a common mutual understanding as to the meaning of the contract. It is therefore admissible (subject to s 8 of the Act) (at [76]).
  - if the evidence shows only a party's subjective intention or belief as to the meaning of the words, or what their undeclared negotiating stance was at the time, it is inadmissible (at [75]).
- **Conduct subsequent to the contract**: As with prior negotiations, the Court must ask itself whether the subsequent conduct tends to prove anything relevant to the objective approach to interpretation. The conduct need not necessarily be mutual. It will not be often that conduct after the contract will be relevant (at [89]-[90]).
- **Declarations of subjective intent given orally at the hearing**: An undeclared understanding or intention as to the meaning of a contract is not relevant to the task of contractual interpretation and is therefore inadmissible (at [68]).
- **Specialised meanings**: If the parties have agreed on a word having particular meaning, evidence demonstrating that agreement can be admissible (at [81]).
- **Trade and industry practice**: Evidence of trade and industry practice can be admissible if it tends to prove anything relevant to the notional reasonable person tasked with interpreting the contract (at [82]).

Implied terms

The Supreme Court considered that Lord Hoffmann in *Belize* did not set out to change the law in relation to the implication of terms, but rather to clarify the doctrinal basis of implication. The Court therefore affirmed the *BP Refinery* test as representing the law in New Zealand, albeit with some qualifications.

It summarised the applicable principles as follows (with some editorial abbreviation) (at [116]):

- The legal test for the implication of a term is a standard of strict necessity, a high hurdle to overcome.
- The starting point is the words of the contract. If a contract does not provide for an eventuality, the usual inference is that no contractual provision was made for it.
- The task of implication follows the task of interpretation – but both tasks are part of the construction of the written contract as a whole. An unexpressed term can only be implied if the court finds that the term would spell out what the contract, read against the relevant background, must be understood to mean.
- The inquiry is an objective one. The court is tasked with the role of constructing the understanding of that reasonable person.
- The implication of a term does not depend upon proof of the parties' actual intentions, nor does it require the court to speculate on how the actual parties would have wanted the contract to regulate the eventuality if confronted with it prior to contracting.
- The *BP Refinery* conditions are a useful tool to test whether the proposed implied term is strictly necessary to spell out what the contract, read against the relevant background, must be understood to mean. Whilst conditions (4) (clear expression) and (5) (no contradiction of express terms) must always be met before a term will be implied, conditions (1)–(3) (reasonable and equitable; business efficacy; goes without saying) can be viewed as analytical tools that overlap and are not cumulative. The business efficacy and the "so obvious that 'it goes without saying'" conditions are both ways, useful in their own right, of testing whether the implication of a term is strictly necessary to give effect to what the contract, objectively interpreted by the court, must be understood to mean.

The Court splits on the outcome on the facts

To recap the facts of Bathurst:

- *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 USD40m 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.
- Bathurst raised two key arguments:
  - first, because the relevant coal was sold domestically, it was not "shipped" under the Agreement, which meant the First Performance Payment was not payable.
  - second, even if the relevant coal was "shipped", a later amendment to the Agreement, under cl 3.10 of the 'Third Deed', which provided as follows, applied to relieve it of any liability to make the First Performance Payment:

    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.

    Bathurst's argument was that, even though it was no longer mining in the relevant area, (because it was uneconomic to do so), which meant it was not paying any relevant royalty payments, it was not breaching the Royalty Deed because royalty payments were only payable if it mined the relevant area – which it was not doing. As such, it argued it could take the benefit of the above clause which relieved it from liability to make the First Performance Payment (at [29], [35], [249]).
- In the High Court, Bathurst was found liable to pay the First Performance Payment. It appealed to the Court of Appeal, which also found Bathurst liable to pay the First Performance Payment.

The Supreme Court was split, 2:3, on application of the principles to the facts.

The minority view

The minority, Winkelmann CJ and Ellen France J, held that:

- **Shipped meant transported**: The relevant coal had been "shipped" from the area being mined, with "shipped" to be interpreted as "transported." The majority concurred with the minority on this point. The Court held the text of the Agreement was a clear indication – as "[a]nyone who has ever purchased goods online knows" that "shipped" is used to describe "all means of transport of goods from one place to another" (at [134]).
  - in reaching its conclusion, the Court was also prepared to consider a pre-contractual study undertaken by Bathurst ([140]) and a market announcement made by Bathurst (at [142]) before entry into the contract. It was also prepared to consider Bathurst's 2014, 2015, and 2016 financial statements and annual reports, which acknowledged a liability for the First Performance Payment (at [151]).
  - however, the Court was not prepared to consider letters written by the solicitor acting for L&M to obtain consents to support Bathurst (which allegedly showed a focus on the export of coal, rather than domestic production) (at [149]). Nor was it prepared to consider evidence of executives that negotiated the Agreement about what they thought "shipped" meant (at [152]-[154]) or L&M's use of language in other publications (at [156]), or expert evidence about "shipped" in the logistics and communications context (which differed from the context of the Agreement) (at [157]).
- **Clause 3.10 of the Third Deed required continued mining for Bathurst to receive benefit**: The minority held, consistent with the Court of Appeal, that cl 3.10 of the Third Deed required Bathurst to pay royalties from the ongoing mining for it to receive the benefit of cl 3.10 of the Third Deed (at [187], [189], [192], [195]). That seems clearly correct, given that the clause applied "*for so long as*" the relevant royalty payments "*continue[d]* to be made." It was therefore unnecessary for the minority to imply a term (at [201]). But, if an implied term were necessary, the minority would have implied a term that Bathurst ceasing to mine on a level equating to that which triggered the obligation to make the First Performance Payment (while, at the same time, refusing to pay the USD40m payment that has become due) is a breach of contract, entitling L&M to compensation.

The majority position

The majority, Glazebrook, O'Regan and Williams JJ, agreed with the minority on the interpretation of "shipped", as mentioned above.

The majority differed on the interpretation of cl 3.10 of the Agreement and whether a term should be implied into the Agreement.

- **Clause 3.10 allowed Bathurst to postpone the performance payments (at [244])**: The majority found that cl 3.10 was inserted into the Third Deed in the context of Bathurst risking having triggered the performance payments, while lacking sufficient revenue to fund the payment, and therefore potentially lacking the ability to raise capital because of its potential

default in making the First Performance Payment (at [241]). While the parties assumed that the mine would be operative and continue to be operative, it was unaccompanied by any legal obligations on the part of Bathurst (at [245]). L&M, in the majority's view, clearly accepted the risk that the performance payments would never be paid (at [244]) and as a major commercial entity, L&M was to bear that risk (at [249]).

- **Clause 3.10 simply required royalty payments "as and when" the Royalty Deed required them (at [252])**. On the majority's interpretation, Bathurst could take the benefit of cl 3.10 of the Third Deed even if it was not paying any royalty payments. That was because while the parties assumed that there would be a "continuous stream of royalty payments" there was "no legal obligation behind that to ensure that assumption became reality" (at [252]).
- **No implied term**: The majority declined to imply any term. It was not strictly necessary (at [263]), the inference from an absence of obligation to mine is that there was no obligation (at [264]), the majority's interpretation resolved the issue (at [265]), objectively, an implied obligation would create uncertainty for the parties (at [266]), and the *BP Refinery* conditions were not met (at [269]).

Comment

There are several legal and practical points that arise from the decision.

Legal points

- **Battle but not the war?** The minority is clearly right (as the majority appears to accept) in finding that the First Performance Payment is an accrued debt (albeit contingent, on the majority's analysis (at [253])). The majority found that cl 3.10 of the Third Deed permitted Bathurst to postpone the First Performance Payment, but it did not find that Bathurst had no liability for the First Performance Payment (at [244]). That being so, it seems that L&M would be entitled to sue Bathurst in an action for a debt (for the First Performance Payment) once the Agreement is terminated, since the condition on which cl 3.10 of the Third Deed is predicated would have become inoperative.
- **Extrinsic evidence as a matter of the law of evidence?** The Court's assertion that issues of the admissibility of evidence of the parties' conduct before and after contract are issues for the law of evidence, rather than the law of contract, is contestable (at [54]-[55]). While it is true that the law of evidence undoubtedly has a role to play, it is not self-evident that the exclusion of evidence of the parties' conduct before and after contract was historically a matter of the law of evidence, and there are quite persuasive arguments to support the previous exclusionary rules as substantive rules of law and policy founded in the law of contract. This point was made expressly by Lord Hoffman in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 (HL) at 913, referring to the exclusionary rules as being for reasons of "practical policy". One important consequence of reorganising the principles squarely as ones of evidence rather than the proper law of the contract is that the scope of extrinsic evidence admissible on interpretation issues may differ according to the law of the forum. The Act applies only to proceedings (s 5), which is defined to mean proceedings conducted by a court, which in turn means the District Court, High Court, Court of Appeal, and Supreme Court (s 4). Accordingly, if a New Zealand law contract falls to be interpreted other than in a court to which the Act applies, there could well be asymmetrical approaches adopted between different fora (for instance, an overseas court or arbitral tribunal). (That is unless the conflict of laws principles of the applicable forum apply the laws of evidence ordinarily applicable to the proper law of the contract: Maria Hook and Jack Wass *The Conflict of Laws in New Zealand* (LexisNexis, Wellington, 2020) at [4.232]-[4.233].)
- **Benefit of wrongdoing?** The decision of the majority appears a harsh result, as the majority appears to accept (at [249]). Harshness, of course, does not determine correctness. But it is well recognised in contract law that a contracting party should not be entitled by his or her own action to end a state of affairs essential to the continuance of the contractual arrangement. A recent and authoritative exposition of that principle appears in *Ali v Petroleum Co of Trinidad and Tobago* [2017] UKPC 2, [2017] ICR 531. In *Bathurst*, the minority referred to the principle briefly but found it unnecessary to determine the issue, and said that the courts below had not considered the relevant evidence in that context (at [204]). The majority rejected the basis for any implied term to that effect and doubted that Bathurst had in fact, disabled itself from contractual performance (at [260]). However, the majority found a common assumption that mining would continue, and that that assumption underlay cl 3.10 of the Third Deed (at [189] and [245]). It also referred to obligations on Bathurst to satisfy a minimum work programme and maximise coal sales at the best available price (at n 231). There would, therefore, appear to have been a clear basis on which the Court could have implied an obligation on Bathurst not to end the very state of affairs on which cl 3.10 of the Third Deed was predicated. The same point favours the interpretation reached on the text of cl 3.10 by the minority.
- **Commerciality?** The Supreme Court reiterated its previous position on "commercial absurdity", namely, that it is only to be reached in the "most obvious and extreme of cases" (at [45]). However, it seems a strange and unusual result to say that by cl 3.10 of the Third Deed, L&M would agree to provide Bathurst with a unilateral option indefinitely to defer payment of an accrued performance payment. The majority's point, made in relation to the implied term, that the performance payments were "performance-based" and that there was a "very distinct possibility that no development of a mine would occur and therefore no further payments would be made" (at [270]) does not appear to address the issue. Clause 3.10 of the Third Deed is predicated on a performance payment having fallen due. Whether it was at risk before then does not appear relevant. Instead, as the majority found, the expectation was that Bathurst would continue mining the relevant area. And given that the courts below and the minority found clearly tenable readings of cl 3.10 on the text, it seems a good case to prefer the less commercially surprising of the two constructions.

Practical points

- **Say what you mean**: The text used in a contract remains central. Parties should therefore seek legal assistance to ensure that the contract accurately reflects their agreement. In most cases, the parties should expect that the terms of the contract will be determinative of the dispute.
- **Negotiations**: Parties should be aware that the court may look at their pre-contractual negotiations in appropriate cases. However, there is unlikely to be significant benefit in attempting to shape the pre-contractual correspondence in a way that will influence the interpretation of the contract. Doing so is likely to detract from efficacy of the negotiations. The parties are best to focus on negotiating the terms of the contract as will best reflect what they have agreed.
- **Post-contract conduct**: One point of interest to emerge from *Bathurst* is that the Court was prepared to consider Bathurst's market statements, financial accounts, and annual reports when interpreting the Agreement, although that evidence was not given significant weight. Parties should therefore seek legal advice about any potentially significant liabilities to ensure that their external communications are consistent with the correct legal position. If a party unnecessarily admits a liability, that may count against it. On the other hand, it seems unlikely that a Court will place much (if any) weight on a party's unilateral denials of liability in any contexts similar to *Bathurst*.

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