INTERPRETATION OF CONTRACTS AND THE ADMISSIBILITY OF PRE-CONTRACTUAL NEGOTIATIONS

This essay examines the general rule that pre-contractual negotiations are not admissible in evidence when interpreting a contract. It does so in the light of Lord Hoffmann's recent restatement in *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896 of the principles that are applicable when seeking to interpret a contract. The scope of the general exclusionary rule is examined, as well as its rationale. Given the adoption by the modern courts of an approach to interpretation which seeks to give a commercially sensible construction to the clause in dispute, it is suggested that the justification for excluding pre-contractual negotiations from evidence appears suspect. They may in fact provide very good evidence of the issue which is at stake between the parties and, to that extent, should be admissible in evidence unless they relate to the subjective state of mind of the negotiating parties. However, caution must be exercised by judges in order to ensure that the evidence is relevant, reliable and does not add unduly to the cost of the litigation.

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1 In 1998, Lord Hoffmann purported to restate the rules or principles which are applicable to the interpretation of contracts. His speech in *Investors Compensation Scheme Ltd v West Bromwich Building Society*[1] must be the most widely-cited statement in modern English contract law.[2] The extent to which his restatement is applicable in Singapore is a question which is beyond the scope of this essay. Rather, my aim in writing this essay is to explore the impact of Lord Hoffmann's restatement on the admissibility of evidence of pre-contractual negotiations in cases concerned with the interpretation of contracts.[3] This is an issue which has recently been considered by the Court of Appeal of

1 [1998] 1 WLR 896 ("*Investors Compensation Scheme*").
2 Electronic sources show that the case has been cited well over 200 times in the last five years.
3 See generally Gerard McMeel, "Prior Negotiations and Subsequent Conduct – The Next Step Forward for Contractual Interpretation" (2003) 119 LQR 272.

Singapore in *MCST Plan No 1933 v Liang Huat Aluminium Ltd*[4] where the general rule which declares evidence of pre-contractual negotiations to be inadmissible was upheld, albeit by a majority. It has also been considered in recent years by the courts in New Zealand and England where divergent answers have been given to the question of the circumstances in which pre-contractual negotiations should be admissible in evidence. Before examining this issue in more detail, it is necessary to set the scene by considering the speech of Lord Hoffmann in *Investors Compensation Scheme* in rather more detail.

I. The *Investors Compensation Scheme* decision

2 The primary significance of the decision of the House of Lords in *Investors Compensation Scheme*[5] is to be found in the following passage from the speech of Lord Hoffmann. He stated:[6]

> … I think I should preface my explanation of my reasons with some general remarks about the principles by which contractual documents are nowadays construed. I do not think that the fundamental change which has overtaken this branch of the law, particularly as a result of the speeches of Lord Wilberforce in *Prenn v. Simmonds* [1971] 1 W.L.R. 1381 at 1384-1386 and *Reardon Smith Line Ltd. v. Yngvar Hansen-Tangen* [1976] 1 W.L.R. 989, is always sufficiently appreciated. The result has been, subject to one important exception, to assimilate the way in which such documents are interpreted by judges to the common sense principles by which any serious utterance would be interpreted in ordinary life. Almost all the old intellectual baggage of "legal" interpretation has been discarded. The principles may be summarised as follows.
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> (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.
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> (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

4 [2001] 3 SLR 253.
5 *Supra* n 1.
6 *Ibid* at 912–913.

> anything which would have affected the way in which the language of the document would have been understood by a reasonable man.
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> (3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.
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> (4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax: see *Mannai Investment Co. Ltd. v. Eagle Star Life Assurance Co. Ltd.* [1997] A.C. 749).
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> (5) The "rule" that words should be given their "natural and ordinary meaning" reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *Antaios Compania Naviera S.A. v. Salen Rederierna A.B.* [1985] A.C. 191, at 201:
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> > if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense.

3 The case itself concerned the proper interpretation of a badly-drafted claim form which required investors to assign to the Investors Compensation Scheme Ltd all of their rights arising out of the sale to them of some home income plans which had proved to be a disastrous investment. Crucially, the form excluded certain rights from the scope of the assignment and it was the proper interpretation of the phrase which excluded these rights that was the subject of dispute before the House of Lords. Lord Hoffmann, speaking for the majority, concluded that the phrase excluding "[a]ny claim (whether sounding in rescission for undue

influence or otherwise)" was actually used by the parties to mean "[a]ny claim sounding in rescission (whether for undue influence or otherwise)". In reaching this conclusion Lord Hoffmann acknowledged that he had not given the words their natural and ordinary meaning but sought to justify his decision on the ground that the parties had not used the words in their natural and ordinary sense. The court was therefore "engaged in [choosing] between competing unnatural meanings".[7]

4 Lord Lloyd dissented. He was of the opinion that the majority had gone too far. In his view, the construction adopted by the majority was not an available meaning of the words used by the parties. He stated that he knew of "no principle of construction" which enabled a court "to take words from within the brackets, where they are clearly intended to underline the width of 'any claim', and place them outside the brackets where they have the exact opposite effect".[8] In his opinion, the majority had crossed the line between purposive interpretation, which is legitimate, and creative interpretation, which is not.

II. The impact of Lord Hoffmann's restatement

5 Lord Hoffmann's restatement attracted some initial judicial hostility[9] but it is now regularly applied in the courts in England.[10] It has not necessarily led to a greater degree of predictability in the case law. Indeed, cases can be found recently in which the House of Lords has failed to reach agreement on issues of interpretation (and, indeed, have expressed their disagreement in robust terms).[11] Despite these difficulties in the application of the principles to the facts of particular cases, it can be said that Lord Hoffmann's restatement is now firmly established in the case law in England.

7 *Id* at 914.
8 *Id* at 904.
9 See, for example, *National Bank of Sharjah v Dellborg*, 9 July 1997, Court of Appeal, and *Scottish Power plc v Britoil (Exploration) Ltd*, *The Times* 2 December 1997.
10 See generally E McKendrick "The Interpretation of Contracts: Lord Hoffmann's Re-Statement" in *Commercial Law and Commercial Practice* (S Worthington ed) (Hart, 2003) p 139.
11 See, for example, *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749 where their Lordships were divided 3:2. In *Investors Compensation Scheme*, *supra* n 1; *Deutsche Genossenschaftsbank v Burnhope* [1995] 1 WLR 1580 and *Bank of Credit and Commerce International SA v Ali* [2002] 1 AC 251 they were divided 4:1. The latter case is particularly noteworthy because Lord Hoffmann was in a minority of one in a case concerned with the application of principles of interpretation which he himself had formulated.

6 The restatement has had a number of consequences. First, it has widened the range of materials to which the courts can have regard when seeking to interpret commercial contracts. The key concept here is the "matrix of fact" which is a frequently used if somewhat elusive concept.[12] Lord Hoffmann's second principle is stated in very broad terms and, while he subsequently attempted to clarify its scope,[13] its sphere of application remains broad. Second, it has enabled judges, in an appropriate case, to depart from the natural and ordinary meaning of the words used by the parties without having to resort to the remedy of rectification (which remedy is only available within narrow limits).[14] While Lord Hoffmann in his fourth and fifth principles urges the exercise of caution before a judge departs from the ordinary meaning of the words used by the parties, he expressly recognises that it is right and proper for a judge to depart from that meaning in a case where he is satisfied that the parties must have "used the wrong words or syntax".[15]

7 Third, Lord Hoffmann's restatement has been accompanied by the rise of a purposive approach to the interpretation of contractual documents which favours the adoption of a commercially sensible construction of contracts.[16] In some ways it is difficult to object to the latter approach because there is little virtue in the adoption of an approach which is lacking in commercial good sense. Nevertheless, the modern emphasis on the "commercial purpose" which the parties had in mind and on a "contextual" approach to interpretation is open to criticism in so far as it has generated a degree of uncertainty in the case law. This uncertainty is apparent at a number of points. For example, the extent to which the re-statement is applicable to contract clauses which have traditionally attracted restrictive rules of interpretation is presently

12 For criticism, see Sir Christopher Staughton, "How do the Courts Interpret Commercial Contracts?" [1999] CLJ 303.

13 *Bank of Credit and Commerce International SA v Ali*, *supra* n 11. The qualification which he added was that he meant "anything which a reasonable man would have regarded as *relevant*". However the qualification does little to cut down the width of the matrix of fact.

14 The relationship between interpretation and rectification is discussed in more detail at para 41 of the main text below.

15 *Investors Compensation Scheme* itself would appear to be a case in this category: see *supra* n 7.

16 See, for example, *Deutsche Genossenschaftsbank v Burnhope*, *supra* n 11, at 1589; *Lord Napier and Ettrick v R F Kershaw Ltd* [1999] 1 WLR 756 at 763; *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd*, *supra* n 11, at 770 and *Total Gas Marketing Ltd v Arco British Ltd* [1998] 2 Lloyd's Rep 209 at 221 and more generally Gerard McMeel, "The Rise of Commercial Construction in Contract Law" [1998] LMCLQ 382.

unclear.[17] Further, some judges have struggled to find the dividing line between a purposive interpretation and a creative interpretation.[18] At what point does the adoption of a "commercial construction" stray into impermissible territory and constitute the re-writing of the contract? Cases can be found in which the courts have been prepared to make allowances for the "vicissitudes of drafting"[19] but the suspicion is that some judges are more willing than others to make allowances for the deficiencies in the parties' drafting.[20] A related point is the question whether or not the courts can depart from the natural and ordinary meaning of the words even in the case where there is no ambiguity in the words which the parties have used. The traditional position was that it was only in cases of ambiguity that a judge could have regard to the surrounding circumstances for the purpose of adopting a meaning other than the natural and ordinary meaning of the words used.[21] Post-*Investors Compensation Scheme* it is clear that this limitation is no longer applicable and that the courts can take account of the surrounding circumstances even in the case where there is no ambiguity in the terms of the contract.[22] However the willingness of the courts to have regard to the surrounding circumstances does seem to vary. In particular, where the parties draw up a formal document, such as a trust deed, the courts seem to be reluctant to adopt a meaning other than the natural and ordinary meaning of the words which the parties have used.[23] The aim of this paper is not, however, to resolve these uncertainties. Its aim is much narrower, namely to focus on the third of Lord Hoffmann's principles.

8 Lord Hoffmann's third principle recognises that the "factual matrix" has its limits in that it excludes pre-contractual negotiations from evidence. At the same time he notes that the exceptions to the rule are "in

17 Contrasting views have been expressed in the case law. Support for the abolition of artificial rules of interpretation can be found expressly in *Bank of Credit and Commerce International SA v Ali*, *supra* n 11, at [62] and implicitly in *British Fermentation Products Limited v Compair Reavell Limited* [1999] BLR 352. A more restrictive approach was, however, apparent in the speeches of their Lordships in *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] 2 Lloyd's Rep 61 at [11].

18 See, for example, *Sinochem International Oil (London) Co Ltd v Mobil Sales and Supply Corporation* [2000] 1 Lloyd's Rep 339 at 340.

19 *Id* at 345.

20 The divergence of judicial view can be seen in *Investors Compensation Scheme*, *supra* n 1, itself where Lord Hoffmann adopted a more liberal approach than that adopted by Lord Lloyd.

21 See, for example, *National Bank of Sharjah v Dellborg*, *supra* n 9 .

22 *R (Westminster City Council) v National Asylum Support Service* [2002] 1 WLR 2956 at [5].

23 *Breadner v Granville-Grossman* [2001] Ch 523 at [36].

some respects unclear". The issue of the admissibility of pre-contractual negotiations has arisen in a number of post-*Investors Compensation Scheme* cases and the courts have, in general, affirmed the general exclusionary rule.[24] Rather than draw upon English cases in order to demonstrate continued adherence to the exclusionary rule, attention will be given to cases from other common law jurisdictions. First, consideration will be given to the decision of the Court of Appeal of Singapore in *MCST Plan No 1933 v Liang Huat Aluminium Ltd*[25] where, as has been noted, the court affirmed the continued existence of the general exclusionary rule. We shall then travel south to New Zealand where Thomas J in the Court of Appeal in *Yoshimoto v Canterbury Golf International Ltd*[26] sought to introduce some flexibility into the exclusionary rule. Our final destination is, however, the Privy Council in London[27] where the general exclusionary rule was held, at least for now, to have survived the challenge of Thomas J.

III. The decision of the Court of Appeal of Singapore

9 *MCST Plan No 1933 v Liang Huat Aluminium Ltd* was a case concerned with the proper interpretation of a deed headed "INDEMNITY FOR ALUMINIUM & GLAZING WORKS." The defendant, Liang Huat Aluminium Ltd ("LHA"), was a subcontractor on a building project. It was responsible for the design, supply and installation of aluminium windows. The employer, Hong Leong Holdings Ltd ("HL"), required LHA and the contractor, Comtech Corporation Pte Ltd ("Comtech"), to give certain undertakings by deed in relation to making good any defects in the work done. The relevant clauses in the deed were cll 2, 3 and 4 which provided:

24 See, for example, *Stroude v Beazer Homes Ltd* [2005] EWCA Civ 265; [2005] All ER (D) 298 (Mar); *ProForce Recruit Ltd v The Rugby Group Ltd* [2005] EWHC 70 (QB); [2005] All ER (D) 22 (Feb); *John v Price Waterhouse,* 24 June 2002, Court of Appeal; *Aqua Design and Play International Ltd v Kier Regional Ltd*, [2003] BLR 111; *Jones v Forest Fencing Ltd*, 20 November 2001, Court of Appeal; *Bank of Credit and Commerce International SA v Ali*, *supra* n 11, at [31]; *P & O Overseas Holdings Ltd v Rhys Braintree Ltd,* 5 July 2001, Chancery Division; *Champion v Workman,* 20 July 2001, Chancery Division; *John v Price Waterhouse,* 11 April 2001, Chancery Division; *Sloggett and Perry Ltd v Stroud,* 25 May 2000, Court of Appeal; *Nella v Nella*, 23 July 1999, Chancery Division, *Inland Revenue Commissioners v Botnar* [1999] STC 711; (1999) 72 TC 205.

25 *Supra* n 4.

26 [2001] 1 NZLR 523.

27 [2004] 1 NZLR 1.

> 2. In the event of any deterioration or defects (as shall be determined by the Employer) in the workmanship, quality of materials, installation, watertightness or deterioration appearing in the Works, the Contractor shall forthwith upon notice given to either of them and within such time as the Employer may direct, effect remedial works to the defective area or areas and shall make good to the absolute satisfaction of the Employer all damages to surface finishes including but not limited to plaster, panelling, tiling and other similar works, mechanical, electrical or other installations or other property arising directly or indirectly out of the said defects.
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> 3. In the event that remedial works undertaken by the Contractor or the Sub-Contractor prove ineffective as determined by the Employer whose decision shall be final and conclusive, or are not to the satisfaction of the Employer, the Contractor and the Sub-Contractor shall effect such additional works in such a manner and within such time as the Employer may direct and shall carry out all test, as directed by the Employer until all the defects have been remedied to the absolute satisfaction of the Employer.
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> 4. Should the Contractor or the Sub-Contractor fail to perform their obligations under Clause 2 and 3 above within the time directed by the Employer or in the absence of such direction, within a reasonable period, the Employer shall [*sic*] entitled to remedy the said defects and the Contractor and the Sub-Contractor shall forthwith on demand reimburse the Employer all costs and expenses incurred by the Employer for making good the said defects including all legal costs on a Solicitor and Client basis incurred by the Employer in enforcing this Clause.

10 HL assigned all its interests, rights and benefits under the deed to the plaintiff, the Management Corporation Strata Title Plan No 1933 ("the MC"). When defects in the works materialised, the MC demanded that LHA carry out the necessary remedial works.[28] LHA failed to do so and so the MC brought a claim for damages for breach of contract arising out of the failure of LHA to effect the necessary repairs. LHA defended the claim on the ground that the MC's claim was not one for damages for breach of contract but was a claim for an indemnity pursuant to cl 4 of the deed and that any such claim was doomed to failure on the ground that the MC had not made good the defects itself or expended any money in making them good prior to bringing the claim.

28 A claim was initially made against Comtech but it was not pursued as Comtech went into liquidation before trial.

11 In essence, the dispute between the parties turned on the true nature of the obligations to be found in cll 2 to 4 of the deed. LHA claimed that the deed was in the nature of an indemnity so that the MC was only entitled to make a claim under cl 4 when the MC itself had expended money in making good the defects; in other words, the claim was one to be indemnified in respect of costs and expenses actually incurred. The MC, on the other hand, claimed that it had been given a warranty by LHA in relation to the quality of the workmanship and the materials used and that its right to recover under the deed was not subject to a requirement that it expend money before bringing a claim against LHA.

12 The judge at first instance found for LHA. While he held that there were defects in the works which LHA was liable to make good, he held that the deed was in the nature of an indemnity so that the MC's right against LHA was confined to claiming reimbursement for the costs and expenses incurred by the MC in making good the defects. The MC appealed to the Court of Appeal and, by a majority, the appeal was allowed.

13 The majority, L P Thean JA and Lai Kew Chai J, accepted that, when interpreting the deed, the court should seek to "place itself in thought in the same factual matrix as that in which the parties were"[29] at the time that the deed was executed. The background factors to which the majority had regard consisted of the following:[30]

(a) HL had engaged the main contractor, Comtech;

(b) LHA was engaged as a subcontractor by Comtech to carry out the design, supply and installation of the aluminium windows and glazing works;

(c) HL required certain undertakings from Comtech and LHA as to making good of any defects in the works and it required that LHA be joined as a party to these undertakings; and

29 *Supra* n 4, at [8] of the majority judgment. This quotation is in fact taken from the speech of Lord Wilberforce in *Reardon Smith Line Ltd v Hansen-Tangen* [1976] 1 WLR 989 at 997.

30 *Supra* n 4, at [9] of the majority judgment.

(d) the parties negotiated and eventually the deed was prepared and agreed to by the parties and was executed by Comtech and LHA in favour of HL.

14 Interpreting the deed by reference to this factual matrix, the majority concluded that cll 2 and 3 required Comtech and LHA to carry out remedial works in certain circumstances and that a breach of either of these clauses gave rise to an action for damages at law.[31] Further they held that cl 4 entitled the MC to "step in to remedy the defects and thereafter to be reimbursed by Comtech and/or Liang Huat in respect of all costs and expenses incurred in remedying such defects".[32] Finally they held that cl 4 did not take away the right which the MC had at law to sue for damages for breach of contract. Clear words are needed in order to take away a right to claim damages[33] and it was held that there were no such clear words to be found in cl 4. The MC was therefore entitled to recover damages from LHA and that right was not subject to a requirement that it first expend money in making good the defects in the works.

15 Chao Hick Tin JA dissented. He held that the deed was in the nature of an indemnity. In his view, cll 2 and 3 did not create warranties in favour of HL and the MC. Rather, the function of these clauses was to set out the "steps to be followed"[34] in order to obtain the indemnity provided for in cl 4. This being the case, the entitlement of the MC to recover from LHA was dependent upon the MC first expending money to carry out the necessary repair work. Not having incurred any expenditure, the MC could not be said to have suffered any loss and therefore it was not entitled to recover an indemnity from LHA pursuant to cl 4.

16 This difference in approach to the interpretation of cll 2 to 4 of the deed is primarily of significance for the parties to this particular deed. Cases concerned with the interpretation of contracts have little weight in terms of precedent value[35] unless the contract term in dispute is in standard form which is widely used in industry. Of greater significance is the difference in approach to the admissibility in evidence of the pre-contractual negotiations between the parties. The majority excluded from consideration the pre-contractual negotiations and a warranty submitted by Comtech and LHA which was rejected by HL. Relying upon the speech

31 *Id* at [17] of the majority judgment.
32 *Id* at [19] of the majority judgment.
33 See, for example, *Pearce and High Ltd v Baxter* [1999] BLR 101.
34 *Supra* n 4, at [34] of the dissenting judgment.
35 *Surrey Heath Borough Council v Lovell Construction Ltd* (1990) 48 BLR 113 at 118.

of Lord Wilberforce in *Prenn v Simmonds*[36] and an earlier decision of the Court of Appeal of Singapore in *Pacific Century Regional Development Ltd v Canadian Imperial Investment Pte Ltd*,[37] they concluded that "these matters may be the objective facts in the sense that they had actually happened and were not disputed, but they were evidence of the subjective intentions of the parties prior to the execution of the Deed"[38] and were consequently not admissible in evidence. Chao JA, by contrast, adopted a broader approach to the identification of the "factual matrix". In his view, "while evidence on pre-contract negotiations and subjective intention do not constitute factual matrix and should be disregarded, objective facts which indicate the 'aim' of the transaction are admissible on the construction of the final document".[39] He then referred to "some of the background facts leading to the execution of the Deed in this form"[40] which included discussions between the parties prior to the execution of the deed and the terms of an earlier warranty submitted by Comtech and LHA to HL and which was rejected by HL. In his view, this evidence demonstrated that the objective aim or purpose of the parties in relation to the eventual transaction was to provide HL with an indemnity and not a warranty. On this basis he would have dismissed the appeal and held that the MC was not entitled to recover damages for breach of contract from LHA.

17 Two points should be noted about this difference of view before we move on to consider our next case. The first is that Chao Hick Tin JA stated that he would have reached the same conclusion even if he had ignored the evidence of the earlier warranty.[41] Thus it would be going too far to conclude that the admissibility of the previous draft was the crucial issue in the resolution of the case. But, while it was not decisive, it did appear to be an influential factor. Second, Chao JA sought to modify the general exclusionary rule; he did not attempt to abrogate it entirely. The previous draft was admissible in evidence only in so far as it shed light on the "aim" of the transaction, namely that it was to provide a warranty and not an indemnity. He expressly recognised that evidence of the parties' subjective intentions was not admissible. Thus he was attempting to carve out from the general rule, that evidence of pre-contractual negotiations is inadmissible, an exception to the effect that previous drafts can be

36 [1971] 3 All ER 237 at 241.
37 [2001] 2 SLR 443.
38 *Supra* n 4, at [10] of the majority judgment.
39 *Id* at [14] of the dissenting judgment.
40 *Id* at [16] of the dissenting judgment.
41 *Id* at [35] of the dissenting judgment.

admitted in evidence provided that the evidence demonstrates the "aim" or the purpose of the transaction entered into between the parties. This exception did not, however, command the support of the majority.

IV. The Court of Appeal of New Zealand

18 We now turn to consider the decision of the Court of Appeal of New Zealand in *Yoshimoto v Canterbury Golf International Ltd*.[42] The main issue at stake in the litigation was the price payable under an agreement to buy shares in a company whose principal activity was the development of a piece of land into a golf course. The two parties were the vendor, Mr Yoshimoto, and the purchaser, Canterbury Golf International ("CGI"). The base purchase price was NZ$2m. In addition, two further payments of NZ$1m and NZ$400,000 would become payable on the happening of specified events. The issue which divided the parties was whether or not CGI was liable to pay the additional NZ$1m.[43]

19 The operative provision of the contract (cl 6.3) specified that the NZ$1m would only be payable by CGI if CGI obtained "all necessary authorisations or resource consents to the Development within 12 months of the date of this agreement". As Thomas J observed, this provision, on its face, was a "recipe for disaster"[44] as far as Mr Yoshimoto was concerned because it gave to CGI a considerable financial incentive not to obtain the consents within the stipulated period. In the event, CGI failed to obtain one resource consent until five months after the expiry of the 12-month period. Mr Yoshimoto nevertheless claimed that he was entitled to be paid the additional NZ$1m. CGI denied that it was liable to make the payment.

20 At first instance, Panckhurst J held that Mr Yoshimoto was not entitled to be paid the additional NZ$1m because the requirements of cl 6.3 had not been satisfied. He concluded that the resource consent which had not been obtained was "necessary" within the meaning of cl 6.3 so that the condition precedent to the entitlement to the additional payment had not been satisfied. Mr Yoshimoto appealed to the New Zealand Court of Appeal which allowed his appeal.

42 *Supra* n 26 ("*Yoshimoto*").
43 The NZ$2m base payment had already been made and the liability to pay the NZ$400,000 had not accrued.
44 *Supra* n 26, at [13].

21 The consent which had not been obtained within the 12-month period was a consent which, essentially, related to a right of access to the site. It is not necessary for present purposes to enter into the details of the particular resource consent. It suffices to note the perception of Thomas J that the "consent under the proposed plan was pretty much a formality".[45] He therefore concluded that the resource consent was not "necessary" in terms of the requirements of cl 6.3. In reaching this conclusion Thomas J had regard to the contractual context, the commercial objective of the contract and the broader factual matrix. Having had regard to these matters, he concluded that the meaning of the word "necessary" in cl 6.3 emerged "securely enough".[46] Doogue and Salmon JJ agreed with the conclusion that the consent was not "necessary".[47] In reaching this conclusion the Court of Appeal declined to adopt a literal interpretation of cl 6.3. Thus Doogue J conceded that the consent was "technically necessary" but nevertheless concluded that "in substantive terms" the necessary consent had been achieved in time to render the NZ$1m payable.[48]

22 The significance of *Yoshimoto* does not, however, lie in the fact that the New Zealand Court of Appeal declined to adopt a literal approach to the interpretation of cl 6.3. Many cases can be found in which the courts have refused to apply, or have even derided, a literal approach to the interpretation of contractual documents.[49] Rather, its significance lies in the willingness of Thomas J to have regard to extrinsic evidence, and in particular, evidence of pre-contractual negotiations, for the purpose of supporting the conclusion which he had reached on the proper interpretation of cl 6.3. Thus on the facts, the extrinsic evidence appeared to play a confirmatory role. But the novelty of the case lies in the expansive view which Thomas J adopted of the material to which he could legitimately have regard in the interpretative process. This expansive approach was not endorsed by Doogue and Salmon JJ. Thus Doogue J expressly reserved his opinion on the relevance of pre-contractual negotiations,[50] while Salmon J did not mention the issue at all.

45 *Id* at [29].
46 *Id* at [48].
47 *Id* at [101]–[103] and [107]–[108].
48 *Id* at [102].
49 A recent example is provided by *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd* [2004] 1 WLR 3251 at [19] *per* Lord Steyn.
50 *Supra* n 26, at [99].

23 Thomas J stated that he was "fully aware of the problems associated with evidence of the parties' precontractual negotiations".[51] He noted that such evidence "may not be unequivocal" and he excluded from the process "evidence of the parties' subjective intention".[52] But he did have regard to "the earlier draft contracts, the changes made to cl 6.3, and an earlier recital relevant to that clause".[53] Up until the very meeting at which the contract was finally signed, when the briefer version of cl 6.3 was substituted by handwritten amendment, there had been a much longer version of cl 6.3 that set out much more fully the circumstances in which the NZ$1m was to become payable. These prior drafts, together with the relevant recitals, confirmed his opinion that the only consents that were thought to be necessary were those presently applied for.

24 Having had regard to the prior drafts which had passed between the parties, Thomas J then turned to consider the legal rule relating to the admissibility in evidence of pre-contractual negotiations. He noted that the rule excluding evidence of pre-contractual negotiations was "seemingly absolute"[54] and formulated the policy underlying the rule in the following way:[55]

> The rule that evidence of the precontractual negotiations of the parties or their subsequent conduct cannot be used in aid of the construction of a written contract follows from the primary rule that the task of the Court is simply to ascertain the meaning of the language of the contract.

25 Thomas J did not attempt to abrogate this rule entirely. Rather, his aim was to introduce a degree of flexibility into the rule so as to permit a departure from it "where a departure would enable the Court to arrive at a meaning of the contract which accords with the ascertainable intention of the parties".[56] The factors which, in his view, justified a departure from the general rule on the present facts were as follows:

> (a) the literal meaning of cl 6.3 could not be adopted and, "[o]nce a departure from the literal meaning of the words is necessary, it cannot be said with security that the clause has a plain and obvious meaning and that the Court's task of

51 *Id* at [49].
52 *Ibid.*
53 *Ibid.*
54 *Id* at [69].
55 *Id* at [60].
56 *Id* at [69].

> interpreting the meaning of the clause would not be assisted by reference to such reliable extrinsic evidence as is available";[57]
>
> (b) the "substance of the forerunners of cl. 6.3 was not contested";[58] and
>
> (c) the earlier drafts did not "represent declarations of the parties' subjective intentions" but rather were the "expression of a common assumption as to which consents were 'necessary' to discharge the condition precedent".[59]

26 This list should not be seen as a closed list. The aim is to introduce a degree of flexibility into the law and so the list must be seen as indicative rather than definitive. Thomas J emphasised the need to proceed with "caution" and to ensure, as far as possible, that the evidence admitted was "reliable".[60] Thus documentary evidence (for example, a prior draft) is more likely to be reliable than oral evidence. This is not to say that oral evidence should never be admissible. But it seems clear that Thomas J would approach such evidence with considerable caution.

27 The "preference" of Thomas J was therefore to receive evidence of the previous drafts of cl 6.3 because that evidence was sufficiently reliable: it served "to put beyond serious argument the indications already evidenced in the contract and the contractual matrix that the parties intended the necessary consents on which the further payment depended to be those consents which had been applied for and which were in train".[61] However, he noted that the Court of Appeal was not (at that point) the final court of appeal in New Zealand and that there was a right of appeal to the Privy Council in London. Further, he noted the more conservative approach adopted towards the interpretation of contracts in England. In the light of this he concluded that:[62]

> [I]t would be foolhardy to ignore the clear tenor of the decisions of the English Courts to press for a plain meaning, even in the face of controversy, and to attribute an intention to the parties which they may not have had and which may, indeed, be contrary to their actual intention. For the moment, therefore, this Court must accept that, until

57 *Id* at [70].
58 *Ibid*.
59 *Ibid.*
60 *Id* at [77].
61 *Id* at [83].
62 *Id* at [95].

> the rule is reviewed by the Privy Council (or, possibly, the House of Lords) the extrinsic evidence relating to the draft agreement must be disregarded as part of the negotiations. The cautious flexibility in the application of the rule which would seem sensible to ensure effect is given to the reasonable expectations of commercial men or women is lacking. This Court must therefore be [content] with its earlier finding that, having regard to the context of the clause, the commercial objective of the provision, and the contractual matrix a resource consent under the proposed plan does not come within the purview of cl 6.3.

V. The Privy Council

28 The pessimism of Thomas J was shown to be justified when the Privy Council advised Her Majesty to allow the appeal from the decision of the Court of Appeal.[63] Lord Hoffmann, delivering the advice of the Privy Council, paid closer attention to the strict wording of cl 6.3 than did the Court of Appeal of New Zealand. The key word in cl 6.3 was the word "necessary". In agreement with Panckhurst J at first instance, Lord Hoffmann pointed out that "the resource consent under the proposed plan was a necessary consent because an essential part of the development could not lawfully proceed without it".[64] The Court of Appeal attached considerable significance to the fact that the consent was very likely to be obtained but, as Lord Hoffmann pointed out, "the fact that a consent is very likely to be obtained cannot affect the question of whether it is necessary".[65] The word used in cl 6.3 was "obtains" and the Court of Appeal had read it as if it had said "is very likely to obtain". The obvious difficulty with the approach of the Court of Appeal was that they had read into the clause words which were not there.

29 In respect of the evidence of pre-contractual negotiations, the Privy Council declined to take the bait offered by Thomas J and simply said:[66]

> Their Lordships do not think that this is a suitable occasion for re-examining the law because they consider that in this case the evidence is, as Lord Wilberforce predicted [in *Prenn v Simmonds*], unhelpful.

63 *Supra* n 27.
64 *Ibid* at [15].
65 *Id* at [20].
66 *Id* at [25].

30 To take the earlier version of cl 6.3 as an example, Lord Hoffmann stated that it was "unhelpful" because "it was dropped and the present cl 6.3 substituted."[67] He refused to speculate upon the reasons which led to the change and stated that:[68]

> No doubt each party had their reasons for proposing it on the one hand and accepting it on the other. All a Court can do is to decide what the final contract means.

31 Accordingly, the Privy Council did not place any weight on the pre-contractual negotiations. They held that the consent under the proposed plan was indeed "necessary" and, as it had not been obtained within the 12-month period required by cl 6.3, that the NZ$1m was not payable.

VI. The rationale for the general exclusionary rule

32 Why did the Court of Appeal of Singapore and the Privy Council affirm the continued existence of the general rule which declares pre-contractual negotiations to be inadmissible in evidence? A number of possible reasons can be given in support of the general rule.

33 The first is that the test to be applied when seeking to ascertain the existence of a contract and the meaning of its terms is an objective one, not subjective.[69] Thus, in so far as a party seeks to refer to pre-contractual negotiations for the purpose of showing that he or she attached a particular meaning to a contract term, the court will declare such evidence to be inadmissible. The law does not wish to give incentives to parties to make self-serving statements in the course of negotiations and then produce them in evidence when a dispute breaks out in relation to the meaning of a particular term of the contract. This argument does not, however, support the exclusionary rule in its present form: in particular, it does not justify the exclusion of previous drafts. Previous drafts exist in an objective form and cannot be attributed to the subjective intention of one or other party. It is thus necessary to

67 *Id* at [28].
68 *Ibid.*
69 See, for example, *Smith v Hughes* (1871) LR 6 QB 597 at 607 and the first of Lord Hoffmann's five principles in *Investors Compensation Scheme* (see para 2 of the main text above). See also Lord Steyn "Contract Law: Fulfilling the Reasonable Expectations of Honest Men" (1997) 113 LQR 433. This is in contrast to the approach which prevails in some civilian legal systems where the test applied is a subjective one.

distinguish between previous drafts and declarations of subjective intent, a point which Lord Hoffmann recognised in *Investors Compensation Scheme*.[70] In so far as the rule operates to exclude evidence to the effect that "this is what I thought the contract meant" it can be supported and it should be noted that attempts to modify the general exclusionary rule have not taken the form of an attack on the objective principle as it currently operates in common law systems. Thus both Chao JA[71] and Thomas J[72] expressly affirmed that evidence of the parties' subjective intentions should remain inadmissible. But the rule in its present form goes much further than excluding statements of subjective intent and, to the extent that it does, the justification for the rule must be sought elsewhere.

34 Secondly, the general exclusionary rule has been supported on the ground that evidence of pre-contractual negotiations is not "helpful" because the parties' positions are constantly changing prior to the conclusion of the contract and it is only the final document which records the agreement which the parties actually made. Further, the court should not be asked to speculate on the reasons which led the parties to depart from the text of a previous draft. The task of the court is to ascertain the meaning of the contract, not to give meaning to the process that led up to the formation of the contract. These were in essence the arguments put forward by Lord Wilberforce in *Prenn v Simmonds*[73] and affirmed by Lord Hoffmann in *Yoshimoto.* While these arguments have force, they are not conclusive. In the first place, the proposition that the evidence is "unhelpful" does not lead inevitably to the conclusion that it should be inadmissible. Rather, it suggests that the evidence is unlikely to weigh heavily in the scales but that is a proposition which appears to relate to the weight of the evidence rather than its admissibility. Secondly, a judge can only conclude that the evidence is "unhelpful" once he or she has first had a look at it. Thus Lord Hoffmann could only conclude that the evidence in *Yoshimoto* was "unhelpful" after he had examined the previous drafts and the recital which had been deleted. Given that he had actually looked at the evidence, why then declare it to be inadmissible? Would it not have been more sensible to conclude that the evidence was admissible but that, on the facts, little weight should be attached to it? A

70 *Supra* n 1, at 913. He stated that the "law excludes from the admissible background the previous negotiations of the parties *and* their declarations of subjective intent" [emphasis added].
71 *Supra* n 4, at [14] of the dissenting judgment.
72 *Supra* n 26, at [49] and [76].
73 *Supra* n 36.

further problem with the proposition that evidence of pre-contractual negotiations should be excluded because it is "unhelpful" is that it encounters difficulty in the (possibly rare) case where the parties submit that the evidence is "helpful" because, for example, it demonstrates that the parties attached a particular meaning to the word or phrase which is in dispute.[74] Thus the proposition that pre-contractual negotiations should be excluded on the ground of their "unhelpfulness" seems to be too sweeping because there are likely to be cases where such evidence will prove to be helpful. Of course it can be argued that the benefits obtained in the rare case where evidence of pre-contractual negotiations is likely to be helpful are heavily outweighed by the costs incurred in the vast majority of cases where the evidence is likely to be of little or no use. But that is an objection which relates to the cost of admitting such evidence and it is to such an objection to which we now turn.

35 The third justification which can be advanced in support of the general exclusionary rule relates to the cost of admitting such evidence in court proceedings. This argument has not been explicitly advanced by judges in support of the rule declaring evidence of pre-contractual negotiations to be inadmissible but it has underpinned some of the concerns initially expressed about Lord Hoffmann's restatement in *Investors Compensation Scheme*.[75] However, these initial concerns have proved to be largely unfounded[76] and, in any event, the problem, in so far as it exists, can be addressed by the effective exercise by the judge of the case management powers contained in the Civil Procedure Rules and, in an appropriate case, the award of costs.[77] But the high cost of litigation in England may in fact go some way towards explaining why pre-contractual negotiations are generally inadmissible in England but are generally admissible in civilian legal systems. The cost of litigation in England is extremely high and one response to the high cost of litigation is to seek to restrict the range of evidence that is admissible in civil proceedings and which lawyers are required to collect and retain. The need for such a rule is not, however, so obvious in civilian jurisdictions where the cost of

74 Evidence of pre-contractual negotiations is, in fact, likely to be admissible in such a case: see *The Karen Oltmann* [1976] 2 Lloyd's Rep 708.

75 See, for example, *National Bank of Sharjah v Dellborg*, *supra* n 9 and *Scottish Power plc v Britoil (Exploration) Ltd*, *supra* n 9.

76 *Static Control Components (Europe) Ltd v Egan* [2004] 2 Lloyd's Rep 429 at [29] *per* Arden LJ.

77 See, for example, *NLA Group Ltd v Bowers* [1999] 1 Lloyd's Rep 109 at 113 where Timothy Walker J concluded that there was a "basis for ordering indemnity costs" although he in fact ordered that the plaintiff pay half of the defendant's costs at the hearing before him on an indemnity basis.

litigation is not so prohibitive. Once again the objection does not justify the total exclusion of evidence of pre-contractual negotiations. Rather it encourages the use by judges of their case management powers under the Civil Procedure Rules. In this respect it is important to note that neither Chao JA nor Thomas J advocated the total abolition of the general rule. Rather, their aim was to introduce a greater degree of flexibility into the law while, at the same time, emphasising the need for caution in order to ensure that steps are taken, as far as possible, to ensure that the evidence admitted is both reliable and helpful. Thus, provided the judges approach the matter with caution, it is suggested that it is unlikely that a relaxation of the rule prohibiting reliance upon pre-contractual negotiations in evidence will add significantly to the cost of litigation in common law systems.

36 The fourth objection is that contracting parties may prefer the certainty of the present exclusionary rule to the uncertainties inherent in a more liberal regime. This is a difficult argument to evaluate, largely because of the lack of empirical evidence as to the preferences of contracting parties. Some support for the claim that contracting parties may not prefer a more liberal regime can be gleaned from the prevalence of entire agreement clauses in modern commercial contracts. In *ProForce Recruit Ltd v The Rugby Group Ltd*[78] the entire agreement clause provided as follows:

> This Agreement together with any other document expressed to being operated herein constitutes the entire contract between the parties and supersedes all prior representations, agreements, negotiations or understandings whether oral or in writing.

37 Field J held that the effect of this clause was to preclude a contracting party from relying on an oral statement alleged to have been made during the negotiations and which had not been included in the written contract concluded between the parties. What inference should we draw from the presence of entire agreement clauses in modern commercial contracts? This is not an easy question to answer. On the one hand, they could be used to demonstrate that commercial parties (or their lawyers) wish to confine the attention of the court to the final written agreement and that the law ought to maintain the rule that pre-contractual negotiations are inadmissible in evidence. On the other hand, it can be said that entire agreement clauses have become commonplace

78 [2005] EWHC 70 (QB); [2005] All ER (D) 22 (Feb).

precisely because the law has adopted a more liberal approach to the admissibility of evidence in contractual disputes. On this basis it can be argued that the underlying legal regime ought to be a liberal one, with liberty being given to contracting parties to contract out of this more liberal regime by the incorporation into the contract of an appropriately drafted entire agreement clause. It is certainly the case that the trend in the modern law of contract has been in the direction of the relaxation of the parol evidence rule.[79] This being the case, it is suggested that the default rule should be a liberal one subject to the entitlement of the contracting parties to contract into a more restrictive regime by the inclusion of an entire agreement clause in the contract. The presence of entire agreement clauses in modern commercial contracts should not therefore prevent further liberalisation of the rules relating to the admissibility of evidence in contractual disputes.

38 Finally, it can be argued that the admission of pre-contractual negotiations may operate to the detriment of third parties who rely on the final written contract, unaware of the content of the prior negotiations which took place between the contracting parties. Both the courts[80] and commentators[81] have expressed concern about the plight of third parties in the light of Lord Hoffmann's restatement. The concern to protect the position of third parties is a legitimate one but it should not be allowed to trump the interests of the contracting parties themselves. As Thomas J observed in *Yoshimoto*, "[w]hy third parties may be thought to be entitled to hold the parties who are privy to the contract to a meaning which is not their meaning is difficult to see".[82] The protection of the interests of third parties does not demand the exclusion from evidence of pre-contractual negotiations; at most it demands that care be taken when assessing the weight to be given to such evidence.

39 Thus it can be said that the arguments advanced in favour of the general exclusionary rule are not wholly convincing. The arguments certainly support the need for caution and they emphasise the importance of taking steps to ensure that any evidence admitted is reliable but they do not support a blanket rule to the effect that evidence of pre-contractual negotiations should be inadmissible.

79 See generally UK Law Commission, *Law of Contract: The Parol Evidence Rule* (Law Com No 154, 1986).

80 *National Bank of Sharjah v Dellborg*, *supra* n 9.

81 See Elizabeth Macdonald "Developing *Investors*: Previous Decisions, Third Parties and Contract Interpretation" (2003) 2 Journal of Obligations and Remedies 87.

82 *Supra* n 26, at[81].

VII. The exceptions to the general rule

40 In any event the rule which declares evidence of pre-contractual negotiations to be inadmissible is not absolute. The rule does admit of exceptions, as Lord Hoffmann recognised in *Investors Compensation Scheme*, and the scope of these exceptions is, in some respects, unclear.[83]

41 One exception to the rule is, however, clear and that is the rule that evidence of pre-contractual negotiations is admissible in an action for rectification. Rectification is a remedy which is concerned with defects, not in the making, but in the recording of a contract.[84] Thus it is a process whereby a document, the meaning of which has already been ascertained, is rectified so that it gives effect to the intention of the parties. In this context the good sense behind the exception to the general rule is evident. In so far as the rectification claim is one that the final document has failed accurately to record the agreement which the parties made, it is sensible to entitle the courts to examine the previous drafts which have passed between the parties with a view to discovering whether or not a mistake has been made in the recording of the agreement. This exception is of some importance in practice because one of the reasons sometimes given for pleading rectification is to render evidence of pre-contractual negotiations admissible. Of course this can only be done where there is a plausible basis for seeking rectification and, where such a claim is made, the pre-contractual negotiations are only admissible in the rectification proceedings. The judge should therefore disregard such evidence when considering any later submissions made by the parties on the proper interpretation of the contract.[85] However, the party asking for rectification doubtless hopes that the pre-contractual negotiations, once admitted into evidence, will influence the judge in reaching his or her conclusion on the proper interpretation of the contract, even though, for obvious reasons, no express reliance is placed by the judge on these negotiations when seeking to interpret the contract. The law should not encourage this form of subterfuge. Further, it can be argued that the case for distinguishing in this way between rectification and interpretation is weak given that the distinction between the two is not as bright as it once was. In particular, Lord Hoffmann's fourth and fifth principles in *Investors Compensation Scheme* give to the courts greater freedom to

83 The exceptions, particularly in a statutory context, are discussed further by Chan Leng Sun "Resolving Ambiguity Through Extrinsic Evidence" (2005) 17 SAcLJ 277 at paras 62–69.

84 *Frederick E Rose (London) Ld v William H Pim Jnr & Co Ld* [1953] 2 QB 450.

85 *Arrale v Costain Civil Engineering Ltd* [1976] 1 Lloyd's Rep 98.

"rectify" the contract under the guise of interpretation. A judge who concludes that the parties have used the wrong words or syntax is no longer required to attribute to the parties an intention which they did not have. Nor is it necessary for him or her to resort to rectification in order to give effect to the agreement which the parties in fact made. Instead the judge can conclude that something has "gone wrong with the language" and adopt, as a matter of interpretation, a meaning which gives effect to the parties' intention, even if that meaning is difficult, if not impossible, to reconcile with the ordinary meaning of the words which the parties have actually used. In future cases, there may be less need for parties to resort to rectification because the judge may be able to perform the necessary surgery using Lord Hoffmann's principles. In this new environment, is it sensible to maintain the traditional rule that pre-contractual negotiations are admissible in the rectification stage of the proceedings but not when seeking to interpret the contract? In raising this question, the aim is not to suggest that rectification and interpretation should be entirely assimilated. They will continue to enjoy their respective spheres of application. Rather the point which is being made is that the relationship between the two is now closer than it ever was and, in such circumstances, the wisdom of distinguishing between the two in terms of the admissibility of evidence seems, at best, doubtful.

42 Secondly, evidence of pre-contractual negotiations may be admissible in the case where there is an ambiguity in the final written document and the negotiations between the parties were conducted on the basis of a particular common assumption. The relevant principle was stated by Kerr J in *The Karen Oltmann*[86] in the following terms:[87]

> If a contract contains words which, in their context, are fairly capable of bearing more than one meaning, and if it is alleged that the parties have in effect negotiated on an agreed basis that the words bore only one of the two possible meanings, then it is permissible for the Court to examine the extrinsic evidence relied upon to see whether the parties have in fact used the words in question in one sense only, so that they have in effect given their own dictionary meaning to the words as the result of their common intention.

43 On the facts of *The Karen Oltmann*, cl 26 of the contract between the parties stated that: "Charterers to have the option to redeliver the vessel after 12 months trading subject giving 3 months' notice." The case

86 *Supra* n 74.
87 *Ibid* at 712.

turned on the meaning of the word "after". The owners contended that "after 12 months trading" meant "when the vessel has traded 12 months" or "on the expiry of 12 months' trading". The charterers submitted that it meant "at any time after the vessel has traded for 12 months". In other words, the owners argued that the charterers could only exercise the option to redeliver the vessel at one fixed point in time, whereas the charterers maintained that they could exercise the option at any time after the vessel had traded for 12 months provided that the requisite notice period was given. Kerr J found that the telex exchanges between the parties prior to the conclusion of the contract established that the words "after 12 months trading" had been used in an agreed sense, namely "on the expiry of" and not "at any time after the expiry of" 12 months. There appear to be two elements to this principle. The first is the presence of some ambiguity in the words which the parties have used and the second is the adoption by the parties of an agreed meaning for the disputed word or phrase. The principle appears to have some resemblance to an estoppel by convention and of course the courts can and do have regard to the negotiations between the parties when deciding whether or not an estoppel by convention has been made out.[88] However, the scope of the principle is open to question on two grounds. The first relates to the need for an ambiguity before resort can be had to the pre-contractual negotiations. This is consistent with the traditional rule that the courts may only have resort to extrinsic evidence where the words used by the parties are ambiguous but, as we have already noted,[89] this rule is no longer applied by judges when seeking to interpret contract documents. If it has been abandoned as a general rule of contract interpretation, there is no point in retaining it in the particular context of the admissibility of pre-contractual negotiations. The second criticism relates to the need for an agreed meaning to the disputed words. This is a matter which can only be established after the evidence has been examined and weighed. Thus the court should first declare the evidence to be admissible and then decide whether or not it has been established that the word or phrase in the contract has been used by the parties in a particular sense. On this basis the supposed principle in *The Karen Oltmann* should be seen as an example of a much wider principle, namely that evidence of prior negotiations should be admissible whenever such evidence proves to be both reliable and helpful in the resolution of the issue which is before the court.

88 See, for example, *Amalgamated Investment & Property Co Ltd v Texas Commerce International Bank Ltd* [1982] QB 84.

89 At para 7 of the main text above.

44 Thirdly, evidence of pre-contractual negotiations is admissible where the issue before the court is one that relates to the existence of a contract or to the validity of one of the terms of the contract. Courts thus routinely examine pre-contractual negotiations when deciding whether the negotiations have reached the point that a contract has been concluded between the parties.[90] Similarly, when deciding whether or not a clause is a valid liquidated damages clause or a penalty clause, a court may have regard to pre-contractual negotiations for the purpose of deciding whether the pre-estimate of damages was genuine or reasonable.[91]

45 Fourthly, it would appear that evidence of the background to, and the object and genesis of, the transaction is admissible but that evidence of the parties' previous negotiating positions is not.[92] This distinction is not an easy one to draw. As Judge MacDuff QC stated in *Sykes v Pannell Kerr Forster*:[93]

> [T]here is…a very fine borderline between the admissible and the inadmissible. One may look at the facts and circumstances surrounding the negotiation and that about which the parties were negotiating, but not at what the parties said during negotiations nor at previous drafts. The rationale, at least in part, appears to be a wish on the part of the courts to encourage open negotiations and to discourage the creation of self-serving documents or utterances.

46 Judges have on a number of occasions noted the difficulty in distinguishing in this context between evidence which is admissible and

90 See, for example, *Tesco Stores Ltd v Costain Construction Ltd* [2003] EWHC 1487 (TCC); [2003] All ER (D) 394 (July) where the issue between the parties was whether or not a letter of intent issued by one party to the other resulted in the creation of a contract between the parties.

91 See, for example, *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 281 (TCC); [2005] All ER (D) 396 (Feb).

92 *Gehe AG v NBTY Inc*, 30 July 1999, Queen's Bench; *cf MCST Plan No 193 v Liang Huat Aluminium Ltd*, *supra* n 4.

93 30 March 2001, Queen's Bench. See also *Bank of Scotland v Dunedin Property Investment Co Ltd* 1998 SC 657 at 665 where Rodger LP stated that the rationale behind the exclusionary rule "shows … that it has no application when the evidence of the parties' discussions is being considered, not in order to provide a gloss on the terms of the contract, but rather to establish the parties' knowledge of the circumstances with reference to which they used the words in the contract".

evidence which is not.[94] The evident difficulty involved in drawing the line of distinction leads one to question the wisdom of drawing the distinction in the first place. It can be argued that the refusal of the courts to admit evidence of pre-contractual negotiations can be traced back to the old literal rule of interpretation whereby it was the duty of the court to "construe the document according to the ordinary grammatical meaning of the words used therein, and without reference to anything which has previously passed between the parties to it".[95] On the basis of this approach, the answer to any question of interpretation was to be found within the four corners of the document in which the parties had elected to enshrine their agreement. However the courts have long since abandoned such a narrow approach to the interpretation of contracts. The dominant approach is now a "contextual" or a "purposive" approach which seeks to interpret the document in its context and to adopt an interpretation which advances the commercial purpose behind entry into the transaction.[96] In this new environment, the pre-contractual negotiations may provide very good evidence from which the courts can discern the "context" of the transaction or its "commercial purpose". Take an example. Suppose that the parties have entered into a lengthy transaction which has been concluded in a relatively short space of time (as is the case with many modern commercial transactions). The relationship between some of the clauses in the document appears to be rather awkward so that it is no easy task to identify the meaning of a particular clause and its relationship with another clause. In such a case the previous drafts may provide very good evidence from which a court may be able to discern the intended relationship between the two clauses. Alternatively, the drafting history may show that the clause which is the source of the difficulty was inserted into the contract in the early hours of the night and that, with the benefit of hindsight, it can be seen that insufficient thought had been given to the relationship between this clause and other clauses which had already been inserted into the document. Why should a judge deprive himself or herself of the opportunity to consider the history of the negotiations when that history may shed valuable light on the interpretative difficulty that is now before

94 See, for example, *Gould v BG Transco Ltd,* 10 August 2001, Chancery Division; *The Tychy (No 2)* [2001] 2 Lloyd's Rep 403; *Biggin Hill Airport Ltd v Bromley London Borough Council, The Times,* 9 January 2001, [2001] EWCA Civ 1089; *Gehe AG v NBTY Inc*, *supra* n 92; and *Demolition Services Ltd v Castle Vale Housing Action Trust* (1999) 79 Con LR 55.

95 *Lovell and Christmas Limited v Wall* (1911) 104 LT Rep 85 at 88 *per* Cozens-Hardy MR.

96 See the authorities cited at *supra* n 16.

him or her? The refusal to take advantage of this opportunity was understandable in an era when the court was confined to a consideration of the document itself but, now that it has been freed from this restriction and witness statements are commonly produced in cases concerned with the interpretation of contracts, why declare inadmissible previous drafts which may contain more useful information than lengthy witness statements produced by those responsible for the negotiation of the contract? For better or worse, the courts have elected to go down the road of a "contextual" or a "purposive" approach to the interpretation of contracts and, having done so, they should not continue to turn their backs on previous drafts and rely on more dubious evidential sources in their search for the "context" of the agreement or the "commercial purpose" which the agreement was intended to advance. The attempt to distinguish between "the facts and circumstances surrounding the negotiation and that about which the parties were negotiating"[97] (which are admissible) and previous drafts (which are not) is neither tenable nor useful and should be abandoned.

VIII. The arguments for reform

47 It is therefore suggested that the time has come to re-consider the general rule which declares pre-contractual negotiations to be inadmissible in evidence. It is suggested that the general exclusionary rule ought to be abandoned, or heavily modified, for three principal reasons. First, the objections advanced to the introduction of such evidence relate, as we have seen,[98] to the weight of the evidence, not to its admissibility. There is a need for caution, given the desire to avoid adding unnecessarily to the cost of litigation, but the legitimate desire to control the cost of litigation does not demand the exclusion of such evidence. Instead it requires caution and care when deciding whether or not to attach importance to the evidence. It does not demand the blanket exclusion of previous drafts. Rather, it requires the courts to examine the reason for the attempt to introduce pre-contractual negotiations into evidence. Where it relates to the subjective state of mind of one of the parties, it should be inadmissible because it is irrelevant (the test of intention being objective, and not subjective). However, where it is alleged that an earlier written draft of the agreement sheds light on the aim of the parties in entering into the contract, it should in principle be admissible provided that it is relevant to the issue at stake between the parties. Second, as has

97 *Supra* n 93.
98 At para 34 of the main text above.

been noted, the adoption of a contextual or purposive approach to the interpretation of contractual documents should lead the courts to have regard to the previous drafts given that they may play a valuable role in enabling the court to discern the contractual context or the commercial purpose behind the transaction.

48 The third argument in favour of reform is that English law is presently not consistent with the approach taken in the most important international instruments which are applicable to commercial contracts. Thus pre-contractual negotiations are declared to be admissible in the Vienna Convention on Contracts for the International Sale of Goods[99] ("the Vienna Convention"), the Unidroit Principles of International Commercial Contracts[100] and the Principles of European Contract Law.[101] These instruments were relied upon by Thomas J in his judgment in *Yoshimoto*[102] in support of his argument that pre-contractual negotiations should, in an appropriate case, be declared to be admissible in evidence and, further, he noted Prof McLauchlan's observation that it is "odd that evidence of the parties' negotiations are admissible to aid the interpretation of international sales agreements but not commercial or other domestic contracts".[103] This point may be said to have more force for Singapore and New Zealand, given that they have both ratified the Vienna Convention whereas the UK, at present, has not. But the difference is one of degree and not kind. It can be said that there is an international consensus emerging to the effect that courts ought to be free to have regard to pre-contractual negotiations in the interpretation of contracts and, to the extent that the common law presently does not comply with that rule, pressure is likely to be brought on the common law to conform to the expectations of international practice.

IX. Conclusion

49 Now that the courts give more weight to the adoption of an approach to contractual interpretation which seeks to give a commercially sensible construction to the clause in dispute, the justification for excluding pre-contractual negotiations from evidence appears suspect. They may in fact provide very good evidence of the issue

99 Art 8(3).
100 Art 4.3(a).
101 Art 5.102(a).
102 *Supra* n 26, at [88]–[90].
103 *Id* at [88], citing D W McLauchlan "A Contract Contradiction" (1999) 30 Victoria University of Wellington Law Rev 175 at 193.

which is at stake between the parties and, to that extent, should be admissible in evidence. The courts should continue to exclude from evidence "self-serving utterances" but the reason for this exclusion is that it is for the court, not the parties, to decide what the contract means. Lord Hoffmann's first principle makes the point that the test applied by the court is an objective, not a subjective, one. Evidence of the subjective state of mind of the parties is therefore irrelevant and this is so whether the evidence relates to his or her state of mind during the negotiations or at a later stage in the process. This being the case, evidence of pre-contractual negotiations should be admissible in evidence unless that evidence relates to the subjective state of mind of the negotiating parties. This is not to say that a great deal of weight should necessarily be given to evidence of pre-contractual negotiations. The weight will very much depend upon the facts of the case and caution must be exercised by the judges in order to ensure that the evidence is relevant, reliable and does not add unduly to the cost of the litigation. But in principle, evidence of pre-contractual negotiations should be admitted. To the extent that the admission of pre-contractual negotiations may threaten to add to the cost of litigation, judges should be able to resolve this issue by making use of their case management powers and, in an appropriate case, by the award of costs in order to ensure that lawyers are not tempted to waste the time of the court by trawling through previous drafts which are of little or no value.