

INTERPRETATION OF CONTRACTS:  
ADMISSIBILITY OF PRE-CONTRACTUAL NEGOTIATIONS

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## **DEDICATION**

This thesis is dedicated to my wife, Sharifah Shifaa, who delivered our second child in a matter of days after this thesis is printed. I could not thank her enough for her love and unwavering support towards completion of this dissertation and the graduate program for past two years. In this space also I would like to express my sincerest gratitude to my parents for their understanding and unconditional love.

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My fellow comrades also deserve mention here. Without them this journey would not be as great as it has been.

## ABSTRACT

Differing interpretation of contract requirements is among key causes of construction contractual disputes. Generally interpretation of a contract is confined to the four corners of the document. In reality, commercial contracts do not artificially live in isolation from context, and courts have already subscribed to contextual approach in construing a contract. Despite this approach being applied in interpretation of contracts, pre-contractual negotiation evidence have been conventionally excluded from being considered to help understand the meaning of the words in the contract, except in action for rectification. This research aimed to comprehend the current state of law with respect to admissibility of pre-contractual negotiations in interpretation of contracts, and whether there are exceptions to the rule. Based on examination of case law, the highest court in England remains with status quo, which received mixed reactions from other common law jurisdictions. It was found that Malaysia continues to follow the approach set in England albeit with reservation. Decisions from other common law countries reveal circumstances that provide for prior negotiations' admissibility. They are; reference to private dictionary; harmonisation with international contract convention; when evidence is relevant, reasonably available to all contracting parties and relates to an obvious context; when it illuminates the genesis of the transaction; when used to construe without prejudice settlement negotiations; and when the evidence provides consistency with commercial common sense. A common theme underlying the exceptions, is that prior negotiations, if referred to, must be objective and reflective of the parties' mutual understanding prior to contract.

## ABSTRAK

Perbezaan penafsiran kontrak dikenalpasti sebagai salah satu punca pertikaian kontrak pembinaan. Secara dasar, penafsiran kontrak adalah berdasarkan apa yang termaktub di dalam dokumen tersebut sahaja. Realitinya, sesuatu kontrak komersil tidak terasing daripada konteks, dan pandangan ini telah diterima pakai di mahkamah. Walaubagaimanapun, secara konvensional, persetujuan di dalam dokumen-dokumen pra kontrak tidak diterima pakai sebagai bahan bukti bagi menjelaskan makna di dalam kontrak, kecuali bagi tindakan pembetulan. Kajian ini bertujuan mendalami status terkini dalam undang-undang kontrak, sama ada peraturan untuk meniadakan dokumen pra-kontrak dalam penafsiran masih digunapakai. Jika ianya masih digunapakai, apakah situasi yang membolehkan dokumen pra-kontrak dirujuk untuk menjelaskan terma kontrak yang dipertikaikan. Berdasarkan kes-kes undang-undang, mahkamah tertinggi di England masih mempertahankan *status quo*, dan Malaysia mengunapakai pandangan yang sama walaupun tidak bersetuju sepenuhnya. Keputusan perbicaraan dari negara-negara *common law* membuktikan terdapat beberapa situasi yang membolehkan dokumen pra-kontrak digunapakai untuk penafsiran. Situasi-situasi tersebut adalah, penggunaan kamus persendirian; asimiliasi dengan konvensyen kontrak antarabangsa; bila dokumen pra-kontrak adalah relevan, tersedia dengan semua pihak dan berkaitan dengan konteks; bila dokumen tersebut menerangkan tujuan kontrak; bila digunakan untuk menerangkan perbincangan kontrak tanpa prejudis; dan bila bukti tersebut menunjukkan konsistensi dengan konteks komersil. Semua situasi ini mempunyai satu persamaan, iaitu dokumen pra-kontrak, bila dirujuk, harus bersifat objektif dan adalah refleksi persetujuan sebelum kontrak.

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## LIST OF ABBREVIATIONS

AC	Appeal Cases
ALL ER	All England Reports
CA	Court of Appeal
CISG	Convention of International Sales of Goods
EWCA	England and Wales Court of Appeal
EWHC	England and Wales High Court
FC	Federal Court
FCJ	Federal Court Judge
JCA	Judge of Court of Appeal
HCA	High Court of Australia
Lloyd's Rep	Lloyd's Law Report
MLJ	Malayan Law Journal
MLJU	Malayan Law Journal (Unreported)
NZCA	New Zealand Court of Appeal
NZSC	New Zealand Supreme Court
PC	Privy Council
QB	Queen's Bench
SGCA	Singapore Court of Appeal
SGHC	Singapore High Court
UKHL	United Kingdom House of Lords
UKSC	United Kingdom Supreme Court
UNCITRAL	United Nations Commission on International Trade Law
WLR	Weekly Law Report

# CHAPTER 1

## INTRODUCTION

### 1.1 Background Study

Cheung & Pang (2014) reported that differing interpretation of performance requirements as among key causes of construction contractual disputes. An analytical study by Cakmak & Cakmak (2014) revealed that contract related disputes, i.e. differing interpretation of contract provisions, document ambiguities as the second most important category, after contractor related disputes i.e. work progress delay, extension of time and quality.

According to Lewison (2007), when parties to a contract differ as to their rights and obligations are under their agreement, courts or arbitral tribunals may be called upon to construe the true effect of the disputed subject in accordance with rule of law.

When the contract is reduced to a written document, generally interpretation is confined to the four corners of the document, as held by Abdul Malik bin Ishak JCA in the Court of Appeal judgment of *Syarikat Binaan Utara Jaya (a firm) v Koperasi Serbaguna Sungai Glugor Bhd*<sup>1</sup>:

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<sup>1</sup> [2009] 2 MLJ 546 CA

*“...the contract here is in writing and so the parties are confined within the four corners of the document in which they have chosen to seal their agreement and neither of them can adduce evidence to say that his intention has been misstated or overlooked in the agreement or that some essential features of the contract has been omitted or ignored...”*

In reality, contracting parties often pay little attention to the details in the contract in their routine activities, and would only pay look for the terms in greater detail when dispute arises, as described by Clarke J in *Balmoral Group Ltd v Borealis (UK) Ltd*<sup>2</sup>:

*“...there were, in effect two parallel universes: the "real world" in which the parties moved and had their being, and an artificial world created for them by their lawyers when, but only when, a dispute arose. In the real world... none of the individuals who were doing business with each other on behalf of Balmoral and Borealis paid any attention to the terms and conditions that the lawyers had drafted for them...”*

In examining the above phenomena, Mitchell (2009) argued that commercial contracts cannot artificially live in isolation from context, and opined that the contextual approach to contract interpretation has already been culminated in the much-cited passage by Lord Hoffman in *Investors Compensation Scheme v West Bromwich Building Society*<sup>3</sup>, where his Lordship defined interpretation as:

*“...ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would*

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<sup>2</sup> [2006] EWHC 1900 (Comm)

<sup>3</sup> [1998] 1 WLR 896



*reasonably have been available to the parties in the situation in which they were at the time of the contract...*”

The Oxford Law Dictionary (2016) defines “construction” and “interpretation” as the same, i.e. the process of determining the true meaning of a written document, while Lewison (2007) noted that both words may be used interchangeably.

In the aspect of interpretation of contracts, the English courts traditionally adopted a literal approach. McKendrick (2018) stated that the traditional approach of interpreting the meaning of a contract within the four corners of the document has its merits; primarily, that the courts do not have to indulge into the commercial purpose of the disputed clause, but rather focus on interpreting the words used by the parties and hence, the dispute can be resolved swiftly as such exercise could be undertaken on the solely based on document review. In *Lovell and Christmas Ltd. v Wall*<sup>4</sup>, the learned Judge emphasized this principle and its standing in the English legal framework:

*“If there is one principle more clearly established than another in English law it is surely this: It is for the court to construe a written document. It is irrelevant and improper to ask what the parties, prior to the execution of the instrument, intended or understood... it is the duty of the court, which is presumed to understand the English language, 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...”*

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<sup>4</sup> (1911) 104 LT 85

In *Koh Siak Poo v Perakayan OKS Sdn Bhd & Ors*<sup>5</sup>, the same position was taken by Hashim Yeop Sani J as he underscored the importance of construing a contract within itself:

*“...Where the written contracts are clear and unambiguous the court should not go behind the written terms of the contract to introduce or add new terms to it...”*

However, McKendrick (2018) cautioned that the literal approach has significant disadvantages as it denies context of the words in the documents from being taken into account. This is where courts may look into background evidence known to the parties then, per Sir John Pennycuik in *St Edmundsbury v Clark (No 2)*<sup>6</sup>:

*“It is no doubt true that in order to construe an instrument one looks first at the instrument and no doubt one may form a preliminary impression on such inspection. But it is not until one has considered the instrument and the surrounding circumstances in conjunction that one concludes the process of construction...”*

However, admissible background evidence excludes pre-contractual negotiation for interpretation of contracts per Lord Hoffman in *Investors Compensation Scheme v West Bromwich Building Society*<sup>7</sup>, albeit qualifying that the boundaries are opaque:

*“The law excludes from the admissible background the previous negotiations of the parties and their declaration of subjective intent... the boundaries of this exception are... unclear. But this is not the occasion to explore them”*

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<sup>5</sup> [1989] 3 MLJ 164

<sup>6</sup> [1975] 1 WLR 468

<sup>7</sup> Ibid

The English approach is not aligned with the approach taken by other jurisdictions, reflected in instruments published by the United Nations (United Nations Convention on Contracts for the International Sale of Goods, also known as the “Vienna Convention”), the Principles of International Commercial Contracts by the International Institute for the Unification of Private Law (UNIDROIT) and the European Principles of Contract law. These instruments provides for the admissibility of pre-contractual negotiations (Lewison, 2007).

## **1.2 Problem Statement**

### 1.2.1 Negotiations in Construction Contracts

The procurement of construction projects is an important and complex process. It requires employers to make key decisions at the outset of the development, and decisions taken at the beginning can have a major impact on the ultimate success of a project. Construction projects typically involve protracted communications in the pre-award (tender) period leading up to the execution of contract. Ideally, contracting parties would want to ensure all agreed changes to the tender documents are reflected in the contract documents signed by the parties, to avoid incurring additional cost and/or time (Milner, 2011).

As such, negotiations form an important part of the early stages in the relationship between contracting parties, as it is the starting point of building trust between the parties, which in turn contribute towards better risk allocation and eventually cost saving in the construction industry (Zaghloul & Hartman, 2002).

At the other end of the contract period when dispute typically arises, negotiations have also become an established alternative dispute resolution (ADR), and according to research, the greatest strength with this method is that it is the lowest cost of resolution with parties being the least hostile (Love et.al, 2007). A study by Chan & Tse (2003) on cultural considerations in international construction contracts reveal that negotiation for commercial settlement is the preferred dispute resolution mechanism, regardless of whether the project is international or domestic.

McCormack (1995) describes negotiation as the process of obtaining the best deal from the other party, essentially a balancing act between two different interests. However, Corbin (1965) reminded that it is trite law that a contract is formed by the words used by the parties, and not their intentions which may or may not translate into express provisions in the contract.

### 1.2.2 Prior Negotiations: The Conventional Position

When dispute arises, Lord Nicholls (2005) argues that courts are expected to identify the purpose of the contractual provision and this process would not be complete without reference to the surrounding circumstances at the time of contract. In *Prenn v Simmonds*<sup>8</sup>, the parties had diverging interpretation of the term profit, as it affected the amount of shares of the claimant's company that can be sold to the respondent. The respondent contends that the term profit in their agreement refers to the consolidated profit of the holding company, and not profit of the subsidiary company, which is only a small fraction of the total profit of the parent company, which was claimed by the claimant. The House eventually ruled in favour of the respondent as the provision was meant to provide

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<sup>8</sup> [1971] 1 WLR 1381

incentive for the respondent, whose role was indispensable, to continue working for the company after it was acquired by the claimant.

However, the House rejected the respondent's reliance on pre-contractual negotiation correspondence, as Lord Wilberforce explained that until any agreement is concluded where parties had reached a consensus, parties have diverging positions and communication prior to the consensus is not helpful as will likely create confusion and raise doubt rather than helping construction of words. In *Investors Compensation Scheme v West Bromwich Building Society*, Lord Hoffman stated that pre-contractual negotiation evidence are only referred to in action for rectification.

### 1.2.3 The Conundrum and Previous Studies

Construction litigation typically involves multifaceted technical issues, multiple parties and a large volume of documents. These factors significantly increase the prospective for lengthy delays and costs (Gerber & Serra, 2011). Hence, before deciding to pursue for litigation, businesses conduct risk assessment, taking into account the likelihood of winning the case. One of the fundamental, strategic considerations is assessing whether the evidence is likely to be admissible (Watkins, 2013).

In an extra-judicial capacity, Menon (2013) argued that in negotiating terms of a contract, negotiators are fixated with commercial and financial considerations rather than principles of interpretation. Therefore, his lordship held that many contracts are fundamentally incapable of being construed strictly within their four corners. However, the rule of thumb regarding pre-contractual negotiations is that it cannot be used for interpretation of contracts. Be that as it may, considering the important role of negotiations

in documenting the background context prior to formation of the contract, this research seeks to explore the exceptions to the rule.

There have been several previous research into the matter in different aspects. McLauchlan (2012) looked into the permissible aids of interpretation based on literature on contract construction and found that there are no conclusive reasons for the refusal to rely on pre-contractual negotiations. In examination of key English Courts decisions, Milner (2011) suggested that the rule of excluding prior negotiations be relaxed in certain circumstances. Similar research was undertaken by Botchway & Choong (2011), whom looked into great detail on the case of *Chartbrook Homes Ltd v Persimmon Homes Ltd*<sup>9</sup> and argued for waiver and setting aside the exclusionary rule. Much earlier, McMeel (2003) argued that there are more reasons to liberalize the rule as he reviewed the development of English contract law in the modern era. Kramer (2003) commented that this case illustrated that the exclusionary rule is inconsistent with common sense principles of everyday interpretation.

In review of the exclusionary rule and Singapore and Malaysia's Evidence Acts, Rajah (2010) found that the statutory provisions do not limit relevant evidence, including prior negotiations to construe an agreement. In a similar background study, Goh (2013) argued for Singapore to depart from the exclusionary rule against pre-contractual negotiations as it retains freedom to liberate from English contract law principles.

The recent New Zealand case of *Vector Gas Ltd v Bay of Plenty Energy Ltd*<sup>10</sup> was referred in more than 10 regional law journal articles, due to the diverging opinions of the Supreme Court panel judges on admissibility of prior negotiations, albeit ruling unanimously in favour of the appellant. Among notable literature is by Palmer & Geddis (2012), who were highly critical of the judgment as it argued that the differing reasoning

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<sup>9</sup> [2009] UKHL 38

<sup>10</sup> [2010] NZSC 5

created confusion in subsequent lower court rulings. While Barber (2016) looked into further detail on the rationale of Judge Tipping, whom in this case, handed relatively the most liberal opinion with regards to admissibility of prior negotiations.

Moustaka (2016) examined the approach of Australian courts with regards to prior negotiations and found that the boundary is unclear and the nature of the rule is unpredictable. In review of Australian cases on contract interpretation, Tiernan (2003) argued that evidence of surrounding circumstances, including prior negotiations are important in construing building contracts.

### **1.3 Research Objectives**

The objectives of this research is as follows:

- i. To determine whether pre-contractual negotiations are admissible for interpretation of contracts.
- ii. To determine the exceptions to exclusion of pre-contractual negotiations specifically with regards to construction contracts.

### **1.4 Scope of Study**

The approach adopted in this research is case law based. Only cases related to interpretation of contracts will be discussed in the research. This research will focus on

the principles of contract interpretation, particularly the exclusionary rule and rectification.

## 1.5 Significance of Study

McKendrick (2016) outlined three main reasons why the principles applied by courts in interpreting contracts are of high importance for contracting parties. Firstly, issues pertaining interpretation of contracts are among the most popular disputes brought by contracting parties before courts. Second, many commercial parties who adopt industry-wide standard forms prefer certainty in their business dealings, including certainty of the meaning of their contract terms. Thirdly, contract drafting process are time consuming and the process must reflect the interpretation principles applied by the courts.

Hamid (2008) examined the following scenarios of reliance on wrong interpretation of a contract. First, a contracting party insisting on an inaccurate interpretation of a contract, demonstrates its refusal to perform the contract per its terms, hence repudiating the contract. Second, a party, performs his duties under contract despite insisting on a wrong interpretation that it believes that is correct. In such situation, Pearson LJ held that the best course of action is to continue to perform the contract until the dispute has been determined by the courts, per judgment in *Sweet & Maxwell Ltd v Universal News Services Ltd*<sup>11</sup>, quoted:

*“In the last resort, if the parties cannot agree, the true construction will have to be determined by the court. A party should not too readily be found to have refused to perform the agreement by contentious observations in the course of discussion or arguments.”*

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<sup>11</sup> [1964] 2 QB 699



Considering the importance of the principles of interpretation of contracts during contract drafting and the parties conduct towards dispute over interpretation, the circumstances that enables admissibility of pre-contractual negotiations will facilitate understanding on the contemporary position in this particular field of commercial contract law.

Corporations typically want to avoid litigation due to its direct and indirect costs (Allison, 1990). Further, bringing litigation action may result in decrease in company worth as it introduces uncertainty to the business and will deter investors (Wong, 2018).

Hence, improved understanding of how the courts should approach issues of contractual interpretation which will be relevant in risk management, particularly in assessing the likelihood of winning a contractual dispute and whether to rely on pre-contractual negotiation as evidence.

## **1.6 Research Methodology**

This research is divided into the following stages: Identification of research issue, development of theoretical framework, data collection, data analysis and writing, as summarized in the flowchart below:

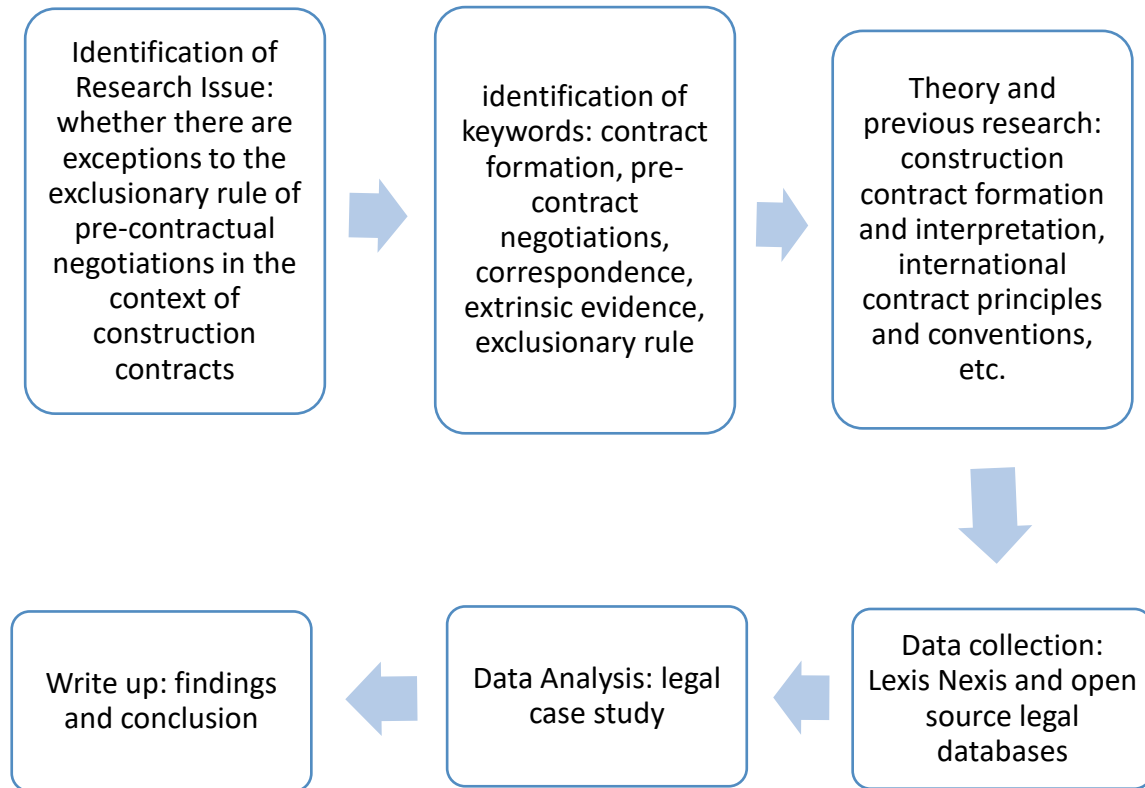


Chart 1.1: Research Methodology Flowchart

### 1.6.1 Development of Research Proposal

The opening phase is to identify the area of research and issue. Preliminary literature review was carried out in order to obtain the overview of the particular research topic. It involved reading on various sources of published materials for example, articles, journals, seminar papers, related cases, and previous relevant research materials. Subsequently, using these materials, a research proposal was formulated.

### 1.6.2 Data Collection

Data collection involves scanning of various sources and collating important data to be collected and cross-checking with other published data to verify data accuracy. The data will be collected through documentary study on the Court cases from MLJ, BAILI, Building Law Report and other law journals available via open source or the Asian International Arbitration Centre (AIAC) library database. Further data are collected through published resources, like books, journals, articles, varies standard form of contract and related statutes.

### 1.6.3 Data Analysis

Case law collected are analysed and interpreted, converted into a systematic analysis that embodies the research framework. Particular focus is taken on the background facts, the underlying issues and reasoning for judgment for each case law.

### 1.6.4 Writing

The process of writing up completes the research process. A concluding statement will be formulated and as well as drawing up recommendation for future research to further enhance knowledge base in the field.

## **1.7 Organisation of Chapters**

This report was prepared in accordance with the guidelines published by the School of Graduate Studies, UTM. The following paragraphs explain the report structure according to the chapter number.

Chapter one (1) provides an overview of the research report. It contains an introduction to the study that describes construction of contracts, issue of admissibility of pre-contractual negotiations and highlighted landmark decisions pertaining the research subject. This chapter also consists of the scope of the study and brief research methodology undertaken for the endeavour.

Chapter two (2) deliberates the theory related to formation and interpretation of contracts and the evolution of contract construction and discuss in further detail literature on extrinsic evidence, pre-contractual negotiations, mistakes and rectification of contracts.

Chapter three (3) is a discourse of the research methodology of the research undertaking. It comprises the author's approach to legal research and phases of research methodology.

Chapter four (4) focuses on the review and analysis of data, where court judgments are deliberated, with particular focus on circumstances of admissibility of pre-contractual negotiation evidence in construing a contract.

Chapter five (5) concludes the report where the summary on the research findings are concluded recommends areas for further research.

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