Subjective Intention in the Law of Contract: Its Role and Limits

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In 2015 I was in England on sabbatical leave and I was asked by University College London to provide a commentary on a paper to be delivered by another leading judge. The judge on that occasion was Sir Terence Etherton, then Chancellor of the High Court of England and Wales and shortly afterwards Master of the Rolls. Sir Terence delivered a paper aptly entitled "Contract Formation and the Fog of Rectification".[1] My commentary was naturally very respectful but I did take issue with some of his observations, particularly those concerned with my writings in the area. Afterwards in the course of a very pleasant dinner I asked the Judge what he thought when he learned that I was to be the commentator. He looked me in the eye and, with only the hint of a smile, he said: "Well, you know, you agree to do a good deed, and what happens, you get punished!" I don't know what Justice Leeming will think of my comments this evening, but I very much hope that he won't think he has been punished. Certainly there is little that I disagree with in his comprehensive and insightful paper.

What I want to do is to suggest a way forward from the fine distinctions that the judge has highlighted – distinctions that make the law hard to understand or more complicated than it need be.

In my view two of the most troublesome terms in the law of contract are "subjective intention" and "objective intention". We are routinely told by judges who are faced with issues concerning the formation or interpretation of contracts that their task is to determine the parties' *objective* intention, not their *subjective* intention. It is said that evidence of subjective intention is irrelevant and inadmissible, and such evidence is often understood to embrace anything that points to the parties' *actual* intention. I have been arguing for years that this is an oversimplification. Of course, no-one has ever suggested that a court should be able to inquire into the parties' states of mind and hence allow them to testify as to what they each intended at the time of the alleged contract. However, the situation is entirely different where there is reliable evidence that, *as a result of communications between the parties*, they reached an agreement that was intended to be binding or, as the case may be, they formed a common understanding as to the meaning of language in dispute. What I am saying is that too often the dirty words "subjective intention" are used to rule out *any* evidence pointing to the parties' actual mutual intention on the basis that the sole task of the court is to determine their presumed (objective) intention. In fact, accepting and giving effect to evidence of the kind I have mentioned is not in any way inconsistent with an objective approach. One is still ascertaining the parties' intentions through objective evidence.

I have read judgments that in effect say to the parties "don't you tell me what you intended, it's my job to decide what you intended"! I also recall one New Zealand case[2] which included a

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1 Later published in (2015) 68 CLP 367.

2 *Brierley Investments Ltd v Shortland Securities Ltd* (1994) 5 TCLR 615.

finding by a very good High Court judge that the parties actually intended to be bound by an informal commercial property agreement. He said that their "actual belief at the time was that a binding deal had been concluded" and that "anything which remained was drafting detail". However, he then concluded that this was irrelevant. The question of intention to be bound was "not to be approached subjectively". It was "to be approached on an objective basis". The test was whether a reasonable person in the position of the promisee would have inferred that the promisor intended to be bound. I call this "objectivity gone mad"! How reasonable persons would have understood the transaction was irrelevant in this case. While the presence of actual consensus ad idem and intention to be bound is not *necessary* for formation of a binding contract, it is surely *sufficient*.

Difficulties also arise in relation to the term "objective intention". It is routinely said that it is a basic principle that the law is only concerned with the intention of the parties as *objectively ascertained*. So, in an interpretation dispute the judge must try to ascertain what a reasonable person would have understood the parties to have meant. But who is this reasonable person and what does he or she know about the background to the contract and the parties' dealings? It is widely thought that the common law depersonalises contracting parties and asks what a detached or outside observer would have taken their intention to be. On one view, this observer is imbued with business common sense and has knowledge of the all the terms of the contract and the surrounding circumstances, but apparently he or she is unaware of, or wholly unconcerned with, their actual intention, even if it is shared and manifested in communications between them.

However, it is equally common to refer to the objective test as requiring a determination of what the reasonable person *in the position of the parties* would have inferred. Numerous statements to like effect are to be found in the judgments of the High Court of Australia. For example, the Court said in *Toll v Alphapharm*[3] that "[w]hat matters is what each party by words and conduct would have led a reasonable person in the position of the other party to believe". On this version of objectivity, a reasonable person, who is asked to determine what the parties appeared to mean by the relevant language, would surely give decisive weight to communications between the parties establishing *either* a shared actual understanding of the meaning of the language *or* the understanding of one party where that party was led reasonably to believe that its understanding was also shared by the other party. In this context there is no sensible distinction between meaning and *what the parties meant* because what the parties meant IS the meaning!

Nevertheless, at the same time the High Court continues to adhere to rules that evidence of the parties' prior negotiations and subsequent conduct reflecting their actual intentions is inadmissible as an aid to interpretation. However, despite this, as Justice Leeming has explained, the courts are able, by one mechanism or another, to ensure that contractual terms are given a meaning that is consistent with a proven actual mutual intention of the parties. Well-informed counsel, and sympathetic judges who believe that it would be unjust to deny the parties' true bargain, have at their disposal various methods of achieving this. Justice Leeming has highlighted Justice Mason's "united in rejecting" principle, the "private dictionary" principle, the "objective background facts" exception, and of course the equitable remedy of rectification. All I will say about these is that, although their scope is to varying extents uncertain or contentious and they are sometimes overlooked, they do demonstrate that the law has no settled policy against enforcing a commonly understood or agreed meaning that is

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[3] (2004) 219 CLR 165 at [40].

apparent from the parties' negotiations. Indeed, given that the very purpose of the law of contract is to give effect to the parties' true intention or bargain, any such policy seems counter-intuitive.

I would add two other possible exceptions to Justice Leeming's list. The first is estoppel by convention. Not surprisingly, his Honour did not highlight this because the Australian authorities, at least when I last looked, are conflicting.[4] However, there is now substantial authority from other jurisdictions for the view that the doctrine of estoppel by convention may be invoked to avoid the rule excluding evidence of prior negotiations As Lord Hoffmann explained in the *Chartbrook* case, "if the parties have negotiated an agreement upon some common assumption, which may include an assumption that certain words will bear a certain meaning, they may be estopped from contending that the words should be given a different meaning".[5] This has precisely the same effect as if the evidence had been admitted as an aid to determining meaning in the first place. So, instead of saying that the objectively determined actual mutual intention of the parties is the meaning of the contract, it is said that, where both parties have proceeded on the basis that the contract did mean what they intended it to mean, the party denying that meaning is estopped from doing so. No wonder this whole area of the law makes our heads spin!

Turning now to my other addition, depending on the circumstances it may also be possible to argue that a common understanding or agreement gave rise to a collateral contract or that it was a term of a partly written and partly oral contract. I mention this because the very existence of these well-established "exceptions" to the parol evidence rule leads me to question why it should make a difference that the oral agreement concerns the meaning of a term contained in a written document as opposed to an agreement on a matter not covered in the document. In other words, why should the admissibility of extrinsic evidence depend on whether the evidence concerns the meaning the parties gave to the contractual language or the existence of a collateral contract or an independent oral term?

This brings me to what is perhaps the main reason why Australian law in this area is particularly difficult. It concerns the continuing belief that there is a meaningful parol evidence rule. As Justice Leeming has mentioned, the rule states that evidence is inadmissible to add to, vary or contradict the terms of a written contract. However, none of the leading Commonwealth jurisdictions, apart from Australia, take the rule seriously nowadays because it is riddled with so many exceptions or qualifications. Certainly it no longer has the stringent effects that it once had. The English Law Commission was surely correct in its 1986 report on the subject when it said that "no parol evidence rule today requires a court to exclude or ignore evidence which should be admitted or acted upon if the true contractual intention of the parties is to be ascertained and effect given to it".[6]

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4 *Johnson Matthey Ltd v AC Rochester Overseas Corp* (1990) 23 NSWLR 190 SC at 195 and *Australian Co-operative Foods Ltd v Norco Co-operative Ltd* (1999) 46 NSWLR 267 at [52]. However, *Johnson* was not followed in *Whittet v State Bank of New South Wales* (1991) 24 NSWLR 146 SC at 153 where Rolfe J said that "[i]t would be strange … if matters arising out of pre-contractual negotiations, which could be proved to the extent necessary to justify rectification, namely, by clear and convincing proof, could not be relied upon to found an estoppel by convention because of the source from which they arose". The conflict was noted but left unresolved by the New South Wales Court of Appeal in *Ryledar Pty Ltd v Euphoric Pty Ltd* (2007) 69 NSWLR 603 at [227] and *Franklins Pty Ltd v Metcash Trading Ltd* (2009) 76 NSWLR 603 at [34] and [577].

5 *Chartbrook Ltd v Persimmon Homes Ltd* [2009] AC 1101 at [47]

6 *The Parol Evidence Rule* (Law Com. No.154, 1986), para 1.7. The Commission later concluded (para 2.45) that the rule, "in so far as [it] can be said to have an independent existence", no longer has "the effect of excluding evidence which ought to be admitted if justice is to be done between the parties".

In the USA the rule has been described as a "treacherous bog in the field of contract law"[7] and as "a positive menace to the due administration of justice".[8] One leading commentator has said that "[i]n virtually every jurisdiction [of the USA], one finds irreconcilable cases, frequent changes in doctrine, confusion, and cries of despair",[9] and this might equally be regarded as a description of the position across the states of Australia. Actually, I feel sorry for Australian counsel and judges who regularly have to grapple with the rule. However, a solution is at hand. They can escape this "treacherous bog" by emigrating to New Zealand! Our judges have fewer constraints on finding and enforcing the parties' true bargain, and of course they have good rugby union teams to support!

Let me finish with three points. First, the scope of the parol evidence rule is most commonly raised in Australian cases when the issue is one of contract interpretation. Indeed, the rule is commonly understood as *either* a synonym for a plain meaning rule *or* the basis for excluding evidence of prior negotiations. Yet the rule as classically formulated has no application in such cases. As the greatest Contract lawyer of them all, Yale law professor Arthur Corbin, argued, "the terms of any contract must be given a meaning by interpretation before it can be determined whether an attempt is being made to 'vary or contradict' them".[10]

Secondly, the judgment of the New Zealand Supreme Court in the *Bathurst* case that Justice Leeming has mentioned repays careful study if one is seeking to bring about much-needed coherence in the law of contract interpretation. Well, I would say that, wouldn't I, given that the Court accepted arguments I have been harping on about for many years concerning both interpretation and implication of terms!

However, I have one caveat. Although I think the Court was right to jettison the rules forbidding resort to prior negotiations and subsequent conduct as aids to interpretation, I think it was wrong to hold that the issue is one of evidence and therefore governed by the provisions of our Evidence Act stating that all relevant evidence should ordinarily be admissible. This is because the meaning of a written contract has long been regarded as a question of law and, as a corollary, the permissible aids to determining that meaning have also been regarded as embodying rules or principles of the substantive law of contract. It is one thing to say that all relevant evidence is admissible in determining a question of fact – for example, did the defendant say anything to the plaintiff before the contract was formed about the matter in dispute and, if so, did it indicate assent to the plaintiff's understanding of that matter. It is quite another to say that, once these facts are proven, they can be determinative of the objective intention of the parties and hence the true meaning of the contract.

Finally, we must not lose sight of the fact that the great majority of interpretation disputes that come before the courts concern situations where the parties did not, at the time of formation, contemplate the issue that has arisen. Since there is no question, therefore, of their having formed an actual intention as to the meaning of the term in dispute, the law that we have talked about today won't be relevant. The task of the court will be to ascertain the meaning that the document would convey to a reasonable person with knowledge of the background. And any attempt by counsel in such cases to burden the court with a large volume of evidence

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7 *Chase Manhattan Bank v First Marion Bank* 437 F 2d 1040 (1971) at 1045.

8 WG Hale, "The Parol Evidence Rule" (1925) 4 Or L Rev 91 at 91.

9 EA Posner, "The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation" (1998) 146 U Pa L. Rev 533 at 540.

10 AL Corbin, *Corbin on Contracts* (rev ed, 1960) Vol 3, at §543 (pp 130–131).

concerning the parties' negotiations in an endeavour to establish an actual mutual intention that in reality simply did not exist ought to be stopped at the case management stage or lead to an adverse costs order.