# KENYA SCHOOL OF LAW
## HAND OUT ON COMMERCIAL TRANSACTIONS

## CONSTRUCTION OF CONTRACT

### (1) The nature of the construction process

- In its broad sense, construction of a contract denotes determination of the total legal effect of the agreement concluded by the parties. This may involve two entirely distinct processes:

- (i) interpretation of the language used by the parties, and (ii) implication of terms where the contract is silent.

### (2) Interpretation Process

- The modern approach to the interpretation of contracts is neatly encapsulated in the speech of Lord Hoffomann in *Investors Compensation Scheme Ltd v West Bromwich Building society* (1998) I WLR 896

  - 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.

  - The background was famously referred by the Lord Wilberforce as the 'matrix of fact'. Such background knowledge includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.

  - The law excludes from the admissible background of the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification not for interpretation of contract. 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.

- 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. 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 Investments Co Ltd. V. Eagle Star Life Assurance Co Ltd.* [1997] AC 749.

- The 'rule that words should be given their 'natural and ordinary meaning' reflects the commonsense 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] AC 191, 201
'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) <u>Implication</u>

- Implication is usually stated to be a process by which the court arrives at the presumed intention of the parties. But it is clear that in many cases the intention thus attributed to the parties is fictitious since the facts generating the dispute were not within their contemplation at all and no one can tell with confidence how they would have framed the contract if they had addressed their minds to the question. In such cases the court is in truth reaching a solution by the application of external rules based on considerations of policy, though it may disguise this process by use of labels such as 'construing the contract' or' deducing the intention of the parties'. Thus, terms implied by law, whether established by prior authority or enunciated in the light of the relationship between the parties and other policy factors, will be imported into a contract without the court finding it necessary to consider what the parties would have been likely to

agree if they had addressed their mind to the prospect of the terms in question. Similarly, rules for determining whether a contract is frustrated by change of circumstances represent a judicially imposed solution which may be buttressed by appeal to the assumed intention of the parties but which in reality depends on the court's view of the degree of fundamentality of the change.

(4) **The Parol evidence rule**

- If there be a contract which has been reduced into writing, verbal evidence is not allowed to be given of what passed between the parties, either before the written instrument was made or during the time that it was in a state of preparation, so as to add to or subtract from or in any manner to vary or qualify the written contract.

- This is the classical exposition of the so-called parol evidence rule, a rule which, in truth, extends to all extrinsic evidence, whether oral or otherwise, and which, moreover, is in some respects a rule of substantive law rather than a mere rule of evidence. Thus it has been held impermissible to construe a contract by reference to the negotiations that led up to it or the conduct of the parties after conclusion of the contract. Such a rigid rule, characteristic of the law of evidence has little to commend it, and is believed to be widely ignored in practice. Very often the record of negotiations culminating in the contract is the best guide to the intention of the parties, as is their behaviour subsequently. It is well-established that in construing a contract the court looks at the factual matrix, or business setting, in which it was made. It is clear that this is not confined to cases where the disputed term is ambiguously expressed. This being so, it is hard to see why the court should ignore pre-contract and post-contract acts and documents to construe the contract, even on its face there is no ambiguity.

- The parol evidence rule is in any event subject to numerous exceptions. It does not apply where the evidence establishes the existence of a collateral contract, or where it can be shown that the document was not intended as a complete record of the contract terms. (A typical case is where the contract is partly in writing, partly oral), or where its existence or operation was dependent on some prior unexpressed stipulation; or that it was procured by misrepresentation or was tainted by illegality or that it disguised the true nature of the transaction. Further, the court may order rectification of a document which does not correctly record the agreement between parties. These exceptions have largely destroyed the rule and today's judges are more reluctant to use it as a short-cut method of

excluding extrinsic evidence of doubtful credibility, preferring to avoid the risk of injustice or even the appearance of injustice) by letting in the evidence while requiring it to be of a compelling nature before accepting it in the face of an apparently comprehensive contract document. As that outstanding contract scholar Corbin said some 60 years ago: 'The writing cannot prove its own completeness and accuracy.'

- But where the parties have included an 'entire agreement' clause in their contract stating that it represents the entirety of what they have agreed to the exclusion of all prior agreements, the court will usually refuse to give effect to prior supplemental or inconsistent terms.

(5) **Collateral contracts**

- One way of surmounting the parol evidence rule is to find that statements by a party preceding the contract were distinct promises constituting a collateral warranty or undertaking, the consideration for this being the other party's entry into the main contract. The device of the collateral contract has been developed with some vigour by the courts and has been extended to cases where the statement induces the recipient of it to enter into a contract not with the maker of the statement but with a third party. For example, a motor dealer induces a customer to take one of his cars on hire -purchase from a finance house by representing the car to be in excellent condition. If the court is satisfied that the representation was a warranty, that is, that it was given as a promise by which the dealer bargained for the customer's entry into the hire-purchase agreement with the finance house, the if representation was false, the dealer will be held liable in damages for breach of the warranty embodied in a collateral contract between him and the customer. Of course, liability of this kind cannot logically be confined to cases where the action induced was the reprenteee's entry into a *contract. Any* activity bargained for by the warranty suffices to ground an action for damages if the warranty is broken, for the warranty is promissory in nature.