THE SIGNIFICANCE OF IMPLIED CONTRACTUAL TERMS

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Introduction

Contractual relationships between people are often not just about the written words or terms the parties have used, but are also about the spaces in between: the silences, the things not said.

As lawyers we have to be conscious not only of the written words, but also the significance of the silences and omissions. Obviously, the circumstances in which implied terms may become relevant are infinite. Different circumstances will involve different types of implied terms. This is not an area, therefore, which lends itself to rigid classification.

However, I will be discussing recent cases about implied terms, including *The Attorney-General of Belize v Belize Telecom Ltd* ("Belize Telecom")[1] and *Hickman v Turn and Wave Ltd*[2], and to do that it is convenient to put them into context by briefly canvassing the broad notional categories:

(i) Terms implied by custom;

(ii) Terms implied by law; both statute and common law;

(iii) Terms implied in fact.

What we will be looking at is the "*traditional*" versus "*modern*" approaches to implication, and whether the latter approach is too relaxed and inappropriately blurs the boundaries between interpretation and inference.

Terms Implied by Custom

The requirements for implication by custom were set out in the leading New Zealand case *Woods v N J Ellingham*[3] where it was held that there was no proof of an alleged custom that a person employing a drainlayer in abnormal terrain must give the drainlayer advanced notice of the abnormality or pay for all extra costs incurred.

The Court (Henry J) discussed the principles for deciding whether a custom can be implied. In other words, whether the parties can be taken not to have expressed in writing the whole of the contract by which they intended to be bound, but to contract with reference to, and in the context of, customer or usage:

(i) The custom must be so well known that the parties must be taken to have known of it and intended that it should form part of the contract ("presumed intention");
(ii) It must be certain;
(iii) It must be reasonable;

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[1] [2009] UKPC 10
[2] [2011] NZCA 100; [2011] 3 NZLR 318
[3] [1977] 1 NZLR 218

(iv) There must be clear and convincing evidence of the custom (unless the doctrine of judicial notice applies);

(v) It must not be contrary to an express term of the contract or inconsistent with the tenor of the contract as a whole.

Terms may be implied by custom even though the parties themselves had no actual knowledge of the existence of the custom: *Lawrence v Power*[4]. Mr and Mrs Lawrence bought a residential house from Mr and Mrs Power. After the purchase, and because they were carrying out alterations to the house, the plaintiff purchasers discovered the house was structurally unsound and would have to be demolished. Their cause of action against the defendants in failing to comply with a building permit was statute-barred. However, they sued the plaintiffs on the basis that the agreement for sale and purchase contained an implied term that the house was sound and safe to live in. The defendants applied to strike-out the cause of action. The Court held that it was arguable that such terms could be implied. They did not involve the application of a warranty, but a custom/understanding that if you are selling a home, its safety and soundness are part of the character of the thing being sold.

In *Everist v McEvedy*[5] the appellant (Mr Everist) was a lawyer and the employer of a solicitor (Mr McPhail) who had caused damage to a client through his negligence.

Mr Everist sought indemnity from Mr McPhail. Mr McPhail sought to avoid liability by saying it was an implied term that Mr Everist would indemnify him from any personal liability he might have (except for dishonesty or fraud). The District Court found that all five ingredients of the *BP* test for the implication of terms was satisfied (more about these below).

However, on appeal the High Court doubted that such a clause was necessary to give business efficacy to the employer/employee relationship, or that such a term would be so obvious that it would go without saying. However it held that its implication by custom was still open to Mr McPhail. Evidence as to the understanding that employers would indemnify staff solicitors was given by the then President of the NZLS. As the Court said, it was always open for an employer solicitor to contract out of what was found to be the invariable practice or custom in New Zealand, but that if they did they might find recruitment difficult.

The Court also noted that there had been clear evidence of the custom, and that in the future Courts could take judicial notice of that unless there was any suggestion that it had changed or no longer existed.

As pointed out in *Law of Contract in New Zealand*[6], commercial law develops in large part as a recognition of custom. There is evidence of a particular practice, and parties to a contract are taken to have relied upon it. The custom or practice is assumed by the Courts to be so prevalent within a particular industry/trade/place as to form the basis of contracts made within that area unless expressly excluded.

Finally, such customs and practices may be enacted into legislation as the standard rule for conduct of the business in question. Law is by this means imposed as a result of the pressure of commercial practice and convenience: how people organise affairs between themselves.

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[4] [1977] 3 NZLR 503
[5] [1996] 3 NZLR 348
[6] Burrows, Finn & Todd (paragraph 6.3.1)

Terms Implied by Law

Statute

There are a number of statutes which provide for terms to be implied into particular types of contract:

(a) Sale of Goods Act 1908, sections 14-17 (title, quality, fitness for purpose);

(b) Consumer Guarantees Act 1993, section 5, 6, 8-12, 28-31 (title, quality, fitness for purpose);

(c) Marine Insurance Act 1906, section 40 (seaworthiness);

(d) Property Law Act 2007, subpart 2 (implied covenants);

(e) Carriage of Goods Act 1979, section 17 (fitness of goods to be carried);

(f) Employment Relations Act 2000, section 4 (good faith).

A good example of the development of custom into legislation is the Sale of Goods Act 1908. In centuries past buyers and sellers would often not turn their minds to matters which later became the source of dispute.

At first the courts would not recognise any term which had not been expressly agreed. The doctrine of *caveat emptor* prevailed.

Gradually, however, particularly in the first half of the 19th century, the customs and usages of the market were recognised by the Courts and were accepted as part of the context of commerce.

By the end of the century the various customs recognised by the courts were codified in the English Sale of Goods Act 1893. That Act set out a number of terms which applied unless the parties had expressly provided otherwise.

The New Zealand Sale of Goods Act 1908 is almost exactly the same as the English 1893 Act.

In other statutes, like the Consumer Guarantees Act, what started out as implied terms have been given legislative force. The public policy behind the consumer protection legislation means that the terminology of implied terms that can be excluded by the parties has disappeared, and instead we have statutory guarantees out of which the parties cannot contract.

Common law

Terms implied by common law are less common now because, as we have seen, many of the terms previously implied by common law are now embodied in statutes such as the Sale of Goods Act 1908. A term implied by common law is one which is implied into a contract because such a term is needed to give efficacy to that class of contracts (*Laws of New Zealand*)[7]. In *Williams v Gibbons*[8]

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[7] *General Principles of Contract and Quasi-Contract*, paragraph 4.4.1 *Terms Implied by law*

the Court of Appeal held that there was to be implied into contracts for the sale and purchase of land a term that payment by bank cheque was a satisfactory method of payment.

Terms Implied in Fact

The pre-*Belize Telecom* approach to implication

In the United Kingdom the most common tests applied were the "*business efficacy*" and "*officious bystander*" tests.

Whether these tests overlapped, or were cumulative or alternative, was unclear.

The business efficacy*" test derived from The Moorcock*[9]. The owner of a wharf and adjoining jetty contracted with a shipowner for a ship to be unloaded at the wharf and moored alongside the jetty. At low tide, the ship was damaged as a result of grounding itself on a hard ridge of the river bed. The Court of Appeal implied an undertaking by the defendants that the river bed was, so far as reasonable care could provide, in such a condition as not to endanger the vessel. Bowen LJ said:

> "*... the law is raising an implication from the presumed intention of the parties, with the object of giving to the transaction such efficacy as both parties must have intended that at all events it should have. In business transactions such as this, what the law desires to effect by the implication is to give such business efficacy to the transaction as must have been intended at all events by both parties who are business men*".

The officious bystander test derived from *Shirlaw v Southern Foundries (1926) Limited*[10]*:*

> "Prima facie *that which in any contract is left to be implied and need not be expressed is something so obvious that it goes without saying ... [I]f, while the parties were making their bargain, an officious bystander were to suggest some express provision for it in their agreement, they would testily suppress him with a common: "oh, of course*".

In his article "*Recent developments in the law of implied terms*"[11], Paul S Davies argues that the tests are appropriately restrictive and give little scope for Implication. The officious bystander test may lead to the implication of terms that are not strictly necessary, but a term will not be implied if one of the parties would not actually or subjectively have agreed to the implication of that term if he or she had been asked about it at the time the contract was made. Necessity can be seen to trump subjective intensions, but subjective intensions trump all other "*obvious*" terms. This gives rise to the difficult issue of where the limits of necessity lie. Davies argues that necessity has rightly been given a restrictive definition as affording "*a more appropriate level of respect and protection to the document agreed by the parties*".

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[8] [1994] 1 NZLR 273
[9] (1889) 14 pd 64
[10] (1939) 2 KB 206
[11] (2010 LMCLQ 140)

In New Zealand the test applied to determine whether a term should be implied in fact was that stated in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings*[12]. The Privy Council set out five criteria:

1. **It must be reasonable and equitable**; a term should not be implied that is unfairly advantageous to one or the other party. For example in *Aotearoa International Limited v Scancarriers A/S*[13], the Privy Council refused to imply into a contract for shipping goods a term requiring the shipper to guarantee that space was available. The Court held that such a term would have radically altered the bargain made by the parties, as well as being inequitable in all the circumstances.

2. **It must be necessary to give business efficacy to the contract**. If the contract cannot work without a term being implied as to some matter, then this test is met. If it can work without the implied term, although perhaps less fairly, the term is not to be implied.

3. **The term must be "*obvious*"**. This requires the Court to be certain of what the parties would have provided had the matter been drawn to their actual attention at the time of the formation of the contract; *Shirlaw v Southern Foundries Ltd*[14]. In *The Power Co Ltd v Gore District Council* [15], the appellant's argument that a "*perpetual*" agreement supply power at a cheap rate was subject to an implied term allowing the agreement to be ended on reasonable notice failed in part because there were many ways such a term could have been phrased, and therefore none was "*obvious*".

4. **The term must be capable of clear expression.**

5. **The proposed term must not contradict any express term of the contract**. In *The Power Co Ltd* case mentioned above, the Court held that no term allowing the contract to be brought to an end on reasonable notice could be implied because any such term would contradict the express statement in the contract that the agreement was "*perpetual*".

***Belize Telecom* – the facts**

Belize Telecommunications Limited ("BT") was formed to take over from the public body which had been the monopoly provider of telecommunications services in Belize. The government of Belize wanted to sell out of BT but retain some control. The government kept a special share which gave it no voting rights but the right to attend shareholder meetings. It had the right to appoint two directors.

The ordinary share capital, apart from the special share, was divided into two classes designated B and C. Two designated B directors could be appointed and removed by the majority of B shareholders. Up to four designated C directors could be elected and removed by C shareholders.

In addition to its right as special shareholder to appoint two directors, the government could also appoint two of the C directors as long as it held 37.5% or more of the C Shares. The government as

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[12] (1977) 16 ALR 363, 376
[13] [1985] 1 NZLR 513
[14] Above, note 10
[15] [1997] 1 NZLR 537

special shareholder had other rights if it held 25% or more of the C shares. The extent to which the interests of the special shareholder were protected was therefore graduated in accordance with its economic interest in the company.

BT acquired the special share and the majority of the share capital (the B and C shares) and purported to appoint all eight directors. BT pledged its shares to the government to secure borrowings to finance the purchase of the shares and then, unfortunately, and within a year, defaulted on its obligations. The government took back a substantial number of ordinary shares. BT was then left with the special share and C shares amounting to less than 37.5% of the issued share capital.

The question which then arose was whether the two special C directors appointed by BT remained members of the board. There was no holder of C shares with more than 37.5% of the share capital. There was no express provision in the articles that in such circumstances the special C directors would vacate office. BT therefore argued that the C directors were "*irremovable*" unless they chose to resign or came within the article providing that they had to leave office in the event of bankruptcy, lunacy and so on. The appellants argued that this would be an absurd result and the articles should be construed as providing by implication that a director appointed by virtue of a specified shareholding had to vacate his or her office if there was no longer any holding of such a shareholding.

Such a term was implied by the Supreme Court of Belize but not by the court of Appeal. The Privy Council overturned the decision of the latter. As commentators have noted (see for example Davies16), the result seems perfectly sensible: it would be absurd to have a director who was meant to represent the interests of a shareholding of a particular size which no longer exists. The implication seems appropriate in terms of *The Moorcock* criterion of being "*necessary to give business efficacy to the contract*".

Lord Hoffmann, delivering the decision of the Board, starts with some general observations about the process of implication (paragraph 16):

> "*The court has no power to improve upon the instrument which it is called upon to construe, whether it be a contract, a statute or articles of association. It cannot introduce terms to make it fairer or more reasonable. It is concerned only to discover what the instrument means. However, that meaning is not necessarily or always what the authors or parties to the document would have intended. It is the meaning which the instrument would convey to a reasonable person having all the background knowledge which would reasonably be available to the audience to whom the instrument it addressed:* see *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, 912-913".

At paragraph [21] Lord Hoffmann summarised the principle thus:

> "*It follows that in every case in which it is said that some provision ought to be implied in an instrument,* ***the question for the court is whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean*** *... [T]his question can be reformulated in various ways*

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[16] Above note 11

> *which a court may find helpful in providing an answer – the implied term must 'go without saying', it must be 'necessary to give business efficacy to the contract' and so on – but these are not in the Board's opinion to be treated as different or additional tests.* ***There is only one question: is that what the instrument, read as a whole against the relevant background, would reasonably be understood to mean?"*** (emphasis added)

At paragraph [25] Lord Hoffmann said that the imaginary conversation with an officious bystander ("*celebrated throughout the common law world*") carried the danger "*of barren argument over how the actual parties would have reacted to the proposed amendment. That, in the Board's opinion, is irrelevant*".

The Court then went on to say, at paragraph [27], that the five points in the *BP Refinery* case were not intended to created a "*series of independent tests which must each be surmounted*", but rather were all different ways of expressing the central idea that the proposed implied term must spell out what the contract actually means.

Davies[17] argues that Lord Hoffmann's stated aim, to assimilate implication within interpretation ("*the implication of the term is not an addition to the instrument. It only spells out what the instrument means*"[18]) is questionable as a matter of logic. If the contract is silent on a point, then by implying a term the Court is supplementing, or replacing, silence.

The interpretation approach, regarding the consideration of the subjective intentions of the parties as irrelevant, runs the risk of blurring the boundaries between seeking to ascertain the intentions of the parties from all possible evidence, and seeking to determine what intentions the parties manifested in the written document. Traditionally the Courts and the commentators recognise that there is value in aiding certainty with which contracts can be interpreted and their contents relied upon.

As Sir Tom Bingham MR said in *Philips Electronique Grand public SA v British Sky Broadcasting Limited*[19]*:*

> *'the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court to then fashion a term which will reflect the merits of the situation as they then appear. Tempting, but wrong*".

Interestingly, the UK courts appear to have maintained a "*business as usual*", traditional approach to implication following the *Belize Telecom* decision. In *The Reborn (Mediterranean Salvage & Towage Limited v Seamar Trading and Commerce Inc (the Reborn)*[20] *)* Lord Clarke MR, referring to *Belize Telecom*, placed great weight on the default position being that no term should be implied, the stressed "*the importance of the test of necessity*" (that is, not reasonableness). The Master of the Rolls also cited a further passage of Sir Thomas Bingham MR in *Philips Electronique*:

> "*The court's usual role in contractual interpretation is, by resolving ambiguities or reconciling apparent inconsistencies, to attribute the true meaning to the language in which the parties*

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[17] Above, note 11
[18] Above, note 1 at paragraph [18]
[19] [1995] EMLR 472
[20] [2009] EWCA Civ 531

> *themselves have expressed their contract. The implication of contract terms involves a different and altogether more ambitious undertaking: the interpolation of terms to deal with matters for which, ex hypothesi, the parties themselves have made no provision. It is because the implication of terms is potentially so intrusive that the law imposes strict constraints on the exercise of this extraordinary power*".

In *Lancore Services Ltd v Barclays Bank Plc*[21]*, a case which did not refer to Belize Telecom* despite its being heard a month after the Privy Council case, the UK Court of Appeal was clear in concluding that a term should not be implied unless both parties would have actually agreed to such a term:

> "*It is not in fact a question of what an officious bystander might think, but how the parties would react if such a bystander raised with them the [relevant] point ;.. it by no means follows that it would have responded with a testy "Oh, of course'. It might well have responded 'Certainly not'. If so, that points away from the implication of any such term*".

The State of Play in New Zealand

In *Byrne v Australian Airlines Limited*[22]*,* the High Court of Australia adopted earlier judicial statements that the cases in which the BP Refinery test had been mainly employed were cases where there was a formal contract complete on its face. Where there is no formal contract, such a rigid approach should be avoided. Rather, the test should be simply *"whether the implication of a particular term is necessary for the reasonable or effective operation of a contract of that nature in the circumstances of the case".*

In *McNeill v Gould*[23]*,* the New Zealand Court of Appeal took the view that the "*business efficacy*" and "*obviousness*" (officious bystander) tests were best treated as alternatives, and not cumulatively.

Hammond J said:

> "*The BP Refinery case ... has to be approached with a good deal of caution in a case such as the present. That case concerned the suggested implication of a term in a rating agreement to make it accord with a refinery construction agreement. Patently, a stringent approach was required in such a context, where a great deal of care had already been taken over complicated documents.*
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> *We think it more appropriate to adopt, in the context of this case, the formulation of the learned editors of* chitty on Contract, *Vol 1 para 13-004 viz,*
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>> *[A] court will be prepared to imply a term if there arises from the language of the contract itself, and the circumstances under which it is entered into, an inference that the parties must have intended the stipulation in question. An implication of this nature may be made in two situations; first, where it is necessary to give business efficacy to the contract, and secondly where the term implied represents the obvious,* but unexpressed*, intention of the parties. These criteria often overlap, and*

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[21] [2009] EWCA Civ 752
[22] (1995) 185 XLR 411,422
[23] (2002) 4 NZConvC 193 557, at paragraphs [25] to [27]

> *in many cases, have been applied cumulatively, although it is submitted that they are, in fact, alternative grounds. Both, however, depend on the presumed intention of the parties* (Emphasis added)"

The Court of Appeal considered *Belize Telecom* in *Hickman v turn and Wave Limited*[24], where it was said, at paragraph [248], that while the *BP Refinery* list should not necessarily be regarded as cumulative, each element is a useful indicator relevant to the ultimate question of what the reasonable person would have understood the contract to mean. "*This is to be construed objectively by a notional reasonable person with knowledge of the relevant background*".

The case concerned investors who had signed unconditional agreements to buy apartments in three separate developments in Auckland. The Investors also signed separate investment agreements with Blue Chip under which they were entitled to certain financial returns and assistance.

On appeal, the investors sought to amend their pleadings to allege that there was an implied term in the sale and purchase agreements that the investors would not be called upon to settle under the agreements unless the relevant Blue Chip company performed its obligations.

The Court of Appeal, by reference to the *BP Refinery* criteria, found that the term could not be implied:

- The term would render an unconditional contract conditional;
- It was not necessary to give business efficacy to the sale and purchase agreements;
- It would frustrate the business purpose of the parties;
- It would be inconsistent with the terms of the other documents the investors had entered into.

In *Vodafone New Zealand Limited v M5 Investments Limited*[25], Keane J was of the view that the *Belize Telecom* test (what the instrument, read as a whole against the relevant background, would reasonably be understood to mean) was how the test was to be applied in New Zealand. The Court found that the implication of the duty and liability sought by Vodafone would have been at odds with those that the defendant had actually assented to.

Summary

Although there are justifiable concerns that the "*modern*" approach to implication, as represented by *Belize Telecom*, is too relaxed and blurs the boundaries between interpretation and inference, it appears that the New Zealand courts remain appropriately reluctant to imply terms and continue to take a principled approach in light of the five considerations in the *BP Refinery* case.

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[24] [2011] NZCA 100, [2011] 3 NZLR 318
[25] (High Court, Auckland, CRI 2008-404-002860, 3 December 2010, paragraphs [73] to [78\