Principles of Contractual Interpretation: The Demotion of the Importance of Commercial Common Sense

Gareth McAloon

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+44 (0) 115 947 2581 - www.ropewalk.co.uk

Introduction

1. The Supreme Court has recently handed down judgment in the matter of *Arnold v Britton & Others [2015] UKSC 36* and, in giving his lead judgment of the majority, Lord Neuberger has again emphasised the general principles of interpreting provisions in a contract. The principles enunciated will be familiar to most who deal in this area and do not really expand on those which his predecessor's had already identified (see for example Lord Hoffman's speech in *Chartbrook Limited v Persimmon Homes Limited [2009] UKHL 38* or the judgment of Lord Clarke in *Rainy Sky SA v Kookmin Bank [2011] 1 WLR 2900* para's 14-30). However, what is slightly different is the hierarchical approach to those principles which Lord Neuberger has identified and the demotion, in that hierarchy to the role of 'commercial common sense' as a source for interpretation.

Background

2. *Arnold* concerned a holiday park in South Wales. The park contained a number of chalets who were each the subject of 99 year leases. The leases contained covenants for both the tenant and the landlord. Further to this the leases also provided for a service charge to be paid to the landlord for the general upkeep and maintenance of the park itself. The service charge was expressed to in clause 2(3) of 70 of the leases as follows:

3. *"To pay the Lessor without any deduction in addition to the said rent a proportionate part of the expenses and outgoings incurred by the Lessor in the repair maintenance renewal and the provision of services hereinafter set out the yearly sum of Ninety Pounds and value added tax (if any) for the first three years of the term hereby granted increasing thereafter by Ten Pounds per Hundred for every subsequent three year period or part thereof."*

4. In essence, the appellants (the tenants under the leases) argued that the service charge clause did not read such as to provide for a compound 10% uplift every three years on the base charge of £90 but that it provided that they would pay the landlord their reasonable expenses incurred in maintaining the site 'up to' a maximum of £90 plus the uplift. They argued this on the apparent existence of a contradiction within the term in question - the first half of it providing for a 'proportionate' service charge to the landlords maintenance costs, and the second half providing for an amount by way of a calculation which could yield a disproportionate level of charge. Accordingly, due to this contradiction they asked the Court to give more weight to the first half of the clause and make the second halves calculation subject to a capping provision to an amount 'proportionate' to the landlords incurred maintenance costs.

5. The landlord contended that the clause should be construed as read so as to provide for an uplift and if this amount exceeded the landlord's maintenance costs for the year then that was still the amount which should be paid. Equally, the landlord contended that the calculation could provide for an amount below their maintenance costs with them bearing the costs over and above that level. In either event, the landlord submitted that an ordinary reading of the clause could not be interpreted as capping the level of charge.

The Approaches to Contractual Interpretation

(i) The majority

6. At paragraph 14 Lord Neuberger refers to the established factors in *Prenn v Simmonds [1971] 1 WLR 1381* and states, at paragraph 15:

> *"That meaning has to be assessed in light of the (i) the natural and ordinary meaning of the clause and the lease, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions."*

7. The more developed part of the judgment comes from paragraphs 17-23. In these sections, Lord Neuberger makes it clear that the factors identified above are both hierarchical and qualified:

I. 'Ordinary meaning' - the most fundamental principle is to ascertain what the parties agreed from the ordinary meaning of the words in the relevant provision. The Court should always have this as its starting point and, save in unusual instances, departure from them should not be undertaken. The Court is not re-writing the contract but is giving effect to the agreement the parties reached. Even in cases where it is necessary for the Court to look at other factors the ordinary meaning of the provision lingers, akin to an overriding objective, throughout the interpretation process to ensure that effect is given, so far as is possible, to the parties agreement.

II. 'Other provisions' - Where there is another contractual provision which appears to be at odds with the provision now under scrutiny, the resolution between the two can be dealt with by reference to the other factors but focus should again be on the ordinary meaning of the two conflicting provisions as a first point of recourse. Where there is another provision which supplements or elaborates upon another provision then again that other provisions' wording should be the Court's primary assessment. Where ambiguity prevails, then other factors should be examined to ensure correct interpretation of it.

III. ‘Knowledge of the parties’ - When assessing the facts known to the parties the Court must focus on their knowledge at the time of agreement - it is that snapshot in time of their knowledge then which the Court is concerned with - hindsight should be disregarded in this assessment. This factor can, it seems, play a part in the assessment of the everyday meaning of the wording of the provision in question, but also feeds into the assessment of commercial common sense where that factor is engaged. Note that emphasis is applied by Lord Neuberger at paragraph 21 so that the focus is on what was common knowledge to both parties - the contract, by its nature, is bilateral and therefore facts which were known to one party but not to another will not be of assistance in identifying what was actually agreed.

IV. ‘Commercial common sense’ - This is a factor which is “very important” but which is significantly qualified and is not to be applied without appreciation of its boundaries. In particular:

a) “Commercial common sense and surrounding circumstances should not be invoked to undervalue the importance of the language of the provision which is to be construed.” [para17] - to that end it must follow that it will not always be necessary to revert to this factor in every case. In short, where the wording is clear and can be interpreted by itself, there will be no need for the Court to look at the other factors;

b) “Commercial common sense is only relevant to the extent of how matters would or could have been perceived by the parties, or by reasonable people in the position of the parties, as at the date that the contract was made.” [para 18] - The message here being that though what is commercially sensible at the time of the contract may not be commercially sensible at the time of performance, this should not relieve the non-performing party from the bargain they entered into just because it now appears to have been a bad one.

V. In cases where there is an unintended or unforeseen event which occurs, firstly the Court must satisfy itself that the event in question was outside of the scope of the agreement having regard to the language of the contractual provisions, and secondly the Court will always try and interpret the contractual provision now in doubt in accordance from the general intentions of the parties as evidence from the wording of the contract itself. Again the message is clear - the Court must not enter into the territory of re-writing the contract but is giving effect to the agreement insofar as it is able.

8. Applying this hierarchy to *Arnold*, Lord Neuberger noted that the effect of the wording of clause 3(2) was that the tenants would be paying over and above the actual maintenance costs of the landlord in him performing his covenants under the lease. Commercially speaking this represented a poor bargain for the

tenants since they were adding to the landlords overall profits as opposed to capping them at a level of incurred expenditure – indeed, by 2072 the annual service charge would be £550,000 due to its compound nature. Notwithstanding this, commercial common sense was not a factor which came into the interpretation assessment since the wording of the clause clearly provided for this outcome. He held at paragraph 28:

> *"It is true that the first part of the clause refers to a lessee paying a 'proportionate part' of the cost of the services, and that, unless inflation increases significantly in the next 50 years it looks likely that the service charge payable under each of the 25 leases may exceed cost of providing services to the whole of the Leisure Park. However, if, as I believe is clear, the purpose of the second part of the clause is to quantify the sum payable by way of service charge, then the fact that, in the future, its quantum may substantially exceed the parties' expectations at the time of the grant of the lease is not a reason for giving the clause a different meaning."*

9. Lord Neuberger therefore interpreted the clause in the landlord's favour, holding that the first half of the clause imposed a liability on the tenants and the second part provides a method for calculating its amount. The clause went no further than this and did not provide for a cap to be placed on the amount relative to the landlords incurred maintenance costs - whether or not the outcome was commercially prudent for the tenant was irrelevant.

10. From Lord Neuberger's point of view therefore the role that commercial sense plays in interpretation is limited to when the ambiguity of the language requires it, and even then only in confined circumstances. One can see the attraction in this argument from a 'certainty' point of view.

(ii) The minority

11. For Lord Carnwath however, the matter was not so straightforward and he advocated that an assessment of the clauses' commercial outcome should undertaking almost immediately in the interpretation process. In his minority speech he referred to a number of authorities which touched upon cases where the language of a clause had yielded unreasonable results (see paragraphs 109-110). Lord Carnwath's approach, therefore, was not to deploy a hierarchy amongst the tools of interpretation, but rather to either; look at the matter applying all of the tools available to find a true interpretation - a view he had already cast in *KPMG LLP v Network Rail Infrastructure Ltd [2007] Bus LR 1336* - para 50) - put simply, this would start with the ordinary meaning of the wording of the clause and then cross-check this against the commercial sense of the outcome. If there was an unreasonable outcome then a correction needs to be made to give effect to the parties proper commercial intention of the clause. Alternatively, he mooted for a correction technique of implying terms, or words into terms, to give business efficacy to a provision so

as to again give effect to the proper commercial intention the parties had when they agreed the clause. The only way that an unreasonable commercial outcome should be given effect to is where *"only the clearest words would justify the court in adopting it"* [para 158]. He said this at paragraph 115:

> *"In any event, this example provides support for the proposition that, where an ordinary reading of the contractual words produces commercial nonsense, the court will do its utmost to find a way to substitute a more likely alternative, using whichever interpretative technique is most appropriate to the particular task."*

12. Unsurprisingly, therefore, Lord Carnwath found that there was an inherent contradiction between the two halves of clause 3(2) which required resolution and held that he would have implied the 'upper limit' interpretation into the clauses so as to have capped the level of charge.

Conclusion

13. The approach by Lord Carnwath therefore differs quite substantially from that taken by Lord Neuberger, particularly in regards to the role of commercial sense in contractual interpretation. On the one hand, it seems that a hierarchical approach is adopted by Lord Neuberger such that commercial sense is only referred to as a measure of last resort with the actually wording of the clause ruling supreme regardless of the commercial consequence. On the other hand, Lord Carnwath's approach enlarges the role of commercial sense because it would always need to be referred to by the Court - even in cases of clear language - since the commercial consequence will provide a context for the clauses' interpretation. Only then in exceptional cases where it is clear from the wording of the provision that the unreasonable commercial result was that which must have been intended, will the Court give effect to such an outcome and not intervene.

14. The debate between which approach is correct is unlikely to end here. Parties to a contract which has turned sour against them will inevitably try to avail themselves of a commercially correct interpretation to minimise or eradicate their losses. Likewise parties in the ascendency will always rely on the literal and ordinary wording of a clause to ensure they maximise their returns out of the bargain.

15. However, what is fundamental is that the essence of a contract is agreement - it is what was agreed which must override everything. The Court does not adjudicate matters according to what was not agreed. The approach of Lord Carnwath runs the real risk of offending this principle since it opens the door for commercial reasonableness to usurp and change the very nature of contracts in some situations. However, applying this approach, would there ever really be such a thing as a 'bad bargain'?

16. It should be remembered that parties with full capacity to contract, who have full opportunity to think matters through and take appropriate advice, and who enter into contracts of their own free will, run their own risk in the outcome. Save for exceptional circumstances where there is evidence of clear misrepresentation or mistake (for which the Court has readily available doctrines to invoke), the Courts will, following *Arnold*, be highly reluctant to do anything other than read the parties own agreed words in interpreting contractual provisions. However, the arguments of Lord Carnwath will no doubt continue to be ever present.

Gareth McAloon

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