

## ***CONTRACTUAL INTERPRETATION AND THE IMPLICATION OF TERMS: A RETURN TO OTHODOXY?***

### **Introduction**

1. Over the last 45 or so years, the House of Lords and Supreme Court have examined the relevant principles of contractual interpretation in some landmark authorities.
2. Notable cases include: *Prenn v Simmonds* [1971] 1 WLR 1381; *Investors Compensation Scheme Ltd v West Bromwich Building Society (No.1)* [1998] 1 WLR 896; *Bank of Credit and Commerce International SA v Ali* [2002] 1 AC 251; *Chartbrook Ltd v Persimmon Homes Ltd* [2009] AC 1101; *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10 and *Rainy Sky SA v Kookmin Bank* [2011 WLR 2900
3. To that list, we must now add the two recent decisions of the Supreme Court in *Arnold v Britton* [2015] AC 1619 and *Marks & Spencer v BNP Paribas Security Services Trust Co (Jersey) Ltd* [2016] AC 742.
4. Both cases were landlord and tenant disputes in which the Supreme Court took the opportunity to review and restate fundamental aspects of the law on contractual interpretation and the implication of terms.

### ***Arnold v Britton: Contractual Interpretation***

#### **The facts**

5. *Arnold* concerned a dispute over service charge provisions contained in leases granted over holiday chalets on an estate on the Gower peninsular. The estate consisted of 91 holiday dwellings, let on different dates under 99 year leases all commencing on 25 December 1974.
6. A recital in all the leases recorded that all the chalets in the leisure park were intended to be subject to leases “*upon terms similar in all respect to the present demise, the intention being that the estate was to form a building or letting scheme. This was reinforced by clause 4(8) of the leases which contained a covenant by the lessors as follows:*  
  
*“(viii) That the leases granted by the lessors of all other plots on or comprised in the estate shall contain covenants on the part of the lessees thereof to observe the like obligations as are contained herein or obligations as similar thereto as the circumstances permit”*
7. Despite these provisions, the leases were not all in identical form. Although similar in almost every other respect, there were 5 different versions of the service charge provisions. The provisions contained in the original leases granted between 1974 and 1980 had been varied in subsequent leases granted between 1980-1983; 1985-1988; 1988-1991 and finally in 2000.

8. The service charge provisions for the majority of the leases required a fixed sum payment of £90 in the first year, increasing triennially thereafter:

*“3(2) To pay to the lessors without any deductions in addition to the said rent a proportionate part of the expenses and outgoings incurred by the lessors in the repair maintenance renewals and the provisions of services hereafter set out in the yearly sum of £90 and VAT (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 of part thereof”*

9. However, 25 of the leases granted between 1980 and 1988<sup>1</sup> contained service charge provisions that required payment of the £90 with an annual increase in these terms:

*“for the first year of the term hereby granted increasing thereafter by ten pounds per hundred for every subsequent year thereof”*

10. The result was that 25 out of 91 lessees were paying a service charge that increased 10% a year on a compounded basis, whereas the majority had 10% increases triennially.
11. At first blush this difference seems relatively innocuous. However, the disparity created an extraordinary difference to the service charge payable over the term of the lease, particularly when compared to the actual inflation figure, which meant the 25 lessees paid a grossly disproportionate contribution towards services, whilst the majority were paying considerably less than fairness dictated:

Y	T	A	R
1	£	£	£
0	0	0	0
2	£	£	£
0	2	1	5
2	£	£	£
0	2	2	7
2	£	£	n
0	1	1	/

12. Because the charges were fixed charges, with an inflation adjustment, and not variable charges dependent upon the relevant costs incurred, they fell outside the definition of service charge contained in s.18(1) of the Landlord and Tenant Act 1985:

**18.— Meaning of “service charge” and “relevant costs”.**

<sup>1</sup> Some of the leases granted in the later versions also contained an annual increase but were subject to deeds of variation that made the increases triennial.

(1) In the following provisions of this Act “*service charge*” means an amount payable by a tenant of a dwelling as part of or in addition to the rent—

(a) which is payable, directly or indirectly, for services, repairs, maintenance, improvements or insurance or the landlord's costs of management, and

(b) the whole or part of which varies or may vary according to the relevant costs.

13. There was therefore no relevant statutory control over the service charges or any requirement that they be limited to an amount “reasonably incurred”.
14. Salt was rubbed into the wounds by the fact that the lessors (Mrs Arnold and her daughter) had produced no evidence explaining the reasons for granting differently worded leases at different times, even though they were the original lessors.
15. Furthermore, because Mrs Arnold had issued a Part 8 Claim seeking a declaration as to the proper construction of the service charge clauses in response to an application by the lessees for pre-action disclosure, she had managed to avoid (possibly by design) giving disclosure of any accounts or documents evidencing what services had been provided and whether the service charges paid under the leases had in fact been spent on services.
16. It was perhaps no surprise that in his dissenting judgment, Lord Carnwarth described the clauses as “wretchedly conceived”, “extreme and arbitrary” and had potentially catastrophic financial consequences for the lessees concerned.

### **The proceedings and the issues**

17. Reduced to its essentials, the argument before the court was whether the inflated £90 was to be read as a fixed amount payable in any event, or merely a cap on the service charge payable.
18. The lessees’ principal argument was that, having regard to the commercial absurdity that a literal construction of the clause produced, the clause had to be construed in a manner that required the lessee to pay a fair proportion of the lessors’ costs subject to a maximum of the £90 plus compounded annual interest of 10%. This was reinforced by the fact that the preamble to all the leases recorded the fact that they would all be let on the same terms as part of a building or letting scheme, which was inimical to the idea of different lessees paying different sums for the same services.
19. The lessor argued that the words used by the parties were clear and unambiguous. Furthermore, that it was not commercially absurd to agree a fixed rate of increase against the backdrop of the rate of inflation prevailing at the time the leases were taken.
20. The claim started in the County Court where the Judge held in favour of lessees. In the High Court, Morgan J. allowed Mrs Arnold’s appeal, and his judgment was upheld by the Court of Appeal. The Supreme Court gave permission to appeal.

### **The Judgments**

21. Lord Neuberger gave the lead judgment for the Majority (with whom Lord Clarke, and Lord Sumption agreed). Lord Hodge gave a judgment concurring with Lord Neuberger (with which Lord Neuberger agreed). Lord Carnwarth gave a dissenting judgment.

22. It is fair to say that all the JSCs recognised the overwhelming moral merit of the lessees' case and the unattractive consequences for them in having to pay the service charges strictly in accordance with the leases. The lack of evidence going to the circumstances of how and why the different leases were entered into, and what the rationale was for the differing contributions was also a source of great frustration for the court.

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### The Majority

23. At the outset of his judgment, Lord Neuberger observed that over the past 45 years, the House of Lords and Supreme Court had discussed the correct approach to contractual interpretation on a number of occasions, starting with *Prenn v Simmonds* [1971] WLR 1381 and culminating in *Rainy Sky SA v Kookmain Bank* [2001] 1 WLR 2900. He then neatly summarised the relevant principles as follows:

“[15] When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to “what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean”, to quote Lord Hoffmann in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] AC 1101, para 14. And it does so by focussing on the meaning of the relevant words, in this case clause 3(2) of each of the 25 leases, in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (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. In this connection, see *Prenn [1971] 1 WLR 1381*, 1384-1386; *Reardon Smith Line Ltd v Yngvar Hansen-Tangen (trading as HE Hansen-Tangen)* [1976] 1 WLR 989, 995-997, per Lord Wilberforce; *Bank of Credit and Commerce International SA v Ali* [2002] 1 AC 251, para 8, per Lord Bingham of Cornhill; and the survey of more recent authorities in *Rainy Sky [2011] 1 WLR 2900*, paras 21-30, per Lord Clarke of Stone-cum-Ebony JSC.”

24. Lord Neuberger then went on to emphasise what he described as seven important factors:

[17] First, the reliance placed in some cases on commercial common sense and surrounding circumstances (eg in *Chartbrook* [2009] AC 1101, paras 16-26) should not be invoked to undervalue the importance of the language of the provision which is to be construed. The exercise of interpreting a provision involves identifying what the parties meant through the eyes of a reasonable reader, and, save perhaps in a very unusual case, that meaning is most obviously to be gleaned from the language of the provision. Unlike commercial common sense and the surrounding circumstances, the parties have control over the language they use in a contract. And, again save perhaps in a very unusual case, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision.

<sup>2</sup> Lord Carnwarth was particularly coruscating in his criticism of Mrs Arnold and her daughter and their failure or refusal to produce evidence about the background to the leases. Of the submission that the court should draw “inferences” as to the rationale for the various versions, Lord Carnwarth said: “*With respect to Mr Daiches I have to say that, even in this extraordinary case, I find these submissions quite astonishing. Given that his client and her daughter were the principal parties to these transactions, why on earth should the court be expected to draw “inferences” as to what was in their minds? Why should we speculate as to the extent of any “historic shortfalls”, when she presumably has access to the actual accounts, and has resisted the lessees' requests for disclosure?*”

[18] Secondly, when it comes to considering the centrally relevant words to be interpreted, I accept that the less clear they are, or, to put it another way, the worse their drafting, the more ready the court can properly be to depart from their natural meaning. That is simply the obverse of the sensible proposition that the clearer the natural meaning the more difficult it is to justify departing from it. However, that does not justify the court embarking on an exercise of searching for, let alone constructing, drafting infelicities in order to facilitate a departure from the natural meaning. If there is a specific error in the drafting, it may often have no relevance to the issue of interpretation which the court has to resolve.

[19] The third point I should mention is that commercial common sense is not to be invoked retrospectively. The mere fact that a contractual arrangement, if interpreted according to its natural language, has worked out badly, or even disastrously, for one of the parties is not a reason for departing from the natural language. 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. Judicial observations such as those of Lord Reid in *Wickman Machine Tools Sales Ltd v L Schuler AG* [1974] AC 235 , 251 and Lord Diplock in *Antaios Cia Naviera SA v Salen Rederierna AB (The Antaios)* [1985] AC 191 , 201, quoted by Lord Carnwath JSC at para 110, have to be read and applied bearing that important point in mind.

[20] Fourthly, while commercial common sense is a very important factor to take into account when interpreting a contract, a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed, even ignoring the benefit of wisdom of hindsight. The purpose of interpretation is to identify what the parties have agreed, not what the court thinks that they should have agreed. Experience shows that it is by no means unknown for people to enter into arrangements which are ill-advised, even ignoring the benefit of wisdom of hindsight, and it is not the function of a court when interpreting an agreement to relieve a party from the consequences of his imprudence or poor advice. Accordingly, when interpreting a contract a judge should avoid re-writing it in an attempt to assist an unwise party or to penalise an astute party.

[21] The fifth point concerns the facts known to the parties. When interpreting a contractual provision, one can only take into account facts or circumstances which existed at the time that the contract was made, and which were known or reasonably available to both parties. Given that a contract is a bilateral, or synallagmatic, arrangement involving both parties, it cannot be right, when interpreting a contractual provision, to take into account a fact or circumstance known only to one of the parties.

[22] Sixthly, in some cases, an event subsequently occurs which was plainly not intended or contemplated by the parties, judging from the language of their contract. In such a case, if it is clear what the parties would have intended, the court will give effect to that intention. An example of such a case is *Aberdeen City Council v Stewart Milne Group Ltd* 2012 SC (UKSC) 240 , where the court concluded that “any ... approach” other than that which was adopted “would defeat the parties' clear objectives”, but the conclusion was based on what the parties “had in mind when they entered into” the contract: see paras 21 and 22.

[23] Seventhly, reference was made in argument to service charge clauses being construed “restrictively”. I am unconvinced by the notion that service charge clauses are to be subject to any special rule of interpretation. Even if (which it is unnecessary to decide) a landlord may have simpler remedies than a tenant to enforce service charge provisions, that is not relevant to the issue of how one interprets the contractual machinery for assessing the tenant's contribution. The origin of the adverb was in a judgment of Rix LJ in *McHale v Earl Cadogan* [2010] HLR 412, para 17. What he was saying, quite correctly, was that the court

should not “bring within the general words of a service charge clause anything which does not clearly belong there”. However, that does not help resolve the sort of issue of interpretation raised in this case.

25. The primary emphasis, therefore, must be on the actual words used by the parties. If they are clear and unambiguous and have a natural meaning, they should be given that meaning, despite the commercial absurdity or unwelcome consequences that this might bring for one of the parties.

*The internal inconsistency point*

26. Applying those principles to the instant case, the Majority were not persuaded that they could depart from the natural and ordinary meaning of the service charge clause. Lord Neuberger recognised that it would be tempting to see the two halves of clause 3(2) as inconsistent.
27. The argument would be that the first part of the clause referred to the lessee paying a “*proportionate part*” of the costs and services whereas, given what was now known about the likely inflation rate, the second part of the clause would require (in the case of the annual increases) a sum far in excess of the costs and services. Such an internal inconsistency would allow the court to modify the clause and give effect to the “real intention” of the parties.
28. Tempting as it might be to do justice in the instant case, such an approach would involve the court inventing a lack of clarity in the clause as an excuse for departing from its natural meaning, in the light of subsequent developments (at [29]). A reasonable reader would see that the first half of the clause as descriptive of the purpose (to provide for an annual service charge) and the second half as to quantification (at [27]).

*The “upper limit” point*

29. What of the argument that, because the parties cannot have intended the £90 charge to be compounded year on year to reach levels of £100,000s in the later years of the lease, and because all the leases were intended to be in the same form and operate on the same basis, the second part of the clause should be interpreted as imposing an upper limit on the service charge? Again, despite the unattractive consequences, this was not a convincing point. It would involve inserting words which were not there and departing from the natural meaning of the clause (at [32]).

*The commercially-based inflation point*

30. Furthermore, even apart from the fact clause 3(2) was clear as a matter of language, Lord Neuberger and the Majority were not persuaded by the commercially-based argument that it was inconceivable that a lessee, in the 1970s and much of the 1980s, would have agreed to a service charge provision that required a fixed sum of £90 that increased by 10% per annum, even on a compound basis.
31. Inflation was running at over 15% per annum for 6 of 8 years between 1974 and 1981.

The parties were therefore taking a gamble on inflation – but it was a bilateral one. If inflation was more than 10%, the lessor would lose out. The fact that economists could not predict future inflation with accuracy was nothing to the point:

“[37] People enter into all sorts of contracts on the basis of hopes, expectations and assessments which no professional expert would consider prudent, let alone feel able to “predict with accuracy”. I have little doubt that many fortunes have been both made and lost (and sometimes both) by someone entering into such a contract.”

*The letting scheme and implied term point*

32. Finally, the Majority accepted that the recital and clause 4(8) meant that a degree of reciprocity and mutual enforceability was envisaged under the leases. That was not however enough to displace the ordinary meaning of clause 3(2) and imply a term that the lessor was not permitted to ask of the disadvantaged lessees more than of the remaining lessees. There were 5 reasons for this (at [51 to [55]):
- a) First, letting schemes were usually only relevant to the enforcement of restrictive covenants. It was doubtful whether they had relevance to positive covenants (at [51]).
  - b) Secondly, clause 4(8) referred to future lettings, not to past lettings (at [52]).
  - c) Thirdly, there was no reported case where a landlord had been held liable to a tenant in damages for having let a property on different terms within a letting scheme prior to the grant of the tenant’s lease (at [53]).
  - d) Fourthly, the closing words of clause 4(8) in fact permitted a degree of variation between the leases (at [54]).
  - e) Fifthly and fatally (even if all the other points were wrong and assuming everything else in the lessee’s favour) it would not be correct to imply a term because it would be inconsistent with (a) the express term in clause 3(2) and (b) with what is implied in relation to future leases, which would be the same as the instant lease (at [56]).

**Lord Hodge**

33. Lord Hodge agreed with Lord Neuberger but emphasised a number of other points.
34. First, he considered whether any of the cases on rectification by construction could assist the lessees, but came to the conclusion that, the lack of information about the relevant background and context and, more fatally, the lack of clarity about what correction ought to be made even if there had been a mistake, meant such an argument failed. The language was clear:

“[75] We are invited to construe that which reads on a first consideration as a fixed service charge with an escalator to deal with future inflation, as a variable service charge which is subject to a cap to which the escalator applies. I find that very difficult.”

35. Secondly, on Lord Hodge’s approach, this conclusion was not a matter of reaching a clear view on the natural meaning of the words and then seeing if there were circumstances that would displace that meaning. Rather, he would accept the formulation of a unitary process of construction given by Lord Clarke in *Rainy Sky*:

“the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has

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, would have understood the parties

to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other.” [at 21]

36. Lord Hodge therefore still supported the “unitary exercise”, which involves an iterative process by which each of the rival meanings is checked against the provisions of the contract and its commercial consequences are investigated.
37. But does that accord with the Majority approach? Although Lord Neuberger cited the passage from Lord Clarke’s judgment in *Rainy Sky* with apparent approval (at [15]) and agreed with Lord Hodge’s reasons for dismissing the appeal (at [60]), he did not expressly endorse the unitary formulation favoured by Lord Clarke in *Rainy Sky*. Moreover, the seven points of importance emphasised by Lord Neuberger at paras.17-23 and the approach of the Majority overall suggest that, if not wrong, the unitary approach may not be the most appropriate starting point, or even finishing point.

### **Lord Carnwarth**

38. Lord Carnwarth gave a strong dissenting judgment which, notably, Lord Neuberger expressed considerable sympathy with, not least because its conclusion was a much more satisfactory outcome in common sense terms (at [62]).
39. Like Lord Hodge, Lord Carnwarth placed particular emphasis on Lord Clarke’s judgment in *Rainy Sky* and the unitary approach to construction. Having reviewed the authorities, he held that they supported 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” (at [115])

40. Lord Carnwarth concluded that something had gone wrong in the drafting of the original 1974 leases, and therefore the subsequent leases. This was because clause 3(2) imposed an obligation to pay but two different descriptions of the payable amount: one by reference to a “proportionate amount” and the other to a “yearly sum”. Linguistically, there was no connection between the two and they were inconsistent (at [125]).
41. Once this was established, it was then a question of determining how to reconcile the two and which of the two alternative possibilities for the second part of the clause should be preferred: either a fixed sum or an upper limit. Lord Carnwarth preferred the latter. The officious bystander or reasonable person looking at the position at the time would have concluded that the parties did not intend to enter into a long term contract that bound the lessees to pay a fixed sum at compounded increases, irrespective of the actual cost of the services provided. That would have been absurd and unreasonable.

### **Marks & Spencer v BNP Paribas: The Implication of Terms**

42. Soon after *Arnold* had been decided, the Supreme Court was presented with another opportunity to review a fundamental area of the law of contract, this time in relation to the implication of terms.

## Belize Telecom

43. Until the Privy Council's decision in 2009 in *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10, the law relating to implied terms had been relatively uncontroversial.
44. The law books and cases were more or less consistent with the approach that a term would only be implied into a contract in two situations: either because the law imposed such terms (whether by statute or through established common law rules) or because the implication of the term was necessary to give the contract business efficacy, or on the basis that an officious bystander, if asked what would happen in a certain event, would have replied "of course, its so and so" (*The Moorcock* (1889) 14 PD 64; *Reigate v Union Manufacturing Co (Ramsbottom) Ltd* [1918] 1 KB 592; *Trollope & Colls Ltd v North West Metropolitan Regional Hospital Board* [1973] 1 WLR 601; *Liverpool City Council v Irwin* [1977] AC 239).
45. In *Belize Telcom*, Lord Hoffman sought to rationalise and explain the law in what would prove to be controversial terms.

17 The question of implication arises when the instrument does not expressly provide for what is to happen when some event occurs. The most usual inference in such a case is that nothing is to happen. If the parties had intended something to happen, the instrument would have said so. Otherwise, the express provisions of the instrument are to continue to operate undisturbed. If the event has caused loss to one or other of the parties, the loss lies where it falls.

18 In some cases, however, the reasonable addressee would understand the instrument to mean something else. He would consider that the only meaning consistent with the other provisions of the instrument, read against the relevant background, is that something is to happen. The event in question is to affect the rights of the parties. The instrument may not have expressly said so, but this is what it must mean. In such a case, it is said that the court implies a term as to what will happen if the event in question occurs. But the implication of the term is not an addition to the instrument. It only spells out what the instrument means.

19 The proposition that the implication of a term is an exercise in the construction of the instrument as a whole is not only a matter of logic (since a court has no power to alter what the instrument means) but also well supported by authority. In *Trollope & Colls Ltd v North West Metropolitan Regional Hospital Board* [1973] 1 WLR 601, 609 Lord Pearson, with whom Lord Guest and Lord Diplock agreed, said:

"the court does not make a contract for the parties. The court will not even improve the contract which the parties have made for themselves, however desirable the improvement might be. The court's function is to interpret and apply the contract which the parties have made for themselves. If the express terms are perfectly clear and free from ambiguity, there is no choice to be made between different possible meanings: the clear terms must be applied even if the court thinks some other terms would have been more suitable. An unexpressed term can be implied if and only if the court finds that the parties must have intended that term to form part of their contract: it is not enough for the court to find that such a term would have been adopted by the parties as reasonable men if it had been suggested to them: it must have been a term that went without saying, a term necessary to give business efficacy to the \* contract, a term which, though tacit, formed part of the contract which the parties made for themselves."

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20 More recently, in *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408, 459, Lord Steyn said: “If a term is to be implied, it could only be a term implied from the language of [the instrument] read in its commercial setting.”

21 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. It will be noticed from Lord Pearson's speech that this question can be reformulated in various ways 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?

46. The academic reception to this was mixed, with some regarding it as a radical departure from established principles. The decision was criticised and not followed by the Singapore Court of Appeal in *Sembcorp Marine Ltd v PPL Holdings Pte Ltd* [2013] SGCA 43. Nevertheless, the English courts subsequently followed and endorsed Lord Hoffman's approach (see *Mediterranean Salvage & Towage Ltd v Seamer Trading & Commerce Inc* [2009] EWCA Civ 531; *Jackson v Dear* [2012] EWHC 2060 per Briggs J.).

### **Marks & Spencer: the issue**

47. In *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd and another* [2016] A.C. 742, the Supreme Court came to consider a matter that had been vexing property lawyers for many years: the apportionment of rent paid as a condition of exercising a break clause.

48. The basic facts were not uncommon. M&S (the tenant) had served a notice on 7 July 2011, exercising a break clause to determine the lease on 24 January 2012. As a condition, the tenant was required to pay on or before the break date the sum of £919,800 and ensure, in the usual way, there were no arrears of rent as at the break date. Rent was payable in advance. And so in order to effect the break, the tenant had to pay the £919,800 and the December 2011 quarter's rent (£309,172 plus other charges) on time, which it duly did.

49. The lease came to an end on 24 January 2012. But the tenant had paid the rent in advance up to the March 2012 quarter. It therefore issued proceedings to recover the apportioned part of the rent from 24 January 2012 to 24 March 2012.

50. The difficulty facing the tenant was that it has been established law for many years that the Apportionment Act 1870 only allows the recovery of apportioned rent paid in arrear, not paid in advance (*Capron v Capron* (1874) LR 17 Eq 288; *Ellis v Rowbotham* [1900] 1 QB 740). There are two reasons for this. First, the mischief that the Act was concerned to correct related to rent payable in arrear. Secondly, the wording of section 2 of the 1870 Act is apt only to apply to rent paid in arrears since rent paid in advance cannot be said to be “accruing from day to day”:

<sup>3</sup> See Paul S Davies, “Recent Developments in the Law of Implied Terms” [2010] LMCLQ 140, John McCaughran, “Implied Terms: The Journey of the Man on the Clapham Omnibus” [2011] CLJ 607 and JW Carter and Wayne Courtney, “Belize Telecom: a reply to Professor McLauchlan” [2015] LMCLQ 245

## **2. Rents, &c. to accrue from day to day and be apportionable in respect of time.**

All rents, annuities, dividends, and other periodical payments in the nature of income (whether reserved or made payable under an instrument in writing or otherwise) shall, like interest on money lent, be considered as accruing from day to day, and shall be apportionable in respect of time accordingly.

51. The tenant therefore had to argue its case on the basis of an implication of a term, namely that the lease contained an implied term that in the event that the tenant exercised the break clause and paid the December quarter's rent in advance, it would be entitled to be repaid an apportioned sum for the period failing due after the lease expired on 24 January 2012.
52. That argument failed before Morgan J. in the High Court and in the Court of Appeal.

### **The Majority Judgment**

53. Lord Neuberger gave the lead judgment, with which Lords Sumption and Hodge agreed.
54. The tenant made two points that had "real force". First, the rent paid in advance was referable to the tenant's use and enjoyment in the forthcoming quarter. It was the *quid pro quo* for being able to occupy the premises. If the landlord could retain the apportioned sum, it would be unfair to the tenant and a windfall for the landlord. It was reasonable and equitable therefore that the apportioned sum be repaid.
55. Secondly, the lease stipulated that rent should be paid "*yearly and proportionately*" for any part of the year. Had the lease expired by effluxion of time in February 2018, the tenant would not have been liable to pay the whole December 2017 quarter rent. It could have apportioned it. When the tenant made the payment of rent for the December 2011, the parties did not know for certain that the break would be effective and that the lease would in fact expire on 24 January 2012. This was because the £919,800 that was required to be paid to exercise the break was not paid until January 2012. But had the break payment been paid before 25 December 2011, it would have been clear to the parties that the lease would be coming to an end, and so only an apportioned part rent would have been payable. Commercial common sense meant that the tenant should be in the same position whether it paid break payment before or after 25 December 2011.
56. Lord Neuberger rejected the submission that these arguments allowed the implied term contended for.
57. The lease was a detailed 70-page document drafted by solicitors. Both parties knew that the Apportionment Act 1870 did not apply to rent payable in advance, which the Majority confirmed was and remained good law (at [45]). The parties could therefore have addressed the matter had they chosen to do so. There were also other indications in the lease that the parties had applied their minds to what would happen with apportioned rent in other circumstances.
58. At the forefront of his judgment was an emphasis upon the need for necessity and the strictures of the historical formulations of the test set out in the authorities. The five conditions set out by Lord Simon in the Privy Council case of *BP Refinery (Westernport)*

*Pty Ltd v President & Councillors of the Shire of Hastings* (1977) 52 ALJR 20 remained good law and the starting point for the analysis:

“for a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that ‘it goes without saying’; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.”

59. Lord Neuberger then drew upon the judgment of Sir Thomas Bingham in *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd* [1995] EML 472 for further explanation of the underlying principles. In that case, Sir Thomas observed that it was difficult to infer with confidence what the parties must have intended when they have entered into a lengthy and carefully-drafted contract but have omitted to make provision for the matter in issue because it may well be doubtful whether the omission was the result of the parties' oversight or of their deliberate decision. He went to caution:

“The question of whether a term should be implied, and if so what, almost inevitably arises after a crisis has been reached in the performance of the contract. So the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court then to fashion a term which will reflect the merits of the situation as they then appear. Tempting, but wrong. .... it is not enough to show that had the parties foreseen the eventuality which in fact occurred they would have wished to make provision for it, unless it can also be shown either that there was only one contractual solution or that one of several possible solutions would without doubt have been preferred ...”

60. In Lord Neuberger's judgment these judicial observations represented a clear, consistent and principled approach. Although it was dangerous to reformulate the principles, he would add six comments to the summary of Lord Simon, as extended by Sir Thomas Bingham:

“First, in *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408 , 459, Lord Steyn rightly observed that the implication of a term was “not critically dependent on proof of an actual intention of the parties” when negotiating the contract. If one approaches the question by reference to what the parties would have agreed, one is not strictly concerned with the hypothetical answer of the actual parties, but with that of notional reasonable people in the position of the parties at the time at which they were contracting. Secondly, a term should not be implied into a detailed commercial contract merely because it appears fair or merely because one considers that the parties would have agreed it if it had been suggested to them. Those are necessary but not sufficient grounds for including a term. However, and thirdly, it is questionable whether Lord Simon's first requirement, reasonableness and equitableness, will usually, if ever, add anything: if a term satisfies the other requirements, it is hard to think that it would not be reasonable and equitable. Fourthly, as Lord Hoffmann I think suggested in *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988, para 27, although Lord Simon's requirements are otherwise cumulative, I would accept that business necessity and obviousness, his second and third requirements, can be alternatives in the sense that only one of them needs to be satisfied, although I suspect that in practice it would be a rare case where only one of those two requirements would be satisfied. Fifthly, if one approaches the issue by reference to the officious bystander, it is “vital to formulate the question to be posed by [him] with the utmost care”, to quote from *Lewison, The Interpretation of Contracts* 5th ed (2011), p 300, para 6.09. Sixthly, necessity for business efficacy involves a value judgment. It is rightly common ground on this appeal that the test is not one of “absolute necessity”, not least because the necessity is judged by reference to business efficacy. It may well be that a more helpful way of putting Lord Simon's second requirement is, as suggested by Lord Sumption JSC in argument, that a term can only be implied if, without the term, the contract would lack commercial or practical coherence.”

**What of *Belize Telecom* ?**

61. Where, then, did Lord Hoffman’s formulation in *Belize Telecom* fit in with this analysis? For the Majority, the answer was not very well at all. In Lord Neuberger’s view, properly construed, *Belize Telecom* did not in fact dilute the essential tests of necessity and, in so far as the decision had been interpreted as doing so, that was a misanalysis.

62. But what of Lord Hoffman’s postulation that the process of implying a term is all part and parcel of the exercise of interpretation? It was on this point that the Majority were most critical. Lord Hoffman’s analysis could obscure the fact that construing the words used and implying additional words are different processes governed by different rules. As Sir Thomas Bingham explained in *Philips* at p.418:

“The courts' 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 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 so potentially intrusive that the law imposes strict constraints on the exercise of this extraordinary power.”

63. As far as the Majority were concerned, the exercise of construing the express terms must come before any issue of implication, Lord Neuberger holding:

“28. Until one has decided what the parties have expressly agreed, it is difficult to see how one can set about deciding whether a term should be implied and if so what term. This appeal is just such a case. Further, given that it is a cardinal rule that no term can be implied into a contract if it contradicts an express term, it would seem logically to follow that, until the express terms of a contract have been construed, it is, at least normally, not sensibly possible to decide whether a further term should be implied. Having said that, I accept Lord Carnwath JSC's point in para 71 to the extent that in some cases it could conceivably be appropriate to reconsider the interpretation of the express terms of a contract once one has decided whether to imply a term, but, even if that is right, it does not alter the fact that the express terms of a contract must be interpreted before one can consider any question of implication.”

64. What status then did *Belize Telecom* now have? As far as Lord Neuberger and the Majority were concerned, it should no longer be followed:

“31. It is true that the *Belize Telecom case* [2009] 1 WLR 1988 was a unanimous decision of the Judicial Committee of the Privy Council and that the judgment was given by Lord Hoffmann, whose contributions in so many areas of law have been outstanding. However, it is apparent that Lord Hoffmann's observations in the *Belize Telecom* case, at paras 17–27, are open to more than one interpretation on the two points identified in paras 23–24 and 25–30 above, and that some of those interpretations are wrong in law. In those circumstances, the right course for us to take is to say that those observations should henceforth be treated as a characteristically inspired discussion rather than authoritative guidance on the law of implied terms.”

### **Lord Carnwarth**

65. Lord Carnwarth and Lord Clarke gave separate judgments. They were both members of the Court of Appeal in *Mediterranean Salvage & Towage Ltd v Seamer Trading & Commerce Inc* [2009] EWCA Civ 531, which had been decided shortly after *Belize Telecom* and in which Lord Clarke had adopted Lord Hoffman’s analysis and explained

that “the implication of a term is an exercise in the construction of the contract as a whole”

66. Although Lord Carnwarth agreed with the result, he firmly disagreed with the majority’s treatment of *Belize Telecom*. Pointing out that *Belize* was a unanimous decision of the whole Board and had been recognised in works such as *Lewison* as representing the current state of the law of England, Lord Carnwarth remarked [at 58] “we would need very good reasons for treating the judgment as less than authoritative and we have not been asked by the parties to do so”.

67. Lord Carnwarth was of the clear view that *Belize Telecom* was still good authority and that, properly understood, it did not water down the test of necessity as some commentators had suggested. As to the proper approach, Lord Carnwarth noted that Lord Neuberger preferred a sequential approach: first interpretation, then implication, but that he also accepted that both processes were part of the exercise of “determining the scope and meaning of the contract” [at 68]. He went on to hold:

“69. On this point also I see no reason to depart from what was said in the *Belize* case. While I accept that more stringent rules apply to the process of implication, it can be a useful discipline to remind oneself that the object remains to discover what the parties have agreed or (in Baroness Hale JSC’s words in the *Geys case* [2013] 1 AC 523 , para 55) “must have intended” to agree. In that respect it remains, and must be justified as, a process internal to the relationship between the parties, rather than one imposed from outside by statute or the common law (see the distinction noted by Lord Neuberger PSC: para 15.”

### **Lord Clarke**

68. Lord Clarke agreed with the judgment of Lord Neuberger but felt it necessary to clarify his own position, having regards to the difference between Lord Neuberger and Lord Carnwarth. He recognised that Lord Hoffmann’s view in *Belize Telecom* involved giving a wide meaning to “construction” and that both construing the actual words used and implying terms involve determining the scope and meaning of the contract and so both are part of the process of construction in the broad sense.

69. However, he also agreed with Lord Neuberger and Lord Carnwarth that *Belize Telecom* did not water down the traditional tests of necessity. It was not sufficient that it should merely be reasonable to imply a term [at 77].

### **The Message of Marks & Spencer**

70. One very clear message emerges from *Marks & Spencer*: in order to imply a term into a written contract, either the requirement for necessity or the “it goes without saying test”, as enunciated by Lord Simon’s five conditions in the *BP Refinery Case*, and explained and overlain by Lord Neuberger’s six comments [at 21] have to be satisfied.

71. But what about the proper approach? Is there still any scope for a unitary process whereby the court looks at the proper construction of the contract holistically, to include express and implied terms? It seems not.

72. The Supreme Court had to look at the question of implied terms again in the recent case of *Impact Funding Solutions v AIG Europe Insurance Ltd* [2016] 3 WLR 1422, a case which concerned the construction of an exclusion clause in a solicitor's professional

indemnity policy. Lord Hodge, giving the majority judgment affirmed the approach taken in *Marks & Spencer* and explained it thus [at 31]:

“this court confirmed that a term would be implied into a detailed contract only if, on an objective assessment of the terms of the contract, the term to be implied was necessary to give the contract business efficacy or was so obvious that it went without saying (paras 15–31, per Lord Neuberger PSC). This court also held that the express terms of the contract must be interpreted before one can consider any question of implication (para 28).”

73. A sequential approach is therefore required. Any question of implication must come after the process of construing the express words. In *Impact Funding*, Lord Carnwarth was once again on the panel and once again he dissented in the outcome. This time, however, he chose not become embroiled in any academic debate, confining himself to citing with approval the approach to contractual interpretation in *Arnold v Britton* and remaining silent on *Marks & Spencer*

### **Further Discussion**

74. What then are to make of these two important Supreme Court decisions?

75. Both cases represent a clear attempt by the Supreme Court to re-establish a more orthodox approach to contractual interpretation and the implication of terms: to emphasise the pre-eminent importance of the words actually used by the parties in construing their contract and to limit the implication of terms to cases where it is absolutely necessary, particularly in the case of detailed, commercial contracts.

76. However, the decision in *Arnold* probably does not represent any great sea-change in the essential aspects of the law concerning the construction of contracts, but it does represent a clear shift in emphasis and a reiteration of the principle that the language used by the parties is of preeminent importance in ascertaining their objective intention. Commercial absurdity and business common sense are still relevant factors to consider in the construction of a contract, but they cannot be invoked to undermine the importance of the words used. Party autonomy, as expressed in the language actually used, is paramount.

77. Even though *Marks & Spencer* rejected Lord Hoffman’s unitary test in *Belize Telecom* and re-established the test of necessity, the case does not contain any new propositions of law.

78. Both cases have since been described by the Court of Appeal as “recent adjustments of emphasis” (per Beatson L.J. in *Globe Motors v TRW Lucas Varity Electric Ltd* [2016] EWCA Civ 396 at [58]).

### **Boilerplate clauses**

79. This perhaps comes as no great surprise. Even before *Arnold* and *Marks & Spencer*, there had been strong judicial leanings towards holding parties to the bargain they had made as expressed in the language they have actually used. This is perhaps exemplified nowhere better than recent decisions on boilerplate clauses.

80. For many years, boiler plate clauses such as non-reliance clauses and entire agreement clauses had been treated by the courts as subject to special principles that permitted parties to avoid them on the grounds of estoppel if they could show that, despite their

words, the facts were otherwise (see for example Lord Denning's judgment in *Lowe v Lombard Ltd* [1960] 1 WLR 196; *Watford Electronics Ltd v Sanderson CFL Ltd* [2001] EWCA Civ 317 per Chadwick L.J.)

81. However, in *Springwell Navigation Corp v JP Morgan Chase Bank* [2010] EWCA Civ 1221, the Court of Appeal, when considering a non-reliance clause, reiterated that there was absolutely nothing in principle to prevent parties agreeing to a state of affairs that they knew to be untrue and that it accorded with principles of contractual certainty to enforce such clauses by means of a contractual estoppel.
82. Similarly, in the case of entire agreement clauses, the Court of Appeal has emphasised that such clauses should take effect according to their terms (*North Eastern Properties v Coleman* [2010] 3 All ER 528; *Axa Sun Life Services Plc v Campbell Martin Ltd* [2011] EWCA Civ 133).
83. Two years before *Arnold* was decided, the Privy Council (in a Board including Lords Neuberger and Carnwarth) handed down its judgment in *Prime Sight Ltd v Lavarello* [2013] UKPC 22. That case concerned the effect of an acknowledgment clause in a deed that recorded that a deposit of £499,950 had been paid and received.
84. In fact, it was common ground that no such payment had been made and, it was on that basis, that the assignor under the deed sought to claim the deposit and thereafter to present a winding up petition. The Privy Council held that there was no logical reason to treat a declaratory statement in a deed, which was intended to be contractually binding, as any less effective than any other term it contained. To treat the deed as creating a valid contract, but delete the acknowledgment of payment would be to alter significantly the nature of the bargain agreed between the parties (per Lord Toulson at [53]).
85. There is of course a conceptual difference at one level between, on the one hand, construing the words a party has used in a contract (*Arnold*) and only implying terms in the case of necessity (*Marks & Spencer*) and, on the other, recognising the essential enforceability of boiler plate clauses that the parties have included in their bargain, often as a result of simply adopting a precedent as opposed to being the product of specific negotiation (*Springwell, Axa, Primesight*).
86. But on another level, there is a connection and resonance between the two: the parties will be held to the bargain they have made as expressed in the language they have actually used. That will be starting point when considering what a contract means and whether any terms should be implied into it, and, in the vast majority of cases, the end point.
87. However, there are seemingly limits to this. In two recent cases, the Court of Appeal has had to grapple with the issue of whether a clause in a written contract excluding the ability of the parties to vary its terms orally and requiring all variations to be in writing is enforceable and thus effective to prevent reliance upon a later oral variation. The first was *Globe Motors v TRW Lucas Varity Electric Ltd* [2016] EWCA Civ 396 and the second was *MWB Business Exchange Centres Ltd v Rock Advertising* [2016] EWCA Civ 533.

88. Prior to these decisions, there had been conflicting Court of Appeal authority on whether an anti-oral variation clause was effective to preclude reliance upon a subsequent oral

variation (*United Bank Ltd v Asif*, 11 February 2000, unreported, suggesting it was; *World On line Telecom v I-Way Ltd* [2002] EWCA Civ 413 suggesting it was not).

89. In *Globe Motors* (albeit *obiter*) and *MWB*, the Court of Appeal held that such clauses did not preclude a party from relying on a later oral variation, even though the written contract made clear this was not possible. Previous authority tended to support that view. More importantly, it was consistent with the notion of party autonomy that the parties could later make a new oral contract varying the terms of the previous written contract. In *MWB*, Kitchen L.J. cited with approval the following passage by the great American jurist, Cardozo J in *Alfred C Beatty v Guggenheim Exploration Company* (1919) 225 NY 380:

“Those who make a contract, may unmake it. The clause which forbids a change, may be changed like any other. The prohibition of oral waiver, may itself be waived ... What is excluded by one act, is restored by another. You may put it out by the door, it is back through the window. Whenever two men contract, no limitation self-imposed can destroy their power to contract again...”

90. Whether that approach is correct, is debatable. Surely the same could be said about the effect of a collateral contract made in the face of an entire agreement clause? However, unless the Supreme Court takes a further opportunity to review the matter, the current state of the law is that, unlike most boiler plate clauses, anti-oral variation clauses will not be enforceable strictly in accordance with their terms.

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November 2016

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