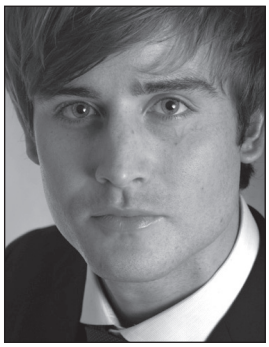
Unfavourable bargains

A recent case has demonstrated that the courts will not construe a contract so as to re-write an unfavourable bargain, as Nikolas Ireland finds out



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'It is clear that, while the court is able to look elsewhere for assistance in the event of ambiguity in a document, and can correct a document where the parties have used the wrong words and there is a clear mistake, it is not the function of the court to search for ambiguity or mistake in order to make a bargain fairer or more commercially sensible.'

The High Court judgment delivered on 3 December 2012, on appeal in the case of *Arnold v Britton* [2012], serves to demonstrate how the High Court these days goes about construing a badly drafted document and how important the background circumstances can be in deciding what was intended.

What is clear from the judgment at first instance in the County Court is that the lower courts will sometimes strive, incorrectly, to find a fair and commercial interpretation of a document in order to seek to do justice. The decision of the High Court, however, illustrates how the court should seek to give effect to the wording used, and that it will not spare a party from having entered into a bad bargain even if the consequences were not foreseen and the resulting effect is very severe.

This case serves as a reminder that it is not uncommon for leases and agreements for leases to be badly drafted or thought out, or be far too complex. Frequently, they are not fully understood by the parties and/or their advisers. The case also clarifies some principles of construction and lays to rest any general presumption that a landlord can only recover by way of service charge a sum that does not exceed its actual expenditure.

Background and county court proceedings

The claimant is the landlord of chalets on the Oxwich Leisure Park in Swansea. He brought a County Court claim against 25 of the 91 chalets' long leaseholders in respect of their service charge liabilities under their leases, which were entered into between 1977 and 2000. The service charge covered maintenance of the roads and recreation areas and limited other services such as security and refuse collection.

The dispute concerned the true interpretation of five different versions of a service charge clause used over this period of time. Version 1 contained a covenant on the part of the tenants as follows:

> 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 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.

Versions 2-5 were not materially different. All versions seemed to leave out a word or words before the reference to the amount payable.

The claimant argued that the omitted word was 'namely' so that this would appear after 'set out' and a fixed service charge of £90 pa was thereby payable subject to a 10% compound increase every year after the first three years. The tenants argued that the missing words were 'limited to' so that a variable service charge was payable but it could not exceed the stated amount.

As a fixed service charge is not subject to the Landlord and Tenant

Other recent cases on construction

In *Kingerlee Holdings Ltd v Dunelm (Soft Furnishings) Ltd* [2013] the judge agreed with counsel for the defendant that the provisions of the agreement for lease were 'labyrinthine', and a host of other recent cases have illustrated that drafting issues are certainly not confined to old documents.

In *Ridgewood Properties Group Ltd & ors v Valero Energy Ltd* [2013], the development agreements failed to include a provision preventing the owner of the properties from selling them and the claimant had to argue there was an implied term to this effect, and failed.

Acts that control service charges of dwellings, and a chalet has been held to be a dwelling, a substantial amount depended on whether the charge was fixed or variable? As the tenants pointed out in support of their contention that a variable charge was intended, the amount each would have to pay on an annual basis by the end of their leases in 2072/3 would be £1,025,004.22 if the charge were fixed.

The landlord's case was that the provision for a fixed 10% annual increase on the fixed sum previously payable was originally agreed at a time of high inflation that made commercial sense then and that a variable service charge was clearly not intended as the leases all omitted any provisions or mechanism for determining the amount payable if it was not fixed.

The tenants relied on the reference to paying 'a proportionate part' and the fact that, not only would they relatively soon be paying substantially more than the costs of the limited obligations the claimant was liable to undertake, but that the claimant would be making a substantial profit.

Neither party sought to rectify any of the leases. There was, presumably, no evidence of any common mistake ever being made.

The County Court judge found in favour of the tenants. He was clearly sympathetic to their plight. He thought the court should lean against a construction whereby a landlord could make a profit out of a service charge and he considered that the tenant's construction made more commercial sense. Accordingly, he held that the service charge was capped at a yearly sum of £90 plus VAT plus the 10% increase. Importantly, he held that the charge was variable so was indeed a 'service charge' as defined by s18 of the Landlord and Tenant Act 1985 and therefore the tenants could challenge its reasonableness.

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The law as to the construction of documents

When construing a contract, the court seeks to determine what the parties meant by the language used. This involves ascertaining what a reasonable person would have understood the parties to have meant. Where ordinary words have been used in the drafting of a document their ordinary meaning should be also used so, in the absence of any ambiguity, it is this wording literally read and construed that will demonstrate the parties' intentions (*Rainy Sky SA v Kookmin Bank* [2011])

However, the language used will often have more than one potential meaning and it is always essential that the words used are not interpreted in a vacuum. Justice Holmes described the importance of context rather poetically in the case of *Towne v Eisner* [1918]:

> A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in colour and content according to the circumstances and the time in which it is used.

Lord Hoffman echoed this sentiment in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1997] and confirmed that one has to have regard to what the reasonable man would interpret the provision to mean having all the background knowledge reasonably available to the parties at the time of the document being negotiated and entered into and also having regard to commercial common sense. The background knowledge, or 'factual matrix', includes anything that could effect the way in which the wording would be interpreted, for instance facts which would be reasonably available to the parties. This does not include, however, the subjective intent of the parties or their previous negotiations of the parties. By way of illustration in the present case, it was important for the court to consider the RPI figures submitted by the claimant as these supported the reasoning for the 10% fixed annual increase.

In the High Court, Morgan J commented on the lack of background documents. He noted there was no evidence as to how the £90 was originally calculated or as to the history of the dispute. There was no specific evidence as to whether the fixed sum had been charged throughout. In fact, the court had very little to go on other than the actual wording used and knowledge of inflation rates at the various times the different versions of the service charge were entered into.

It is clear that, while the court is able to look elsewhere for assistance in the event of ambiguity in a document, and can correct a document where the parties have used the wrong words and there is a clear mistake, it is not the function of the court to search for ambiguity or mistake in order to make a bargain fairer or more commercially sensible. The court does not readily accept that people have made mistakes in formal documents (*Chartbrook Ltd v Persimmon Homes Ltd* [2009]).

In *City Alliance Ltd v Oxford Forecasting Services Ltd* [2001], Chadwick LJ said that the court 'cannot introduce words that the parties have not used' unless:

> ... satisfied
>
> i) that the words actually used produce a result that is so commercially nonsensical that the parties could not have intended it, and
>
> ii) that they did intend some other commercial purpose which can be identified with confidence.

It is this approach to construction that is demonstrated in the present case. Where the court is satisfied that the wording of any disputed contract is not ambiguous enough to warrant court intervention, it will, or certainly should, refrain from interfering with the literal interpretation so as to give effect to what the parties should have agreed to rather than what they agreed to.

Therefore, case law in respect of the construction of contracts is clear in that the court will not rewrite contracts that already make sense in order to simply make them more commercially sensible. However, in the event of ambiguity in wording, so as to create uncertainty as to the understanding of the document by a reasonable man, the court can seek to give effect to the more natural or commercial interpretation having regard to the background facts of the case. Its overriding objective is to try to give true effect to the actual intentions of the parties.

As the judge in the High Court found and made clear:

> ... it is not uncommon for commercial documents to use words which are unnecessary and which do not alter the meaning which the document would have had if those words had been omitted.

Draftsmen sometimes do not make construction easy by adapting wording from previous documents without making all necessary changes or actually thinking what the words actually mean in practice.

The judge also considered whether the *contra proferentum* rule should be applied against the claimant as landlord, ie the tenants be given the benefit of any doubt in interpretation. He thought there was a real issue as to whether this rule was still to be applied in modern times but, in any event, he eventually thought the wording was so clear that it would not avail the tenants anyway.

High Court proceedings

In the appeal proceedings before Morgan J, counsel for the tenants maintained that the parties could not have intended the claimant be able to make a profit out of the service charges. He highlighted that the ground rent was only £10 pa subject to a £5 increase every 21 years. He argued that, if the landlord had been intent on making a profit, he would have provided for a much higher rent instead.

While 'the covenants in a lease must be construed by reference to the covenants which follow or precede them' (*Dobbs v Lingford* [1953]), Morgan J was not persuaded that this contrast shed any light on the issue before the court. A nominal ground rent is a common feature of long leaseholds and its presence is not evidence that the parties did not intend to seek to profit in other ways – for example, through the service charge provisions.

While *Woodfall: Landlord and Tenant* refers to a service charge provision not being construed (in the absence of clear words) so as to entitle a landlord to make a profit, the judge held there was no general principle to this effect. Such a construction might find favour where a lease allows a landlord to recover a sum calculated by reference to the cost of services, as the word 'cost' would tend to indicate that a profit was not intended. However, in the case of a non-typical service charge provision, the judge found the

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Arnold v Britton & ors
[2012] EWHC 3451

Chartbrook Ltd v Persimmon Homes Ltd
[2009] UKHL 38

City Alliance Ltd v Oxford Forecasting Services Ltd
[2001] 1 AER (Comm) 233

Dobbs v Lingford
[1953] 1 QB 48

Investors Compensation Scheme Ltd v West Bromwich Building Society
[1997] UKHL 28

Kingerlee Holdings Ltd v Dunelm (Soft Furnishings) Ltd
[2013] EWHC 47 (Ch)

Multiservice Bookbinding Ltd v Marden
[1979] Ch 84

Rainy Sky SA & ors v Kookmin Bank
[2011] UKSC 50

Ridgewood Properties Group Ltd & ors v Valero Energy Ltd
[2013] EWHC 98 (Ch)

Towne v Eisner
(1918) 245 US 418

textbook reference to be of no assistance. He said that, if there was some special principle about charging for services, it would apply generally and not just to leases.

- A proportionate part of the expenses and outgoings. But there is no provision to govern how a proportionate part would be assessed or collected. The normal detailed machinery in leases for the landlord would have agreed to this.

- The yearly sum of £90, etc. If this were the case, then the operation of the clause would be clear. No added provisions would be necessary. However, it rather renders the reference to paying 'a proportionate part' redundant unless, as the judge found, these words merely identify the character of the payment in the context of the lease. They just make clear it is a service charge rather than rent payment. Importantly, the judge highlighted the various different ways a service charge can be provided for and noted that a clause that allows a landlord to recover an initial fixed sum, which rises with inflation, was not unusual and does serve a commercial purpose. Clearly, at the time these leases were first entered into, inflation was high and 10% made sense and it appeared the rate had simply never been questioned thereafter.

The judge emphasised that it cannot be said that a contract is frustrated by the simple fact that it turns out to be more onerous on one party than was originally foreseen.

In the end, the judge focused on the meaning of the words actually used and whether they could sensibly be given effect. The question was what is the object of the verb 'to pay'? There were two possible candidates: estimating and collecting a variable service charge was missing entirely. Furthermore, the reference to £90 would make no sense. There was also no obvious reason why a cap on the costs was necessary or

It was the latter candidate the judge preferred. He therefore disagreed with the County Court judge and allowed the appeal.

The judge emphasised that it cannot be said that a contract is frustrated by the simple fact that it turns out to be more onerous on one party than was originally foreseen (*Multiservice Bookbinding Ltd v Marden* [1979]). He commented upon the tenants having made 'a bad bargain… but that is what they did'. What they and their advisers had failed to appreciate, it appears, was that a fixed annual increase was very dangerous if inflation fell. They clearly had no real issue with a fixed service charge but with how much it could rise by. Accordingly, they should have not allowed the increase to be compounded so that the 10% applied to the amount by which £90 had already increased to, and they should have limited increases to the increase in the Retail Price Index. Unfortunately for the tenants, a failure to take account of the commercial consequences cannot allow the court to construe the language used so as to avoid these consequences. ■

Key points

This case is just another example, albeit a stark one, of the approach the court takes when considering the construction of a contract. It follows the Supreme Court ruling in *Rainy Sky* that the ultimate aim is to determine what the parties meant by the language used, by reference to the reasonable man and what he would have understood the parties to have meant, having regard to the factual background. Where the parties have used clear language, the court will apply it unless it is manifestly clear something has gone wrong.

The case serves as a very good example to solicitors as to how not to simply follow what others have done before. The fact that previous leases are in this form does not mean that this is right. Unfortunately, the actual parties, who often have more financial acumen than their lawyers, generally do not read or understand leases particularly where they are residential – they leave them to their lawyers. Unless their lawyer flags something, they will generally not raise any issue themselves. All too frequently, service charge provisions and/or percentages in leases are found to be defective. A common example is often seen where the contributions from tenants do not add up to 100%.

The case is also a useful lesson of the importance of collating as much of the background circumstances as possible to support one's construction of the document. Unfortunately, very little evidence was collated and the judge therefore had to construe the wording in something of a vacuum. Interestingly, as many of the leases preceded the 1985 and 1987 Landlord and Tenant Acts, and all preceded the clarification of the law as to whether these Acts applied to chalets, the judge could not take into account whether a tenant would have thought that the service charge would be liable to statutory control.

It may be thought that the tenants have good claims for negligence against their conveyancing solicitors but this would really only be the case if they were advised incorrectly as to the meaning of the service charge clause. It seems likely that they would have understood it was a fixed charge and a solicitor generally is not under any obligation to give commercial advice about likely movements in inflation rates or suchlike. Furthermore, many claims are likely to be statute-barred by now.

Of course, not only do the tenants now have the prospect of extortionate service charges and the burden of substantial legal costs as a result of the proceedings, but their chalets must be very difficult to sell.