Contracts & commercial (non)sense?

Gateley Plc

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It is an old legal adage that the courts will not rescue a party from a bad bargain. This makes sense, because if they did, they would be inundated with claims from parties who had negotiated poor deals.

But what happens if a contractual provision produces a result that is so absurd that it does not make any commercial sense at all?

Will the courts then rescue a party from the deal? They have the tools to do so, for example by interpreting the contract in a different way to give it commercial sense, or implying a term into it, or rectifying (i.e. correcting) it.

The Supreme Court was recently asked to tackle this thorny question in the case of *Arnold -v- Britton and Others* [2015] UKSC 36. Although this case was about a leisure park on the Gower Peninsula in Wales, the Supreme Court's decision contains important lessons for anyone involved in negotiating and drafting contracts, and in particular provisions, such as options and overage payments, that endure for many years.

The leisure park consisted of over 90 chalets, all let on long leases of 99 years. At the centre of the dispute was a service charge provision, by which the owners of chalets on the park were to pay their respective proportions of the maintenance and repair of the caravan site.

The first leases, which dated from the 1970's, provided that the service charge was to be £90 in the first year of the term, to be increased by 10% every 3 years. However 25 of the leases, which dated from the 1980s, provided that the service charge was to be £90 in the first year of the term, with increases **every** year of 10%.

It was the latter provision, which provided for the annual increase of 10%, which caused the problems. No doubt it would have seemed sensible to the parties at the time, because at the beginning of the 1980's annual inflation was consistently well over 10%, and so the annual increases would have been at or below the rate of inflation.

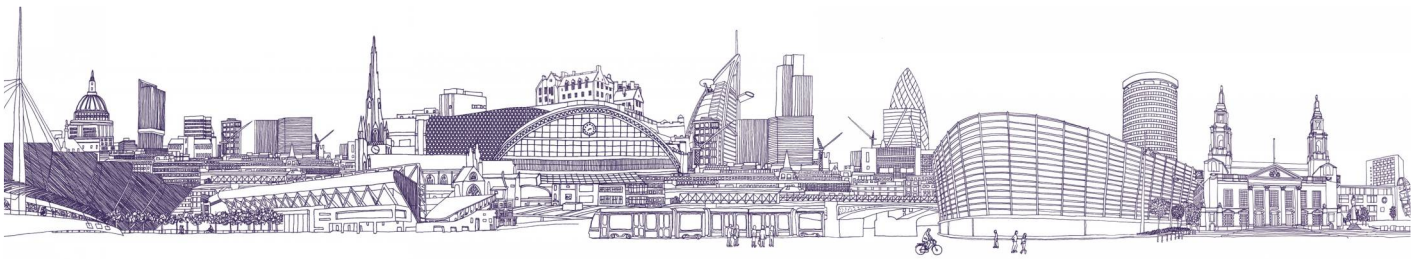
Of course, the rate of inflation fell significantly since then, and in the last 15 years or so has hardly ever been above 4%, and has been under 3% for the last 10 years. The result is that the 10% increase in the service charge has far outstripped the rate of inflation. Since the increases are on a compound basis, over the course of the leases (which were for 99 years), the resulting service charges become more and more absurd. By 2012, the annual charge for a single chalet was £3,366, and by 2072 it will be over £1 million.

To say that this is an absurd result is an understatement. It was clearly not a result that any of the parties had anticipated back in 1980. The problem was that, at the time of agreeing the provision, they had simply not thought about what might happen if inflation fell.

Naturally, the chalet owners, who were all locked into 99 year leases, wanted to escape the effects of this annual increase. They therefore sought to argue that the £90, and subsequent annual increases of 10%, were caps on the service charge, rather than fixed charges.

At this point it is worth setting out the service charge provision. It provided that the chalet owners were:*"to pay the Lessor without any deduction….a proportionate part of the expenses and outgoings incurred by the Lessor…the yearly sum of Ninety Pounds and Value Added Tax (if any) for the first Year of the term hereby granted increasing thereafter by Ten Pounds per hundred for every subsequent year or part thereof".*

In order to justify their argument that the £90 plus annual increases was a cap, the chalet owners argued that what the provision actually meant was that they had to pay the yearly sum of **up to** £90 plus annual increases. They supported this argument by pointing to the fact that their obligation was to pay a proportionate part of the expenses and outgoings of the park owner. The £90 plus annual increases must therefore have been meant as a cap, because if it was a fixed charge with annual increases, it



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would soon become completely disproportionate to the actual sums spent by the park owner.

The chalet owners arguments make perfect commercial sense, and no doubt they would have been encouraged by a line of recent cases by which the courts have interpreted contractual provisions to give 'commercial sense' to contracts.

However, that recent line of cases involved provisions that were ambiguous - in other words, they could be read in two or more ways. In those circumstances, the courts can interpret the meaning of the provisions, by asking what a reasonable person, having all the background knowledge which would have been available to the parties to the contract, would have understood the provision to mean. More often than not, that reasonable person would understand the provision in a commercial context.

Unfortunately for the chalet owners there was no such ambiguity in the service charge provision. It undoubtedly produced a result that the parties could not have intended when they agreed the provision back in the 1980's, but it was clear as to what it meant - the chalet owners had to pay a yearly sum of £90 per year, with annual increases of 10%. The Supreme Court called this the 'natural meaning' of the clause, and refused to interfere with it. The chalet owners were therefore stuck with a service charge that is already out of all proportion to the amounts actually spent by the park owner.

Interestingly, one of the five Supreme Court Justices, Lord Carnwarth, disagreed with this decision. He noted the 'potentially catastrophic' consequences of the service charge provision. He went on to say 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*." In his view, the service charge provision could and should be interpreted to be a cap, and not a fixed charge.

As interesting as Lord Carnwarth's more 'commercial' approach is, he was in a minority of one, and it is safe to assume that it will be extremely difficult to persuade a court to depart from the 'natural meaning' of a contractual provision where that provision is unambiguous, even if it produces a result that makes commercial nonsense.

The problems in this case arose from the fact that the provision would be effective for many years, and yet the parties who negotiated it clearly didn't think about what might happen in the long term (i.e. the possibility that inflation might fall). There is an important lesson here for those in the housebuilding industry who are involved in negotiating and drafting contracts, and in particular 'long term' provisions such as options and overage payments: try and think about all the ways in which circumstances may change over the duration of the provision, and make sure you specifically provide for them. If you don't, you cannot rely on the courts to rescue you from a bad deal.

If you would like to discuss any of the issues raised in this update, please contact:

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