Commercial Contracts: A Practical Guide to Standard Terms

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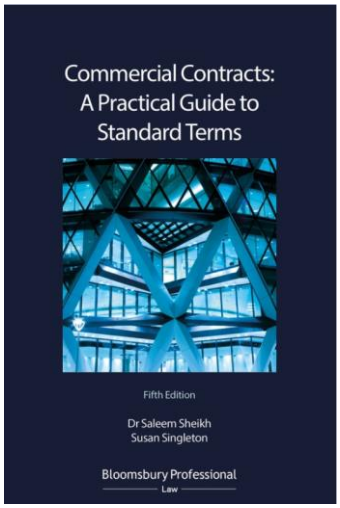

Sample Chapter - Section A:

Commentary

A1:

Forming and Concluding a Contract

At a glance

A1.1

- Ideally, though not essentially, a contractual arrangement should be expressed in a formal document (that is to say in writing and signed by both parties).
- An agreement which is not formally expressed will still be binding but since the parties may have a different recollection of what exactly was agreed, there should always be a document setting out, if only in the form of bullet points, the heads of agreement.
- A binding agreement will normally be reached between parties if they have agreed on the essential points of the contract. Items such as the precise subject matter of the agreement and the price to be paid should usually be definitely agreed.

- Include all the key terms in a written agreement signed by all the parties before any obligations are performed by them.
- Contracts may sometimes be entered into unintentionally and care should be taken to ensure that nothing is mentioned in negotiations or correspondence that could be construed as binding the parties contractually.
- Ensure that the terms agreed are certain and contain sufficient detail to ensure enforceability. If the terms are vague or uncertain, the courts may determine the terms void.
- Recent judicial authorities have demonstrated that the courts will try and ensure that a contract is workable. Therefore, uncertain clauses should not be accepted on the basis that they may not be enforceable by the courts.
- The courts will objectively assess whether the parties by their words and conduct intended to create a legally binding relationship and that they had agree all the terms that the law requires as essential for that purpose.
- The relevant contract terms must be adequately brought to the attention of the other side. The terms themselves do not have to be presented to the other side; it is enough if reference is made to them, eg by stating in a letter that copies of the contract terms are available on request.
- If the parties have formed contracts between themselves in the past, terms can be incorporated as a result of this normal course of dealing. It will be a matter of fact dependent on the circumstances of each case as to how many previous contracts need to have been made between the parties.
- Contract terms are categorised as ‘conditions’, ‘warranties’ or ‘intermediate terms’. The remedies for breach depend on which category of term has been broken. Following enactment of the *Consumer Rights Act 2015*, however, this is no longer so in contracts made with consumers, but remains the case in business-to-business contracts.
- When parties send their own terms and conditions to each other, this is often called the ‘battle of the forms’. In broad terms, the victor is the person who presents his terms last of all.
- For most contracts a signature is not required to make it binding although contracts relating to the sale of land are something of an exception to this rule. Provision has been made by statute for the treatment of electronic signatures.
- Any description applied to the goods in the contract must be very closely complied with. The courts generally assume that businessmen want goods exactly as described in the contract.
- Where the contract for sale is made by reference to a sample, similar provisions to those described above apply in relation to description, fitness and quality.
- One of the most important issues in a contract of sale is whether the risk of damage to the goods has passed to the buyer. Statute sets out basic rules, but these can be displaced by the specific terms of the contract.
- The passing of property is no less important than issues of risk. Again, statute sets out certain rules, but the parties in this case can displace them with the express terms of the contract.
- Sellers often seek security for payment by retaining title to the goods. This requires great care in the drafting of the specific terms.
- Parties are well advised to use exclusion or limitation clauses to ensure that they do not face open-ended liability in the event of a breach. At the same time, statute significantly restricts the effect of such clauses, making it difficult to use them in business-to-business contracts, and particularly difficult to exclude or limit liability in the case of a consumer contract.
- Damages for breach of contract are, by long-established principles, assessed on the basis of what the guilty party contemplated as the probable result of the breach. Principles have also been developed by the courts concerning the reimbursement of expenditure incurred by the innocent party.
- The basic rule laid down by statute is that no action for breach of contract can be brought after six years, though there are many exceptions to this rule. This can be addressed by the parties in the contract.

- A party may enter into a contract on the basis of a mistake or because of a misrepresentation which the other party might have made in the course of negotiation. A considerable body of law has developed as to the remedies available in such circumstances.
- There are strictly limited circumstances where a contract becomes void due to supervening circumstances.
- The so-called doctrine of privity of contract means that only the actual parties to the contract acquire rights and duties under it. This rule remains intact but has been considerably affected by legislation.
- Parties will often wish to protect their intellectual property. This can happen where the buyer is heavily involved in the development of the contract goods. Likewise, there will be matters which neither party may wish to be disclosed. These issues should be catered for in the contract when appropriate.
- To ensure correct delivery of documents, the contract should provide for the service of notices on each other.
- If the contract is made with a party overseas, care should be taken for the contract to have a term specifying which legal system applies.
- When drafting a contract, the parties should always bear in mind that certain aspects of the agreement, such as pricing, can fall foul of UK competition law.
- If a party wishes to ensure that no binding agreement is reached until a formal document has been signed, this must be stated in very clear words, such as a clear statement that all negotiations are 'subject to contract'.

Whether agreement has been reached

A1.2

Negotiations between the parties can often be a long, drawn out process, before being concluded by one side or the other. In such a case, there will often be a dispute as to whether a contract had been concluded, or whether the parties had simply been engaged in negotiations which had, in the end, achieved no result. For example, the parties may reach agreement on essential points of principle, but still leave some important points unsettled and whether the courts would enforce the contract despite the absence of certain terms from the parties' contractual relationship.

This arose in the leading Supreme Court case of *Wells v Devani* [2019] UKSC 4. This case concerned Mr Wells, a property developer and Mr Devani, an estate agent. Various correspondence and telephone exchanges took place between the parties for the sale of Mr Wells' remaining unsold properties. Subsequently, Mr Devani found a purchaser for the properties and claimed 2% plus VAT as his commission. The parties had not defined at what stage a commission would be payable to Mr Devani.

One of the issues raised on appeal concerned the agreement between the parties and whether it was complete and enforceable despite there being no express identification of the event which would trigger the obligation to pay the commission. The Supreme Court unanimously ruled in favour of Mr Devani. On the issue as to whether there was a binding contract, Lord Kitchin (with whom Lords Wilson, Sumption and Carnwath agreed) stated that the question was whether objectively assessed, the parties by their words and their conduct intended to create a legally binding relationship, and that they had agreed all the terms that the law requires as essential for that purpose: see *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH* [2010] 1 WLR 753. It may be the case that the words and conduct relied on are so vague that the court is unable to identify the terms on which the parties have reached agreement. However, the courts are reluctant to find an agreement is too vague or uncertain to be enforced where it is found that the parties had the intention of being contractually bound and have acted on their agreement: see *Scammel v Ouston* [1941] AC 251.

In this case, the Supreme Court was of the view that the parties had intended to create legal relations leading to a binding contract. On the issue of the commission, the Supreme Court stated that it would naturally be understood that payment of the commission would become due on completion of the purchase of the flats and the commission would be made from the proceeds of sale. Mr Devani and Mr Wells had agreed that if Mr Devani found a purchaser for the flats, he would be paid his

commission. Therefore, it was not necessary to imply a term into the contractual relationship. The Supreme Court stated that if it had been necessary, it would imply such a term. According to Lord Kitchin: '…if, as here…the bargain is, in substance, 'find me a purchaser' and the agent introduces a prospective purchaser to whom the property is sold, then a reasonable person would understand that the parties intended the commission to be payable on completion and from the proceeds of sale'. This was the 'only sensible interpretation' from the parties' telephone conversation and surrounding circumstances. The Supreme Court applied *Marks & Spencer plc v BNP Paribas* [2015] UKSC 72 that such a term would be necessary to give the contract business efficacy and would not go beyond what was necessary for that purpose. On the issue of implying terms into a contractual relationship, Lord Kitchin stated that it was possible to imply something that was so obvious that it goes without saying, including something the law regards as no more than an offer. He stated that if the offer is accepted, the contract is made on the terms of the words used and what those words imply. Moreover, where it was apparent that the parties intended to be bound and to create legal relations, it may be permissible to imply a term to give the contract such business efficacy as the parties must have intended. For example, an agreement may be enforceable despite calling for some further agreement between the parties, say as to price, for it may be appropriate to imply a term that, in default of agreement, a reasonable price must be paid. On implying terms into a contractual relationship, see A1.9.

Lord Briggs agreed with Lord Kitchin and added that there are occasions, where the context in which the words are used to inform a person as much, or even more, about the essential terms of the bargain than the words themselves. This was the situation with Mr Wells and Mr Devani. Accordingly, a sufficiently certain and complete contract had been agreed between them. The Supreme Court's decision highlights the court's reluctance to find that an agreement is too vague or uncertain to be enforced where the parties intended to be bound and had acted on their agreement. The decision also highlights the importance of the parties ensuring that all key terms are expressly agreement between the parties and stated in the contract.

In *AMP Advisory & Management Partners AG v Force India Formula One Team Limited* [2019] EWHC 2426, Moulder J rejected the company's claim for commission for introducing a sports sponsorship opportunity. The judge was of the view that there was no binding oral or written contract between the parties for the commission to be payable particularly when the mandate agreement in question which would have triggered off the commission payment had not been signed by the parties. The High Court stated that viewed objectively, the verbal exchange between the parties was not intended to create legal relations or binding on the parties, having regard to the social nature of the meeting between the parties, and that one of the parties had no prior experience of acting as a sponsorship agent. On the issue of an unjust enrichment claim by the claimant, the evidence showed that a third party and not the claimant had introduced the sponsorship deal. Nevertheless, the Court recognised a limited contribution made by the claimant for its services in facilitating the sponsorship deal and awarded the sum of £150,000 as a result of the services provided on the basis that these services were an enrichment of the defendant at the expense of the claimant even where the contract did not materialise: *MSM Consulting Ltd v United Republic of Tanzania* [2009] EWHC 121. This decision emphasises the importance of ensuring that the principal terms of an agreement are clearly documented and signed by the parties to ensure their enforceability and to create legally binding relations, and opens up the possibility of a claim for unjust enrichment as an alternative in the absence of a binding contract.

Enforceability of incomplete contractual terms

A1.3

Recent judicial authorities demonstrate that the courts are inclined to give effect to a contractual term whose overall effect is explicit but whose detailed terms are incomplete. The courts will be slow to find contract terms void for uncertainty. In *Openwork Ltd v Forte* [2018] EWCA Civ 783, Forte was a financial adviser who entered into a franchise agreement with Openwork Limited for the sale of investment products. The franchise agreement provided for a clawback clause the effect of which was that Openwork was entitled to claim back a percentage of the commission which it had paid Forte, where an investment was withdrawn within three years. The clawback term did not however set out the percentage or formula for the calculation except that the commission would be calculated by reference to the amount invested, length of time invested and the amount withdrawn. Openwork sought to enforce the clawback provision. Forte contended that the clause was void for uncertainty.

The issue before the Court of Appeal was the extent to which the court could give effect to a contractual term whose overall effect was explicit, but whose detailed terms were incomplete. The Court of Appeal held that the clawback term was enforceable. According to Simon LJ, the court should strive to give some meaning to contractual clauses agreed by the parties if at all possible: see *WN Hillas v Arcos Ltd* (1932) 147 LJ 503. On the facts, the parties intended the words of the clawback provision to have some effect – otherwise the intent of the clause would be defeated. Although the clause did not set out a calculation formula, it did set out the necessary detail to identify the amount Forte would have to pay as part of the clawback. The effect of the Court of Appeal decision is that the court will attempt to give effect and meaning to a contract term if at all possible. Accordingly, the parties should not accept the inclusion of vague or uncertain terms on the basis that they will not be capable of enforcement. Where the terms are not clear, the court may try and determine their meaning, as it would be understood by a reasonable third party.

Effect of subsequent communications between parties and contractual enforceability

A 1.4

From time to time the courts have recognised that there may be in existence certain factors that are inconsistent with the formation of a contractual relationship between the parties. Subsequent communications can be relevant to determining whether a contract has been concluded. The Court of Appeal considered this position in *Global Asset Capital, Inc v Aabar Block S.A.R.L* [2017] EWCA Civ 37, where the claimants claimed that on 6 May 2015, the defendants entered into a contract to sell them some rights and other debt interest for €250 million. The claimants contended that there was a valid contract between the parties and sought specific performance. As part of the background to the case, the parties agreed on the following facts.

- On 23 April 2015, the claimants sent an offer letter to the defendants headed 'Without Prejudice – Subject to Contract'.
- On 6 May 2015, there was a telephone conversation between the parties. One of the defendant's representatives stated that they accepted the offer subject to the claimants resending the offer letter in open and binding form; and also providing satisfactory evidence of their ability to fund the transaction.
- On 7 May 2015, the claimants emailed the defendants stating that they would provide the binding terms and funding commitment later in the day or following day.
- On 9 May 2015, the claimants sent the defendants a further offer letter setting out the main commercial terms of the previous offer which also included additional terms different from the original offer letter. The email from the claimants stated that the claimants looked forward to receiving confirmation of acceptance of the offer.
- On 10 May 2015, the defendants replied that the offer was not accepted.

A major matter in dispute between the parties was whether the court could consider events after the telephone conversation in deciding whether, during the conversation, a contract had been made. The Court of Appeal held that the parties' communications following 6 May 2015 telephone call should have been taken into account in determining whether a contract had been formed. In determining whether a contract had been made during the course of those negotiations, the court would consider the whole course of those negotiations, regardless of whether those negotiations were conducted in writing, orally or by conduct. By focusing on part of the communications in isolation, this could give a misleading impression that the parties had reached an agreement when they had not. Although the court will not consider subsequent events when interpreting the words of a contract, the issue in this case was not concerned with the interpretation of a contract but whether a contract had been entered into between the parties. The Court of Appeal decided that a contract had not been concluded during a telephone conversation following a 'subject to contract' offer letter, as this was inconsistent with the parties' subsequent communications.

According to the Court of Appeal, in spite of the parties' subsequent communications, the claimants had no real prospect of showing that there had been a binding offer and acceptance during the telephone conversation. There were certain factors which were inconsistent with the formation of a contract which included the fact that the claimants had marked the offer letter as 'subject to contract'.

Further, the offer letter sent on 9 May referred to the purchase as the ‘proposed transaction’; and that some of the terms of the contract provided the clause ‘upon your agreement that you are willing to proceed…’ which words indicated that a contract had not been formed. From a practical viewpoint when entering into negotiations, all correspondence should be marked ‘subject to contract’ to avoid entering into a contract prematurely, as in some circumstances, the courts may find that the ‘subject to contract’ status has been waived by a party. Further, the parties should ensure that they agree on all the terms of a contract between them set out in a written contract and signed by the parties.

An ‘agreement to agree’ provision

A1.5

Some provisions in a contract have the effect of ‘an agreement to agree’ at a future stage which are not binding on the parties to a contract. This aspect was considered in *Morris v Swanton Care & Community Limited* [2018] EWCA Civ 2763. In 2006, Morris sold his shares in a company to Swanton Care for an initial consideration subject to certain adjustments, through an earn-out provision. The terms of the agreement were set out in a Share Purchase Agreement. The earn-out provision stated that Morris ‘shall have the option’ to provide consultancy services for four years after completion and ‘following such period as shall reasonably be agreed between [the parties]’. Although Morris had provided the consultancy services for four years, Swanton Care rejected his ‘reasonable extension’ to the earn-out period. Morris contended that he had a contractual right to a further earn-out period which would have earned him additional remuneration.

The Court of Appeal held that Morris did not have an enforceable right to provide the consultancy services during any earn out period other than the initial period agreed for four years. The further earn-out period was in essence an agreement to agree and was unenforceable for uncertainty of terms. Further, the parties intended to leave the issue of any extension to the period to be agreed. This necessarily meant that either of them would be free to agree or disagree about the matter and they would need to reach agreement between them. Accordingly, there was no bargain which the courts could enforce. There was no obligation on the parties to negotiate in good faith about the matter which remained to be agreed between them. See too *Walford v Miles* [1992] 2 AC 128. A practical point to note which arises from the Court of Appeal decision is that if the parties wish to create an enforceable agreement which takes into account an objective framework which can fill in any gaps later provided these are not uncertain in nature and scope, then the parties should consider setting out in detail how the objective framework should operate including the factors and circumstances that should be taken into account.

Effect of waiver on mode of acceptance

A1.6

One of the essential elements in the formation of a contract is the mode of acceptance of the offer made by the offeror. In some circumstances, the offeror may stipulate the particular mode of acceptance that is to be followed by the offeree. An issue arises as to the position where there is a waiver of specific mode of acceptance by subsequent conduct of the parties and whether this constitutes formal acceptance of the offer. This issue was considered in *Reveille Independent LLC v Anotech International (UK) Ltd [2016] EWCA Civ 433*, where the Court of Appeal posed the following question: ‘In what circumstances will a contract result when a written offer document states that it is not binding until signed by the offeree and the offeree does not sign but performs in a manner contemplated by its terms?’

Reveille, a US television company issued proceedings against Anotech, a UK cookware distributor for breach of contract. Reveille alleged that there was an agreement whereby it had agreed to integrate and promote Anotech’s products in episodes of the US MasterChef television series and license Anotech the right to use the MasterChef brand on its products. Although long form agreements negotiated between the parties were never completed, the parties began to negotiate a short written agreement (‘Deal Memo’). The Deal Memo provided that it would not be binding on Reveille until executed by both Anotech and Reveille. Subsequently Anotech amended and signed the Deal Memo (which became a counter offer) but Reveille did not sign it.

The Court of Appeal held that the Deal Memo was binding on the parties as Reveille had accepted the contract by its conduct notwithstanding the prescribed mode of acceptance in that Reveille had

not signed it. On the facts, Reveille had waived the requirement that there would be no binding contract in the absence of its signature on the Deal Memo by its subsequent conduct. There was no prejudice to Anotech. Reveille's actions such as integrating Anotech's products into episodes of MasterChef and approving Anotech's request to use the MasterChef brand at a show demonstrated that by its conduct it had waived the requirement for a signature. Further, both parties through subsequent conduct had confirmed the existence of a contract by performance of their respective obligations.

Cranston J summarised the following contractual principles required for contract formation.

- Consent to a contract is found in the acceptance of an offer. Acceptance can be by conduct as long as that conduct is objectively intended to constitute acceptance: *Brogden v Metropolitan Railway Co (1877)* 2 App Cas 666.
- An offer which is set out in a draft agreement can be accepted even though it is never signed by the parties: *Brogden v Metropolitan Railway Co*.
- If a party has a right to sign a contract before being bound, it is open to it by clear and unequivocal words or conduct to waive the requirement and conclude the contract without insisting on its signature: *Oceonografia SA de CV v DSND Subsea AS (Botnica)* [2006] EWHC 1360.
- Where signature is the prescribed mode of acceptance, the offeror will be bound by the contract if it waives that requirement and acquiesces in a different mode of acceptance as long as that has not prejudiced the offeror: *MSM Consulting Ltd v United Republic of Tanzania* [2009] EWHC 121.
- A draft contract can still have contractual force, although the parties did not comply with a requirement that to be binding it must be signed, if essentially all the terms have been agreed and their subsequent conduct indicates this: *RTS Flexible Systems v Molkeroi Alois Muller GmbH* [2010] 1 WLR 753.
- The subsequent conduct of the parties is admissible to prove the existence of a contract and its terms.

According to Cranston J, these contractual rules take effect against a background of legal policies recognised in case law. One such policy is the need for certainty in commercial contracts, commercial negotiations and the question of whether a contract has come into existence: *Cobbe v Yeoman's Row Management Ltd* [2008] 1 WLR 1752.

A second policy is that in commercial dealings, the reasonable expectations of honest, sensible business persons must be protected: see *RTS Flexible Systems Ltd*; and *G. Percy Trentham Ltd v Archital Luxfer Ltd* [1993] 1 Lloyd's Rep 25.

A practical point to note is that the parties to a contract should in advance sign an agreement before commencement of their obligations to ensure certainty in a contract. Further, this case demonstrates that a formal prescribed mode of acceptance can be waived by subsequent conduct.

The position where an agreement is subject to consent being obtained

A1.7

Some cases have demonstrated that a contract cannot be formed and there cannot be a legally valid binding contract where an agreement is expressed and is subject to board approval and therefore not binding until approval is given. This arose in *Goodwood Investments Holding Inc v ThyssenKrupp Industrial Solutions AG* [2018] EWHC 1056, where the court was required to consider whether an arbitration claim was settled in without prejudice correspondence between the parties' respective solicitors. The court held that a binding settlement had not been reached as the offer was made subject to the conclusion of a formal settlement agreement as well as subject to board approval which had not yet been obtained.

According to Males J, words such as 'subject to contract' indicated that the parties do not intend to be bound until a formal contract is entered into between them: *Generator Developments Ltd v Lidl UK GmbH* [2018] EWCA Civ 396. The same principles applied to an agreement which was stated to be

subject to board approval of one or both parties. The effect of this is that the person concluding the agreement does not have the authority or is not prepared to commit the company unless the approval is forthcoming: see *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH & Co KG* [2010] 1 WLR 753; and *Pagan SpA v Feed Products Ltd* [1987] 2 Lloyd's Rep 601. In determining whether an agreement has become legally binding, the whole course of the parties' negotiations must be considered: *Global Asset Capital Inc v Aabar Block Sarl* [2017] EWCA Civ 37. Since the directors are required to exercise an independent judgment whether the transaction is in the best interests of the company, it was difficult to see how there could in such circumstances be any implied promise binding the company to the effect that approval will be forthcoming or that it is a mere formality or a 'rubber stamping' exercise.

Proper parties to the contract

A1.8

A contract which is entered into must ensure that appropriate parties are included in the contract to ensure enforceability against the party concerned. The decision in *Erith Holdings v Murphy* [2017] EWHC 1364 serves to highlight the importance of knowing who are the exact parties to the contract. In this case, a group of waste removal companies which provided services to a company that subsequently went into liquidation was not entitled to recover outstanding amounts from the company's owner. The court found that the agreement for works had been entered into with the company itself and the company's owner had not given any guarantee or indemnity in his personal capacity. Even where a guarantee had been given by the owner, it was merely oral and therefore unenforceable. A practical point to note is the importance of knowing who a party is contracting with to ensure enforceability. This case emphasises that terms should be formally set out in writing rather than relying on oral discussions. Where a guarantee is to be provided by the owner in an individual capacity, that party should be added to the agreement or that any such guarantee is properly documented.

Implied terms

A1.9

In certain circumstances, the courts may imply some terms into the contractual relationship between the parties. The law recognises two types of contractual implied terms:

1. A term may be implied into a particular contract, in the light of the express terms, commercial common sense, and the facts known to both parties at the time the contract was made. This section is concerned with the first type of implied term.
2. The second type of implied term arises because unless such a term is expressly excluded, the law (sometimes by statute or through the common law) imposes certain terms into certain classes of relationship (for example the *Supply of Goods and Services Act 1982*): see *Geys v Societe Generale* [2013] 1 AC 523, at para 55.

Over the years, there have been various classic judicial interpretations as to the requirements that have to be satisfied before a term can be implied into a commercial contract. Three principal tests have been highlighted: (i) business efficacy; (ii) necessity; and (iii) officious bystander.

The requirement for business efficacy test was set out in *The Moorcock (1889)* 14 PD 64. Bowen LJ stated that in all the cases where a term had been implied, 'it will be found that …the law is raising an implication from the presumed intention of the parties with the object of giving the transaction such efficacy as both parties must have intended that at all events it should have.'

The business efficacy test was further developed in *Reigate v Union Manufacturing Co (Ramsbottom) Ltd* [1918] 1 KB 605. Scrutton LJ stated that a term can only be implied if it is necessary in the business sense to give efficacy to the contract. A term would only be implied 'if it is such a term that it can confidently be said that if at the time the contract was being negotiated, the parties had been asked what would happen in a certain event, they would both have replied 'of course. So and so will happen; we did not trouble to say that; it is too clear.''

Shirlaw v Southern Foundries (1926) Ltd [1939] 2 KB 206 introduced the 'officious bystander' test. MacKinnon LJ stated that 'prima facie that which in any contract is left to be implied and need not be

expressed is so obvious that it goes without saying.' Further, that a term would only be implied 'if, while the parties are making their bargain, an officious bystander were to suggest some express provision for it in their agreement, they would testily suppress him with a common 'Of, of course!'' See too *Powell v Lowe* [2010] EWCA Civ 1419; and *Trollope & Colls Ltd v North West Metropolitan Regional Hospital Board* [1973] 1 WLR 601; and *Liverpool City Council v Irwin* [1977] AC 239.

Modern Test on Implied Terms

A1.10

Given the nature of the diverse tests for implying a term into a contractual relationship, the leading test on implied terms has been set out by the Supreme Court in *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72. Lord Neuberger stated that the classic tests for implied terms (considered above) represented a clear, consistent and principled approach, and that it would be dangerous to reformulate the principles. He favoured the approach to implied terms set out in the Privy Council decision by Lord Simon in *BP Refinery (Westernport) Pty Ltd v President Councillors and Ratepayers of the Shire of Hastings* (1977) 52 ALJR 20:

> '[F]or 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 expression; (5) it must not contradict any express term of the contract.'

Lord Neuberger added the following six observations to the above implied term principles enunciated by Lord Simon.

- There is no need to show an actual intention of the parties when negotiating the contract. The court is instead concerned with the notional intention of reasonable people in the position of the parties at the time at which they were contracting.
- 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 to it if it had been suggested to them. Those are necessary but not sufficient grounds for including a term.
- 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.
- Business necessity and obviousness can be alternatives in the sense that only one of them needs to be satisfied.
- 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.'
- Necessity for business efficacy involves a value judgment. The test is not one of 'absolute necessity', not least because the necessity is judged by reference to business efficacy. A term can only be implied if, without the term, the contract would lack commercial or practical coherence.

Lord Neuberger further stated that the exercise of implying a term into a contract was not the same as the exercise of interpreting a contract, particularly because the express terms of a contract must first be interpreted before considering any question of implication.

Practical Points

A1.11

- The Supreme Court in *Marks and Spencer plc* has emphasised the strict nature of the legal test which must be met before a term can be implied into a contractual relationship.
- The process of construction of an express term will first be considered by the court and only thereafter will the issue of implication of a term will arise.
- When drafting a commercial agreement, set out expressly and specifically and clearly the objectives and intentions of the parties.

- The court will not rewrite provisions of a contract for the parties.
- The court will uphold the bargain struck by the parties as set out in the commercial agreement.
- A term cannot be implied into a commercial agreement if it contradicts an express term.
- The courts are now placing emphasis towards a more literal approach to contractual interpretation and in particular to the actual words set out in the commercial agreement.
- In *Kason Kek-Gardner Ltd v Process Components Ltd* [2017] EWCA Civ 2132, Lewison LJ applied the test for implying terms in commercial agreements: the term must be necessary to give the contract business efficacy, or it must be so obvious that it goes without saying. He also stated that that the necessity required by the test is necessity for the business efficacy of the contract itself and 'not some wider business purpose of the contracting party.'
- The *Marks and Spencer plc* case was applied by the Court of Appeal in JN *Hipwell & Son v Szurek* [2018] EWCA Civ 674, where Hildyard J (with whom Gross LJ agreed) stated:

  '….it is well established, and was not disputed before us, that a term may be implied where it is necessary to give business efficacy to the contract in question. In such a context, the touchstone is always necessity and not merely reasonableness, and the term is implied as a matter of fact in the particular case, rather than as a matter of law and as a legal incident of contracts of an identified type.'
- Since *Marks and Spencer plc* case, the courts have demonstrated that a strict approach will be taken when implying terms in a contractual relationship between the parties. Further, the courts will construe the express term first before considering whether or not to imply a term into the contract. In *Robert Bou-Simon v BGC Brokers LP* [2018] EWCA Civ 1525, BGC Brokers ('B') lent £336,000 to Simon ('S') under a loan agreement which assumed that S would become a partner in B. The agreement provided that the loan would be repaid from S's partnership distributions with interest. S resigned within four years and B claimed that the outstanding loan plus interest was due from S. B contended that the loan was due pursuant to a term which should be implied to that effect into the loan agreement. The Court of Appeal held that although the judge at first instance had identified the correct test for implied terms in *Marks and Spencer plc*, he had misapplied the test. The judge had implied a term in order to reflect the merits of the situation as they now appear. He did not approach the matter from the perspective of a reasonable reader of the loan agreement, knowing all its provisions and the surrounding circumstances at the time the agreement was made. It was not appropriate to apply hindsight and to seek to imply a term in a commercial contract merely because it appears to be fair or because one considers that the parties would have agreed to it if it had been suggested to them. Those are necessary but not sufficient grounds for the implication of a term. Further, the issue of implied terms should only be considered once the process of construing the express terms of the agreement had been completed.
- In *Takeda Pharmaceutical Company Limited v Fougera Sweden Holding AB* [2017] EWHC 1995, the High Court was required to consider whether a term for the parties to cooperate following completion was to be implied into a share purchase agreement ('SPA'). Arnold J relying on *Marks and Spencer plc*, held that an implied duty to cooperate could not be implied in the SPA. He noted that there was no dispute as to the principles to be applied in interpreting the SPA taking account of the decision in *Wood v Capital Insurance Services*. The Court's task was to ascertain the objective meaning of the language which the parties had chosen to express their agreement when read in the context of factual background known or reasonably available to the parties at the time of the agreement, excluding prior negotiations. The practical point to note is that if a party is seeking cooperation from the other party, it should be expressly drafted in the agreement as such a term will not be implied, particularly because on the facts Arnold J determined that the SPA had been professionally drafted on behalf of sophisticated and well-resourced parties, and was detailed and complex.
- In *Hayfin Opal Luxco 3 SARL v Windermere VII CMBS plc* [2018] 1 BCLC 118, Snowden J was of the view that where an analysis of the express term of a contract led to the clear conclusion that something was missing, the court could supply the missing words or terms by the process of correcting mistakes by construction or by the implication of terms. In either case, however, there was a strict test to justify such a result: the court would not supply additional words or imply terms simply because it was reasonable to do so in the circumstances which had arisen.

The court would only add words to the express terms of the agreement if it was necessary to do so because the agreement was incomplete or commercially incoherent without them. Even then, the court had to be certain both that the absence of the missing words was inadvertent, and that if the omission had been drawn to the attention of the parties at the time of contracting they would have agreed what additional provisions should be made.

- In *Merthyr (South Wales) Ltd v Merthyr Tydfill County Borough Council* [2019] EWCA Civ 526, a dispute arose between the parties in connection with a planning permission granted by the Council to a mining company, which provided a requirement that the company fund restoration of the land after its mining operations concluded. The parties entered into an escrow agreement in 2015 establishing a fund to secure £15 million of the restoration costs. Clause 4.2(a) of the escrow agreement provided that 'subject to [subclauses (b) and (c)], on each Funding Date, the Company shall deposit an amount equal to £625,000 (as adjusted pursuant to [subclauses (c) and (d))] into the Account.' The funding dates occurred quarterly and subclauses (b) and (c) set out that, subject to subclause (d), if a deposit or consecutive deposits were missed, the amount due on the next funding date would increase by the amount outstanding. Subclause (d) was a longstop provision, specifying that if the final deposit was missed, the company was to pay the outstanding balance of the £15 million by 30 June 2022. The company did not however make any deposits and the Council sought an order for specific performance. The company's defence was that the relevant provisions allowed the company to make quarterly deposits as long as the company paid £15 million by the longstop date. The High Court granted the specific performance and ordered the company to pay the deposits outstanding at that time into the escrow account. The Court of Appeal considered one of the issues regarding textual analysis and business common sense. According to the mining company, the escrow agreement should reasonably be understood to mean that, if a quarterly payment was missed, there was no enforceable obligation to make the payment until the longstop date. The company contended that this followed from the fact that the requirements to make the quarterly payments were expressed to be 'subject to' the provisions stating that missed payments would be rolled forward to the next funding date. The Court of Appeal rejected the company's purported interpretation of the escrow agreement based on the textual analysis and because it would be 'an extraordinary and improbable intention to attribute to contracting parties', which was contrary to business common sense. According to the Court of Appeal, the decision in *Arnold v Britton* cautioned against relying on considerations of commercial common sense where to do so would undervalue the importance of the commercial language used. Leggatt LJ stated that in this case no question arose of rejecting the natural meaning of the contractual language as there were no words in the agreement which had as their natural meaning that the amount to be deposited on each funding date ceased to be due if the company failed to pay it. Implying such a term would be inconsistent with the express terms of clause 4.2 which used terminology ('shall', 'fails to pay', 'payable', and 'outstanding') clearly indicating that payment of the amounts on the funding dates was a legal obligation rather than merely a statement of non-binding intention. Further, such a construction would undermine the commercial purpose of the escrow agreement which was to ensure that a fund of restoration money was established from the revenue generated from the mine. As a practical point, the decision in *Merthyr* demonstrates the importance of ensuring that all contractual provisions are drafted clearly. Where any assumptions or background information may be necessary to understand the purpose and intended operation of a particular provision, these should be set out in the contract by way of recitals or similar with clearly drafted provisions demonstrating the intentions of the parties. The Court of Appeal decision illustrates the strict operation of the common law rule against relying on evidence of pre-contractual negotiations to interpret contracts. The decision highlights that it is not only statements reflecting one party's subjective intentions or aspirations which are excluded for the purposes of interpreting a contract, but also communications that are capable of showing that the parties reached a consensus on a particular point or used words in an agreed sense in concluding the contract.
- *Triple Point Technology Inc v PTT Public Company Ltd* [2019] EWCA Civ 230 raised the issue of implying a term into a commercial contract to the effect that the independent contractor could suspend work and its services in the event of non-payment by the employer. The Court of Appeal rejected the implication of such a term on the basis that if the employer failed to make payments to the contractor on the due dates, the contractor would have all the usual remedies for non-payment rather than liquidated damages. These would include suing for the money due, applying for summary judgment, and treating the non-payment as a repudiation. Further,

even if the contract were to favour one party strongly, there was no reason for the court to redress the balance by implying terms into the contract. Although there were express provisions dealing with suspension of work, these provisions did not specifically include non-payment. Therefore, a clause providing for liquidated damages for delay did not apply where the contractor failed to complete the contracted work.

Implied Duty of Good Faith in a Commercial Agreement and Relational Contracts

A1.12

The issue here is whether the courts would imply a duty of good faith where there is an oral commercial joint venture agreement or a long-term contract? Although there is no general principle of good faith in English contract law, there is a recognition that a duty of good faith may be implied in certain circumstances and to categories such as a fiduciary relationship or in contracts of employment.

In *Sheikh Tahnoon Bin Saeed Bin Shakhboot Al Nehayan v Ioannis Kent* [2018] EWHC 333, Leggatt LJ considered that 'there appears to be a growing recognition that such a duty may readily be implied in a relational contract.' A 'relational contract' is a contract that 'may require a high degree of communication and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties' understanding and necessary to give business efficacy to the arrangements': per Leggatt LJ in *Yam Seng Pte Ltd v International Trade Corp* [2013] EWHC 111. Relational contracts may include joint venture agreements, distribution agreements and franchise agreements. It includes a category of contract in which the parties are committed to collaborating with each other, typically on a long-term basis, which respect to the spirit and objectives of their venture, but which they have not tried to specify, and which may be impossible to specify, exhaustively in a written contract. Such 'relational' contracts involve trust and confidence but of a different kind from that involved in fiduciary relationships. The trust is not in the loyal subordination by one party of its own interests to those of another. It is the trust that the other party will act with integrity and in a spirit of cooperation. The legitimate expectations which the law should protect in relationships of this kind are embodied in the normative standard of good faith.

Leggatt LJ found the following features in the dealings between the parties to conclude that there was a relational contract:

- The nature of the parties' relationship was one in which they 'naturally and legitimately' expected of each other greater candour and cooperation and greater regard for each other's interests than ordinary commercial parties dealing with each other at arm's length.
- The two parties entered into a joint venture agreement which was intended to be a long-term collaboration, in which their interests were inter-linked and which they saw commercially albeit not in law, as a partnership. Their collaboration was formed and conducted on the basis of a personal friendship and involved much greater mutual trust than is inherent in an ordinary contractual bargain between shareholders in a company.
- Although the parties did not attempt to formalise the basis of their cooperation in any written contract, they were content to deal with each other entirely informally on the basis of their mutual trust and confidence that they would each pursue their common project in good faith.

On the facts, Leggatt LJ concluded that the joint venture agreement was a 'relational contract.' Therefore, the implication of duty of good faith in the contract was essential to give effect to the parties' reasonable expectations and satisfied the business necessity test as set out in the *Marks and Spencer plc* case.

The obligation to act in 'good faith' is an obligation to act honestly and with fidelity to the bargain. It is an obligation not to act dishonestly and not to act to undermine the bargain entered into or the substance of the contractual benefit bargained for. It is also an obligation to act reasonably and with fair dealing having regard to the interests of the parties (which will, inevitably, at times conflict) and to the provisions, aims and purposes of the contract, objectively ascertained.

The court identified two forms of 'furtive or opportunistic' conduct which would be incompatible with the obligation of good faith. First, it would be inconsistent with the duty of good faith for one

party to agree or enter into negotiations to sell his interest or part of his interest in the companies which they jointly owned to a third party covertly and without informing the other beneficial owner. Second, it would be contrary to the obligation to act in good faith for either party to use his position as a shareholder of the companies to obtain a financial benefit for himself at the expense of the other.

In *Bates v Post Office Ltd (No 3)* [2019] EWHC 606, the High Court decided that certain contracts between the Post Office and sub-postmasters were 'relational contracts' and subject to an implied obligation on the parties to act in good faith. According to Fraser J, the obligation of good faith will not be implied in every commercial contract but in accordance with the decision in *Yam Seng Pte Ltd v International Trade Corp*, there was a recognition in English law that in relation to 'relational contracts' an obligation of good faith was implied into a commercial agreement. The nature of a relational contract depended on the circumstances of the relationship, defined by the terms of the agreement, set in its commercial context. Fraser J stated that it was not sufficient in the duty of good faith for the requirement that the parties only act honestly. Although the duty included honesty, it also required the parties to refrain from conduct which in the relevant context would be regarded as commercially unacceptable by reasonable and honest people.

The *Bates* case involved group litigation between 550 sub-postmasters and the Post Office pursuant to a sub-postmaster contract and subsequently the Network Transformation Contract between the respective parties. The terms of these contracts provided that the sub-postmasters and their personnel were solely responsible for any losses caused by negligence on their part, and they were required to make good any shortfalls to the Post Office. In the late 1990s, the Post Office introduced a computerised accounting system named Horizon which was to be used by all sub-postmasters in their branches. The Horizon system identified a number of shortfalls and discrepancies in the accounting systems in the various branches to which the sub-postmasters were required to contribute from their own personal resources despite their protestations that the Horizon system was defective with many becoming bankrupt and convicted of fraud and false accounting.

Having determined that there was a contractual relationship between the Post Office and the claimants, Fraser J focused on the characterisation of the contract as a 'relational contract' and whether there was an implied obligation of good faith in such a contract. Fraser J decided that the contract between the Post Office and the sub-postmasters was a relational contract:

> 'I consider that there is a specie of contracts, which are most usefully termed "relational contracts", in which there is an implied obligation of good faith (which is also termed "fair dealing" in some of the cases). This means that the parties must refrain from conduct which in the relevant context would be regarded as commercially unacceptable by reasonable and honest people.'

Fraser J decided that although there was no general duty of good faith implied into all commercial agreements, but 'such a duty could be implied into some contracts, where it was in accordance with the presumed intention of the parties.' In the course of his judgment, he set out the essential characteristics of a relational contract which carried the obligation of good faith:

- there is no specific express term in the contract that prevents a duty of good faith being implied;
- the contract is a long-term contract, with mutual intention of a long-term relationship;
- there is an intention to perform the parties' respective roles with integrity and fidelity to the bargain;
- there is a commitment to collaboration in the contract's performance;
- the 'spirits and objectives' of the parties' venture is incapable of exhaustive expression in a written contract;
- the parties reposing trust and confidence in each other (but of a kind different to that reposed in fiduciary relationships);
- there is a high degree of communication, cooperation and predictable performance based on mutual trust and confidence, and expectations of loyalty;
- there is a degree of significant investment by one or both parties;
- there is exclusivity of contractual relationship.

The above list of characteristics was not exhaustive of a relational contract and that no single factor was determinative with the exception of the first characteristic, so that if the express terms prevented the implication of a duty of good faith, such duty could not be implied in such contracts. Fraser J decided that each of the above characteristics was present in the contractual relations between the Post Office and the sub-postmasters, but with the following additional elements from the facts that lent support to a relational contract namely:

- the significant of the sub-postmaster's investment in buying or leasing premises for the branch;
- the Post Office's awareness of the size of the investment and the sub-postmaster's source of funds;
- the sub-post master's entitlement to certain benefits similar to those under an employment contract;
- the requirement on the Post Office to maintain branches widely, even in locations that would not normally be commercially viable;
- the importance of trust between the sub-postmaster and the public and the Post Office and the sub-postmasters.

The *Bates* case involved implying terms of good faith into the contractual relationship between the parties. However, the scope for implying further terms of good faith are very limited especially where there is an express duty to act in good faith. In *Teesside Gas v CATS North Sea* [2019] EWHC 1220 one of the clauses in the agreement between the parties stated that Teesside Gas had 'the right to dispute, in good faith, any amount specified in an invoice'. Butcher J held that 'The contract thereby defined, in my judgment exhaustively, the extent of any good faith obligations arising under it. It would be inconsistent with those terms to imply any wider duty of good faith'.

The issue and scope of the label 'relational contracts' and implied duty of good faith was considered in *UTB LLC v Sheffield United Ltd* [2019] EWHC 2322 including the circumstances in which a duty of good faith should be implied in an investment and shareholder agreement. According to Fancourt J:

> 'If by "relational contract" it is clear that one means a relational contract of the kind described by Leggatt LJ in *Sheikh Tahnoon* and not all relational contracts in a broader sense, then there is no difficulty and the characteristics identified by Fraser J [in the *Bates* case] may assist to identify such a contract. But there is a danger in using the term "relational contract" that one is not clear about what exactly is meant by it. There is a great range of different types of contract that involve the parties in long-term relationships of varying types, with different terms and varying degrees of detail and use of language, and to characterise them all as "relational contracts" may be in one sense accurate and yet in other ways liable to mislead. It is self-evidently not all long-term contracts that involve an enduring but undefined, cooperative relationship between the parties that will, as a matter of law, involve an obligation of good faith: see *Globe Motors, Inc v TRW Lucas Varity Electric Steering Ltd* [2016] EWCA Civ 396.
>
> Rather than seek to identify and weigh likely indicia of a "relational contract" in the narrower sense used by Leggatt LJ, it is, I consider, preferable to ask oneself first – as Leggatt LJ did in the *Sheikh Tahnoon* case – whether a reasonable reader of the contract would consider that an obligation of good faith was obviously meant or whether the obligation is necessary to the proper working of the contract. The overall character of the contract in issue will of course be highly material in answering that question but so will its particular terms, as recognised by the principle that (as restated in the *Marks and Spencer* case) no term may be implied into a contract if it would be inconsistent with an express term.
>
> That approach is, in my respectful opinion, preferable also because the exact content of any implied obligation of fair dealing, or to act with integrity, or to act in good faith, will be highly sensitive to the particular context of the contract, as observed by Dove J in *D&G Cars Ltd v Essex Police Authority* [2015] EWHC 226 (QB) at [175]. The greater part of that context is the express terms of the contract. Thus, to imply a general obligation to act at all times in good faith towards the counterparty because the contract is a relational contract may fail to have regard to rights and obligations created by the express terms, to which any implied obligation must be tailored if it is not to be excluded as being inconsistent with them. In the instant case there is a real example of just such a question...'

On the facts, Fancourt J did not find that good faith should be implied in an investment and shareholder agreement.

Inconsistency between express and implied terms

A1.13

There may be some situations where the implied terms which are pleaded by a party are substantially inconsistent with the express terms of the contract between the parties because the express terms do not fully reflect the parties' intentions. The issue arises whether the courts will uphold the implied terms or the express terms. This aspect was considered by the Court of Appeal in *Irish Bank Resolution Corp Ltd (In Special Liquidation) v Camden Market Holdings Corp* [2017] EWCA Civ 7.

The bank, Irish Bank Resolution Corp Ltd ('IBRC') and the developer, Camden Market Group ('CMG') entered into a Facility Agreement in 2005 under which IBRC provided £195 million to CMG to purchase and develop properties at Camden Market with the extension of the loan in 2008 and 2012. Thereafter, IBRC was placed in special liquidation. The liquidators of IBRC were instructed to sell off IBRC's loan books including the loans made to CMG. The loan agreement between IBRC and CMG expressly allowed IBRC to assign any of its loans to another bank and to provide details of the loans to potential assignees who entered into a confidentiality undertaking. At the same time, CMG began to market the properties it had developed under the loan facilities to prospective buyers. IBRC's liquidators began to market CMG's loans as part of a package of loans containing distressed debt. It was contended by CMG that IBRC's marketing of CMG's facilities together with the distressed debt implied that CMG's facilities were also in default, which on the facts was not the case.

CMG issued proceedings against IBRC on the basis that IBRC's right to market the CMG's loans was qualified by an implied term that IBRC should not do anything to hinder CMG's ability to achieve the best price for CMG's properties. CMG alleged that it had suffered substantial losses owing to breach of the implied term. IBRC sought summary judgment and contended that the alleged implied term contradicted the express term in the loan agreements which allowed IBRC to assign the loans with CMG's parent company's consent, and to provide information to any prospective purchaser.

In the Court of Appeal, Beatson LJ affirmed the principles on implied terms set out by Lord Neuberger in *Marks and Spencer plc*, and that it was necessary first to consider the express terms in a contract before determining whether or not a term should be implied. If a term was to be implied, it would always be subject to the 'cardinal rule' that any implied term must not contradict any express term of the contract.

Beatson LJ distinguished between two types of inconsistencies: (a) direct linguistic inconsistency; and (b) substantive inconsistency. He decided that there was no linguistic inconsistency in IBRC's ability to market the loans under the express terms of the loan agreements. Beatson LJ held however that the implied term alleged by CMG would be substantively inconsistent with the express terms of the loan agreements. There would be a 'significant restriction' on IBRC's express power to disclose information to potential purchasers. The express terms and the implied term were therefore held to be substantively inconsistent.

The Irish Bank case signifies a stringent approach that the courts are taking when considering whether to imply terms in a commercial agreement between the parties. A term cannot be implied into a contract between the parties if it contradicts the express terms of the contract. The parties to the contract should therefore ensure that their rights are protected by express terms when entering into a contractual relationship and not to rely upon implied terms to supplement the express terms. The courts will uphold the bargain struck by the parties under the express terms of the contract. The court will only therefore apply the strict test set out in *Marks and Spencer plc* once it has addressed the express terms in the contract. Where an express term provides for an express power on a party to the contract, the express power cannot be qualified, limited or altered by an implied term: see too *Stevensdrake Ltd (Trading as Stevensdrake Solicitors) v Stephen Hunt (Liquidator of Sunblow Ltd)* [2017] EWCA Civ 1173 (terms of an earlier contract could not be implied into a subsequent agreement). See too *Merthyr (South Wales) Ltd v Marthyr Tydfill County Borough Council* [2019] EWCA Civ 526.

Contractual interpretation

A1.30

The UK courts often resort to contractual interpretation to ascertain the meaning of a word or a phrase in the context of a commercial agreement. However, over the years, there have been some judicial inconsistencies as to the correct test to be applied in the context of contractual interpretation.

The Supreme Court's approach to Contractual Interpretation

A1.31

In *Rainy Sky SA v Kookmin Bank* [2011] 1 WLR 2900, Lord Clarke stated that the ultimate aim of interpreting a provision in a contract, especially a commercial contract, is to determine what the parties meant by the language used which involves ascertaining what a reasonable person would have understood the parties to have meant (see *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896; *Pink Floyd v EMI* [2010] EWCA Civ 1429; *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC 1101; *Wickman Machine Tools Sales Ltd v Schuler AG* [1974] AC 235*; and The Antaios* [1984] AC 91).

The issue on appeal in *Rainy* was the role to be played by considerations of business common sense in determining what the parties meant. According to Lord Clarke, 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 reject the other.

Where the parties have used unambiguous language, the court must apply it. It is not necessary to conclude that a particular construction would produce an absurd or irrational result before proceeding to have regard to the commercial purpose of the agreement (see *Chalabi v Agha-Jaffar* [2011] EWHC 203). The courts will therefore take a commercial approach towards interpreting ambiguities in commercial contracts.

The leading authority on contractual interpretation is the Supreme Court decision in *Arnold v Britton* [2015] UKSC 36. Oxwich Leisure Park contained 91 chalets, each of which was let for a period of 99 years from 25 December 1974. The Appellants were the current tenants under 25 of the leases. Clause 3(2) of each lease contained a covenant to pay a service charge. Each lease also contained covenants by the lessor including an obligation to promote services to the Park such as maintaining roads, paths, fences, a recreation ground and drains, mowing lawns and removing refuse.

The respondent who was the current landlord, contended that the service charge provision in clause 3(2) required from the lessee an initial service charge of £90 which increased at a compound rate of 10% for the first 70 chalets to be let every three years, but for the last 21 chalets to be let, every year.

A typical service charge provision in every lease provided:

> 'To pay to 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 provision of services hereinafter set out the yearly sum of Ninety Pounds and value added tax (if any) for [the first three years or the first year] of the term hereby granted increasing thereafter to Ten Pounds per Hundred for every subsequent [three year period or year] or part thereof.'

The issue on appeal before the Supreme Court was whether the respondent's interpretation of Clause 3(2) in the 25 leases, where the increase was to be every year, was correct. The Supreme Court decided by a majority of 4-1 for the respondent. In the course of his judgment Lord Neuberger considered the issue of contractual interpretation of commercial agreements, taking account of the House of Lords and Supreme Court decisions in *Prenn v Simmonds* [1971] 1 WLR 1381; and *Rainy Sky SA v Kookmin Bank*. According to Lord Neuberger, when interpreting a written contract, the court must 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.' (see *Chartbrook Ltd v Persimmon Homes Ltd* [2009] 1 AC 1101). This involves focussing on the meaning of the relevant words in their documentary, factual and commercial context. That meaning had to be assessed in the light of:

- the natural and ordinary meaning of the clause.
- any other relevant provisions of the contract.
- the overall purpose of the clause and the contract.
- the facts and circumstances known or assumed by the parties at the time that the document was executed.
- commercial common sense.

However, subjective evidence of any party's intentions must be disregarded.

Lord Neuberger emphasised the following factors in contractual interpretation.

- The reliance placed in some cases on 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.
- The exercise of interpreting a provision involves identifying what the parties meant through the eyes of a reasonable reader, which meaning will be obtained 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. Accordingly, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision.
- When it comes to considering the centrally relevant words to be interpreted, the less clear the words, the more ready the court can properly be to depart from their natural meaning. The clearer the natural meaning, the more difficult it is to justify departing from it. It does not justify the court embarking on an exercise of searching for or constructing, drafting infelicities in order to facilitate a departure from their 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.
- Commercial common sense should not 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, should not be 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.
- Although commercial common sense is a very important factor to take into account when interpreting a contract, the court should not 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 they should have agreed. It is not the function of the court when interpreting an agreement to relieve a party from the consequences of his imprudence or poor advice. When interpreting a contract, the court should avoid re-writing it in an attempt to assist an unwise party or to penalise an astute party.
- 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 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.
- 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 circumstances, if it is clear what the parties would have intended, the court will give effect to that intention: see *Aberdeen City Council v Stewart Milne Group Ltd* [2011] UKSC 56.

Practical Points

- In *Arnold v Britton*, the Supreme Court emphasised its approach towards literal interpretation of contracts rather than a purposive or commercial approach considered in *Rainy Sky v Kookmin Bank*. The Supreme Court in *Arnold* gives prime importance to the language of the provision which is to be construed. The courts will consider the language and provisions chosen by the parties to the contract. On the application of the literal approach, see *Exsus Travel Ltd v Baker Tilly* [2016] EWHC 2818; and *Metlife Seguros De Retiro v J P Morgan Chase Bank* [2016] EWCA Civ 1248.
- In *Wood v Capital Insurance Services Ltd* [2017] UKSC 24, the Supreme Court reaffirmed the principles of contractual interpretation as set out in *Arnold v Britton* as being the correct approach. Lord Hodge stated that the court's task was to ascertain the objective meaning of the language which the parties had chosen to express their agreement. In doing so, the court must also consider the contract as a whole and, depending on the nature, formality and quality of the drafting of the contract, giving more or less weight to elements of the wider context in reaching its view as to that objective meaning. Where appropriate, the court would also have regard to the factual background known to the parties at or before the date of the contract. Textualisation and contextualism were not conflicting paradigms in contractual interpretation. The court, when interpreting any contract, can use them as tools to ascertain the objective meaning of the language which the parties have chosen to express their agreement. The extent to which each tool will assist the court in its task will vary according to the circumstances of the particular agreement. Some agreements may be successfully interpreted principally by textual analysis because of their sophistication and complexity. The correct interpretation of other contracts may be achieved by a greater emphasis on the factual matrix because of their informality or brevity. Lord Hodge confirmed that on the approach to contractual interpretation, *Rainy Sky* and *Arnold* could be reconciled with one another. See too *Triple Point Technology Inc v PTT Public Company Ltd* [2019] EWCA Civ 230.
- In *Kason Kek-Gardner Ltd v Process Components Ltd* [2017] EWCA Civ 2132, the Court of Appeal emphasised that subsequent conduct of the parties to an agreement could not affect the true interpretation of the agreement, much less the subsequent conduct of those not party to the agreement. Lewinson LJ made reference to *Arnold v Britton* and stated that admissible background was limited to the facts that were known or reasonably available to both parties. It was not right to take into account facts that were only known to one of them. According to Lewinson LJ, reliance on commercial common sense and background should not be used to devalue the importance of the language of the provisions to be interpreted.
- In *MT Højgaard A/S v E.On Climate & Renewables UK Robin Rigg East Limited* [2017] UKSC 59, the Supreme Court was required to interpret provisions in a construction contract which imposed design obligations and performance obligations on the contractor. Lord Neuberger sought to give effect to the terms in the contract by applying a literal interpretation which had the effect that the contractor was liable for the remedial works in breach of its performance obligations which imposed higher standards. The court therefore seeks to give effect to, and not interfere in the freedom of parties to reach their own commercial agreements and recognise that they bear the burden involved in understanding and fulfilling the agreements that they make. The *Højgaard* decision reinforces the approach in *Arnold v Britton* of an approach towards the literal meaning of contractual provisions. The Supreme Court in Højgaard stated that the reconciliation of various terms in a contract, and the determination of their combined effect must be decided by reference to ordinary principles of contractual interpretation. While each case must turn on its own facts, the courts are generally inclined to give full effect to the requirement that the item as produced complies with the prescribed criteria, even if the customer or employer has specified or approved the design. Generally speaking, the contractor is expected to take the risk if he agreed to work to a design which would render the item incapable of meeting the criteria to which he has agreed.
- The Court of Appeal decision in *Classic Maritime Inc v Limbungan Makmur SDN BHD* [2019] EWCA Civ 1102 further highlights the modern judicial approach towards contractual interpretation. The Court of Appeal emphasised that the issue of contractual interpretation was not how the clause should be labelled (whether as an exceptions clause or a force majeure clause) but rather how it should be interpreted, based on its language and having regard to its context and purpose. According to Males LJ: 'As with most things, what matters is not the label

but the content of the tin.' As a practical point, it is therefore essential to ensure that the parties' intentions are made absolutely clear in the language of the clause when drafting or entering into contracts.

- In *Merthyr (South Wales) Ltd v Merthyr Tydfill County Borough Council* [2019] EWCA Civ 526, the issue concerned the interpretation of a contract to establish an escrow account. The Court of Appeal highlighted the strict operation of the common law rule against relying on evidence of pre-contractual negotiations to interpret agreements. The Court of Appeal's decision emphasises that while it is permissible for a court to take account of pre-contractual material for the limited purpose of understanding the genesis and commercial aim of the transaction as a whole, this does not extend to admitting material in order to elucidate further on the genesis and aim of a particular contractual provision. Leggatt LJ summarised the law as follows:

  '(1) Previous documents may be looked at to show the surrounding circumstances and, by that means, to explain the commercial or business object of a contract;

  (2) The approach is, by considering the circumstances which led to the execution of the contract, to identify the purpose of the transaction and to construe the language used in the light of that purpose;

  (3) Evidence of negotiations, or of the parties' intentions, ought not to be received;

  (4) What is not permissible, is to seek to rely on evidence of what was said during the course of pre-contractual negotiations for the purpose of drawing inferences about what the contract should be understood to mean;

  (5) It is also clear that it is not only statements reflecting one party's intentions or aspirations which are excluded for this purpose, but also communications which are capable of showing that the parties reached a consensus on a particular point or used words in an agreed sense;

  (6) In other words, there is a line between referring to previous communications to identify the 'genesis and aim of the transaction' and seeking to rely on such evidence to show what the parties intended a particular provision in a contract to mean, may be hard to draw.'

- In *Stobart Group Ltd v Stobart* [2019] EWCA Civ 1376, the sellers agreed to sell all the issued share capital of Stobart Rail Ltd ('SRL') to the buyers, Stobart Group Ltd. Under the share purchase agreement (SPA) entered into by the parties, there were various tax warranties and covenants addressing the sellers' liability for tax incurred prior to the sale of the business including the ability of the buyers to claim against the sellers under the warranties and covenants. According to paragraph 6.3 of the SPA, the sellers were not liable in respect of a tax claim unless the buyers gave written notice of it within seven years of the sale completion. Also, the SPA provided the possibility of a claim, demand or notice being received from HMRC in respect of tax for which the sellers might be liable. In this respect, paragraph 7.1 required the buyers, if they became aware of any such claim, to notify the sellers within 10 business days. Therefore, two different and separate regimes operated for the service of the applicable notices under either paragraph 6.3 or paragraph 7.1.

  In 2008, the buyers sent a letter to the sellers notifying them that under paragraph 7.1 of the SPA, HMRC had issued a claim against SRL for unpaid insurance contributions. Subsequently, in March 2015, the buyers sent a letter to the sellers which gave notice pursuant to the SPA of a 'potential liability to Taxation under the Tax Covenant'. The letter set out details as to the likely amount of the claim and asked the sellers whether pursuant to paragraph 7, the sellers wished to have continued conduct of discussions with HMRC in relation to the claim. The letter did not refer to any claim under paragraph 6.3 of the SPA. The buyers contended that the letter in 2015 was notification of a tax claim under paragraph 6.3, whereas the sellers contended that the letter only served to confirm a further paragraph 7.1 notice and not one under paragraph 6.3 so that as no tax claim was notified within the seven year period, the buyers were statute-barred from bringing any claim against the sellers. The Court of Appeal held that the letter sent by the buyers did not constitute a notice of a claim under the tax covenants in the SPA. The claim was not therefore properly notified within the contractual time limit and therefore time-barred. The Court of Appeal concluded that a person receiving the 2015 letter with knowledge of the terms of the SPA would have understood it to be a notice under paragraph 7.1 and not paragraph 6.3.

The Court of Appeal considered its approach towards construction of the notice provisions in the SPA following the ruling in *Wood v Capita Insurance Services Ltd* and the strict approach taken in respect of contractual notices. The Court of Appeal in *Stobart* considered the letter written by the buyers in March 2015 to the sellers and stated that the court's task when construing a unilateral contractual notice was similar to when construing agreed contractual terms. Its task was to ascertain the objective meaning of the language used. The question to be answered was what a reasonable recipient of the notice would have understood it to mean. In *Wood*, the Supreme Court stated that the court could be assisted in ascertaining the objective meaning by considering both the ordinary meaning of the language use and the relevant context or factual matrix known to the parties. It did not matter whether the language or the factual matrix is analysed first, provided the court balances the indications given by each. In *Stobart*, the Court of Appeal stated that the courts would not take account of the subjective understandings of the parties as to what was intended by a document. A subjective understanding could not displace the objective criteria for interpreting contractual notices. A recipient's subjective understanding may, however, be applicable in an estoppel context.