"*These wretchedly conceived clauses*": the Supreme Court considers the degree to which 'commercial common sense' can be deployed in contractual interpretation (*Arnold v Britton & Ors* [2015] UKSC 36)

By Lucy McCormick

Tenants of a holiday park will ultimately be obliged to pay over £1m a year per chalet, after the Supreme Court endorsed leases in which the service charge increases by 10% a year - regardless of the actual costs of providing those services.

Introduction

1. Mrs Arnold is the owner of Oxwich Leisure Park, a holiday park in South Wales containing 91 modest chalets. Each of these chalets is let for a period of 99 years from 25 December 1974 on very similar terms. There is one key difference between the leases: for 66 of the chalets, the service charge is reviewed every three years, but for the remaining 25 of the chalets, the service charge is reviewed annually. It is the latter group of tenants who are appealing, for reasons which will become clear below.

2. The service charge provision is found at Clause 3(2) of each lease. The language differs in small respects between the leases, but a typical example is:

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

3. With hindsight, the problem is obvious – an increase of 10% per year would put the service charge for these modest holiday chalets at over £1 million each year by the time they came to an end in 2072.

4. The tenants' position was that was that that clause 3(2), rather than providing a fixed 10% rise, should be read as a variable service charge with a cap of £90 in the first year and that thereafter rose at 10% per annum – that is to say that the words "*limited to*" or "*up to*" should be implied into the clause.

Litigation history

5. At first instance, the tenants were successful, HHJ Jarman QC finding that the purpose of the clause was to allow the lessor to recover the costs and not to make a profit.

6. However, on appeal to the High Court, Morgan J took the opposite view, finding that, as a matter of language, the words used are a strong indication that a fixed sum was due. Morgan J was upheld by the Court of Appeal.

7. In January this year, the matter was heard by the Supreme Court. Judgment was handed down a few days ago.

The Supreme Court Decision

8. The leading judgment was given by Lord Neuberger, who began by emphasising seven principles of contractual interpretation he considered relevant to the question of commercial common sense **[16-23]**. In summary:

(1) "*Commercial common sense*" and the surrounding circumstances should not be invoked to undervalue the importance of the language of the provision, save in very unusual cases.

(2) As to the words of the provision themselves, the less clear they are, the more readily the court can properly depart from their natural meaning. However, the court should not embark on an exercise of searching for "*drafting infelicities*" in order to facilitate a departure from the natural meaning.

(3) "*Commercial common sense*" is not to be invoked retrospectively, that is to say the fact that a contractual arrangement has "*worked out badly*" is not a reason for departing from the natural language.

(4) Although commercial common sense is a "*very important factor to take into account*", a court should be slow to reject the natural meaning of a provision simply because it appears to have been a very imprudent term.

(5) Only facts known to both parties at the time the contract was made can be taken into account in interpreting the contract.

(6) When an event subsequently occurs which was plainly not contemplated by the parties, if it is clear what the parties would have intended, the court will give effect to that intention.

(7) There is no special rule of interpretation requiring service charge clauses to be interpreted "*restrictively*". This misapprehension had arisen from McHale v Earl Cadogan [2010] EWCA Civ 14, but in fact all that was being said in that case was that the court should not "*bring within the general words of a service charge anything which does not clearly belong there*".

9. Applying these principles to the leases, Lord Neuberger found that Clause 3(2) did what it said on the tin. Quite simply, the first half of the clause imposed a liability for an annual service charge and the second half explained how it was to be assessed.

10. Lord Neuberger was well aware of the "*unattractive consequences*" of this interpretation. However, his analysis went somewhat deeper **[36-42]**, commenting:

> "*They are taking a gamble on inflation, but at least it is a bilateral gamble: if inflation is higher than 10% per annum, the lessee benefits; if it is lower, the lessor benefits. On the interpretation offered by the* lessees, *it is a one way gamble: the lessee cannot lose because, at worst, he will pay the cost of the services, but, if inflation runs at more than 10% per annum, the lessor loses out.*
>
> …
>
> *In my judgment there is no principle of interpretation which entitles a court to re-write a contractual provision simply because the factor which the parties catered for does not seem to be developing in the way in which the parties may well have expected.*
>
> …
>
> [The tenants' argument is] *ultimately based on the unlikelihood of a lessor and lessee of a single chalet agreeing that an initial annual service charge of £90 should be increased at a rate which could well lead to the annual charge being an absurdly high figure…But it is also rather unlikely…that they will have agreed a ceiling on the annual service charge which would become so absurdly high that it would be meaningless. …*

> [The tenants'] *solution to the problem which they identify does not actually address the problem: it merely changes its commercial consequences*."

11. Lord Sumption and Lord Hughes and Lord Hodge agreed, with the latter giving a short additional judgment in which he commented **[77]** that the court is not permitted to "*re-write the parties' agreement because it was unwise to gamble on future economic circumstances in a long term contract or because subsequent events have shown that the natural meaning of the words has produced a bad bargain for one side*".

12. Lord Carnworth took a different view about what he described as "*these wretchedly conceived clauses*". In a carefully reasoned dissenting judgment, he set out his view that the commercial purpose of clause 3(2) was to enable the lessor to recover from the lessees the costs of maintaining the estate on their behalf, the payment by each lessee being intended to represent a "*proportionate*" part of the expenses incurred. He is of the view that the clause contained an inherent ambiguity between the two parts of the clause **[125-126].** He regarded the "*consequences of the lessor's interpretation as so commercially improbable that only the clearest words would justify the court in adopting it…the limited addition proposed by the lessees does not do such violence to the contractual language as to justify a result which is commercial nonsense*".

Impact

13. The real significance of the decision is in Lord Neuberger's concise and comprehensive distillation of the principles involved in the application of "*commercial common sense*". His reasoning may be seen as shifting the pendulum of contractual interpretation somewhat away from "*commercial common sense*" and somewhat more towards contractual certainty – certainly lawyers will seek to deploy it as such.

14. The more direct effect of the decision is limited. As Lord Neuberger himself notes **[46]**, "*whosever interpretation is correct, clause 3(2) was self-evidently not a "normal" service charge clause"*, and there will be few other tenants struggling with analogous provisions in their leases. It may now be slightly easier to persuade the court that a particular service charge cause should be construed as permitting a profit. Of course, the decision is an object lesson in the importance of reading the clauses of one's lease carefully - and avoiding compound interest provisions like the plague.

15. Finally, spare a thought for the impact on the individual tenants involved. Their ultimate £1m+ liabilities will be particularly galling given what Lord Carnworth described **[104]** as the **"***ultimately grotesque differences between the amounts payable by the two different groups of lessees on the same estate*." [1] It is hard to see any way out for these unfortunate tenants. The Court of Appeal had speculated that they might escape from their problems by surrendering their leases, or through forfeiture. However, since surrender is consensual between lessee and lessor, and forfeiture involves unilateral action by a lessor, neither path can be forced on Mrs Arnold. The tenants are locked into paying an exponentially increasing sum, which if they fail to pay can presumably be enforced against their main homes. A press statement on behalf of Mrs Arnold has indicated that she is "*prepared to consider some sort of re-negotiation having regard to the calculation of the service charges in the long-term*", which the tenants may find falls some way short of reassuring. "*These wretchedly conceived clauses*", indeed.

Lucy McCormick

16 June 2015

[1] i.e. those whose rent increases only every three years, rather than annually.