Hard Cases Sometimes Make Good Law:
Arnold v Britton and others [2015] UKSC 36

Introduction

1. The correct approach to be adopted to the interpretation of contracts has been a recurrent subject in the House of Lords and the Supreme Court over the past 45 years. The relevant principles of construction are well known and firmly embedded in our jurisprudence: see cases such as Chartbrook Ltd v Persimmon Homes Ltd [2009] UKHL 38 and Rainy Sky SA v Kookmin Bank [2011] UKSC 50. It may, therefore, come as some surprise to discover that the decision of the Supreme Court in Arnold v Britton was again concerned with the correct interpretation of a contract. The contract, however, was a lease and the point of construction involved a fixed service charge which, on its face, provided for compounded annual increases of 10% with the result that by 2072 the landlord would be entitled demand a yearly contribution from each of the lessees of over £1m, regardless of what it had in fact spent on services. In view of this, it may, perhaps be less surprising that the case found its way to the Supreme Court.

2. The majority of the Supreme Court, Lord Carnwath dissenting, held that despite the unattractive consequences for the lessees, the court could not depart from the natural meaning of the clause or insert words which were not there. The service charge clause did in fact do what it purported to do on its face, namely provide for a fixed charge of £90 for year one of the tenancy rising thereafter by 10% in every subsequent year, or third year, of the term.

The Facts

3. The case concerned the Oxwich Leisure Park on the Gower Peninsular. The Leisure Park contains 91 chalets, each of which is let on very similar terms on leases granted between 1978 and 1991, either for a modest premium or in return for the lessee constructing the chalet. Each of the 91 chalets was let on a lease for a term of 99 years from 25 December 1974.

4. Each lease also contained a clause which dealt with payment of a service charge by the lessee. In total, across all of the leases granted, there were five slightly different versions of the clause but all provided for an initial annual service charge which increased by 10% either annually or once every three years. A representative version of the clause was as follows:

"*To pay to the Lessor without any deductions in addition to the said rent as a proportionate part of the expenses and outgoings incurred by the Lessor in the repair maintenance renewal and renewal of the facilities of the Estate and the provision of services hereinafter set out the yearly sum of Ninety Pounds and Value Added tax (if any) for the first Year of the term hereby granted increasing thereafter by Ten Pounds per hundred for every subsequent year or part thereof.*"

First Instance Decision

5. The case was heard at first instance by HHJ Jarman Q.C. sitting at Cardiff County Court. The Landlord argued that the question of construction was uncomplicated and relied on a table produced by the Office of National Statistics which set out the conventional measure of inflation from June 1948 to April 2012 (worked out using the retail price index, then the standard measure of inflation). This showed that in December 1974, the start of the term date of all of the Leases, inflation was at 19.1%. It was argued that the leases had been drafted at a time of high and fluctuating inflation rates. For example, in 1975 inflation remained above 20% for most of the year, with a peak of 26.9% in August. It remained in double figures for the whole of 1977. The period of economic stability which has been experienced since the mid-1990s, and which has produced low inflation rates, could not have been predicted in the 1970s. The lease had to provide some formula to take account of the likely increase in the cost to the landlord of providing services and the draftsman of the lease, drafting a 99 year lease to commence from December 1974, would not have thought it unrealistic to suppose that inflation might spend long periods in double figures. 10% a year would accordingly not have been thought to be wholly unrepresentative of the average yearly increase in prices.

6. The tenant sought to argue that the reference to £90 was a cap which applied throughout the term and that the cap, and not the total amount payable by the tenant,

rose at the rate of 10% per annum. To get to this result, the court would have to imply words into the contract. HHJ Jarman Q.C., no doubt motivated by the desire to avoid what he perceived as an unattractive result for the tenant, did imply the words "limited to" before the words "the yearly sum" and held that the clause provided for the lessee to pay a proportion of the cost which the lessor actually incurred in providing the relevant services and that this sum was limited to the sum of £90 in the first year of the term rising by 10% per annum.

The First Appeal and the Court of Appeal

7. The landlord appealed to the Chancery Division of the High Court where Mr Justice Morgan[1] rejected the lessees' contention that the result contended for by the landlord was commercially or otherwise absurd or must have been the result of an error. He held that there was an obvious commercial purpose to a fixed service charge which increased by a fixed percentage to take account of possible inflation and the figure of 10% could not be regarded as irrational or obviously erroneous simply because, given the prevailing rate of inflation since the leases were granted it now appeared to be a high rate. In explaining his decision Morgan J helpfully considered the proper approach to the construction of service charge provisions, and confirmed that there are no special rules which must be applied.

8. Tenants often argue, as the tenant in Arnold v Britton did, that service charge provisions of a lease fall to be construed strictly; or *contra proferentem* against a landlord; or, in reliance on Jollybird v Fairzone [1990] 2 E.G.L.R., that such provisions should not in general be construed so as to permit the landlord to make a profit. (See cases such as Giljie v Charlgrove Securities Ltd [2002] 1 EGLR 41 and Earl Cadogan v 27/29 Sloan Gardens Ltd [2006] L&TR 18 and the commentary in Rosenthal *et al, Commercial and Residential Service Charges,* London, Bloomsbury (2013) at paragraphs 2-38 to 2-54).

9. Morgan J held that service charge provisions are not subject to any special principles of construction and there is no rule requiring serving charge provisions to be

[1] [2012] EWHC 3451 (Ch)

construed restrictively. The correct approach to construction is the same as with any other commercial instrument.

10. On the lessees appeal, the Court of Appeal agreed with Morgan J's decision and his approach to construction. Davis L.J. concluded that the lessees' construction would *"…involve unacceptably rewriting the sub-clause*". The court cannot re-write a contract to relieve a party from the consequences of a bad bargain and he said:

"In effect, the lessees' argument involves trying to turn this service charge clause into another kind of service charge clause. The paradigm no doubt is a clause which gives the landlord no more than – and no less than – his actual outlay on the contractual services. But many such clauses in leases achieve no such thing. A fixed service charge is one example. Even a conventional RPI linked service charge clause may or may not provide commensurate recompense to a landlord. It all depends on whether the RPI matches the actual annual outlay on services; and that cannot be surely predicted.

For that reason, I was ultimately not much moved by [Counsel for the tenants'] complaint that the result would, by reference to the lessor's actual annual outlay, be adventitious and arbitrary. Lack of correspondence between outlay and receipt is the almost inevitable consequence of such a clause if the parties have elected for a fixed charge formula. It has a similarity with a liquidated damages clause: it represents the parties' estimate at the outset for the future with neither guarantee nor even expectation of entire coincidence with the eventual outcome. But the advantage is certainty. The parties know from the outset where they stand. Moreover, it is a surrounding circumstance legitimately to be taken into account here that the leases were made at a time of inflation – in some years, very significant inflation – which the parties, objectively and commercially speaking, could be expected to want to confront. They chose to do so by this particular formula of increase."

The Supreme Court Decision

11. In the Supreme Court the majority judgment was given by Lord Neuberger (with whom Lords Sumption, Hughes and Hodge agreed). Lord Neuberger emphasised seven factors relevant to the question of construction. First he referred to the general

principle that a contract should be construed in a common sense was (see Chartbrook Ltd v Persimmon Homes Ltd at paras [16-26]) but noted that: *"…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."*

12. He also emphasised (his third point) that:

"…commercial common senses in not to be invoked retrospectively. The mere fact that a contractual arrangement, if interpreted according to its natural language, has worked out badly, or even disastrously, for one of the parties is not a reason for departing from the natural language. Commercial common sense is only relevant to the extent of how matters would or could have been perceived by the parties, or by reasonable people in the position of the parties, as at the date that the contract was made. Judicial observations such as those of Lord Reid in Wickman Machine Tools Sales Ltd v L Schuler AG [1974] AC 235, 251 and Lord Diplock in Antaios Cia Naviera SA v Salen Rederierna AB (The Antaios) [1985] AC 191, 201, quoted by Lord Carnwath at para 110, have to be read and applied bearing that important point in mind."

13. His second and fourth points acknowledged that the worse the drafting of a contract, the more ready the court could properly be to depart from the natural meaning of the words used but that:

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

14. Lord Neuberger's fifth point stressed that the court should only take into account facts or circumstances which existed at the time a contract is made (and which were known or reasonably available to both parties). However, he acknowledged in his sixth point that in some cases an event subsequently occurs which was plainly not intended or contemplated by the parties. In such a case, if it is clear what the parties would have intended, the court will give effect to that intention.

15. Finally, in his seventh point, Lord Neuberger specifically addressed the construction of service charge provisions. Like the Court of Appeal and Morgan J., Lord Neuberger was not persuaded that service charge provisions fell to be construed "restrictively" or that any special rules of construction applied:

"I am unconvinced by the notion that service charge clauses are to be subject to any special rule of interpretation. Even if (which it is unnecessary to decide) a landlord may have simpler remedies than a tenant to enforce service charge provisions, that is not relevant to the issue of how one interprets the contractual machinery for assessing the tenant's contribution. The origin of the adverb was in a judgment of Rix LJ in McHale v Earl Cadogan [2010] EWCA Civ 14, [2010] 1 EGLR 51, para 17. What he was saying, quite correctly, was that the court should not "bring within the general words of a service charge clause anything which does not clearly belong there. However, that does not help resolve the sort of issue of interpretation raised in this case."

Conclusion

16. Looking at the result in Arnold v Britton from the perspective of a tenant living in a world where inflation is, and has for some time, been low and relatively stable, the consequences of the decision seem extreme. From the perspective of a lawyer applying the well-established principles of contractual construction the decision is actually unremarkable. If one approaches the question of construction as at the date the contract was agreed, as one must, there is no unfairness or surprise result. As Lord Neuberger said:

"If inflation is running at, say 10% per annum, it is, of course, very risky for both the payer and the payee, under a contract which is to last around 90 years, to agree that a fixed annual sum would increase automatically by 10% a year. 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 appellants, 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."

17. The importance of Arnold v Britton is not only in the fact that the Supreme Court has emphasised the limits of a court's power to re-write a contract to avoid what is, with hindsight, perceived to be an unfair or uncommercial result. Notwithstanding what must have been a temptation to reach a more tenant friendly result, the Supreme Court endorsed the view that service charge provisions do not fall to be to be construed "restrictively" and confirmed that the ordinary principles of construction apply. It is often said that hard cases make bad law. Arnold v Britton could have been one such case but instead, it stands as a good example to dispel a common misconception that service charges should generally be construed in a tenant friendly way.

18. For an in-depth discussion of the principles of construction of service charges the reader is referred to Rosenthal *et al, Commercial and Residential Service Charges,* London, Bloomsbury (2013).

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