KEYNOTE

Judicial Development of the Law of Contract in the United Kingdom

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ABSTRACT

The author, a Justice of the U.K. Supreme Court, analyzes the development of contract law by the Court over the last three years to assess whether there have been significant shifts in the judicial approach to contractual doctrine. He speaks of the swing of the judicial pendulum as a metaphor for changing judicial attitudes over time and for the working of the common law. He identifies continuity as dominant in relation to contractual interpretation, a degree of retrenchment in the presentation of the requirements for the implication of contractual terms and in the boundary between interpretation and rectification, and significant departures from caselaw in the fields of penalty clauses and the doctrine of illegality.

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* Justice, United Kingdom Supreme Court. This Essay is based on my Keynote Address at *The George Washington Law Review* Symposium entitled, "Divergence and Reform in the Common Law of Contracts" on November 19, 2016.

INTRODUCTION

In the three years that I have been a Justice on the U.K. Supreme Court, I have had the privilege of sitting in five cases which give important guidance on the law of contract. They form the core of this discussion. I will give the context for readers in the United States by referring to equivalent rules of contract in the United States and draw some general, but tentative, conclusions about judicial lawmaking in the field of contract.

To begin with an overview: it is trite that judges have to review and update contract law to meet current social and economic needs. Judges develop the principles of the common law organically, building on what was there before. That process occurs in the context of a particular case, which is before the court for determination. Whether consciously or unconsciously, a judge's expression of the relevant rules is often influenced by the circumstances of the case as the judgment seeks to explain the court's decision. While judges aim for precision and choose their words carefully, their statements are not statutory formulae and should not be read as such. Rulings and dicta are applied in other cases by other judges and, over time, the law can move in a direction which eventually calls for correction by a senior court. I call this a judicial pendulum, the limits of whose swing are constrained by corrective appellate decisions which can themselves be controversial.

The cases fall under two main headings. The first is the ascertainment of the terms of the contract, and this involves cases on (i) interpretation, (ii) the implication of terms, and (iii) rectification. The second heading is the regulation of contract by the common law and this involves (i) penalty clauses, and (ii) the court's refusal to enforce illegal or immoral contracts—the doctrine of illegality.

U.S. contract law is generally governed by state law.[1] But Professor Eisenberg has commented on the consistency of contract law in the United States, which he has described as the result of a process of

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[1] Melvin A. Eisenberg, *Why Is American Contract Law So Uniform? National Law in the United States*, *in* EUROPÄISCHES VERTRAGSRECHT 23 (Hans-Leo Weyers ed., 1997), *reprinted in* THOMAS KADNER GRAZIANO, COMPARATIVE CONTRACT LAW: CASES, MATERIALS AND EXERCISES 210, 210 (Eleanor Grant trans., 2009).

"nonmandatory unification,"[2] to which excellent textbooks and the Uniform Commercial Code ("UCC") have contributed and which are reflected in the Restatements of Contracts by the American Law Institute ("ALI").[3] The unification is far from complete. There are persistent differences with particularly acute divergence in areas such as interpretation and illegality. Yet the terms of debate of these differences have been drawn in a way that enables the making of reliable statements as to the tenor of American contract law.[4]

There are neither such restatements nor a commercial code in the United Kingdom. There are distinct legal systems, namely English law and Scots law.[5] But the Treaty of Union of 1707, while preserving Scots law as a separate legal system, envisaged a harmonization of economic and commercial regulation by statutes of the U.K. Parliament.[6] In the last 300 years that process of harmonization has occurred. Nonetheless, the law of contract remains in large measure judge-made, and it has been both the preexisting similarity of the contract law of the two jurisdictions and the demands of an integrated U.K. economy that have maintained and enhanced the essential coherence of contract law in the United Kingdom, at least in the areas which I am addressing. I will therefore simplify matters by speaking generally of U.S. and U.K. contract law.

I. Ascertaining the Terms of a Contract

A. Interpretation

In the United Kingdom, since the 1970s, there has been an increased emphasis on a purposive approach to the interpretation of contracts in order to give effect to the reasonable expectations of honest contracting parties. In 1998, the House of Lords summarized the developments in the celebrated judgment of Lord Hoffmann in *Investors Compensation Scheme Ltd. v. West Bromwich Building Society* ("*ICS*").[7] That judgment was seen by many at the time to be revolutionary, but, as the great Lord Bingham persuasively argued in an ex-

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2 *Id.*

3 *See generally id.* at 212–18.

4 *See* Larry A. DiMatteo & Martin Hogg, *Introduction: British and American Perspectives*, *in* Comparative Contract Law: British and American Perspectives 1, 3 (Larry A. DiMatteo & Martin Hogg eds., 2016).

5 *Id.* at 4.

6 *See* Union with Scotland Act 1706, 6 Ann., c. 11, arts. XVIII, XIX (Eng.); Union with England Act 1707, c. 7, 1706/10/257 (RPS) arts. XVIII, XIX (Scot.).

7 [1997] UKHL 28, [1998] 1 WLR 896 (HL) 912–13 (appeal taken from Eng.) (Lord Hoffmann).

trajudicial writing,[8] its approach to the communication of meaning through language was not new.

A useful summary of the position can be found in a discussion paper by the Scottish Law Commission,[9] which draws on the work of Professor Gerard McMeel[10]:

1. The aim of the exercise of the construction of a contract is to ascertain the meaning it would convey to a reasonable business person.
2. An objective approach is to be taken, concerned with a person's expressed rather than actual intentions.
3. The exercise is a holistic one, based on the whole contract, rather than excessive focus on particular words, phrases, sentences or clauses.
4. The exercise is informed by the surrounding circumstances or external context, with it being permissible to have regard to the legal, regulatory and factual matrix constituting the background to the making of the expression being interpreted.
5. Within this framework due consideration is given to the commercial purpose of the transaction or provision.[11]

There are clear parallels in U.S. contract law, such as the objective approach to construction. There springs to mind Judge Learned Hand's famous statement of the irrelevance of a joint declaration by the contracting parties that their meaning had been other than the natural meaning.[12] As in the United Kingdom, there appears to have been a widespread appreciation of the limits of a formalist approach as scepticism has grown about the fixed meaning of language, and there has developed an increasing awareness that "[t]he meaning of particular words or groups of words varies with the 'verbal context

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8 *See generally* Lord Bingham of Cornhill, *A New Thing Under the Sun? The Interpretation of Contract and the ICS Decision*, 12 EDINBURGH L. REV. 374, 381–90 (2008).

9 SCOTTISH LAW COMM'N, REVIEW OF CONTRACT LAW: DISCUSSION PAPER ON INTERPRETATION OF CONTRACT ¶ 4.7 (No. 147) (2011).

10 Gerard McMeel, *The Principles and Policies of Contractual Interpretation*, *in* CONTRACT TERMS 27, 50–51 (Andrew Burrows and Edwin Peel eds., 2007).

11 SCOTTISH LAW COMM'N, *supra* note 9, ¶ 4.7.

12 Eustis Mining Co. v. Beer, Sondheimer & Co., 239 F. 976, 985 (S.D.N.Y. 1917). Although, as Professor Cunningham shows in his article on contract interpretation in this Symposium, *Corbin on Contracts* would allow "Bunker Hill Monument" to mean "Old South Church." *See* Lawrence A. Cunningham, *Contract Interpretation 2.0: Not Winner-Take-All but Best-Tool-for-the-Job*, 85 GEO. WASH. L. REV. 1626, 1627 (2017) (citing 5 MARGARET N. KNIFFIN, CORBIN ON CONTRACTS: INTERPRETATION OF CONTRACTS § 24.8, at 54–55 (Joseph M. Perillo ed., rev. ed. 1998)).

and surrounding circumstances and purposes.'"[13] Thus one sees a contextual approach in the *Restatement (Second) of Contracts* and the UCC, and also to varying degrees in several states, such as Arizona and California. It was suggested at an earlier conference on comparative contract law that the "hard parole evidence rule," prohibiting the admission of extrinsic evidence to interpret a contract if the language is clear and unambiguous on its face, is unlikely to be applied strictly where it would lead to injustice.[14]

As long ago as 1918, Justice Cardozo, in his famous dictum in *Utica City National Bank v. Gunn*,[15] emphasized the role of "the genesis and aim of the transaction" in guiding the court's choice between a primary or strict meaning and a secondary or loose meaning in order to give purpose to the transaction.[16] Even in New York, which is contrasted with California as a more literalist court, modern judges draw on the work of the contextualist Benjamin Cardozo.[17] But as Professor Cunningham shows in his paper on contractual interpretation at this Symposium, the pendulum has not swung only in one direction or uniformly across all states.[18] Courts are not wedded to the contextualist *Restatement (Second)* approach or the UCC, but can adopt a more formalist approach when the case demands it.

References to "commercial interpretation" and "fulfilling the reasonable expectations of honest contracting parties" have been recurring themes in caselaw on contractual interpretation in the United Kingdom in recent years.[19] It has been suggested that Lord Hoffmann's discussion of the use of interpretation to correct mistakes in contracts (further considered below in the discussion on rectification[20]) shifted the focus of the court from the words which the parties or their legal advisers chose to use in their contract to a broader assessment of the commerciality of the deal. Hard-pressed lawyers, who

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13 Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 644 (Cal. 1968) (quoting Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 187 (1965)).

14 *See* Qi Zhou & Larry A. DiMatteo, *Three Sales Laws and the Common Law of Contracts*, *in* COMPARATIVE CONTRACT LAW: BRITISH AND AMERICAN PERSPECTIVES 347, 365 (Larry A. DiMatteo & Martin Hogg eds., 2016).

15 118 N.E. 607 (N.Y. 1918).

16 *Id.* at 608.

17 *See, e.g.*, Sumitomo Mitsui Banking Corp. v. Credit Suisse, 2014 WL 4209247, at *6, *9 (N.Y. Sup. Ct. Aug. 20, 2014).

18 Cunningham, *supra* note 12, at 1629–34.

19 *See, e.g.*, Mannai Inv. Co. v. Eagle Star Life Assurance Co. [1997] AC 749 (HL) 771A–D (Lord Steyn) (appeal taken from Eng.).

20 *See infra* Section I.C.

must negotiate commercial contracts under strict time constraints, whose clients are reluctant to spend, and who may be forced by the vagaries of commercial negotiation to use deliberate ambiguity in their drafting, may have welcomed a regime by which the courts would seek to impose a sensible interpretation onto their contracts and on occasion get around infelicities of language. Even where there are not such pressures in the drafting of contracts, uncertainties are unavoidable, for example, where a contract is to remain in force and be applied in the future in circumstances which cannot be foreseen. In large financial transactions, huge sums of money may be at stake when a court has to interpret a contract.[21] There is an important place for the application of commercial common sense. But how far did the law move from a contextual focus on the language that the parties used in their contract? The answer is that it was not far.

In *Rainy Sky S.A. v. Kookmin Bank*,[22] one of the early cases of the U.K. Supreme Court, which was established in 2009, Lord Clarke summarized the modern approach in a much quoted statement:

> The language used by the parties will often have more than one potential meaning. I would accept the submission . . . that 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 to reject the other.[23]

In 2015, the U.K. Supreme Court in *Arnold v. Britton*[24] considered contracts, which, with hindsight, should never have been executed. A leisure park near Swansea in Wales comprised ninety-one chalets, each of which was let for a period of ninety-nine years under leases granted between the early 1970s and 1991. In each lease, the tenant entered into a covenant to pay a service charge to the park for main-

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21 *See, e.g.*, BNY Mellon Corp. Tr. Servs. Ltd. v. LBG Capital No. 1 Plc. [2016] UKSC 29, [1] (appeal taken from Eng.).

22 [2011] UKSC 50 (appeal taken from Eng.).

23 *Id.* [21] (Lord Clarke SCJ).

24 [2015] UKSC 36, [2015] AC 1619 (appeal taken from Eng.).

taining the roads and fences and other similar services. In a typical clause, the tenant undertook:

> 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 repair maintenance renewal and the provision of services hereinafter set out the yearly sum of Ninety Pounds and value added tax (if any) for the first three years of the term hereby granted increasing thereafter by Ten Pounds per Hundred for every subsequent three year period or part thereof.[25]

The apparent effect of the clause was that the initial service charge of £90 per annum was to increase on a compound basis every three years, which is broadly equivalent to a compound rate of three percent per year.[26] Twenty-one of the leases were even more burdensome as they provided for an annual escalator of ten percent.[27] If the words of the clauses were given their natural meaning, the tenants with a triennial escalator would be paying £1,900 per year by 2072 and those with an annual escalator would be paying £1,025,004 annually.[28]

Unsurprisingly, the tenants sought to escape this ruinous bargain. Their counsel argued that the clause was properly read as providing that each lessee was to pay a fair proportion of the lessor's costs of providing the services, subject to a maximum, which was at first £90 but which escalated thereafter. In other words, they argued that the words "up to" should be read into the clause immediately before the words "the yearly sum of Ninety Pounds."[29]

The majority of the court did not accept this submission. In the leading judgment, the President, Lord Neuberger, focused on the meaning of the words in the clauses of the leases in their documentary, factual, and commercial context. He gave guidance on the interpretation of contracts, identifying seven factors.[30] It is sufficient to quote from the first, in which he said:

> First, 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

25 *Id.* [6].
26 *Id.*
27 *See id.* [7].
28 *Id.* [99]–[100].
29 *Id.* [10].
30 *Id.* [16]–[23] (Lord Neuberger P).

> meant through the eyes of a reasonable reader, and, save perhaps in a very unusual case, that meaning is most obviously to be gleaned 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.[31]

In a strongly worded dissent in which he supported the tenants' submission, Lord Carnwath emphasized the role of interpretation in both resolving ambiguities and correcting mistakes.[32] He identified long residential leases as "an exceptional species of contract" and stressed the need to interpret service charge provisions in the light of "their intended purpose of securing [a] fair distribution between the lessees of the reasonable cost of shared services."[33] Having regard for the catastrophic consequences of an annual ten percent compound escalator in the long term if general price inflation was well below that level, he thought that it was clear that something had gone wrong with the language that the parties had used to allow the lessor to recoup the cost of the common services.[34]

In a short judgment concurring with the majority, I suggested that the task of the legal construct, the reasonable person, was to "ascertain objectively, and with the benefit of the relevant background knowledge, the meaning of the words which the parties used."[35] The question for the court was "not whether a reasonable and properly informed tenant would enter into such an undertaking," as that would involve the court in "re-writing the parties' bargain in the name of commercial good sense."[36] Before the court could remedy a mistake in the use of language in a contract, it must be satisfied as to both the mistake and the nature of the correction.[37]

Some counsel and commentators have seen the majority's decision in *Arnold* as a "recalibration" of the rules of contractual interpretation with a significantly greater emphasis on literal interpretation at the price of business common sense, and involving a significant move

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31 *Id.* [17].

32 *Id.* [111] (Lord Carnwath SCJ).

33 *Id.* [116], [120].

34 *See id.* [136]–[139].

35 *Id.* [77] (Lord Hodge SCJ).

36 *Id.*

37 *Id.* [78] (citing Pink Floyd Music Ltd. v. EMI Records Ltd. [2010] EWCA (Civ) 1429, [21] (Lord Neuberger MR)).

away from the judicial developments which Lord Clarke ably summarized in *Rainy Sky*.[38] I do not agree.

All three judgments in *Arnold* accepted Lord Clarke's presentation of the law in *Rainy Sky* as accurate and authoritative. What differed between the two cases were the terms of the contracts and the surrounding circumstances.

In *Rainy Sky* the court was concerned with an obligation in a shipbuilder's refund guarantee by which the bank, in consideration of the purchaser's payment of pre-delivery installments for the vessel, undertook to pay as primary obligor "all such sums due to you under the Contract."[39] It was unclear whether "all such sums" referred back to the pre-delivery installments repayable on an insolvency event or to the same installments in a prior clause which were repayable only on termination of the contract or on the total loss of the vessel. The words were open to two credible constructions, and that was the context in which Lord Clarke said what he did in the quoted passage.[40]

By contrast, in *Arnold* the majority of the court considered the clause setting up a fixed sum contribution to the cost of common services with a price escalator was commercially unwise for the tenants to accept, but thought that the words of the contract were not unclear. In reaching that view, the majority took account of (a) the high rates of price inflation which prevailed when the leases were entered into, (b) the utility of a clause imposing a fixed monetary contribution in order to avoid disputes over what would be a proportionate share, and (c) the lack of a credible alternative interpretation of the words used in the leases.[41]

The approach summarized in *Rainy Sky* is not a formulaic one of ascertaining the possibility of more than one meaning for the contractual words and treating that discovery as a green light to the court to apply its view of what is fair and sensible as a commercial deal as a preferred interpretation. Such an approach would risk both a devalua-

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38 *See* Rainy Sky S.A. v. Kookmin Bank [2011] UKSC 50 (appeal taken from Eng.).

39 *Id.* [9].

40 *See supra* text accompanying note 23. There are passages in *Rainy Sky* which could be misapplied out of context. Thus, at paragraphs 29 and 30 in *Rainy Sky*, Lord Clarke endorsed a dictum of Lord Justice Longmore in *HHY Luxembourg SARL v. Barclays Bank Plc.*, [2010] EWCA (Civ) 1248, [25]–[26], to the effect that where alternative constructions are available, one has to consider which is more commercially sensible. *Rainy Sky* [2011] UKSC 50, [29]–[30]. In my view, that was not intended to be and is not a license to override the words that the parties have chosen to use by applying criteria of proportionality or reasonableness.

41 *See Arnold* [2015] UKSC 36, [32]–[33], [40].

tion of the objective contextual interpretation of the words the parties have chosen and also creating avoidable uncertainty.

Lawyers and commentators may have read more into the *ICS* decision and *Rainy Sky* than the cases merited in terms of a willingness of the courts to rewrite contracts in the name of business common sense. The English courts have not moved very far, if at all, from Lord Wilberforce's formulation fifty years ago when he said that "what the court must do must be to place itself in thought in the same factual matrix as that in which the parties were."[42] At the same time, it would not be correct for lawyers to treat the majority judgment in *Arnold* as imposing significant constraints on that contextual approach which allows the court to have regard to business common sense. Since *Rainy Sky*, indeed since Lord Wilberforce's statement fifty years ago, the judicial pendulum has not moved far on the interpretation of contracts.

Can the same be said for the implication of terms into a contract? That is the subject of the next Section.

B. The Implication of Terms

The discussion of the implication of terms in this Section focusses on what, on both sides of the Atlantic, is commonly called "implication in fact." In other words, a term is implied into a particular contract in the light of its express terms, commercial common sense, and the facts known to both parties at the time the contract was made.[43] The implication of terms in determining the scope and meaning of a contract addresses how a contract will operate in circumstances to which the draftsman has often not addressed his or her mind.

The general approach in American law is that when parties have not expressly agreed on some aspect of their contract, which is essential to a determination of their rights and duties, the courts will attempt to ascertain the most reasonable understanding of the agreement from the parties' perspective at the time of the agreement, based on the totality of the surrounding circumstances.[44] As in U.K.

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42 Reardon Smith Line Ltd. v. Hansen-Tangen [1976] 1 WLR 989 (HL) 997 (Lord Wilberforce) (appeal taken from Eng.).

43 *See* Societe Generale, London Branch v. Geys [2012] UKSC 63, [55] (Lady Hale SCJ) (appeal taken from Eng.).

44 RESTATEMENT (SECOND) OF CONTRACTS §§ 204, 216 (AM. LAW INST. 1981); *see also, e.g.*, O.W. HOLMES, JR., *Lecture VIII: Elements of Contract*, *in* THE COMMON LAW 289, 303 (1881) ("The very office of construction is to work out, from what is expressly said and done, what would have been said with regard to events not definitely before the minds of the parties, if those events had been considered.").

law, terms will only be implied in so far as they do not contradict the contract's express terms. In both the United States and the United Kingdom, implication cannot prevent an agreement failing because it is "indefinite" (in U.S. parlance) or "uncertain" (in U.K. parlance) but operates as a gap filler where the courts have already concluded that there is a legally binding contract.

The traditional approach of both English law and Scots law is a restrictive one. The court implies a term into a contract only where it is necessary to give the contract business efficacy.[45] An alternative formulation is that if the parties were asked by an officious bystander what would happen in a certain event, they would both reply, "Of course, so and so will happen."[46]

This traditional approach seemed to be called into question in 2009. In *Attorney General of Belize v. Belize Telecom Ltd*,[47] the Judicial Committee of the Privy Council was tasked with construing the articles of association of Belize Telecom, a company established to take over the privatized telecommunications service. The articles were designed to make sure that the board of the company reflected the different shareholder interests and the appeal addressed a situation where, after a special share had been redeemed, there was no express mechanism to remove from the board the directors who had been appointed by the holder of the special share. Lord Hoffmann, who delivered the Board's advice, described the implication of a term as "an exercise in the construction of the instrument" and supported the contention by reference to authority.[48] The test for the implication of a term, he said, was "whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean."[49] The traditional tests that an implied term would "go without saying" or be "necessary to give business efficacy to the contract" were not different or additional tests.[50] In other words, the Judicial Committee in their advice

45 Wood v. Lucy, Lady Duff-Gordon, 118 N.E. 214, 214–15 (N.Y. 1917) (citing *The Moorcock* (1889) 14 PD 64 (CA) 68 (Bowen LJ) as the source of Justice Cardozo's use of the term "business efficacy"); *see also* Reigate v. Union Mfg. Co. (Ramsbottom) [1918] 1 KB 592 (CA) 605 (Scrutton LJ) (Eng.).

46 *Reigate* [1918] 1 KB at 605; *see also* Shirlaw v. S. Foundries (1926), Ltd. [1939] 2 KB 206 (CA) 227 (MacKinnon LJ).

47 [2009] UKPC 10, [2009] 1 WLR 1988 (PC) (appeal taken from Belize).

48 *Id.* [19]–[20] (first citing Trollope & Colls Ltd. v. N.W. Metro. Reg'l Hosp. Bd. [1973] 1 WLR 601 (HL) 609 (Lord Pearson); and then citing Equitable Life Assurance Soc'y v. Hyman [2002] 1 AC 408 (HL) 459 (Lord Steyn)).

49 *Id.* [21].

50 *Id.*

treated implication as part of the basic process of construction of the instrument and appeared to put the focus on what the reasonable person would understand the contract to mean.

The judgment gave rise to a flurry of academic writing[51] and also criticism from the Singapore Court of Appeal, which refused to follow the Privy Council's reasoning so far as it suggested that the traditional business efficacy and officious bystander tests were not central to the implication of terms.[52]

This apparent liberalization of the implication of terms into a contract was founded upon by the tenant in a case which reached the U.K. Supreme Court in 2015: *Marks & Spencer plc v. BNP Paribas*.[53] Marks and Spencer was a tenant of retail premises under a detailed and professionally negotiated commercial lease which contained a break clause, giving the tenant the option to terminate the lease early.[54] The break clause required the tenant to do three things: (a) to give six months' prior written notice, (b) to have no arrears of basic rent and value added tax, and (c) to pay a substantial premium.[55] Marks and Spencer duly gave written notice. It then paid its quarterly advance rent on time and only thereafter, shortly before the break date, did it pay the premium, thereby meeting all the requirements of the break clause. The lease thus ended on January 24, 2012; but Marks and Spencer had paid a substantial sum as the quarterly rent for the period extending until March 25, 2012.[56] The tenant sought to imply a term into the lease that the landlord was obliged to refund the apportioned part of the advance rent payment for the period from the end of the lease (January 24) to March 25.[57]

The obligation to pay the rent in advance gave the landlords a windfall as it was paid rent for two months after the lease had expired. This seemed unfair, and the tenant's position was a reasonable one. But the court unanimously decided that it could not imply into the

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51 *See, e.g.*, JW Carter & Wayne Courtney, Belize Telecom*: A Reply to Professor McLauchlan*, 2015 LLOYD'S MAR. & COM. L.Q. 245; Paul S. Davies, *Recent Developments in the Law of Implied Terms*, 2010 LLOYD'S MAR. & COM. L.Q. 140; Richard Hooley, *Implied Terms After* Belize Telecom, 73 CAMBRIDGE L.J. 315 (2014); John McCaughran, *Implied Terms: The Journey of the Man on the Clapham Omnibus*, 70 CAMBRIDGE L.J. 607 (2011); Chris Peters, *Case and Comment: The Implication of Terms in Fact*, 68 CAMBRIDGE L.J. 513 (2009).

52 Foo Jong Peng v. Phua Kiah Mai [2012] SGCA 55, [29]–[42] (Singapore).

53 Marks & Spencer plc. v. BNP Paribas Sec. Servs. Tr. Co. (Jersey) [2015] UKSC 72, [2016] AC 742 (appeal taken from Eng.).

54 *Id.* [2], [4].

55 *Id.* [4].

56 *Id.* [9]–[12].

57 *Id.* [13].

lease an obligation on the landlords to refund the post-expiry proportion of the advance rent.[58] The lease was a detailed document prepared by professional lawyers. It was so prepared against the well-established legal background that the common law did not allow for the apportionment of rent.[59] A statute had provided for the apportionment of rent payable in arrear but not rent paid in advance.[60] The lease required the tenant to pay both the rent for the next quarter in full and also a substantial premium before the break took effect. Those provisions "would lie somewhat uneasily" with the suggested implied term requiring the landlords to repay sums already paid.[61] Those and other provisions in the lease suggested that the parties had applied their minds to the financial payments to be made in relation to the break clause, making it inappropriate for the court to imply a term to fill what was only "an arguable lacuna."[62]

The case is of general interest for Lord Neuberger's comments on the law of implied terms in the leading judgment, with which Lord Sumption and I agreed, and the comments of Lord Carnwath and Lord Clarke in their separate judgments. Lord Neuberger reasserted the business efficacy test: "[A] term can only be implied if, without the term, the contract would lack commercial or practical coherence."[63] He emphasized the warning of Sir Thomas Bingham MR in *Philips Electronique Grand Public SA v. British Sky Broadcasting Ltd.*[64]:

> The question of whether a term should be implied, and if so what, almost inevitably arises after a crisis has been reached in the performance of the contract. So the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court then to fashion a term which will reflect the merits of the situation as they then appear. Tempting, but wrong.[65]

Lord Neuberger warned against reading Lord Hoffmann's formulation, with its emphasis on what a reasonable person would understand the contract to mean, as suggesting that reasonableness was a suffi-

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58 *Id.* [52]–[53], [57], [75].

59 *Id.* [7], [43].

60 Apportionment Act 1870, 33 & 34 Vict. c. 35, §§ 2–3; Ellis v. Rowbotham [1900] 1 QB 740 (CA) 743–44.

61 *Marks & Spencer* [2015] UKSC 72, [4], [33]–[34], [49], [2016] AC at 750–51, 758, 762.

62 *Id.* [40].

63 *Id.* [21] (Lord Neuberger P).

64 Philips Electronique Grand Pub. SA v British Sky Broad. Ltd [1995] EMLR 472 (CA) 482 (Bingham MR).

65 *Marks & Spencer* [2015] UKSC 72, [19], [2016] AC at 754 (quoting *Philips Electronique* [1995] EMLR at 482).

cient ground for implying a term. There was to be no dilution of the test for the implication of a term. Interpretation involved construing the words that the parties had used in their contract and preceded the consideration of any question of implication.[66] Because Lord Hoffmann's words in *Belize* were open to more than one interpretation and some of the interpretations were wrong in law, Lord Neuberger stated that "those observations should henceforth be treated as a characteristically inspired discussion rather than authoritative guidance on the law of implied terms."[67]

Lord Carnwath agreed with Lord Neuberger's reasons for dismissing the tenant's appeal and added comments on the *Belize* judgment, in which he argued that *Belize*, properly construed, did not alter the prior law on the implication of terms, remained authoritative, and helpfully emphasized that implication involved the court using objective evidence to identify the presumed intention of the parties.[68] Lord Clarke also concurred, acknowledging that Lord Hoffmann had given a wide meaning to "construction," which involved determining the scope and meaning of the contract by both interpreting the words that the parties had used and also implying terms into the contract.[69]

In conclusion on implied terms, the U.K. Supreme Court has held that *Belize* did not innovate on the test for the implication of a term into a contract. Implication is not merely an aspect of the interpretation of a contract but is available only if the contract would otherwise lack practical or commercial efficacy. One senses that the pendulum has been pushed back from *Belize*, most clearly in the majority judgment but also in Lord Carnwath's rejection of expansionist interpretations of Lord Hoffmann's words.

C. Rectification

In English law, rectification is an equitable remedy that is available in certain circumstances where a document, such as a contract, does not accurately express the intention or agreement of the parties. The remedy is akin to the equitable remedy of reformation in U.S. law, and, like it, may not be given if a third party would be unfairly affected.[70]

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66 *Id.* [22]–[28].

67 *Id.* [31].

68 *Id.* [57]–[74] (Lord Carnwath SCJ).

69 *Id.* [75]–[77] (Lord Clarke SCJ).

70 RESTATEMENT (SECOND) OF CONTRACTS § 155 (AM. LAW INST. 1981).

In 2014, the U.K. Supreme Court considered the boundaries of rectification in a "switched wills" case, *Marley v. Rawlings*.[71] While the case concerns testamentary dispositions and not a contract, it casts light on rectification in a contractual context. In May 1999 Alfred Rawlings and his wife, Maureen Rawlings, were visited by their solicitor to enable them to sign their wills. Their wills were short and mirrored each other: each left his or her entire estate to the other, but, if the other had already died, the estate was left to a younger friend, Terry Marley, whom they treated as their son. Unfortunately, the solicitor gave each spouse the other's draft will to sign. As a result, Mr. Rawlings signed his wife's will and she signed the will meant for him.[72]

When Mrs. Rawlings died in 2003, her estate passed to her husband without anyone noticing the mistake in her will. But the error came to light when Mr. Rawlings died in 2006. Mr. and Mrs. Rawlings's two sons challenged the validity of their father's will, and thus Mr. Marley's right to succeed to his estate.[73] Mr. Marley claimed the estate but lost both at first instance and in the Court of Appeal. He succeeded before the Supreme Court.[74]

Part of the case concerned statutory requirements relating to the validity of wills, which is beyond the scope of this Essay. Lord Neuberger's leading judgment, however, is important to the theme of this Essay, both because he assimilated the interpretation of contracts and the interpretation of wills, and also because of his discussion of the boundary between the interpretation of a document and its rectification.[75]

Mr. Marley's argument on interpretation was simple. The two wills, by cohabiting husband and wife who signed them on the same day, could be read together as part of the factual matrix which was relevant to the interpretation of a document. When one read the two documents together, it was obvious what had happened: Mr. Rawlings intended his will to be in the form of the will which his wife had signed. Thus, it was argued, his will should be so interpreted and read.[76] The respondents' counsel did not challenge the assertion that the two wills could be read together, but instead he argued that the exercise was one of rectification, not interpretation.[77] As the appeal

71 [2014] UKSC 2, [2015] AC 129 (appeal taken from Eng.).

72 *Id.* [2]–[5].

73 *Id.* [6]–[8].

74 *Id.* [9]–[11], [86].

75 *Id.* [17]–[23], [40]–[42].

76 *Id.* [34].

77 *Id.* [35].

succeeded on the ground of rectification, the court declined to express a concluded view on the scope of the use of interpretation to correct mistakes. However, it did set out briefly what the issue was.

In his fifth proposition in the *ICS* case, Lord Hoffmann, after observing that people do not normally make linguistic mistakes in formal documents, stated: "[I]f one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had."[78] Lord Hoffmann revisited the theme in *Chartbrook Ltd. v. Persimmon Homes Ltd.*,[79] in which he spoke of the correction of mistakes by construction and stated:

> [T]here is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed. All that is required is that it should be clear that something has gone wrong with the language and that it should be clear what a reasonable person would have understood the parties to have meant.[80]

There are examples of the correction of mistakes in our caselaw, as when the court interpreted a date in a notice to terminate a lease as January 13 rather than January 12 as stated, because the recipient would have been in no doubt that the notice would take effect on the former date,[81] or where a clause in a bill of lading, which was modelled on a standard clause, had omitted a line from the standard clause as a result of an error in copying.[82]

Lord Reed, when he was a commercial judge in Scotland, held that the classification of mistakes as "patent" or "latent" no longer determined when the court could cure mistakes by construction.[83] It was inherent in the contextual approach to interpretation that both forms of mistake could be corrected by a process of construction.[84] But powerful voices have been raised in protest against the incursion of interpretation into the territory of rectification.[85]

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78 *Id.* [37] (quoting Inv'rs Comp. Scheme Ltd. v. W. Bromwich Bldg. Soc'y (*ICS*) [1997] UKHL 28, [1998] 1 WLR 896 (HL) 913 (Lord Hoffmann) (appeal taken from Eng.)).

79 [2009] UKHL 38, [2009] 1 AC 1101 (appeal taken from Eng.).

80 *Marley* [2014] UKSC 2, [38] (quoting *Chartbrook Ltd.* [2009] UKHL 38, [25]).

81 Mannai Inv. Co. v. Eagle Star Life Assurance Co. [1997] AC 749 (HL) 749 (appeal taken from Eng.).

82 Homburg Houtimport BV v. Agrosin Private Ltd. (The Starsin) [2003] UKHL 12, [22]–[23], [2004] 1 AC 715, 741 (appeal taken from Eng.).

83 Credential Bath St. Ltd. v. Venture Inv. Placement Ltd. [2007] CSOH 208, [22].

84 *Id.*

85 *See, e.g.*, Richard Buxton, *"Construction" and Rectification After* Chartbrook, 69 CAM-

While the U.K. Supreme Court has not expressed a view on the appropriate border between interpretation and rectification, it recognized in *Marley v. Rawlings* that this was not simply a matter of academic categorization.[86] Lord Neuberger stated:

> If it is a question of interpretation, then the document in question has, and has always had, the meaning and effect as determined by the court, and that is the end of the matter. On the other hand, if it is a question of rectification, then the document, as rectified, has a different meaning from that which it appears to have on its face, and the court would have jurisdiction to refuse rectification or to grant it on terms ([e.g.,] if there had been delay, change of position, or third party reliance).[87]

In my view, particular weight should be attached to the interests of third parties who may be prejudiced if the court were to rely on a broad factual matrix when correcting a mistake through interpretation.[88] One might also add that interpretation is a less suitable tool for curing some mistakes, because evidence of prior negotiations is not admissible,[89] in contrast with the equitable remedy of rectification.

While the precise boundary between interpretation and rectification has yet to be fixed, I would venture the prediction that the swing of the pendulum towards interpretation may be constrained and perhaps reversed by these considerations. Correction by interpretation may be confined to cases where the objective contextual interpretation of the words which the parties have used reveals an obvious mistake, as in the cases about the wrong date in a notice and the missed line from a standard clause in a bill of lading.[90]

But that is not the only issue relating to rectification which the court may have to address. Lord Justice Peter Gibson summarized the

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BRIDGE L.J. 253, 259 (2010); Paul S. Davies, *Rectification Versus Interpretation: The Nature and Scope of the Equitable Jurisdiction*, 75 CAMBRIDGE L.J. 62, 63 (2016).

86 Marley v. Rawlings [2014] UKSC 2, [40], [2015] AC 129 (Lord Neuberger P) (appeal taken from Eng.).

87 *Id.*

88 There is much to be said for a general approach that where an instrument will be relied on by third parties who were not involved in the negotiation of the arrangement, its wording should be paramount. *See In re* Sigma Fin. Corp. [2009] UKSC 2, [37] (Lord Collins SCJ) (appeal taken from Eng.).

89 Chartbrook Ltd. v. Persimmon Homes Ltd. [2009] UKHL 38, [28]–[42], [2009] 1 AC 1101, 1115–21 (appeal taken from Eng.); *ICS* [1998] 1 WLR 896 (HL) 912–13 (appeal taken from Eng.).

90 *See supra* text accompanying notes 81–82.

requirements for rectification on the ground of mutual mistake in terms which the House of Lords approved in *Chartbrook*:

> The party seeking rectification must show that: (1) the parties had a common continuing intention, whether or not amounting to an agreement, in respect of a particular matter in the instrument to be rectified; (2) there was an outward expression of accord; (3) the intention continued at the time of the execution of the instrument sought to be rectified; (4) by mistake, the instrument did not reflect that common intention.[91]

It is clear from this formulation that there remain a number of important and related issues to be addressed, including: (1) whether, as *Chartbrook* suggests, there is a role for the objective assessment of the parties' intentions in a claim for rectification or must the parties actually have made a common mistake;[92] (2) whether, in order to establish subjective common mistake, it is necessary that the parties shared the same understanding of their prior intention, which the formal agreement did not express (i.e., an actual common mistake), or is it sufficient that each (even if for contradictory reasons) mistakenly thought that the final agreement gave effect to the objectively construed earlier accord;[93] (3) if the prior accord is to be assessed objectively, whether that objective analysis applies to the assessment of the intention continuing up to the point of the execution of the formal agreement;[94] (4) whether it should be necessary to show any prior consensus if it is plain that there is a textual error.[95]

In English law, rectification of a contract by reason of one party's unilateral mistake at the time of its execution requires proof of sharp practice on the part of the other party so as to make it unconscionable for him to take advantage of the contract. For rectification in this circumstance, does the defendant have to know of the claimant's mistake

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91 *Chartbrook* [2009] UKHL 38, [48] (quoting Swainland Builders Ltd. v. Freehold Props. Ltd. [2002] EWCA (Civ) 560, [33] (Gibson LJ)).

92 *See* Davies, *supra* note 85, at 73–75.

93 *See* Lord Roger Toulson, Justice, UK Supreme Court, Does Rectification Require Rectifying?, Technology & Construction Bar Association (TECBAR) Annual Lecture, at 15 (Oct. 31, 2013), http://tecbar.org/wp-content/uploads/2016/05/2013-11-29-Rectification-311013.pdf (discussing *Chartbrook Ltd.* [2009] UKHL 38; Daventry Dist. Council v. Daventry & Dist. Hous. Ltd [2011] EWCA (Civ) 1153, [2012] 1 WLR 1333 (Eng.); Britoil Plc v. Hunt Overseas Oil Inc. [1994] CLC 561 (CA) (Eng.)). In Paul Davies's, discussion of point (1), he also asks why an earlier objective accord should trump a later, formal written contract. Davies, *supra* note 85, at 75.

94 *See* Toulson, *supra* note 93, at 18–20.

95 *See id.* at 6–10.

or is it sufficient that he intends the claimant to be mistaken and conducts himself towards that end?

There seems to be room for considerable swings of the judicial pendulum in this area of the law.

II. The Regulation of Contracts by the Common Law

A. Penalty Clauses

In U.S. law, the courts will enforce a liquidated damages clause provided that the amount specified is not significantly greater than what is needed to compensate the injured party and the actual losses are difficult to prove. A term that fixes unreasonably large liquidated damages is unenforceable as a penalty.[96] There is a similar rule in U.K. law.

In 2015, it had been 100 years since the senior U.K. court examined penalty clauses. In *Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co.*,[97] the House of Lords considered the application of the rule against penalties in the context of a liquidated damages clause. In a celebrated judgment, Lord Dunedin set out propositions which contrasted penalties and liquidated damages, and distinguished between a genuine pre-estimate of loss, on the one hand, and a penalty to deter the offending party on the other.[98] Over time, his neat propositions came to be misread as if they were a statutory code, which they were not. Properly read, they contained the message which the U.K. Supreme Court has restated.[99]

More recently, the English courts have sought to escape the apparent straightjacket of a dichotomy between a genuine pre-estimate of loss and a penalty, which is a formulation unsuited for clauses that are not liquidated damages clauses. Thus, in one case, Justice Colman upheld a provision in a loan agreement imposing a one percent increase in an interest rate during a default on the basis that it was com-

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96 *See, e.g.*, U.C.C. § 2-718 (Am. Law Inst. & Unif. Law Comm'n 2014); Restatement (Second) of Contracts § 356 (Am. Law Inst. 1981).

97 [1915] AC 79 (HL) (appeal taken from Eng.).

98 *Id.* at 86–88 (Lord Dunedin).

99 *See id.* at 87. In particular, Lord Dunedin spoke of the sum stipulated for having to be "extravagant and unconscionable." *Id.* He also referred to the earlier House of Lords decision in a Scottish appeal, *Clydebank Engineering & Shipbuilding Co. v. Yzquierdo y Castaneda* [1905] AC 6 (HL) (appeal taken from Scot.), which concerned a liquidated damages clause in a shipbuilding contract and set out the test of exorbitance. Incidentally, in that case, which concerned the late delivery of torpedo destroyers to the Spanish Navy, the courts rejected the ambitious defense that the buyers had suffered no loss because, if the vessels had been delivered on time, they would probably have been sunk by the U.S. Navy in the Spanish-American War. *Id.* at 13.

mercially justifiable.[100] Similarly, the Court of Appeal has drawn a distinction between a reasonable commercial condition on the one hand and a penalty on the other.[101]

The Supreme Court came to review the rule against penalties in two appeals which were heard together and which were, in Lord Mance's words, "at opposite ends of a financial spectrum."[102]

Cavendish Square Holding BV v. El Makdessi[103] concerned the purchase by Cavendish—a subsidiary of WPP, the world's leading marketing communications group—from Mr. El Makdessi and another of a majority shareholding interest in the holding company of the largest advertising and marketing communications group in the Middle East. Much of the value of the purchased holding company was its group's goodwill, which depended in large measure on Mr. El Makdessi's personal connections. The purchase price of up to approximately $150 million, which depended on the future performance of the group, was payable by installments. The sale contract contained restrictive covenants by the sellers not to compete with the group in order to protect the goodwill. Breach of the covenants had two serious consequences. First, it stopped the payment of any outstanding installments of the sale price, including the earn-out installments. Second, it entitled Cavendish to exercise a call option, requiring the seller in breach to sell any remaining shares in the group at a set price which did not allow for goodwill, thereby ousting the seller's put option, which was set at a substantially higher price. Mr. El Makdessi did not deny his involvement in the business of a competitor but argued that Cavendish could not enforce these contractual rights because they were unenforceable penalties.[104]

The other appeal concerned a parking charge of eighty-five pounds, which would have been reduced to fifty pounds, if it had been paid promptly. In *ParkingEye Ltd. v. Beavis*[105] the appellant parked his car in a car park, which ParkingEye operated under a contract with the owners of the adjoining retail park. There was a contractual limit

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100 Lordsvale Finance Plc. v. Bank of Zambia [1996] QB 752 at 763–64, 767 (Colman J) (Eng.).

101 Murray v. Leisureplay plc [2005] ECWA (Civ) 963, [38], [50], [70]–[76] (Eng.); Cine Bes Filmcilik ve Yapimcilik v. United Int'l Pictures [2003] EWCA (Civ) 1669, [15], [33] (Lord Mance LJ) (Eng.).

102 Cavendish Square Holding BV v. El Makdessi (*Cavendish-ParkingEye*) [2015] UKSC 67 [116] (Lord Mance SCJ) (appeals taken from Eng.).

103 [2015] UKSC 67 (appeals taken from Eng.).

104 *Id.* [44]–[64].

105 [2015] UKSC 67 (appeal taken from Eng.).

of two hours on parking which was imposed by notice. Mr. Beavis over-stayed the two-hour limit and was presented with a claim for eighty-five pounds. He challenged it as an unenforceable penalty.[106]

In the *Cavendish* appeal, the court considered three principal issues. First, counsel for Cavendish argued that the rule against penalties was an anomalous instance of the common law interfering with freedom of contract and that it should be abolished or at least restricted to noncommercial cases.[107] Second, counsel for Mr. El Makdessi argued for the extension of the rule, in accordance with Australian jurisprudence, beyond its scope as a restraint on remedies for breach of contract.[108] In *Andrews v. Australia & New Zealand Banking Group*,[109] the High Court of Australia held that bank charges, which were imposed on customers on the occurrence of events which were not breaches of contract, could be characterized as penalties and were unenforceable.[110] Cavendish's counsel urged the court to adopt this approach. The third issue was, if the rule against penalties applied to remedies for breach of contract, how to define both its scope and also the appropriate test for its operation.[111]

In relation to the first issue, the court recognized the force of criticisms of the rule against penalties but declined to abolish the rule, which is not only a longstanding rule of both English law and Scots law, but also is common to almost all major legal systems in the western world and features in international codifications of the law of contract.[112]

In relation to the second issue, the court held that there was no freestanding equitable jurisdiction to control stipulations which operated as a result of events which did not entail a breach of contract. Lord Neuberger and Lord Sumption in their joint judgment discussed the historical origins in equity of the rule against penalties and, with the unanimous agreement of the other Justices, declined to expand the

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106 *Id.* [89]–[93].

107 *Id.* [36], [257].

108 *Id.* [40]–[41].

109 (2012) 247 CLR 205 (Austl.).

110 *Andrews* 247 CLR at 205, 236. Recently, the High Court of Australia has confirmed this approach in an appeal in which it considered and declined to adopt the approach of the U.K. Supreme Court in *Paciocco v Australia & New Zealand Banking Group Ltd.* [2016] HCA 28 (27 July 2016) 3–6, 12–13, 25 (Austl.).

111 *Cavendish-ParkingEye* [2015] UKSC 67, [217].

112 *Id.* [36]–[37] (detailing versions of the law from Roman law through modern times).

court's supervisory jurisdiction beyond the control of remedies for breach of contract.[113]

In relation to the question of scope in the third issue, the court held that the rule covered not only liquidated damages clauses, but also clauses which enabled the innocent party to withhold payments on breach as well as clauses requiring a purchaser to pay an extravagant nonrefundable deposit.[114] As I read the case, there was a majority for the view that the rule also covered clauses that required the contract breaker to transfer property to the innocent party on breach. As a result, the court would first ask itself whether such a clause offended the rule against penalties, and, if it did not, then consider whether to give equitable relief against forfeiture.[115]

On the question of the appropriate test, the court rejected a simple dichotomy between a genuine pre-estimate of damage and a penalty, which a narrow reading of the *Dunlop* case had encouraged. While the Justices differed as to the precise way in which the test should be worded, they were in truth asserting the same test of disproportion or exorbitance. Lord Neuberger and Lord Sumption said that the test was "whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[116] On the other hand, I suggested that the test was "whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."[117] Finally, Lord Mance suggested:

> What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable.[118]

In the result, Cavendish succeeded in its appeal: the clauses in its agreement which allowed it to withhold the later installments of the purchase price and force Mr. El Makdessi to sell his remaining shares

113 *Id.* [12]–[15], [130], [241], [293].

114 *Id.* [14], [16].

115 *See id.* [16]–[18], [170], [233].

116 *Id.* [32].

117 *Id.* [255].

118 *Id.* [152].

at a disadvantageous price did not contravene the rule against penalties.[119] Further, Mr. Beavis lost his appeal against the parking charge.[120] In the *Cavendish* case, Mr. El Makdessi's loyalty was of critical importance to the value of the acquired shareholding. In the *Beavis* case, ParkingEye Ltd. had a central interest in making sure that the car park spaces were available for use by shoppers in the retail park and its charges were in line with both local authority parking charges and also the range prescribed by the code of practice for the trade association for private car parks.[121]

The adoption of a test of disproportion or exorbitance in comparison with a legitimate interest in the performance of the contractual obligation amounted, in my view, to a recalibration of the law which placed the rule on a secure footing by escaping the straightjacket of a narrow reading of the *Dunlop* case. The court recognized and accepted the broader approach of Justice Colman in *Lordsvale Finance Plc. v. Bank of Zambia*,[122] and of the Court of Appeal in *Cine Bes Filmcilik ve Yapimcilik v. United International Pictures*[123] and *Murray v. Leisureplay Plc*[124] of determining whether there was a commercial justification for the remedy for breach of contract.[125] The Supreme Court upheld the swing of the judicial pendulum away from an overrigid application of the rule. Where the pendulum will swing in the future application of the rule will depend on how the courts apply the tests in the circumstances of particular cases.

It has been suggested that the Supreme Court has given the rule only a pyrrhic victory in part because skillful lawyers will be able to circumvent the rule by imposing penalties that are not triggered by breach of contract.[126] But I am not persuaded that the rule will vanish from legal practice. The equitable origins of the rule will allow the courts to critically examine a clause which is designed to circumvent the rule and ascertain the substance of the clause rather than its form. The underlying rationale of the rule is that the law will not enforce

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119 *Id.* [88].

120 *Id.* [101].

121 *Id.* [75], [81], [99]–[100].

122 [1996] QB 752 (Eng.).

123 [2003] EWCA (Civ) 1669.

124 [2005] ECWA (Civ) 963 (Eng.).

125 *Cavendish-ParkingEye* [2015] UKSC 67, [26]–[28].

126 *See* William Day, *A Pyrrhic Victory for the Doctrine Against Penalties:* Makdessi v Cavendish Square Holding BV, 2016 J. Bus. L. 115, 118; *cf.* Carmine Conte, *The Penalty Rule Revisited*, 132 Law Q. Rev. 382, 382, 385–86 (2016) (noting that the penalty rule, as restated by the Supreme Court in *Cavendish-ParkingEye*, may be largely irrelevant even though the Court confirmed the theoretical existence of the rule).

clauses that punish the contract breaker for his breach. The moral for drafters of contracts is to avoid punitive clauses. The future health of the rule may depend on the courts' concentration on substance rather than form and their astuteness to recognize disguised penalties. To borrow from Mark Twain, I think that reports of the rule's demise have been greatly exaggerated.

B. Illegality

My final example concerns the illegality defense, which Lord Mansfield summarized over 240 years ago in *Holman v. Johnson*[127]:

> The principle of public policy is this; *ex dolo malo non oritur actio*. No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise *ex turpi causa*, or the transgression of a positive law of this country, there the Court says he has no right to be assisted.[128]

In the United States, the ALI's *Restatement (Second) of Contracts* § 178(1) appears, in cases of common law illegality, to allow the court to balance different public policies when deciding whether to enforce a contractual claim which is tainted by illegality.[129] But there appears to be considerable variation in approach among states. An example of a court balancing different public policies is the New York case of *Nizamuddowlah v. Bengal Cabaret Inc.*,[130] in which an illegal immigrant, who had been brought to the United States by an exploitative employer, was allowed to recover compensation for his labor on the basis of unjust enrichment.[131] That case has influenced recent debates on illegality in the English courts.

In the United Kingdom, the principle of public policy defined by a Latin maxim has given rise to uncertainty, complexity, and incoherence. In the leading case, to which I shall turn shortly, Lord Neuberger described the law on illegality as a "vexed topic" and spoke of

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127 (1775) 98 Eng. Rep. 1120, 1 Cowp. 341.

128 *Id.* at 1121, 1 Cowp. at 343 (italics added).

129 RESTATEMENT (SECOND) OF CONTRACTS § 178(1) (AM. LAW INST. 1981) ("A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms."); *see also id.* § 178(1) cmt. b (on such balancing where a term is illegal but not expressly unenforceable).

130 399 N.Y.S.2d 854 (Sup. Ct. 1977), *aff'd*, 415 N.Y.S.2d 685, 685–86 (App. Div. 1979).

131 *Id.* at 857. The appellate court also allowed recovery under the Minimum Wage Act. 415 N.Y.S.2d at 685–86.

the "inconsistency of reasoning and outcome in different cases" over the centuries since Lord Mansfield described the defense.[132] In 1994, the House of Lords decided an appeal, *Tinsley v. Milligan*,[133] the reasoning of which has been subject of much criticism because it appeared to make the availability of the defense depend on the procedural question of whether the claimant needed to rely on the illegal contract in pleading his claim.[134] The Law Commission of England and Wales published consultation papers on the illegality defense between 1999 and 2009 which highlighted the problems of the law.[135] In its report in 2010, the Commission recommended statutory reform of illegality only in the law of trusts. More generally, it expressed the view that the courts had power to develop the law. It advocated that the courts should have regard to the policies underlying the doctrine in evaluating whether to apply the defense as a matter of public policy, and identified a number of potentially relevant factors.[136]

Since then, the courts have been busy and the Supreme Court has heard four cases on illegality. The cases have generated a numerical escalator of the Justices hearing the appeals. The first two were heard in 2014 by five Justices each, the third, which was heard in 2015, by seven Justices, and finally, in 2016, a nine-Justice bench sought to clarify the law. This Essay discusses each of these cases in turn.

Hounga v. Allen,[137] like the New York case of *Nizamuddowlah*, involved an exploited illegal immigrant who succeeded in her claim of unlawful discrimination, a statutory tort under the Race Relations Act 1976.[138] Lord Wilson, who wrote the leading judgment, did not adopt the analytical framework of *Tinsley v. Milligan*, but instead asked himself two questions, namely, "What is the aspect of public policy which founds the defence?" and, second, "But is there another aspect of public policy to which the application of the defence would run

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132 Patel v. Mirza [2016] UKSC 42, [157] (Lord Neuberger P) (appeal taken from Eng.).

133 [1994] 1 AC 340 (HL) (appeal taken from Eng.).

134 *See id.* at 357.

135 The Law Comm'n, The Illegality Defence: A Consultative Report (Consultation Paper No. 189, 2009); The Law Comm'n, The Illegality Defence in Tort (Consultation Paper No. 160, 2001); The Law Comm'n, Illegal Transactions: The Effect of Illegality on Contracts and Trusts Law (Consultation Paper No. 154, 1999).

136 The Law Comm'n, Report on the Illegality Defence (Report No. 320, 2010).

137 [2014] UKSC 47 (appeal taken from Eng.).

138 Race Relations Act 1976, c. 74 (U.K.), http://www.legislation.gov.uk/ukpga/1976/74/pdfs/ukpga_19760074_en.pdf; *see Hounga* [2014] UKSC 47, [2]–[3], [16]–[18]. Miss Hounga did not pursue a quantum meruit claim for services performed. Had she done so, it might well have succeeded as it did in *Nizamuddowlah*.

counter?"[139] At around the same time, another panel of five Justices heard *Les Laboratoires Servier v. Apotex Inc.*,[140] a case about a cross-undertaking in damages in an interlocutory injunction in a patent dispute. The court upheld the decision of the Court of Appeal but the majority criticized that court's reasoning for its adoption of the approach advocated by the Law Commission in pursuit of a just and proportionate response to the illegality.[141] Lord Toulson dissented, pointing out that the Court of Appeal had adopted an approach of weighing public policy considerations which was similar to that of the Supreme Court more recently in *Hounga v. Allen*.[142]

A panel of seven Justices then faced the question of illegality in *Bilta (UK) Ltd. v. Nazir (No. 2)*.[143] This case answered the question whether a claimant company should be attributed with its directors' knowledge of illegal activity in a tax fraud, thereby barring its claim against them. Lord Sumption favored a rule-based approach along the lines of *Tinsley v. Milligan*,[144] while Lord Toulson and I, in our joint judgment, wanted to adopt a more flexible approach of looking at and weighing the policies which underlay the defense.[145] The majority considered that it was not necessary to resolve that dispute as the appeal could be determined on the basis of the rules on the attribution of knowledge, but Lord Neuberger said that the question needed to be resolved as soon as possible.[146]

The opportunity to do so arose soon afterwards. In *Patel v. Mirza*,[147] Mr. Patel gave Mr. Mirza £620,000 to place bets on the share price of the Royal Bank of Scotland with the benefit of insider information that Mr. Mirza had represented he would obtain about an expected government announcement which would affect the price of the shares.[148] In the event, Mr. Mirza did not obtain the information and the announcement was not made. He did not place the bets nor did he repay Mr. Patel despite promising to do so. Mr. Patel raised an action to recover the money on grounds which included unjust enrichment,

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139 *Hounga* [2014] UKSC 47, [42].

140 [2014] UKSC 55 (appeal taken from Eng.).

141 *See id.* [20]–[21] (Lord Sumption SCJ).

142 *Id.* [62] (Lord Toulson SCJ).

143 [2015] UKSC 23.

144 *Id.* [62] (Lord Sumption SCJ).

145 *Id.* [129] (Lord Toulson & Lord Hodge SCJJ).

146 *Id.* [15] (Lord Neuberger P)

147 [2016] UKSC 42 (appeal taken from Eng.).

148 *Id.* [11]. The agreement involved a conspiracy to commit the offense of insider dealing under the Criminal Justice Act 1993, c. 36 § 52. *Id.* [12].

because there had been a failure of the consideration for his payment.[149]

The nine Justices were unanimous that Mr. Patel was entitled to succeed in his claim. But there was a strong disagreement about the analytical framework that led to the agreed conclusion. The court was split six to three, with strongly worded dissents by Lord Mance and Lord Sumption with whom Lord Clarke agreed.[150]

Lord Toulson wrote the majority judgment.[151] There were two closely related policy reasons for the illegality defense. First, a person should not be allowed to profit from his own wrong-doing, and, second, the law should be coherent and not self-defeating by condoning illegality.[152] The court had three considerations to address when deciding whether allowing a claim, which was tainted by illegality, would be contrary to the public interest because it would be harmful to the integrity of the legal system.[153] The court had, first, to consider the underlying purpose of the prohibition which had been transgressed. Second and conversely, it had to consider any other relevant public policies which might be rendered ineffective or less effective by denial of the claim. Third, the court had to assess whether denial of the claim was a proportionate response to the illegality. Lord Toulson quoted Lord Bingham's advice to steer a middle course between two unacceptable positions:

> On the one hand it is unacceptable that any court of law should aid or lend its authority to a party seeking to pursue or enforce an object or agreement which the law prohibits. On the other hand, it is unacceptable that the court should, on the first indication of unlawfulness affecting any aspect of a transaction, draw up its skirts and refuse all assistance to the plaintiff, no matter how serious his loss nor how disproportionate his loss to the unlawfulness of his conduct.[154]

In deciding whether it would be disproportionate to refuse relief to the claimant, the court could consider various relevant factors. It was not possible to identify all relevant factors, but potentially relevant

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149 *See id.* [11], [13].

150 *Id.* [187], [224].

151 Lady Hale, Lord Kerr, Lord Wilson, and I agreed with it.

152 *See id.* [55]–[57]. Lord Toulson drew on Justice McLachlin's luminous judgment in *Hall v. Hebert* [1993] 2 S.C.R. 159, 160 (Can.), in which she identified the integrity of the legal system as a central justification of the illegality defense.

153 *Patel* [2016] UKSC 42, [101], [120].

154 *Id.* [106] (Lord Toulson SCJ) (quoting Saunders v. Edwards [1987] 1 WLR 1116 (CA) 1134 (Lord Bingham LJ) (Eng.)).

were "the seriousness of the conduct, its centrality to the contract, whether it was intentional and whether there was marked disparity in the parties' respective culpability."[155]

This majority judgment involved a major movement of the judicial pendulum in the direction recommended by the Law Commission. Lord Toulson's assertion that the public interest was best served by a principled and transparent assessment of the considerations identified received strong support in a concurring judgment by Lord Kerr, who praised the "structured approach to a hitherto intractable problem."[156] Lord Neuberger opined that on the specific issue in the appeal there should be a general rule that a claimant is entitled to the return of the money he paid when the contract to carry out an illegal activity does not proceed.[157] On the wider question of the analytical framework for the defense of illegality, he agreed with Lord Toulson.[158] But Lord Mance and Lord Sumption, with whom Lord Clarke agreed, thought that the majority view involved abandoning basic principles which went back 250 years and replacing them with "an open and unsettled range of factors."[159] Rescission of the unimplemented contract created no inconsistency in the law and involved no reliance on illegality in order to enforce the contract or profit from it.[160] Abandoning the reliance test (which is a rule with certain exceptions) for a range of factors risked opening up the ambit of the illegality defense.[161] There was no need to tear up the law and start again.[162]

I am not persuaded that the majority of the court has torn up the existing law. In my view, the majority judgment has analyzed the caselaw as it has developed over time and rationalized it to reflect the substance of those judicial decisions in the hope of creating greater clarity. I am certainly not persuaded that the majority judgment will extend the scope of the illegality defense. On the contrary, as in cases like *Hounga*, it should prevent the defense from causing a serious injustice. But there is no doubt that this swing of the pendulum has been controversial within the court. In large measure the division between

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155 *Id.* [107]. Lord Toulson referred to the factors identified by Professor Burrows identified as relevant in ANDREW BURROWS, A RESTATEMENT OF THE ENGLISH LAW OF CONTRACT 229–30 (2016), but eschewed any definitive list because the circumstances of each case are different. *Id.* [93], [107].

156 *Id.* [123] (Lord Kerr SCJ).

157 *See id.* [146] (Lord Neuberger P).

158 *Id.* [174].

159 *Id.* [187], [192] (Lord Mance SCJ); *id.* [259]–[265] (Lord Sumption SCJ).

160 *Id.* [199] (Lord Mance SCJ); *id.* [250] (Lord Sumption SCJ).

161 *Id.* [239], [261]–[262] (Lord Sumption SCJ).

162 *Id.* [208] (Lord Mance SCJ).

the Justices reflects differing views on whether the pre-existing law was satisfactory.

Conclusion

So what may we learn from the five cases?

The first three are concerned with ascertaining the terms and meaning of a contract. *Arnold v. Britton* has directed people to start with, and give due weight to, the words the parties have used. The courts, when taking account of business common sense, do not have a free hand to reach their own view on what the contract should have been.[163] *Marks & Spencer* has confirmed that the court must be persuaded that a contract would lack commercial or practical efficacy before it implies a term into it. *Marley v. Rawlings* has stated powerful reasons for maintaining a clear border between interpretation and rectification.

It is not incorrect to use the word "construction" in the broad sense of ascertaining the terms and meaning of a contract so that it covers not only the interpretation of express terms, but also both the implication of unexpressed terms and the rectification of terms resulting from errors of expression. But the three cases have reasserted that each of those three judicial activities has its own distinctive rules.

Turning to the regulation of contract by the common law, *Cavendish* has released contracting parties from an ill-fitting straightjacket which resulted from narrow judicial interpretations of what Lord Dunedin had said about penalty clauses in the *Dunlop* case. It has reestablished the role of the doctrine to prevent a party from enforcing a contractual clause which seeks to punish the other party for a breach of contract by imposing an exorbitant remedy. Within the court, *Patel v. Mirza* is the most controversial of the five cases because it has reformulated the analytical framework of illegality. I believe that the majority judgment should bring clarity and should not extend the scope of the defense. But, if the concerns of the minority eventuate through a continued swing of the judicial pendulum, an appellate court can revisit and refine the analytical framework. That is the common law in action.

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163 What Kentridge AJ said in the South African Constitutional Court in *State v. Zuma* 1995 (4) BCLR 401, [18] about the interpretation of statutes applies equally to the interpretation of contracts: "If the language used by the lawgiver is ignored in favour of a general resort to 'values' the result is not interpretation but divination." *See* Matadeen v. Pointu [1999] AC 98 (PC) 108.

POSTSCRIPT

Since this Essay was prepared, the U.K. Supreme Court has returned to the question of contractual interpretation in *Wood v. Capita Insurance Services Ltd.*,[164] which concerned the interpretation of an indemnity clause in a share purchase agreement. The appellant buyers, Capita, argued that the Court of Appeal had fallen into error by accepting a submission that the Supreme Court in *Arnold v. Britton* had "rowed back" from the guidance on interpretation which the court had given in *Rainy Sky SA v. Kookmin Bank*.[165] In a unanimous judgment, the Supreme Court rejected this submission, rejecting both the idea that there had been such a "rowing back" and the submission that the Court of Appeal had decided the case on that basis.[166] The Supreme Court placed emphasis on the continuity of the law in relation to contractual interpretation. The court stated that interpretation was an iterative process in which the court balanced the indications given by a close examination of the language used against those derived from the contractual context and the factual background. The correct approach was summarized:

> Textualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation. Rather, the lawyer and the judge, 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 or agreements.[167]

The court's judgment in this case, which I wrote, supports the contention that the pendulum has not swung far on contractual interpretation.

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164 [2017] UKSC 24 (appeal taken from Eng.).

165 [2011] UKSC 50 (appeal taken from Eng.); *see Wood* [2017] UKSC 24, [8].

166 *Wood* [2017] UKSC 24, [9], [14], [24]–[25].

167 *Id.* [13].