Neutral Citation Number: [2010] EWHC 1681 (Ch)

Case No: CC/2009/PTA/0518

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
On Appeal from The Central London County Court

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 06/07/2010

Before :

MR JUSTICE HENDERSON

- -

Between :

HILDRON FINANCE LIMITED	**Part 20 Claimant/ Respondent**
- and -	
SUNLEY HOLDINGS LIMITED	**Part 20 Defendant/ Appellant**

- -
- -

Mr Alexander Hill-Smith (instructed by **John May Law**) for the **Appellant**
Mr Stuart Hornett (instructed by **Charles Russell LLP**) for the **Respondent**

Hearing date: 26 May 2010

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Judgment

Mr Justice Henderson:

Introduction

1. The issue on this appeal is whether the appellant, Sunley Holdings Limited ("Sunley"), is entitled to receive an overage payment pursuant to the terms of an agreement which it entered into on 25 March 1986 ("the Porter's Flat Agreement") when it sold the freehold interest in a large block of flats on Hampstead High Street, London, NW3, known as "Greenhill", to Hildron Finance Limited ("Hildron"). Hildron is the respondent to the appeal, which is brought by Sunley (with permission granted by Floyd J) against the relevant parts of the judgment and order of Mr Recorder Antonio Bueno QC dated 10 July 2009 in the Central London County Court.

2. At the time of the sale in 1986, the porter's flat at Greenhill (flat 9) was occupied by the resident porter employed by the landlord, Sunley. All the other flats (some 136 in all) were let on long leases reserving a ground rent and service charge. It was the understanding of both Sunley and Hildron, as recorded in a recital to the Porter's Flat Agreement, that the leases all provided for the landlord at its discretion to employ a porter and other employees for the purpose of performing the landlord's covenants,

and to make available either in the block itself or elsewhere accommodation for such porter or other employees. The important point is that the landlord was at liberty to provide the services of a non-resident porter or porters, although there had in fact been a resident porter living in a flat at Greenhill at all times since the block was built in the 1930s.

3. The purpose of the Porter's Flat Agreement, in broad terms, was to regulate future dealings with the porter's flat by Hildron and its successors in title for a period of 21 years, and to require Hildron to sell a new long lease of the flat on the open market with vacant possession if there came a time when the flat was no longer required as accommodation for a resident porter or employee. The net proceeds of any such sale were then to be divided equally between Sunley and Hildron, after deducting from the gross proceeds the sum of £10,500 together with the reasonable legal costs and surveyor's fees incurred by Hildron in connection with the negotiation and grant of the new lease.

4. The present dispute is about the effect on the Porter's Flat Agreement of the collective enfranchisement provisions contained in Part I of the Leasehold Reform, Housing and Urban Development Act 1993. On 8 November 2004 a requisite majority of qualifying tenants served an initial notice on Hildron pursuant to section 13 of the 1993 Act, claiming to exercise the right to collective enfranchisement in respect of the entire block. The proposed nominee purchaser was a company called Greenhill Hampstead Freehold Limited. By a counter-notice dated 20 January 2005 Hildron admitted the tenants' right to enfranchise, and put forward counter-proposals for the price to be paid. Meanwhile, the initial notice was registered at HM Land Registry by the participating tenants pursuant to section 97(1) of the 1993 Act, which provides that such a notice may be registered "as if it were an estate contract". The effect of the registration was to impose certain constraints on the rights of Hildron as the freeholder to deal with the premises specified in the notice, as set out in section 19. Although Sunley has at times disputed the point, it was common ground at the hearing below, and was again common ground by the time of the hearing of the appeal, that the effect of section 19 would have been to prevent the grant of any new long lease of the porter's flat by Hildron, because the flat formed part of the common parts which the tenants were entitled to acquire under section 2(1)(b) of the 1993 Act. By virtue of section 19(1), any purported grant of such a lease would have been void: the relevant words are "… any transaction shall be void to the extent that it purports to effect … any such grant of a lease as is mentioned in paragraph (a) …"

5. It follows, and is also now common ground, that once the initial notice had been registered section 19 made it unlawful for Hildron to comply with the express terms of the Porter's Flat Agreement in the event that the porter's flat was no longer required to accommodate a porter or other employee, and if Hildron had purported to grant a new long lease of the flat in such circumstances, the lease would have been void.

6. The qualifying tenants and Hildron were unable to agree on the price to be paid for the freehold of Greenhill, and the matter was referred to the Leasehold Valuation Tribunal ("LVT") to determine. In its decision dated 12 July 2006 the LVT determined the total value of the landlords' interests in the property (including the agreed value of the interests of certain intermediate landlords) as £2,298,172. Of this sum, the amount attributable to the porter's flat was £50,000. In reaching this

conclusion, the LVT accepted Hildron's submissions, buttressed by expert evidence, that a willing buyer in the market place would not have been purchasing the porter's flat as a stand-alone investment, but as part of a complex investment in the whole block, and that the service charge provisions in the leases did not allow for the recovery of a notional market rent by the landlord in respect of the porter's flat.

7. Hildron then appealed to the Lands Tribunal, and one of the issues in respect of which permission to appeal was given was the amount to be attributed to the porter's flat. The appeal was heard by His Honour Judge Reid QC and Mr N J Rose FRICS on 12 and 13 November 2007, and on 10 January 2008 they gave their decision. They held that the total price payable by the nominee purchaser was £2,835,255, and that the sum attributable to the porter's flat was £200,000. It was agreed between the expert valuers on both sides that the open market value of the porter's flat was £300,000 as at the valuation date of 20 January 2005 (the date of Hildron's counter-notice, which the Lands Tribunal held in agreement with the LVT to be the correct date to take). The Lands Tribunal differed from the LVT in holding that the later tranches of long leases contained clear provisions which entitled the lessor to recover a notional rent for the porter's flat as part of the service charge, but they agreed that no notional rent was recoverable under the "old leases" which comprised the first tranche. They also expressly found that it was open to the lessor to discharge its obligations in relation to portering services by the provision of non-resident porters, and thus to sell the porter's flat (paragraph 72 of the decision). Nevertheless, they declined to place a value on the flat equivalent to its agreed open market value, but instead settled on the figure of £200,000. For present purposes, their reasoning appears sufficiently from paragraph 76 of the decision:

> "In our view the value put on the flat by [Hildron] is over-optimistic. The sale of the flat or its reduction into possession so as to let it would create other problems in relation to the provision of portering services. It is unlikely that any purchaser would regard the flat as a stand alone investment for which he would be prepared to pay the full open market price as if it were a one-off retail sale. In addition, were the flat retained as a porter's flat, there would be a shortfall on the notional rent because of the terms of the old leases. As against that, the figures proposed by Mr Maunder-Taylor [*the expert witness for the nominee purchaser*] seem to us to be too low. Even allowing for the "bulk discount" point and the difficulty created by the terms of the old leases as to recovering the notional rent, we take the view that a purchaser would attribute a greater value than £150,000 to the flat. In our judgment the appropriate figures is one of £200,000. If we are wrong in concluding that the sale of the porter's flat is not prohibited, our opinion as to the value which a purchaser would attribute to the right to receive a notional rent under the more recent leases – amounting, we understand, to some two-thirds of the total – would be £100,000."

8. Following the decision of the Lands Tribunal, Hildron was still unwilling to execute a voluntary transfer of the freehold to the nominee purchaser. One of the reasons for

this was that Hildron and Sunley were unable to agree whether the overage provisions in the Porter's Flat Agreement had been triggered, and the restriction against the registered title which had been entered to protect Sunley's rights under the agreement remained in place. Eventually, on 23 May 2008 the nominee purchaser issued a Part 8 Claim Form in the Central London County Court seeking a vesting order pursuant to section 24 of the 1993 Act. The defendants to the claim were Hildron and Sunley. Apart from a vesting order, the claimant asked for declarations that Sunley was not entitled to any payment from Hildron before giving its consent to a transfer of the freehold to the claimant, and that Sunley was obliged to give its unconditional consent to such a transfer.

9. In due course Hildron made a Part 20 claim against Sunley seeking declarations to the same effect as those sought by the nominee purchaser, and Sunley filed a defence and counterclaim asking for declarations that Hildron was in breach of the Porter's Flat Agreement, and also in breach of another agreement entered into at the same time as the Porter's Flat Agreement, namely the Car Parking Agreement. These were the live issues which the learned Recorder had to determine when the case eventually came on for trial before him on 17 and 18 February 2009. By that stage a vesting order was no longer sought, and the nominee purchaser had dropped out of the proceedings, because on 20 January 2009 the freehold had been transferred by Hildron to the nominee purchaser, with Sunley's consent, subject to an agreed retention by Hildron from the purchase price of £150,000 which was paid into a joint account to abide the result of Sunley's claim in the Part 20 proceedings.

10. It is unnecessary for me to say anything further about the Car Parking Agreement. The Recorder rejected Sunley's claim founded on that agreement, and Sunley has not appealed against that part of his decision.

11. With regard to the Porter's Flat Agreement, there is one important fact which I have not yet mentioned. On 4 September 2006, nearly 20 months after it had served its counter-notice under the 1993 Act, Hildron granted an assured shorthold tenancy of flat 9 for a term of one year to a Mr Helge Kostka, an employee of Deutsche Bank. It is clear that on the grant of this tenancy, if not before, flat 9 was no longer required as accommodation for a porter or any other employee of Hildron's, with the consequence that the initial triggering event under the Porter's Flat Agreement was satisfied. As I have pointed out, however, it would have been unlawful for Hildron to market a new long lease of the flat, because of the provisions of section 19 of the 1993 Act. There is no suggestion that the grant of the assured shorthold tenancy infringed section 19. The critical question which the Recorder had to determine was whether the supervening illegality, which made it impossible to perform the Porter's Flat Agreement in accordance with its express terms, relieved Hildron from any obligation thereunder, or whether Sunley was still entitled to rely upon it in the changed circumstances where the flat was in effect sold by Hildron, pursuant to the provisions of the 1993 Act, for a consideration of £200,000.

The Porter's Flat Agreement

12. I will now set out the relevant provisions of the Porter's Flat Agreement. It recited:

> (1) that by a transfer of even date Greenhill had been transferred by Sunley to Hildron on the terms therein mentioned;

(2) that Greenhill comprised a block of some 137 flats with six purpose built garages and ancillary grounds for the enjoyment and benefit of the flat occupiers;

(3) that all of the flats (with the exception of flat 9) were then subject to long term leases reserving ground rent and service charge;

(4) that the leases each provided for the landlord at its discretion to employ a porter and other employees for the purpose of performing the landlord's covenants, and to make accommodation available for the porter or other employee either in the block or elsewhere;

(5) that flat 9 was currently occupied by the resident porter employed by the freeholder in accordance with the terms of the leases; and

(6) that in respect of future dealings with flat 9 the parties had agreed to enter into the deed.

13. The operative clauses then provided as follows:

> "1. HILDRON for itself and its successors in title as aforesaid HEREBY COVENANTS with Sunley for a period of 21 years from the date hereof that
>
> (a) if flat No. 9 is no longer required as accommodation for a porter or other employee of the landlord under the provisions of the said leases it will forthwith sell on the open market and with vacant possession a new lease of flat No. 9 in the form and to the effect of the standard form of block lease (a specimen copy of which is annexed hereto) at a price equal to the highest market price reasonably negotiable such price to be first approved in writing by Sunley (such approval not to be unreasonably withheld)
>
> (b) it shall not grant a lease or tenancy of or otherwise dispose of any interest in flat No. 9 except in accordance with the provisions of this Deed
>
> (c) until such time as a new lease is sold in accordance with the provisions of this Deed Hildron shall not use nor permit or suffer flat No. 9 to be used otherwise than as accommodation for a porter or other employee of the landlord under the provisions of the said leases
>
> (d) on the grant of the new lease as hereinbefore provided Hildron will pay to Sunley a sum equal to 50% of the net sale proceeds (the net sale proceeds being the gross price achieved for such new lease as approved by Sunley under Clause 1(a) of this Deed less the sum of £10,500.00 together with Hildron's reasonable legal costs and surveyors fees in connection with the negotiation and grant of such new lease

> in so far as such costs and fees are not made the responsibility of the purchaser).
>
> 2. HILDRON HEREBY FURTHER COVENANTS with Sunley that it will forthwith in conjunction with its application to HM Land Registry to register the transfer hereinbefore recited lodge this Deed at HM Land Registry so that its contents may be noted in the register of title number 461978 and will make an application in Form 75 to register a restriction against title number 461978 in respect of this Deed.
>
> 3. HILDRON HEREBY FURTHER COVENANTS with Sunley that during the term specified in Clause 1 hereof it will not dispose of its interest in the said property known as Greenhill aforesaid unless simultaneously with such disposal the person persons or body acquiring such interest shall have entered into a Deed with Sunley in the terms (mutatis mutandis) of this Deed."

14. The reason why the sum of £10,500 is deductible from the gross sale price of the new lease under clause 1(d) is that this sum represented the price actually paid by Hildron for the porter's flat in 1986. Evidence was given at the trial by Mr Paul Alexander, whose company had been the managing agents of Greenhill for the last 23 years, and who had acted for Hildron when it bought the freehold from Sunley in 1986. He explained that the price for the porter's flat of £10,500 had been based on its investment value, calculated as seven years' purchase of a notional yearly rent at the time of £1,505. It should be noted that the Porter's Flat Agreement contained no provision to index-link or otherwise update the figure of £10,500 during the 21 year life of the agreement.

15. Against this background, the basic commercial purpose of the Porter's Flat Agreement is in my judgment reasonably clear. Hildron had paid Sunley no more than the investment value of the flat, based on a notional yearly rent of £1,505. Part, but not all, of this notional rent could be recovered by the landlord through the service charge mechanism in the leases which were not "old leases". The position with regard to the old leases was, at best, uncertain. The flat had always been occupied by a resident porter employed by the landlord, but the parties were in agreement that it would be open to the landlord in the future to provide accommodation for a porter outside the block. As it happens, the correctness of this assumption has recently been confirmed by the Lands Tribunal in its decision of 10 January 2008 (see paragraph 7 above), but nothing turns on this: what matters is the contemporary understanding of the parties, as recorded in recital (4). Accordingly, a time might well come when the flat would no longer be required for a resident porter, and when the landlord would be free to sell it on the open market. In those circumstances, a bargain was struck. Hildron (or its successors in title) would be obliged, as soon as the flat became available, to sell it on the open market with vacant possession for the highest price it could reasonably negotiate. The interest to be sold would be a new long lease in the standard form used for the block. The price would be subject to the prior written approval of Sunley, such approval not to be unreasonably withheld. On completion of the sale, Hildron would pay Sunley 50% of the net proceeds of sale (defined as the gross price achieved less the specified deductions, including the £10,500 already paid

by Hildron in 1986). The agreement was to remain in force for 21 years, until 25 March 2007. Meanwhile, Hildron was not to grant any lease or tenancy of the flat, or otherwise dispose of any interest in the flat, except in accordance with the provisions of the deed, nor was it to use the flat, or permit its use, otherwise than as tied accommodation for a porter or other employee under the provisions of the leases. The rights of Sunley under the agreement were also to be protected by entry of a restriction against the registered title, and if Hildron disposed of the freehold, it was obliged to ensure that a deed in similar terms was entered into between its successor in title and Sunley.

16. It may be noted that Hildron was under no obligation to take steps to accommodate a porter outside the block, and if it chose not to do so, the initial triggering event in clause 1(a) would never occur. Once the triggering event had occurred, however, the consequences were immediate and mandatory. The requisite sale had to be put in hand forthwith, Sunley had to approve the price, and the proceeds of sale then had to be divided in the specified manner.

The judgment of the Recorder

17. Sunley's pleaded case, in its defence and counterclaim settled by Mr Gerard van Tonder of counsel, was to the following effect. By January 2007 at the latest, flat 9 was no longer required as accommodation for the porter or any other employee of Hildron. Hildron was accordingly obliged to comply with clause 1(a) of the Porter's Flat Agreement, and in breach of its obligation had failed to sell the flat. Sunley had thereby suffered loss and damage, to be calculated as 50% of the net sale proceeds which would have been achieved on a sale of the flat. The point that it would have been prima facie unlawful for Hildron to sell the flat was obliquely recognised in paragraph 14 of the defence, which said that Sunley relied on Article 1 of the First Protocol to the European Convention on Human Rights to avoid the so-called *Slipper* principle (Slipper v Tottenham and Hampstead Junction Railway (1867) L.R. 4 Eq. 112). The *Slipper* principle, as I understand it, is that where leasehold property is acquired under compulsory powers conferred by an Act of Parliament, any requirement for the lessor's consent is taken away by operation of the statute. As amplified in his skeleton argument for the trial, counsel's contention appears to have been that the invalidation by the 1993 Act of the sale required by the Porter's Flat Agreement would amount to an unlawful deprivation of Sunley's possessions which could not be justified in the public interest, with the consequence, so it was said, that section 19 of the 1993 Act should be construed as though it did not invalidate the grant of a long lease of the flat. I confess that I find the argument difficult to follow, and I am not surprised that it was rejected by the Recorder.

18. In his skeleton argument for the trial, Mr van Tonder seems to have departed from his pleaded case that the damages recoverable by Sunley should be based on a retrospective valuation of the flat to be carried out by a jointly instructed expert. He submitted, rather, that the effect of section 19 was to require the flat to be sold to the nominee purchaser, instead of on the open market, and that Hildron could easily perform the substance of its obligation under the Porter's Flat Agreement by paying to Sunley 50% of the net sale proceeds received from the nominee purchaser. The sum claimed by way of damages was therefore £94,750 (i.e. one half of £200,000 after deduction of £10,500 before division).

19. These submissions, too, were rejected by the Recorder. He pointed out that the price of £200,000 paid for the flat, following the decision of the Lands Tribunal, was less than the agreed open market value of the flat with vacant possession. In addition, it was paid for the freehold interest in the flat, and not for a long lease as envisaged by the Porter's Flat Agreement. He thought that this latter point was probably of little significance, but continued:

> "26. However, Hildron has a much more formidable argument. Thus, it contends that once the s.13 notice was served (on 8 November 2004) compliance with Clause 1 of the Porter's Flat Agreement became impossible, for these reasons:
>
> (1) first, s.19(1)(a) of the 1993 Act prohibited Hildron from granting a long lease and would have rendered any transaction purporting to sell Flat 9 void; and
>
> (2) secondly, it would have been legally and/or practically impossible to sell a lease of the flat after a unilateral notice protecting the s.13 notice was registered by the residents on 12 November 2004. Hildron, therefore, contends that the effect in law was to discharge the covenant, on the ground that performance, albeit arising after the contract was entered into, would have been illegal …
>
> 27. Sunley did not contend that there was any breach by Hildron of Clause 3 of the Porter's Flat Agreement (not to sell the Property without requiring purchaser to enter into the same covenants); it concedes that, when the transfer of the property finally took place in early 2009, the Porter's Flat Agreement had expired by effluxion of time, on 24 March 2007, with the result that any possible obligation had lapsed; and it acknowledges that even if this agreement had not expired, Hildron would still have been prima facie relieved from all liability, as assignments made in compliance with statutory requirements cannot result in breaches of covenant …
>
> 28. However, Sunley argued further that, as a matter of construction and so as to give effect to the overage agreement, Clause 1 of the Porter's Flat Agreement should be construed as requiring Hildron "to perform the substance of its obligations" by paying 50% of what it received for the flat (less deductions), as leasehold enfranchisement (whether under the 1993 Act or otherwise) was not even on the horizon when this agreement was entered into, in March 1986.
>
> 29. The situation, as it appears to me, is clear. The application of the so-called *Slipper* principle does not arise, as the Porter's Flat Agreement had already expired when the freehold was finally transferred to Greenhill [*i.e. the nominee purchaser*] and, as I see it, there is insufficient evidence to support the contention that Flat 9 was "*no longer ... required*" for a porter

> during the 21 year life of the covenant. If I am wrong, *Slipper* is determinative of the position and there is no conceptual basis, as I see it, upon which the application of this principle can be avoided. Mr van Tonder expressly disavowed any reliance upon the existence of an independent implied term supporting the manner in which this covenant should be construed, and rightly so.
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> 30. Mr Hornett's contention, simply put, was that Mr van Tonder was effectively inviting the Court to re-write Clause 1 of the Porter's Flat Agreement in a manner which was wholly different to anything the parties can reasonably have contemplated and that such a step would do extreme violence to elementary principles of contract law. I agree."

20. It can be seen, therefore, that the Recorder rejected Sunley's arguments based on the construction of the Porter's Flat Agreement, and held that counsel's argument amounted to an impermissible rewriting of the agreement between the parties, in a way which went far beyond anything they could reasonably have contemplated.

21. Rather puzzlingly, the Recorder also seems to have doubted (in paragraph 29 of his judgment) whether there was enough evidence to support the contention that the initial trigger condition in clause 1(a) of the Porter's Flat Agreement had been satisfied. Mr Alexander had given uncontradicted evidence that flat 9 ceased to be used as the porter's flat in September 2006, and (as I have already said) that it was let on an assured shorthold tenancy dated 4 September 2006. Thus there can be no doubt, and it was common ground before me, that the initial trigger condition was indeed satisfied.

(1) Sunley's primary argument on the appeal

22. Since the hearing below there has been a change of counsel on Sunley's side, and Sunley is now represented by Mr Alexander Hill-Smith. The primary submission that he advances in support of the appeal is an argument of construction. He submits, in short, that the court should seek to give effect to the underlying commercial purpose of the Porter's Flat Agreement, in circumstances which neither party could have foreseen when it was entered into. In 1986, there was no legal impediment to the marketing and grant of a new long lease if the porter's flat ceased to be used to accommodate a porter. Further, as matters then stood, that would have been the obvious way to realise the maximum capital value from a disposal of the flat, and would have placed it in the same position as all the other flats in the block. There was no legislative equivalent to the 1993 Act in existence in 1986, and nobody could have foreseen the statutory scheme that Parliament would subsequently enact, or the prohibitions that would be contained in section 19 of the 1993 Act. In those circumstances, says Mr Hill-Smith, the task of the court is to consider the underlying contractual objectives and to apply them in the light of the new circumstances. It is only if such an exercise is impossible that the court should hold that the original agreement has been discharged by frustration.

23. In support of this submission, Mr Hill-Smith relied on the guidance given by the Court of Appeal on the approach to construction where there are unforeseen

circumstances in Bromarin A B v IMD Investments Ltd [1999] STC 301. The leading judgment was given by Chadwick LJ, with whom Potter and Beldam LJJ agreed. The case concerned two agreements in identical terms, dated 19 March 1990, by each of which the defendant, IMD, bought the shares in a company with accrued capital losses. Bromarin was one of the vendors. Under the law as it then stood, IMD would be able to make use of the losses as a deduction against future chargeable gains, by transferring assets pregnant with gains to the purchased company which could then dispose of those assets and set the accrued losses against the chargeable gain arising on the disposal. The sale price of the shares consisted of an immediate cash sum of £10,000 payable on completion, and a secondary consideration which was payable over a period of five years and consisted (in very broad terms) of one half of any tax saved. As one would expect, the detailed provisions for the ascertainment and computation of the secondary consideration were complex, and involved a number of defined terms. One of those terms was "Losses", which was defined as meaning "the amount of capital losses allowable to the Company [*i.e. the purchased company*] as at the date hereof [*i.e. 19 March 1990*] for deduction from any chargeable gains accruing to it for the purposes of corporation tax".

24. The effect of the contractual scheme was that, in the absence of further provision, no secondary consideration would become payable "unless (i) the purchaser chose to transfer an asset or assets into the company; (ii) the asset was subsequently disposed of by the company, which was under the control of the purchaser; and (iii) a chargeable gain accrued on that disposal" (307b-c). Accordingly, as Chadwick LJ pointed out, the amount and the timing of payments of secondary consideration would depend on decisions taken by the purchaser, over which the vendors had no control. In order to protect the vendors against the possibility that the purchaser might choose to defer indefinitely the realisation of chargeable gains in the company, and thus the payment of secondary consideration, a further clause was introduced which imposed a new payment obligation on the expiry of five years, consisting of an amount equal to half the corporation tax on "deemed chargeable gains". The "deemed chargeable gains" were defined as the difference between the company's chargeable gains accruing to it over the period of the agreement up to and including 31 March 1995, and the amount of the Losses (defined as above).

25. There would have been no difficulty in applying these provisions to the events which happened if there had not been a material and unforeseen change in the law during the five year period. By virtue of new provisions enacted in 1993, the ability to use the pre-entry losses of a capital loss company purchased by another group was brought to an end, and the relevant transitional provisions had the effect that the losses allowable to the purchased companies as at the date of the agreements in March 1990 ceased to be allowable in respect of chargeable gains accruing after 16 March 1993. No assets had been introduced into the purchased companies before the latter date. Against that background, Bromarin claimed that it was still entitled to be paid the sale price for the shares in the company it had sold to IMD. IMD disputed liability, on the basis that the losses had not been used, and there was no possibility of using them after the change in the law. At first instance, Park J decided the case in favour of IMD. Adopting a purposive construction, in reliance on the now well-known principles which had recently been enunciated by Lord Hoffmann in Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 WLR 896 at 912-913, he construed the defined term "Losses", in the context of the provision relating to the

secondary consideration, as meaning only losses which would be allowable as a deduction from chargeable gains as at 31 March 1995. He considered that the parties could not have intended the term to bear its defined meaning in circumstances which they had not foreseen.

26. Chadwick LJ then continued at 310e:

> "The difficulty with that approach is that it is commonplace that problems of construction, in relation to commercial contracts, do arise where the circumstances which actually exist at the time when the contract falls to be construed are not circumstances which the parties foresaw at the time when they made the agreement. If the parties have foreseen the circumstances which actually arise, they will normally, if properly advised, have included some provision which caters for them. What that provision may be will be a matter of negotiation in the light of an appreciation of the circumstances for which provision has to be made.
>
> It is not, to my mind, an appropriate approach to construction to hold that, where the parties contemplated event "A", and they did not contemplate event "B", their agreement must be taken as applying only in event "A" and cannot apply in event "B". The task of the court is to decide, in the light of the agreement that the parties made, what they must be taken to have intended in relation to the event, event "B", which they did not contemplate. That is, of course, an artificial exercise, because it requires there to be attributed to the parties an intention which they did not have (as a matter of fact) because they did not appreciate the problem which needed to be addressed. But it is an exercise which the courts have been willing to undertake for as long as commercial contracts have come before them for construction. It is an exercise which requires the court to look at the whole agreement which the parties made, the words which they used and the circumstances in which they used them, and to ask what should reasonable parties be taken to have intended by the use of those words in that agreement, made in those circumstances, in relation to this event which they did not in fact foresee."

27. Chadwick LJ went on to apply those principles, and held that there was no warrant for departing from the defined meaning of "Losses". There was no basis for giving the words of the definition a different meaning, and the risk of a change in the law was to be borne by the purchaser who had control over the timing of disposals.

28. I have referred to the factual background in the Bromarin case at some length, partly because it is helpful to place the guidance given by Chadwick LJ in its context, but also because Mr Hill-Smith sought to draw some support from a similarity between the position in that case and the facts of the present case. He pointed out, correctly, that both cases were concerned with entitlement to a secondary consideration under a contract, payable after a significant period of time had elapsed from the date of the

contract, and that in both cases there was a significant change in the law between the date of the contract and the relevant date when the issue arose. That is true, but I do not think that these similarities help Mr Hill-Smith's argument. On the contrary, the actual decision of the Court of Appeal in Bromarin provides a salutary reminder of the need to construe a contract in the factual matrix in which it was actually made, and of the danger of making a question-begging assumption about what the parties would have intended in circumstances which they could not foresee.

29. Mr Hill-Smith also submitted that, where unforeseen events have occurred, the court may need to work creatively in order to give effect to the parties' underlying contractual intentions. He referred in this context to the observations of Sedley LJ in Casson v Ostley P J Ltd [2001] EWCA Civ 1013, [2003] BLR 147 at paragraphs 29 to 32:

> "29. In the present case, as in most cases on the interpretation of contracts which reach this court, the words fall short of the facts. It may be axiomatic that we are to deduce the parties' intentions from the words they have used, but the intention itself is in most such cases a fiction. Occasionally, it is true, something which has been agreed on has just been poorly expressed and can be elucidated; but far more often the parties have simply and understandably not even thought about the event which has now caused a problem. No more than a legislature can they be expected to anticipate every eventuality; but when the unexpected happens, as it regularly does, they and the courts have only the now insufficient words on the page to fall back on.
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> 30. What is the court then to do? It may not simply make the contract which it believes the parties would have made if they had thought about the issue. It must keep in focus those agreed purposes which are evident. It must give what effect it can to the words on the page. But since, ex hypothesi, the words on the page do not fit the facts, the court has to work creatively; and consistency requires it do so by adopting and observing principles – in lawyers' language, rules of construction …
>
> 31. …
>
> 32. "Construction" has two meanings, one derived from the verb to construe, the other from the verb to construct. It may be as well to admit that under the guise of the first, the courts in cases like this are doing the second. We mitigate the uncovenanted effect of literalism not by nakedly writing a new contract for the parties but by construing the words according to principles which enable the contract, in effect, to be reconstructed. It is a very reasonable stopping place on the road that runs between second-guessing parties who have simply contracted incautiously and leaving a party at the mercy of unconsidered words."

30. These observations were made in the context of a case where it was necessary to construe an exemption clause in a building contract and to decide whether it excluded loss or damage from fire caused by the negligence of the defendant or its subcontractors. The court held, for a number of reasons, that the clause did not provide exemption in such circumstances. The judgments were extempore, and neither of the other two members of the court, Schiemann LJ and Sir Murray Stuart-Smith, expressly associated themselves with Sedley LJ's observations. Nevertheless, I find the observations helpful, and I do not think they conflict with Chadwick LJ's description of the exercise that the court is required to perform. There is inevitably a considerable degree of reconstruction involved in imputing an intention to the parties in relation to circumstances which they did not foresee. The point made by Chadwick LJ is that any such reconstruction has to be firmly grounded in the words which they actually used in their original factual matrix.

31. Relying on these authorities, Mr Hill-Smith submits that the purpose of the Porter's Flat Agreement was to quantify the entitlement of Sunley to overage once the trigger event had occurred during the 21 year period. The agreement provided for the following steps to be taken following the trigger event:

    (i) the grant of a long lease;

    (ii) the marketing of the lease;

    (iii) the sale of the lease at a price to be approved by Sunley; and

    (iv) the division of the proceeds of sale.

    The overall purpose of these steps, he submits, was to allow the porter's flat to be realised at something approaching market value. Because of the service of the initial notice, the steps could no longer take place in literal compliance with the terms of the contract. In particular, because of section 19 of the 1993 Act, it was no longer possible to grant and sell a new long lease of the flat. Nevertheless, the freehold of the flat was sold through the statutory machinery of the 1993 Act, which uses the terms "vendor" and "purchaser" in connection with the process. The grant of a new lease was not of fundamental importance to the agreement, but was rather considered by the parties, in the circumstances prevailing in 1986, to be the appropriate way of unlocking the value contained in the flat. In the changed context of the collective enfranchisement process, the equivalent unlocking was achieved by obtaining the determination of the Lands Tribunal of the price to be paid for the freehold interest in the flat. Accordingly, the grant of the lease should not be treated as a critical part of the contractual process.

32. The marketing and sale of the lease, with Sunley's approval of the price, were also no longer possible once the initial notice had been registered at the Land Registry, but their equivalent, in the light of the changed circumstances, was the sale by Hildron to the participating tenants. This is the sale that has taken place. It is true that Sunley did not approve the sale, but Sunley is entitled to, and does, waive the requirement for its consent. Further, the price payable under the 1993 Act is based on the open market value of the flat, subject to certain specified assumptions: see paragraph 3(1) of schedule 6, which provides that

> "… the value of the freeholder's interest in the specified premises is the amount which … that interest might be expected to realise if sold on the open market by a willing seller … on the following assumptions …"

It is thus essentially equivalent to the open market sale envisaged by clause 1 of the Porter's Flat Agreement.

33. The relevant price was then fixed by the Lands Tribunal at £200,000 on the assumption that the landlord would be free to accommodate the porter elsewhere and dispose of the flat with vacant possession: see paragraph 76 of its decision, quoted in paragraph 7 above.

34. Hildron's counter-argument, advanced as it was below by Mr Hornett, may be summarised as follows. The triggering event under the Porter's Flat Agreement was not simply that the flat should no longer be required as accommodation for the porter. Before Sunley could become entitled to receive any payment, there had also to be a sale of a new lease pursuant to the terms of the agreement, and only then would Sunley be entitled to a sum equal to half the net sale proceeds. Sub-clauses 1(a) and (d) were inextricably linked, and if the lease was not sold, Sunley could not be entitled to anything under clause 1(d). The failure to sell the flat under clause 1(a) might in theory give rise to a claim in damages, which is how Sunley's case is still pleaded. However, the complete answer to any such claim is that Hildron was prohibited by section 19 of the 1993 Act from complying with its obligations under clause 1(a). The court is not free to ignore the express words of the contract when ascertaining its general commercial purpose: see Bromarin. To construe the agreement in the radical way contended for by Sunley would be to ignore the bargain that the parties actually made, and to substitute a quite different one:

> (a) the disposal of the flat as part of the enfranchisement process is not a sale on the open market, as required by clause 1(a);
>
> (b) the disposal of the flat as part of a freehold disposal of the entire block is not an isolated sale of the flat on a long lease with vacant possession, as again required by clause 1(a);
>
> (c) the valuation of the flat by the Lands Tribunal is not "a price equal to the highest market price reasonably obtainable" within the meaning of clause 1(a); and
>
> (d) the valuation methodology is different.

35. Furthermore, submits Mr Hornett, the enfranchisement process could have led to several different outcomes in relation to the price attributable to the porter's flat. The parties might have reached agreement on the value to be attributed to it. Alternatively, Hildron might have decided not to appeal against the decision of the LVT, in which case it would have received only £50,000. And even on the appeal to the Lands Tribunal, the price which was determined for the flat was £100,000 less than its agreed open market value.

36. More generally, Mr Hornett submits that this is a case where no underlying purpose can be discerned separate from the actual provisions agreed between the parties. Sunley has been unable to offer any precise formulation of the underlying purpose for which it contends, and is merely asking the court to impute retrospectively to the parties a supposed common intention derived from the events which have actually happened. Unlike many overage agreements, the Porter's Flat Agreement is short, simple and relatively unsophisticated. There is no proper basis for assuming that the parties intended it to have any wider application than its terms expressly envisaged.

37. I have not found this an easy question, and I was initially attracted by Mr Hill-Smith's skilful submissions. On reflection, however, I have come to the clear view that Sunley is asking the court to go several steps too far in its reconstruction of the Porter's Flat Agreement. It is true that, in a general sense, the evident purpose of the agreement was to unlock and share the increased capital value of the flat if it was no longer required to accommodate a porter. But the agreed steps to be taken in that event were both narrowly and prescriptively formulated. They were predicated on the assumption that the flat could then be sold in the open market, with a new long lease in the standard form. The only sale ever envisaged by the parties was a separate, self-contained sale of the porter's flat, for a price which Sunley would be able to approve. I am satisfied that a sale of the freehold interest in the flat, as part of a disposal of the entire block, was well outside the contemplation of the parties in 1986; and the further fact that such a sale was then brought about by the compulsory operation of the 1993 Act, rather than by a voluntary decision of the landlord, does not make the position any better. On the contrary, it introduces the further point that the price attributable to the flat was now something outside Sunley's control, to be ascertained by application of the criteria in schedule 6 to the 1993 Act and not by the exposure of the flat to the real, as opposed to a notional, open market.

38. Taken cumulatively, the points of distinction between the agreed steps set out in the Porter's Flat Agreement and the steps which have in fact led to the receipt by Hildron of £200,000 for the freehold interest in the flat are, in my view, so many and so significant that it is impossible to impute a common intention to the parties that the Porter's Flat Agreement should be modified so as to accommodate them. I have already noted several of the points of distinction in my summary of Mr Hornett's argument. A further one, to which he rightly drew attention, is that there would be a chronological dislocation. The agreement envisages that the open market sale of the new lease is to take place as soon as possible after the triggering event in clause 1(a). Yet the service of the initial notice which ultimately compelled Hildron to transfer the freehold took place on 8 November 2004, the best part of two years before the occurrence of the trigger event, and the valuation date adopted by the LVT and the Lands Tribunal was the date of service of Hildron's counter-notice in January 2005, still some 20 months before the trigger event. This dislocation reflects the more general point that there is no causative connection between the vacation of the flat by the porter and the events which led to the enfranchisement of the block and the receipt by Hildron of the £200,000.

39. For these reasons I would decline Sunley's invitation to construe the Porter's Flat Agreement in such a way that it applies to the events which have happened.

(2) Other arguments

40. Mr Hill-Smith put Sunley's case in various alternative ways, but the conclusion which I have reached on his primary construction argument means that none of his other arguments has any prospect of success. One argument was based on the well-established principle that, where the machinery provided in a contract breaks down, and where it is not essential to the achievement of the underlying contractual purpose, the court will substitute its own machinery: Sudbrook Trading Ltd v Eggleton [1983] AC 444. However, there is clearly no scope for the operation of this principle if I am correct in my view that the machinery laid down in the Porter's Flat Agreement was essential to its operation. Another argument was based on the implication of a term to cater for the unforeseen circumstances which arose. Again, however, there can be no scope for the implication of a term, whether the exercise is properly to be regarded as one of contractual interpretation, as Lord Hoffmann said in Attorney General of Belize v Belize Telecom Ltd [2009] UKPC 10, [2009] 1 WLR 1988 at paragraph 19, or whether a more traditional test of necessity is applied, the need for which has been reaffirmed by the Court of Appeal, after the Belize case, in Mediterranean Salvage & Towage Ltd v Seamar Trading & Commerce Inc [2009] EWCA Civ 531 at paragraph 15 per Sir Anthony Clarke MR, with whose judgment Rix and Carnwath LJJ agreed. If the question is properly regarded as one of construction, the argument can add nothing to Sunley's argument on the first question. If the test is one of necessity, it comes nowhere near being satisfied on the facts. The Porter's Flat Agreement provided a perfectly clear and simple mechanism, which was unforeseeably invalidated by the collective enfranchisement process. If, as I have held, it is not possible to discern a broader underlying purpose, there can be no basis for implying a term to salvage the contract. The true position is simply that the contract became impossible to perform in the manner envisaged and intended by the parties.

41. In these circumstances, I accept Hildron's submission that the Porter's Flat Agreement was discharged by a species of frustration: see Chitty on Contracts, 30th edition, volume I, para 23-022 and Baily v De Crespigny (1869) LR 4 QB 180. In that case a lessor covenanted that he and his assigns would not build on a piece of land adjoining the demised premises. When a railway company, in exercise of powers derived from a subsequent statute, compulsorily acquired the land and built a station on it, the Court of Queen's Bench (Sir Alexander Cockburn CJ, Lush, Hannen and Hayes JJ) held that the lessor was discharged from his covenant by the subsequent Act of Parliament, which put it out of his power to perform it. As Hannen J, delivering the judgment of the court, said at 186-7:

> "The legislature by compelling him to part with his land to a railway company, whom he could not bind by any stipulation, as he could an assignee chosen by himself, has created a new kind of assign, such as was not in the contemplation of the parties when the contract was entered into. To hold the defendant responsible for the acts of such an assignee is to make an entirely new contract for the parties."

42. It is also worth quoting a passage from earlier in Hannen J's judgment, at 185:

> "There can be no doubt that a man may by an absolute contract bind himself to perform things which subsequently become

> impossible, or to pay damages for the non-performance, and this construction is to be put upon an unqualified undertaking, where the event which causes the impossibility was or might have been anticipated and guarded against in the contract, or where the impossibility arises from the act or default of the promissor.
>
> But where the event is of such a character that it cannot reasonably be supposed to have been in the contemplation of the contracting parties when the contract was made, they will not be held bound by general words which, though large enough to include, were not used with reference to the possibility of the particular contingency which afterwards happens."

It is accepted by Sunley that the parties could not in 1986 have foreseen the way in which the 1993 Act would subsequently operate, and in my judgment it would plainly be unreasonable to construe clause 1(a) of the Porter's Flat Agreement as imposing an absolute liability on Hildron even where performance became impossible. The right solution, therefore, is to treat the contract as discharged by frustration without fault on either side.

43. It remains for me to notice briefly one further argument which Mr Hill-Smith included in his skeleton argument, but did not advance with any enthusiasm at the hearing. It depended on some views expressed by Professor Sir Guenter Treitel in his book on Frustration and Force Majeure, 2nd edition, at paragraphs 15-007 to 009, where he said that the decision in Baily v De Crespigny appeared to produce an unjust result, because the lessor was able to retain the compensation which he received for the compulsory purchase and was not required to pay over any part of it to the tenant. Professor Treitel commented that the decision might appear to be a logical deduction from the rule that frustration operates automatically, and pointed out that in some systems of law such a result can be avoided, at least to some extent, by applying the principle of conditional discharge or surrogate benefit. He recognised, however, that English law "does not directly recognise any such principle" (paragraph 15-008), and went on to say (in paragraph 15-009) that an English court could "prevent a party from so profiting only by holding that a contract has *not* been frustrated". While this discussion is of great interest, and any views expressed by Professor Treitel deserve the utmost respect, Mr Hill-Smith realistically accepted that, sitting as a first-instance judge, I was bound to apply the general rule of English law that frustration operates automatically, and I could not properly use the threat of frustration as a way of compelling Hildron to accept altered performance of its bargain with Sunley.

Conclusion

44. For these reasons Sunley's appeal will be dismissed.