OUTER HOUSE, COURT OF SESSION

[2020] CSOH 46

P823/19

OPINION OF LORD CLARK

In the petition

ARBITRATION APPEAL No. 4 of 2019

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Pursuer: Findlay QC, MacGregor; Morton Fraser
Defender: Ellis QC; MacRoberts LLP

19 May 2020

Introduction

[1] The petitioner leased a number of properties from a landlord. In terms of the lease, the petitioner was entitled to exercise an option to purchase the properties. The parties could not agree on the price and that matter was remitted to arbitration. The arbitrator issued his award on 12 August 2019. In this petition, the petitioner appeals against the award and argues that the arbitrator erred on points of Scots law. The petition was served on the landlord and also on the arbitrator. The landlord lodged answers and contested the petition.

Background

[2] As this is an arbitration appeal and the identities of the parties are anonymised, it is

important that I do not set out unnecessary information about them or indeed material from which their identities can be inferred. This can create difficulties, when seeking to explain the background and the relevant facts and circumstances. In the present case, it has resulted in me not describing in any detail the operation or activities carried on by the petitioner. Rather, I simply note that significant activities were carried on by the petitioner in the area in which the properties were located. As a result, the petitioner's personnel and their families required substantial housing accommodation.

[3] The petitioner and the respondent entered into a contract on 12 June 1998 ("the contract"). The contract provided for the construction of a number of houses on land in an area in the north-east of Scotland. The respondent was to construct and maintain the houses for a period of twenty years. Towards the end of 1999, the petitioner and the respondent also entered into a lease ("the lease"). In terms of the lease, the respondent let to the petitioner the premises defined in the lease ("the premises"). The premises comprised the houses and the land upon which they were built. In accordance with clause 6 of the lease, the petitioner was entitled to exercise an option to purchase the premises ("the option"). In order to exercise the option, the petitioner required to elect to do so, at the latest, one year and one day prior to the option date. The petitioner served notice exercising the option on 22 August 2018. The option took effect on 2 September 2019.

[4] The price to be paid by the petitioner to the respondent in relation to the exercise of the option is determined in accordance with clause 6.4.1 of the lease. The critical part of clause 6.4.1 is as follows:

> "'**The Price**' shall be and mean such amount as the Landlord and the Tenant shall agree as representing, or failing such agreement shall be determined by an expert as hereinafter provided, the price which would be likely to be paid by a willing purchaser to a willing vendor in the open market at the Option Date for the Premises as a whole with vacant possession…"

The clause then set out various assumptions to be made and a matter to be disregarded, none of which are relevant for the purposes of this appeal. The parties were unable to agree on the price and in terms of a joint deed of referral in March 2019 they agreed that an arbitrator was to be appointed to determine the price. Notwithstanding the terms of the lease, the parties agreed that the arbitrator was to act as such and not to act as an expert. In his award, the arbitrator determined the price payable by the petitioner to the respondent for the exercise of the option. In terms of their deed of referral, the parties had agreed that either party could appeal against the award made by the arbitrator, under rule 69(1) of the Scottish Arbitration Rules which provides that a party may appeal to the Outer House against the tribunal's award on the ground that the tribunal erred on a point of Scots law (a "legal error appeal").

The Award

[5] In applying clause 6.4.1, the arbitrator took the view that

> "… the [petitioner] as an hypothetical entity can be taken into account as contended by the Respondent, and deemed to be a hypothetical bidder in the hypothetical market…"

He made several references to viewing the petitioner in this way as a "factor" and later stated that this factor

> "… can of itself have a potentially positive effect on the market. The petitioner as a hypothetical bidder forms part of the hypothetical market.

Grounds of Appeal

[6] There are three grounds of appeal, expressed as follows:

(i) As a matter of Scots law, the [petitioner] should not have been treated as a hypothetical purchaser. The contract requires the value of the premises to be determined on the basis of vacant possession, i.e. that the [petitioner] had not exercised the option to purchase 12 months previously. It would therefore have had to have relocated personnel to alternative housing by the termination of the lease

otherwise vacant possession could not have been given. There is no basis for assuming that the [petitioner] would be in the market as the [arbitrator] did. Hence, the assumption made by the [arbitrator] is not permitted by the terms of the contract. Moreover the approach is contrary to the "reality principle" which is well established in analogous valuation contexts. The [arbitrator] has made impermissible assumptions as to what the [petitioner] would or would not have done prior to the valuation date. He has in effect assumed it will have done nothing for which there is no support in the contract and is in conflict with the reality principle. This error had a material impact on the [arbitrator's] determination of the Price.

(ii) If the arbitrator was entitled to consider the issue of whether the [petitioner] was a potential hypothetical purchaser and so in the market which the petitioner disputes for the reason set out in relation to Ground of Appeal (1), the [arbitrator] has erred by making an impermissible assumption that the [petitioner] would be in the market for properties similar to the Premises and would have taken no action to provide replacement accommodation since its hypothetical decision not to exercise its option. No suitable findings have been made in relation to what the actual needs of the [petitioner], as [at] the valuation date, would have been if the option had not been exercised. The evidence adduced by the petitioner in regard to this issue was simply dismissed by the [arbitrator] as irrelevant. The [arbitrator] erred in law in failing to consider this evidence. He erred in law in making impermissible assumptions that had no evidential underpinning.

(iii) The arbitrator erred in adopting a "comparator" valuation method when he has found, as a matter of fact, that there were no suitable comparators. Whilst in principle the choice of method of valuation was for the arbitrator he erred in law in reaching a valuation which had no evidential basis.

Submissions for the petitioner

Ground 1

[7] The arbitrator had erred in law in treating the petitioner as a hypothetical bidder. There was no provision in the contract which permitted or required that assumption to be made. Furthermore, the assumption made by the arbitrator was contrary to the "reality principle", which is a well-established criterion in the context of valuation exercises. The arbitrator had been addressed on the relevant principles concerning contractual interpretation and on the reality principle. He erred in law by failing to correctly apply these principles. The starting point was the correct interpretation of clause 6.4.1 of the lease.

Reference was made to the relevant principles on contractual interpretation recently addressed by the Inner House in *Scanmudring AS* v *James Fisher MFE Ltd* 2019 SLT 295. In the present case, the enquiry should start and finish by asking what is the ordinary meaning of the words used. It was acknowledged that the court can in appropriate cases use the concept of business common sense as a tool to aid construction. However, business or commercial common sense should not be an integral part of ascertaining the intention of the parties in the present case and in any event reference to business common sense was not determinative.

[8] Clause 6.4.1 required the arbitrator to assume "vacant possession" when determining the Price. There was then a list of assumptions that had to be made. At no point was it stated that the valuation should proceed on the assumption that the party exercising the option (the petitioner) will be a hypothetical purchaser. If that had been the intention of the parties, it would have been stated in the contract. The petitioner's position was consistent with the requirement that the valuation takes place on the basis of a hypothetical "willing purchaser" purchasing in the "open market". There was no assumption that required the special characteristics of the petitioner to be considered. An interpretation of clause 6.4.1 which imported the petitioner as being a potential hypothetical purchaser was contrary to the wording of the clause. The clause required the valuation to proceed on the assumption that there is vacant possession, ie that the option has not been exercised by the petitioner. A hypothetical purchaser cannot be invested with the qualities of the actual purchaser, but that was what the arbitrator has done. To do so required a conflation of the hypothetical sale and the real sale. Any such construction would not accord with commercial common sense. It would amount to an impermissible rewriting of the terms of the contract.

[9] The respondent's contention, that the reference to "open market" is wide enough to include the petitioner, impermissibly viewed those words in isolation from the rest of the provision in the context of the document as a whole, particularly the terms as to the exercise of the option. The necessary logical consequence of the option not having been exercised, and the assumption of vacant possession, was that the petitioner has met its housing needs by other means. To do otherwise would ignore the requirement to assume the option has not been exercised. It would involve a conflation of the hypothetical sale with the actual sale. The arbitrator went further and hypothesised as to what the petitioner would have done but for the exercise of the option; in effect he had assumed that it would have done nothing. There was no basis for any such assumption to be made. The contractual provision, properly construed, required the arbitrator to disregard the steps the petitioner may have taken had the option not been exercised. These erroneous assumptions underpinned the arbitrator's assessment of the value of the premises and the discount that was applied. For those reasons alone, the award should be set aside.

[10] Turning to the reality principle, it was well established that the hypothetical purchaser should not be invested with the qualities of the actual purchaser. If a value is to be determined on the basis that an option has not been exercised, then there is no basis to assume that the party with the option will be a hypothetical purchaser. The arbitrator rejected this standard analysis when he assumed that the petitioner could be treated as a hypothetical bidder for the premises. The case of *Cornwall Coast Country Club* v *Cardgrange Ltd* [1987] 1 EGLR 146 vouched these propositions. In that case the court held that the incumbent could not be deemed a hypothetical tenant. The rent review provision required the valuer to assume that the lease had come to an end and the court held that further "hypothetical assumptions" were not appropriate. Such assumptions could only be made if

the contract or instrument demanded that further assumptions were necessary. When applied to the present case, clause 6.4.1 of the lease required the valuation to proceed on the basis of vacant possession. There was therefore a hypothetical assumption that the petitioner did not exercise the option whereas in fact it did. There was no further provision which made any stipulation about what the petitioner would have done but for the exercise of the option. The arbitrator made the type of further assumption that Scott J warned against in *Cornwall Coast Country Club*. In particular the arbitrator assumed that the petitioner had done nothing to seek alternative accommodation since the assumed failure to exercise the option. There was no provision in clause 6.4.1 which permitted the arbitrator to go on to speculate as to what the petitioner would have done but for the exercise of the option. There was no provision which permitted the arbitrator to treat the petitioner as a potential hypothetical bidder and he therefore erred in law. The respondent's contentions about the *Cornwall Coast Country Club* decision were incorrect.

[11] Reference was made to *Harbinger Capital Partners* v *Caldwell* [2013] EWCA Civ 492 and *Trustees of Sloane Estate* v *Mundy* [2018] EWCA Civ 35. The normal rule on valuation cases is that the existing tenant should be excluded: *Woodfall: Landlord and Tenant* (para 8.029). Reference was also made to *First Leisure Trading* v *Dorita Properties* [1991] 1 EGLR 133 and *British Airways plc* v *Heathrow Airport* [1992] 19 EG 157. In these cases the fact that the actual lessee was also the tenant of an adjacent property, gave him an independent interest in the market and there was nothing in the vacant possession assumption which required the valuer to ignore that interest. In the present case, the arbitrator had disregarded the legal principles in the case law and fundamentally misunderstood the reality principle. While the arbitrator had stated that the exercise of the option should be ignored, his subsequent analysis failed to follow this through. There was

no basis for further speculation as to what the petitioner would have done next. An assumption that the petitioner would be a hypothetical purchaser conflicted with the reality principle. The respondent's submission that the arbitrator had found as a matter of fact that the petitioner was part of the market was flawed. It confused the hypothesis with reality. In the hypothetical world it was not appropriate to make findings of fact in the sense alluded to by the respondent. In any event, there was no finding of fact as to what the petitioner would have done in the hypothetical world, because the petitioner's evidence on that was ignored and the arbitrator simply assumed it has done nothing.

Ground 2

[12] If, contrary to the submissions just made, the arbitrator was entitled to consider the issue of whether the petitioner was a potential hypothetical purchaser, he had erred by making an impermissible assumption that the petitioner would be in the market for numbers of properties similar to the premises. The open market must be, so far as possible, a market that corresponds with reality. The arbitrator had made an implicit assumption that the petitioner had done nothing to satisfy its demand for housing and accordingly was in the market as a hypothetical purchaser. He erred in law in attributing these hypothetical qualities to the petitioner which did not accord with the real world and were not required by the terms of the lease. He regarded the petitioner's evidence on what its alternative actions might have been had it not exercised the option as irrelevant. The arbitrator could not proceed on the mere assumption that the petitioner would be a hypothetical purchaser without making findings in fact that supported this position. He failed to consider the relevant evidence. This arose from the arbitrator having misdirected himself in relation to the applicable legal principles. This was an error of law: *SS* v *Secretary of State for the Home Department* [2010] CSIH 72. He proceeded upon a misconstruction of the evidence. Having

failed to consider the petitioner's evidence in relation to its actual housing needs, he reached conclusions which had no evidential underpinning. His approach demonstrated that he misunderstood and/or misapplied the reality principle. The simple point was that, if the arbitrator was entitled to hypothesise about what the petitioner would or would not have done, he required to do so based on the evidence.

Ground 3

[13] The arbitrator held, as a matter of fact, that the circumstances in the present case were unique. He also found as a matter of fact that there were no suitable comparators. Nonetheless, he proceeded to determine the price on the basis of a comparison method. There were no findings in fact which justified this approach. Accordingly, there was no basis for the arbitrator to determine the price on the basis of a "comparison method" valuation. This was a plain error of law.

Submissions for the respondent

Ground 1

[14] On a proper interpretation of the lease the arbitrator clearly was entitled to find that the petitioner was a potential purchaser in the hypothetical market required by the lease. In relation to contractual interpretation, reference was made to *Wood* v *Capita Insurance Services Ltd* [2017] AC 1173 and *Rainy Sky SA* v *Kookmin Bank* [2011] 1 WLR 2900. An interpretation which produces a more commercially sensible result is to be preferred. The purpose of the option mechanism was to allow the petitioner to buy the premises at the full price, that is, the open market price. There was nothing in the circumstances of the option to think the petitioner would be expecting to pay a reduced price. To exclude from the market the presence of one of the principal parties who would want to buy the premises was to

envisage an artificially reduced price. Fixing the price only in relation to others was unattractive and did not make commercial sense. There was nothing in the words of clause 6.4.1 which either expressly or by implication excluded the petitioner from being a potential purchaser in the open market, if its presence was established on the facts. If the parties had intended to exclude such a potential purchaser one would have expected that to be clearly expressed. The phrase "open market" strongly indicated that it was the parties' intention that anyone who would be in the hypothetical market desiderated by the lease ought to be taken into account. The parties also contracted in the lease against the background of the then current 1997 RICS Valuation Guidelines which contain a very wide definition of open market value. These indicate that at the time of contracting the parties would have expected the hypothetical market to include all potentially interested parties.

[15] The lease had to be viewed in the context of the earlier contract entered into whereby the respondent undertook to design, build, fund, maintain and operate a substantial number of residential units for the petitioner and to provide building and other services for a twenty-year period. The lease was for that twenty-year period and had a peppercorn rent. If the option to purchase was exercised the petitioner was to pay the price calculated as against the open market. In these circumstances commercial sense would suggest that the parties would have intended the respondent would be paid the full value for its property. There was no commercial reason why it should be paid a price below that full value based on an artificially restricted version of the market. If the arbitrator was to find that as a matter of fact the petitioner would have been in the market, it did not make commercial sense to suggest that the parties intended to exclude the petitioner from the market. The hypothesis of vacant possession on the option date necessarily involved a hypothesis that the petitioner had not exercised its option and bought the premises on the option date. The

reference to "vacant possession" in the lease did not impute a meaning that the petitioner should be excluded from the market. The ordinary meaning of that expression is to express an intent that the valuation should be undertaken without any value being attributed to the existence of legal rights or obligations of any tenants or sub-tenants under the lease. Given that the assumption of vacant possession meant that the petitioner had not exercised its option, it was open to the arbitrator to assess it as part of the hypothetical market. The arbitrator had not invested the hypothetical purchaser with the qualities of the actual purchaser. Rather, he had found as a matter of fact that the petitioner was part of the market.

[16] *Cornwall Coast Country Club* v *Cardgrange* did not assist the petitioner. That case related to its own complex facts, as stated in *First Leisure Trading* v *Dorita Properties.* That case, and *British Airways plc* v *Heathrow Airport*, made it clear that there is no general principle that an existing lessee has to be excluded from the open market, which is normally the hypothetical market, in ascertaining the appropriate market rent in a rent review. Regarding the petitioner as a purchaser in the hypothetical open market did not extend the hypotheses beyond those required in the lease. As to the reality principle, it was clearly explained by the majority in *Harbinger Capital Partners* v *Caldwell*. The *ratio* of *Trustees of Sloane Estate* v *Mundy* did not support the petitioner. In any event, even on the petitioner's view of the reality principle the arbitrator's decision did not fall foul of it. Finding as a matter of fact that the petitioner would have been within the hypothetical open market did not require any illegitimate hypothesis.

Ground 2

[17] The petitioner's criticism articulated in ground 2 was without foundation or merit. The relevance of evidence is not a point of Scots law in respect of which appeal is permitted

by rule 69 (1) of the Scottish Arbitration Rules. Rule 28(1)(c) made clear that the relevance of evidence was a matter for the arbitrator. In any event, having identified the correct legal principle the application of it was a matter for the arbitrator and not a point of law. Reference was made to *Benaim (UK)* v *Davies Middleton & Davies* [2005] EWHC 1370 (TCC). But even if it was a point of Scots law, the arbitrator did not err in law in excluding the evidence as to what the petitioner would have done if it had decided not to exercise its option. The arbitrator had regard to the real world facts as to what the petitioner's demand for housing was at the option date, on the hypothesis demanded by the lease. He quite properly declined evidence hypothesising what steps would have been taken by the petitioner more than a year prior to the option date and about the potential consequences, if any, of this hypothetical action. In any event, the evidence was not material. The evidence would not have been able to lead to a finding that the petitioner would have met its needs as at the option date.

Ground 3

[18] This ground of criticism was both ill-founded and without merit. The question of which comparison method is chosen was not a question of law but a matter for the arbitrator. Reference was made to *Trustees of Sloane Estate* v *Mundy* and *City of Aberdeen Council* v *Bredero Centre* 1998 SC 269. In any event, although the arbitrator found that there was no transactional evidence in relation to a similar size of portfolio in a comparable location being sold as one unit, he proceeded to use the comparator of the total value of all the individual units, on which he had much evidence. He proceeded on the basis of the comparator evidence which was available to him.

Decisions and reasons

Relevant legal principles

Construction of the contract

[19] In *Arnold* v *Britton*, Lord Neuberger (with whom Lord Sumption and Lord Hughes agreed) set out the key principles on contractual construction, including the following:

> "15. When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to 'what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean', to quote Lord Hoffmann in *Chartbrook Ltd* v *Persimmon Homes Ltd* , [2009] AC 1101, para 14. And it does so by focussing on the meaning of the relevant words ... in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions."

He added:

> "17. … The exercise of interpreting a provision involves identifying what the parties 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. And, again save perhaps in a very unusual case, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision."

This approach, as is widely known, fits with a number of other authorities (eg *Rainy Sky* v *Kookmin Bank Co. Ltd* and *Wood* v *Capita Insurance Services Ltd*) and is commonly applied by the Scottish courts (eg *Scanmudring AS* v *James Fisher MFE Ltd, HOE International Ltd* v *Andersen*; *British Overseas Bank Nominees Ltd* v *Stewart Milne Group Ltd 2019 SLT 1253*; *Ashtead Plant Hire Company Limited* v *Granton Central Developments Limited* [2020] CSIH 20; *Midlothian Council* v *Bracewell Stirling Architects* [2018] CSIH 21). The role of commercial common sense primarily concerns the situation in which there are two possible constructions and one is to

be preferred as being more consistent with commercial common sense: *Rainy Sky* v *Kookmin Bank Co. Ltd; Midlothian Council* v *Bracewell Stirling Architects*. However, as Lord Neuberger explained in the passage above the parties have control over the language used, which is a paramount consideration, and as others have observed (eg Lord Reed in *Credential Bath Street Ltd* v *Venture Investment Placement Limited* 2008 Hous LR 2 at [24], and Lord Hodge in *Wood* v *Capita Insurance Services Ltd* at [28]) the concept of commercial common sense has certain limitations. In the present case, both parties contend that their preferred interpretation is the commercially sensible construction. I shall explore that matter below when I come to apply the relevant legal principles, but only after considering the natural and ordinary meaning of the language in the provision.

The valuation cases

[20] As was explained by Lewison LJ in *Harbinger Capital Partners v Caldwell*:

> "22. There are many areas of the law in which an amount is to be ascertained by postulating a hypothetical transaction of one kind or another. Rating is perhaps the oldest example, for which purpose rateable value was measured by postulating the hypothetical grant of a tenancy from year to year. But hypothetical transactions abound in other areas of the law: for example compulsory acquisition, taxation and rent review clauses. Sometimes the hypothesis is statutory and sometimes it is contractual. The courts have developed a well-established set of principles that apply to both kinds of case. The most important of these is that things are to be taken as they are in reality on the valuation date, except to the extent that the instrument postulating the hypothetical transaction requires a departure from reality. In the old cases this is summarised in the Latin phrase *rebus sic stantibus*. In the more modern cases it has been described as the principle of reality: *Hoare v National Trust* (1998) 77 P & CR 366."

Given the close similarity of the language used in rent review clauses in commercial leases and the language used in relation to valuation in the present case, I accept that the cases referred to by the parties provide assistance here. Lewison LJ went on to make these comments:

> "23. The following points amplify the reality principle:

i) The hypothesis is only a mechanism for enabling one to arrive at a value of particular property for a particular purpose. It does not entitle the valuer to depart from the real world further than the hypothesis compels: *Hoare v National Trust*, 380 (Schiemann LJ). The various hypotheses must be taken no further than their terms make strictly necessary: *Cornwall Coast County Club* v *Cardgrange Ltd* [1987] 1 EGLR 146, 152. It is necessary to adhere to reality subject only to giving full effect to the hypothesis: *Hoare* v *National Trust*, 387 (Peter Gibson LJ).

ii) Giving effect to the hypothesis may require a legal impediment to the implementation of the hypothesis to be ignored or treated as overridden; but only to the extent necessary to enable the hypothesis to be effective: *IRC* v *Crossman* [1937] AC 26; *The Law Land Company Ltd* v *Consumers' Association Ltd* [1980] 2 EGLR 109; *Walton* v *IRC* [1996] STC 98.

iii) The world of make-believe should be kept as near as possible to reality: *Trocette Property Co Ltd v GLC* (1972) 28 P& CR 408, 420 (Lawton LJ); *Hoare* v *National Trust*, 386 (Peter Gibson LJ). Reality must be adhered to so far as possible: *Cornwall Coast County Club* v *Cardgrange Ltd*, 150 (Scott J). The valuer should depart from reality only when the hypothesis so requires: *Hoare* v *National Trust*, 388 (Peter Gibson LJ).

iv) Where the hypothesis inevitably entails a particular consequence, the valuer must take that consequence into account: *East End Dwellings Co Ltd* v *Finsbury BC* [1952] AC 109, 132.

v) But there is a clear distinction between hypotheses expressly directed to be made and assumptions allegedly consequential on the express hypotheses. Where the alleged consequence is not inevitable, but merely possible (or even probable), then the consequence cannot be assumed to have happened: *Cornwall Coast County Club* v *Cardgrange Ltd*, 149 (Scott J).

vi) The reality principle applies as at the valuation date. Events which postdate the valuation date cannot generally be taken into account…"

While Lewison LJ gave a dissenting judgment, Beaton LJ and Mummery LJ did not contest what he had said about the reality principle, but instead viewed the meaning of the language in the provision as the key issue. In *Trustees of Sloane Estate* v *Mundy*, Lewison LJ referred back to what he had said in *Harbinger* v *Caldwell* about the reality principle, expressing similar points in summary form.

[21] In understanding the reasoning in the cases to which the parties referred, it is also worth considering an earlier decision, *F R Evans (Leeds) Ltd* v *English Electric Co Ltd* (1977) 36 P & CR 185, in which Donaldson J made some helpful observations. He said (at 189-190)

> "Similarly, in my judgment, the willing lessee is an abstraction—a hypothetical person actively seeking premises to fulfil needs which these premises could fulfil. He will take account of similar factors, but he too will be unaffected by liquidity problems, governmental or other pressures to boost or maintain employment in the area and so on. In a word, his profile may or may not fit that of the English Electric Co. Ltd., but he is not that company."

He added (at 191):

> "I reject entirely the proposition that the potential lessee either is, or necessarily has any of the characteristics of, the English Electric Co. Ltd. He is a complete abstraction, and, like the mule, has neither pride of ancestry nor hope of posterity. He is someone whose needs are such that, in relation to the Walton Works, he is a willing lessee."

Put shortly, Donaldson J was making the point that the hypothetical person is not the real person, that is, the actual lessee.

[22] Under reference to Donaldson J's decision, in *British Airways plc* v *Heathrow Airport* Mummery J stated (at 144 H-J):

> "That does not mean, however, that the actual lessee is necessarily excluded from consideration as a potential lessee of the property…there is no principle of law which requires the valuer to assume that a lessee is not a potential hypothetical lessee of the relevant property."

It could be said that this does not fit with Donaldson J's clear position about the actual lessee not being the hypothetical lessee. There could also be similar reservations about Vinelott J's comments in *First Leisure Trading* v *Dorita Properties* (at 136 H-J) where he seeks to explain Donaldson J's treatment of English Electric Co. Ltd as based upon evidence that it had excluded itself from being a hypothetical lessee. However, when *British Airways plc* and *First Leisure Trading* are each read as a whole, it is appropriate to view the analysis as not that the actual lessee is personally treated as a potential hypothetical tenant, but rather that

on the facts the valuer or arbitrator may find that the hypothetical lessee is a person in the same factual position as the actual lessee. I develop this point below.

[23] It is important to recognise that the cases relied upon by the parties concern quite distinctive facts and circumstances. In *Cornwall Coast Country Club* v *Cardgrange Ltd* the existence of a gaming licence was contended to be a material factor in the valuation exercise. Scott J stated that "Many of the complications in the rent review arise, directly or indirectly, from the fact of Crockford's gaming licence in respect of [the premises]". In *First Leisure Trading* the premises which were the subject of the rent review were on the ground floor of a building and the floor above formed part of a hotel leased by the same tenant. In *British Airways plc* one issue was whether the fact that the plaintiff was the tenant of the first premises located at an airport should be disregarded when assessing the rent for the second premises also located at the airport. However, when one leaves aside the specific considerations and observations made in these cases which relate to their distinct facts, and consideration is given to Donaldson J's observations noted above, there are several reasonably clear principles that emerge from these authorities. For present purposes, these can be summarised as follows. Firstly, the well-established principles of contractual construction apply. Secondly, the purpose of a rent review clause is to ensure that the rent payable reflects changes in the value of money and the value of the premises let (*British Airways plc,* at 144E). Thirdly, the court should be alert to the danger of confusing reality and hypothesis (*Harbinger*, quoted above). The only relevant hypotheses are those agreed by the parties in the provisions in the lease. Any hypothesis should be taken no further than is strictly necessary (*Cornwall Coast Country Club,* at 152J, *British Airways plc*, at 144F-G). Fourthly, the hypothetical lessee is not the actual lessee in actual occupation of the property (*British Airways plc*, at 144H) and so he does not have any of the personal characteristics of

the actual lessee which might operate to increase or decrease the rent which he would be willing to pay (*F R Evans (Leeds) Ltd*, at 189-191; *British Airways plc*, at 144H). Fifthly, there is no principle of law which requires the valuer to assume that the actual lessee is not a potential lessee (*First Leisure Trading*, at 137M; *British Airways plc*, at 144 J). However, sixthly, as a qualification on the last point, the identity or characteristics of the actual lessee are neither here nor there, but the factual circumstances relating to the actual lessee's reasons for being the tenant may well be relevant. Thus, in *First Leisure Trading* it was said (at 138F):

> "…the arbitrator is not required to assume either that First Leisure is or that it is not a possible hypothetical tenant. But he is entitled to find as a fact that a lessee of the Greyhound Hotel, *whoever he might be*, would be a potential tenant" [emphasis added].

Properly understood, this is making clear that it is the actual needs or interests of a person that results in him being regarded as a potential tenant. If he happens also to be the actual lessee, that is neither here nor there. In *Cornwall Coast Country Club*, there was no such factual basis and the only ground for treating the actual lessee (Crockford's) as a possible hypothetical tenant was the building of hypothesis upon hypothesis, or, as it was put, having Crockford's "invested with fictitious qualities and fictitious circumstances", rather than having a factual basis for it having an interest. Interestingly, in that case (at 152 G-H) Scott J said that if the actual lessee is included in the market then the hypothetical lessee must outbid the actual lessee. This supports the view that Scott J regarded the hypothetical lessee as a different and imaginary entity. It is also important to note that Scott J had stated (at 149 C-D) that

> "… for the purposes of the sublease rent review the hypothetical lessee will be a person anxious to use 30 Curzon Street as a casino and anxious to obtain as soon as possible the necessary consent and gaming licence that, on the rent review date, December 8 1983, he does not hold".

When Scott J later came to reject the assumption that Crockford's itself (that specific entity) would be in the market for the premises if vacant, he was not departing from the earlier position that those wishing to use the premises as a casino would be in the market. He was simply ruling out the personal characteristics of the actual lessee.

[24] Distilling these points and viewing the valuation exercise generally, unless the relevant provisions state otherwise the valuer or arbitrator should assess the strength of the market. He should consider the hypothetical persons who would be actively seeking premises to fulfil their needs, which the premises in question could fulfil. He should not invest the hypothetical tenant with the characteristics of the actual tenant. He should disregard the identity of the actual lessee, for two primary reasons. Firstly, the personal characteristics of the actual lessee are of no relevance. Secondly, the hypothetical lessee can in any event, if the facts thus indicate, be treated as being in the same position as the actual lessee. Thus, in *First Leisure Trading* the actual tenant of the hotel (whoever he is) may have an interest in the other parts of the building and in *British Airways plc* the actual tenant of the first premises (whoever he is) may have an interest in the second premises. The decision on whether such facts affect the valuation is one for the valuer or arbitrator. However, if an arbitrator does not in his award disregard the identity of the actual lessee, but bases his views on the factual reasons why the actual lessee may have an interest in the premises rather than any personal characteristics of the actual lessee, then naming the actual lessee makes no difference: a person, whoever he is, having that factual interest can be viewed as a hypothetical lessee.

Application of these principles

Ground 1

[25] Each side made the point that if the other side's position about what was agreed was correct it would have been the subject of provision in the agreement. I see no real force in these submissions; we are concerned with the meaning of the words used. On behalf of the respondent, certain background circumstances were identified and said to have a potential bearing on the construction of clause 6.4.1. These included the prior contract between the parties and the circumstances pertaining to its operation. Reference was also made in submissions to the 1997 RICS Valuation Guidelines. While the petitioner raised no specific issue as to these background circumstances not being part of the shared knowledge of the parties prior to contracting, I do not regard them as being of any assistance in relation to the construction of the terms of clause 6.4.1. In particular, they do not impact upon the meaning of any of the words actually used. In relation to the RICS guidelines, which the petitioner accepted formed part of the background, these were not mentioned in the lease and do not supply any relevant material for the purpose of the assumption of vacant possession.

[26] I turn then to the language used in clause 6.4.1, the key part of which is the reference to "…the price which would be likely to be paid by a willing purchaser to a willing vendor in the open market at the Option Date for the Premises as a whole with vacant possession…" In my opinion, the reference to the open market does not of itself provide support for the respondent's contention that the petitioner could be treated as a hypothetical purchaser. I accept that the phrase supports the view that anyone who would be in the hypothetical market desiderated by the lease ought to be taken into account, but the key point is whether there is a basis for treating the petitioner as part of the market. I note that in, for example, *First Leisure Trading*, *British Airways plc* and *Cornwall Coast Country Club* the clauses in

question each referred to the open market, but that phrase was not viewed in those cases as adding anything of substance to the meaning to be reached. The key points which build the hypothetical situation are the "willing seller", "willing buyer" and the reference to "vacant possession" and it is the latter phrase which is of crucial importance. In line with the reality principle and the approach taken in the authorities, the hypothesis based on the expression "vacant possession" should be taken no further than is strictly necessary. The only consequences of the assumption to which regard should be had are those which are inevitable. In the present case, those are limited to the petitioner no longer being in occupation at the option date and, inevitably, having therefore given the necessary notice at least one year and one day in advance. But the hypothesising ends there. It does not extend into what the petitioner would or would not have done in that hypothetical situation. Various possibilities might have existed, but there was no further inevitable consequence. Senior counsel for the petitioner did not insist on a point made in his Note of Argument that the assumption of vacant possession was that the petitioner had met its housing need by other means. Going any further than the assumption that the petitioner no longer occupied the premises and also that it had given notice in advance would invest the situation with fiction, beyond that necessary assumption and its inevitable consequence.

[27] The petitioner seeks to found on this by contending that the arbitrator hypothesised that the petitioner had done nothing. In my view, that argument must fail. The arbitrator made no such finding, nor did he implicitly proceed on that basis. All that he did was to limit himself to the hypothesis in question, which was the correct approach. Consequences which were merely possible or even probable were not assumed to have happened. Instead, he properly restricted himself to taking the hypothesis no further than was strictly necessary. This is the approach taken in the rent review cases, where the vacant possession

assumption is applied but the consequences of it are not speculated upon, such as whether the lessee, who on the hypothesis of vacant possession would have decided to leave the premises and have been faced with a decision of what to do next, would have left the market by going elsewhere. In cases such as *First Leisure*, where the facts support the proposition that a hypothetical lessee in the same position as the actual lessee would be in the market, the same point as was made by the petitioner in the present case could be argued: that this assumes that he moved out but had then done nothing. There is no support in the authorities for that approach. The fact that proceeding solely on the basis of the hypothesis and otherwise on reality could be viewed as being consistent with the petitioner having done nothing is neither here nor there.

[28] It is correct that the arbitrator expressly stated that the petitioner "… as a hypothetical bidder forms part of the hypothetical market". Interestingly, he also stated that the petitioner "*as an hypothetical entity* can be taken into account … and deemed to be a hypothetical bidder in the hypothetical market …" [emphasis added]. Viewing the petitioner itself as a hypothetical bidder might be argued to run counter to the approach take in *F R Evans (Leeds) Ltd* and also in *Cornwall Coast Country Club.* These cases seem to me to proceed on the basis that the hypothetical lessee is an abstraction and not a real person, legal or natural. In short, they take a strict approach to the concept of a hypothesis; it is something imagined rather than real. It appears that the line taken in the other cases (such as *First Leisure* and *British Airways plc*) is that the hypothetical lessee or bidder can include the actual person. But as I have noted above, this is a distinction without any real difference, so long as the valuer or arbitrator ignores the personal characteristics of the actual person and focuses on the facts which allow a hypothetical person in the same factual position as the actual person to be viewed to be in the market.

[29] In the present case, it was accepted by the respondent that the arbitrator treated the petitioner as a potential bidder in the hypothetical open market. It might be said that the arbitrator regarded the petitioner, as he expressly put it (quoted above), as "an hypothetical entity" to be viewed as "a hypothetical bidder" and that he was therefore not treating the petitioner itself as the hypothetical bidder. But, on balance, other statements made in the award justify the respondent's concession. Proceeding on that basis, for the reasons I have given the reference to identity is of no consequence if the true basis for including the person in the market is factual. Here, as matter of fact, the basis is quite independent from the petitioner being the actual purchaser. As the evidence made clear, the petitioner was running an activity in the local area which required a substantial number of personnel and their families to be accommodated. So, in assessing the strength of the market, the arbitrator had to have regard to the things which would cause such an entity to be interested in the premises, based on the needs of that entity and whether the premises would fulfil those needs. The evidence showed that the petitioner's influence and demand for housing had considerable impact within the market. Where an entity carries on an activity in the local area which requires substantial housing accommodation, the entity may well be viewed as in the market. While it could be said, strictly speaking, to be wrong to view the petitioner itself as the hypothetical bidder, such an entity carrying on such an activity could, on the facts, be regarded by the arbitrator as being in the market. In short, the existence of this activity being carried on in the local area has similar effects to, for example, the lessee of the hotel (whoever he is) in *First Leisure* having a lease of adjoining premises: it is a relevant factual matter.

[30] I reach that conclusion based upon the terms of the relevant provisions in the lease, and assisted by the discussions in the authorities. It does not found upon any view being

reached on commercial common sense. If it had been necessary to take that factor into account, it would have supported the conclusion reached. It makes more commercial common sense to include within the market an entity (whoever it is) which is running a significant activity in the local area and requires substantial accommodation for that purpose. If that entity also happens to be the actual purchaser, then so be it.

Ground 2

[31] This ground proceeds on the basis that, if ground 1 fails, the arbitrator had made another impermissible assumption that the petitioner would be in the market for numbers of properties similar to the premises. The simple point was that, if the arbitrator was entitled to hypothesise about what the petitioner would or would not have done, he required to do so based on the evidence. This argument fails because the arbitrator was not entitled so to hypothesise and did not do so. He simply restricted the assumptions to those which were required. He did not misdirect himself on the legal principles. Given that he approached matters on the basis of the correct legal principles, an incorrect application of them to the facts is not an error of law: *Benaim (UK)* v *Davies Middleton & Davies* [2005] EWHC 1370 (TCC) (at [107]). In any event, he did not incorrectly apply them. I also accept the respondent's position that the relevance of evidence is not a point of Scots law for the purposes of this appeal. Rule 28(1)(b) of the Scottish Arbitration Rules provides that it is for the tribunal to determine the admissibility, relevance, materiality and weight of any evidence. The arbitrator considered and had regard to what he described as "the totality of the evidence" about the petitioner's demand for housing at the "valuation date" on the hypothesis demanded by the lease.

Ground 3

[32] This ground relates to the valuation methodology deployed by the arbitrator in the

valuation of the portfolio of housing as a whole. On that matter, the arbitrator observed that "the evidence before me is anything but ideal". He concluded that "the Comparison method is to be preferred if judiciously applied". This approach "though not perfect does possess the benefit of taking an objective view on far fewer variables" than the approach presented at the arbitration on behalf of the petitioner. He observed that the case "produces evidentially a unique situation". Ultimately, he concluded that the Option Price could "best be computed on the 'Comparison method' (as advanced by the Respondent) but, in contrast, applying what I judge a significant discount …" The petitioner contended that there were no findings in fact which justified this approach of determining the price on the basis of a "comparison method" of valuation. However, while the arbitrator found that there was no transactional evidence in relation to a similar size of portfolio in a comparable location being sold as a whole, he used as the comparator the total value of all the individual units, as set out in reasonably detailed evidence on behalf of the respondent. The fact that he adopted the label applied by the respondent, describing this as a comparison method, is of little consequence. It is true that he was not comparing like with like, in the sense of a sale of the whole portfolio. But having been given two potential approaches, he rejected that of the petitioner, which was entirely a matter for him to decide upon. He was then left with using a comparator of a sort (albeit one which was decidedly imperfect) which gave an overall value to which he could then apply a suitable discount. Faced with the valuation decision, in a difficult and rare set of circumstances, he worked with what he had available to him. He had a sufficient evidential basis for his findings. I therefore conclude that this ground of appeal must also fail.

Disposal

[33] For these reasons, the grounds of appeal are not well-founded. Accordingly, I refuse the petition and confirm the arbitrator's award.