Hilary Term
[2013] UKSC 3
On appeal from: [2011] CSIH 87: [2011] CSOH 105

JUDGMENT

Lloyds TSB Foundation for Scotland (Respondent) *v* Lloyds Banking Group Plc (Appellant) (Scotland)

before

Lord Hope, Deputy President
Lord Mance
Lord Clarke
Lord Reed
Lord Carnwath

JUDGMENT GIVEN ON

23 January 2013

Heard on 27 and 28 November 2012

Appellant	*Respondent*
Helen Davies QC	Richard Keen QC
Jonathan Barne	Jane Munro
(Instructed by Group Legal, Lloyds Banking Group plc)	(Instructed by Simpson and Marwick)

LORD MANCE (with whom Lord Reed and Lord Carnwath agree)

Introduction

1. The issue on this appeal is how a covenant should be construed and understood as applying in a novel legal and accounting context, which was not foreseen or foreseeable - or was, according to uncontradicted expert evidence, "unthinkable" - when the covenant was entered into.

2. The covenant was contained in a Deed agreed and executed in 1997 between the appellant, then known as Lloyds TSB Group plc and now known as Lloyds Banking Group plc (and which I shall for simplicity call "Lloyds Bank"), and the respondent, Lloyds TSB Foundation for Scotland ("the Foundation"). The 1997 Deed replaced an earlier Deed executed in 1986 and varied by agreement between the parties in 1993. The 1986 Deed was one of four entered into upon the floatation of the TSB Group plc ("TSB") and intended to provide four charitable foundations with payments totalling 1% of the pre-tax profits of the TSB.

3. Under Clause 2 of the 1997 Deed, Lloyds Bank covenanted to pay the Foundation the greater of "(a) an amount equal to one-third of 0.1946 per cent of the Pre-Tax Profits (after deducting Pre-Tax Losses)" for the relevant Accounting Reference Periods and "(b) the sum of £38,920". Clause 1 defined "Pre-Tax Profit" and "Pre-Tax Loss" as meaning

> "in relation to any Accounting Reference Period …. respectively the 'group profit before taxation' and the 'group loss before taxation' (as the case may be) shown in the Audited Accounts for such period adjusted to exclude therefrom any amounts attributable to minority interests and any profits or losses arising on the sale or termination of an operation, such adjustment to be determined by the Auditors on such basis as they shall consider reasonable, which determination shall be conclusive and binding on the parties hereto".

The words "and any profits or losses arising on the sale or termination of an operation" were added to the 1986 Deed by the amendments mutually agreed in 1993, and were maintained in the replacement Deed mutually agreed and executed in February 1997. Clause 1 further defined "Audited Accounts" as meaning, in relation to any Accounting Reference Period, "the audited accounts of the Company and its subsidiaries for that period".

4. The appeal concerns the level of payment to be made to the Foundation on the basis of the Lloyds Bank group's audited accounts for 2009. Those accounts included in the consolidated income statement (the modern equivalent of a profit and loss account) a figure for "gain on acquisition" of over £11 billion, converting a loss of over £10 billion into a figure for profit before taxation of over £1 billion. This unrealised "gain on acquisition" related to the rescue of HBOS mounted by Lloyds Bank in 2008. It was described on p 160 of the accounts as reflecting the difference between, on the one hand, the book value of HBOS's assets written down by (in percentage terms) small "fair value adjustments" and, on the other hand, consideration given by Lloyds Bank of about half that written down fair value. Further insight into the envisaged and likely outcome may be provided by the Group Chief Executive officer's statement under the heading Results Overview on p 11 that

> "we acquired the business at half book value in anticipation of the likely losses resulting from their troubled asset portfolios".

5. However that may be, unrealised profits are not the same as realised profits. There is many a slip "twixt cup and lip", and, not surprisingly, a "gain on acquisition" is not capable at any level of a group's or its members' accounts of being income distributable by way of dividends. Nor is it taxable as income. Indeed, it did not even appear in the income statement of Lloyds Bank itself, where the acquisition was accounted for at cost. At the dates of the various Deeds, it would have been contrary to both the law and accounting practice to include in a profit and loss account an unrealised item like "gain on acquisition". This remained the case until 1 January 2005, on and after which date a change in the law and accounting practice instituted at European Union level required listed companies to make such an entry in their consolidated (but not their individual) accounts, albeit with the different implications already mentioned by comparison with other items in the consolidated income statement.

6. In the present case, therefore, Lloyds Bank maintains that the "gain on acquisition" should be left out of account for the purposes of the 1997 Deed when ascertaining the group's profit or loss before taxation by reference to the audited accounts, while the Foundation maintains that it is no more than one of many items making up a bottom line figure for pre-tax profit or loss, with the result that the group made for those purposes a profit of over £1 billion, rather than a loss of over £10 billion, before taking into account minority interests.

The legal and accounting context

7. To understand the Deeds, it is necessary to place them in the legal and accounting context at the dates when they were executed. In this respect, when the original Deed was made in 1986, amended in 1993 and replaced in 1997, there were two fundamental legal and accounting principles: (a) that a profit and loss account was concerned with ordinary activities before taxation and (b) that only profits realised at the balance sheet date could lawfully be included in the profit and loss account.

8. These principles followed from the Companies Act 1985, itself implementing the Fourth Council Directive 78/660/EEC: see Schedule 4, paras 3(6) and 12a. Schedule 4, para 3(6) of the 1985 Act read:

> "Every profit and loss account of a company shall show the amount of the company's profit or loss on ordinary activities before taxation".

Schedule 4, para 12 read:

> "12 The amount of any item shall be determined on prudent basis, and in particular -
>
> > (a) only profits realised at the balance sheet date shall be included in the profit and loss account; and
> >
> > (b) all liabilities and losses which have arisen or are likely to arise in respect of the financial year to which the accounts relate or previous financial year shall be taken into account …."

Paragraph 91 of Schedule 4 of the Companies Act 1985 provided:

> "Realised profits
>
> 91 Without prejudice to—

(a) the construction of any other expression (where appropriate) by reference to accepted accounting principles or practice, or

(b) any specific provision for the treatment of profits of any description as realised,

it is hereby declared for the avoidance of doubt that references in this Schedule to realised profits, in relation to a company's accounts, are to such profits of the company as fall to be treated as realised profits for the purposes of those accounts in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits at the time when those accounts are prepared."

The like principles applied to group accounts: section 230(1) of the 1985 Act. Their function was to "combine the information contained in the separate balance sheets and profit and loss accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts but with such adjustments (if any) as the directors of the holding company think necessary": Schedule 4, paragraph 61.

9. The position regarding group accounts was shortly to change pursuant to the requirements of the Seventh Council Directive 83/349/EEC due for implementation by 1 January 1988. By amending section 255 of, and introducing section 255A into, the Companies Act 1985, the Companies Act 1985 (Bank Accounts) Regulations SI 1991/2705 required banking companies and banking groups to prepare their accounts in accordance with an amended Schedule 9, rather than Schedule 4, of the 1985 Act. Paragraph 19 of the amended Schedule 9 was however in identical terms to paragraph 12 of Schedule 4.

10. An aspect of these statutory provisions worth brief mention concerns the four prescribed Formats for a profit and loss account prescribed by Schedule 4. Consistently with the requirements of the Fourth Directive (articles 23 to 26), they list a number of items of income and expenditure; after such items, no specific line appears for "profit or loss on ordinary activities before taxation". However, the Formats then proceed (with or without a line identifying the tax) to identify "profit or loss on ordinary activities after taxation", thereafter any "extraordinary income" and, finally, "profit or loss for the financial year". Under the prescribed Formats group consolidated accounts could thus have had no single line correlating with a concept of "group profit before taxation". In fact, the group's 1986 accounts did contain such a line, entitled "Group operating profit before taxation". If they had not done, the "group profit [or loss] before taxation" would have had to be

identified by an exercise in subtraction. The figure would however still be "shown in the Audited Accounts".

11. In contrast, the two permissible Formats introduced by the amended Schedule 9 of the 1991 Regulations had specific lines for "[profit] [loss] on ordinary activities before tax" and for "[profit] [loss] on ordinary activities after tax", followed by lines for extraordinary income or charges, for tax on extraordinary profit or loss, for extraordinary profit or loss after tax and, finally, for profit or loss for the financial year.

12. It is common ground that, before its 1993 amendment, the effect of the original Deed was that "any profits or losses arising on the sale or termination of an operation" were not part of the group profits on which the Foundation's rights were to be based. The problem which arose in October 1992 from the introduction of Financial Reporting Standard 3 was that exceptional income of this nature was from now on no longer to appear below, *but as part of*, "profit or loss on ordinary activities", although its tax treatment remained distinct – that is, because under para 24 of Financial Reporting Standard 3 ("FRS 3") issued October 1992 tax was to be computed on ordinary items as if the extraordinary profit or loss did not exist, and the result then compared with the notional tax charge on the profit or loss after the extraordinary items, with any additional tax charge or credit arising being attributed to the extraordinary items).

13. In the light of FRS 3, the parties to the Deed appreciated that there could be a problem when Lloyds Bank came to sell Hill Samuel Bank and TSB Property Services. As the agreed statement of facts and issues records (para 14):

> "The effect of the amendment was to restore the position in relation to profits or losses arising on the sale or termination of an operation to that which existed prior to the adoption of FRS 3."

The Deed was therefore understood by the parties in 1993 to focus on the line showing "profit [or loss] on ordinary activities". When the parties realised that exceptional items consisting of "profits or losses arising on the sale or termination of an operation" were required to be included in "ordinary activities" they agreed the 1993 amendment to make clear that they were not to count towards the "group profit before taxation" to which the Deed referred.

14. The Foundation submits that this confirms that any legal and accounting change whatever affecting the profit or loss shown in the accounts must be accepted, unless the parties met the change by agreeing a specific exclusion. I do

not agree. I have some doubt whether the exclusion in respect of "any profits or losses arising on the sale or termination of an operation" was actually necessary, bearing in mind their extraordinary nature and entirely different tax treatment. But at least such profits or losses were realised and could in 1993 as a matter of law permissibly be included in the profit and loss account. Assuming on that basis that the exclusion was necessary, and it was certainly a sensible precaution, that says nothing about whether the Deed covers an unrealised "gain on acquisition" arising outside the group's ordinary trading activities, which at the time when it was made could not in law or foreseeably ever have been included in a profit and loss account.

15. The fundamental principles of the Companies Act 1985 were (necessarily) reflected in the Generally Accepted Accountancy Principles ("GAAP") and in Statement of Standard Accounting Practice 22 ("SSAP 22") by reference to which the TSB prepared its accounts. Negative goodwill arising on the purchase of an asset for less than its fair value had to be credited to reserves, increasing shareholder funds, and had no effect on the profit and loss account. When SSAP 22 was replaced by Financial Reporting Standard 10 ("FRS 10") in 1997, the balance sheet treatment of any gain on acquisition was changed, and provision was made for the release (or amortisation) of the gain on acquisition through the profit and loss account in proportion to the value of the non-monetary assets of the acquired company realised by sale or depreciation during the same period. This was consistent with the Companies Act principle that only profits recognised during an accounting period could be included in any profit and loss account. Assets could, in contrast, be included at the lower of cost and current value, with any write downs appearing in the profit and loss account as depreciation, impairment or provision for bad debts.

16. On 19 July 2002 the European Union adopted Regulation 1606/2002. Under article 4, this Regulation led to the fundamental change that listed companies must prepare their consolidated accounts in conformity with International Financial Reporting Standards ("IFRS"), rather than the Companies Act 1985. (Under article 5 the United Kingdom was entitled to permit, and has it appears permitted, such companies to continue to prepare their individual accounts in conformity with the 1985 Act, as well as to permit unlisted companies to continue to prepare their consolidated and individual accounts in conformity with the 1985 Act.) With regards to the consolidated accounts of listed companies, the innovation introduced by para 34 of the relevant Standard, IFRS 3, was to require that in any accounting period starting on or after 1 January 2005 any negative goodwill arising from a "bargain purchase" should for the first time be recognised in the profit and loss account "as of the acquisition date" and measured as the excess of "the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed" (this being measured in turn under para 18 at the fair values of such assets and liabilities) over the consideration paid therefor (and of any non-

controlling interest in the operation acquired). As Mr Simmonds of Deloittes put it before the Lord Ordinary, in an unchallenged passage in his first report (para 5.30), para 34 means that such a "gain on acquisition":

> "is recognised immediately in the consolidated income statement, notwithstanding that it reflects an unrealised gain. It is unrealised at the date of acquisition since the related net assets of the acquired entity, which give rise to the negative goodwill, have not been realised through use or sale (hence they are unrealised)".

It is as a result of this development in the legal and accounting position, unforeseen and unforeseeable in 1986, 1993 and 1997, that the present issue arises.

17. The parties did not discuss or agree any further exclusion following the 2002 Regulation, and the change only became relevant as a result of the well-publicised rescue of HBOS undertaken at short notice by Lloyds TSB Group as the financial crisis threatened mortgage lenders in September 2008. If the 1997 Deed does not require an unrecognised gain on acquisition of this nature to be taken into account in identifying the "group profit before taxation", it is circular to try to draw any inference from the fact that the parties did not renegotiate or amend the Deed. It would also be illegitimate to try to do so, since parties' subsequent conduct cannot, in Scots or English law, construe an earlier contract. In any event, it is clear that neither party actually foresaw the present issue until it arose after the acquisition of HBOS.

The factual background

18. The background to the Deed, which was set out by the Lord Ordinary and about which the Foundation must have been aware, was that the payments made to the Foundation and to the three sister Foundations were made by way of covenants for (in total) about 1% of the group's annual pre-tax profits, because such covenants would represent a charge on income and be a more tax-efficient method of providing income than dividends. The covenant was thus seen as an alternative to the issue of shares and to any payment of dividends or their equivalent. If the profits of all group companies were remitted to the parent, and the parent distributed equivalent sums by way of dividends, there would have been a general equation with the covenanted payments. But, as the table produced by the Dean of Faculty demonstrated, there had over the years been considerable discrepancies in particular years between the group profit before tax and the actual dividend payments made by individual group companies. That is understandable. Individual companies in the group may have resolved to retain profits, rather than distribute

them as dividends. Or they may have distributed dividends at a rate greater than the 1% total contemplated when the covenants in the Deeds were entered into.

19. Dividends must be and are, however, paid out of realised profits, and the Lord Ordinary concluded, after hearing oral evidence, that the change which is said to lead to the result that covenanted payments should be by reference to figures which did not constitute realised profits, and could not at any level in the group constitute distributable or taxable profits, "was not and could not have been anticipated" without "magical powers of foresight", and, if it had been foreseen, would certainly have led the parties to "come up with a different formula to express their basic intention" (paras 37 and 78-79). In short, realised profits equate broadly with sums which the group would have available and which Lloyds Bank could correspondingly make available to pay away.

Analysis of the opposing cases

20. The Foundation's case rests in essence upon the use in clause 1 of the phrase "group profit before taxation" in inverted commas, coupled with the phrase "shown in the Audited Accounts". These words are said, in effect, to tie Lloyds Bank to any similarly phrased line which may from time to time be found in a future year's Audited Accounts, however fundamentally different the basis on which it is arrived at from any which existed or was in mind when any of the Deeds were executed. The present dispute relates, as stated, to the group's consolidated income statement in its audited accounts for 2009. This contains a line reading "profit before tax: 1,042[,000,000]". This, the Foundation says, should be taken without further examination or enquiry. The novel previous line, "gain on acquisition: 11,173[,000,000]", entered pursuant to the demands of Regulation 1606/2002 and IFRS 3, is to be ignored: this, although it represents an entry which could never have appeared in company accounts when the various Deeds were executed or any date until 2005 and which converts a realised loss of over £10 billion into an unrealised profit of over £1 billion. It is, for good measure, also a line which finds no place in the individual company accounts of Lloyds Bank, the group's parent company which actually acquired HBOS. In its accounts, the acquisition of HBOS is entered at cost, making it doubly clear the difference between the group "gain on acquisition" and any realised income by reference to which tax might be paid or dividends declared by Lloyds Bank.

21. The Dean of Faculty forcefully advocated the Foundation's case as reflecting an appropriately mechanical application of the combination of clauses 1 and 3. The description mechanical is appropriate, but the value of machinery depends upon its being correctly directed towards the right end. In this respect, the proper approach is contextual and purposive. That this is so needs today relatively

little citation of authority. As Lord Wilberforce said in *Prenn v Simmonds* [1971] 1 WLR 1381, pp 1383H-1384B

> "The time has long passed when agreements, even those under seal, isolated from the matrix of facts in which they were set and interpreted purely on internal linguistic considerations There is no need to appeal here to any modern, anti-literal, tendencies for Lord Blackburn's well-known judgment in *River Wear Commissioners v Adamson* (1877) App Cas 743, 763 provides ample warrant for liberal approach. We must, as he said, inquire beyond the language and see what the circumstances were with reference to which the words were used, and the object, appearing from those circumstances, which the person using them had in view".

Construing the words "actually paid" in *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, Lord Mustill stated that, in cases not involving a specialist vocabulary, "the inquiry will start, and usually finish, by asking what is the ordinary meaning of the words used" (p 384C-D) and that he had:

> "initially thought that the meaning of the words ['actually paid'] was quite clear, and that the complexities and mysteries of this specialist market had hidden the obvious solution, and had led the courts below to abjure the simple and right answer and to force on the words meaning which they could not possibly bear" (p 384F-G).

But he went on (p 384G-H):

> "This is, however, an occasion when a first impression and a simple answer no longer seem the best, for I recognise now that the focus of the argument is too narrow. The words must be set in the landscape of the instrument as whole".

22. Here, the landscape, matrix and aim of the 1997 Deed as well as its predecessors could not be clearer. They were, when made, and could only have been, concerned with and aimed at realised profits or losses before the taxation which would fall on group companies. The change occurring in 2005 was to introduce negative goodwill into the profit and loss account as a "gain on acquisition", which would not appear in Lloyds Bank's individual company accounts (since the HBOS transaction was there accounted for on a cost basis) and which could never attract taxation. In the light of the legal position of the 1980s and 1990s and the Lord Ordinary's findings on the accountancy evidence (para 19

above), the change was wholly outside the parties' original contemplation, and something which they would not have accepted, had they foreseen it.

23. No-one suggests or could suggest that the change meant that the 1997 Deed was frustrated, so the question is how its language best operates in the fundamentally changed and entirely unforeseen circumstances in the light of the parties' original intentions and purposes: *Bank of Credit and Commerce International SA v Ali* [2001] UKHL 8, [2002] 1 AC 251, *Bromarin AB v IMD Investments Ltd* [1999] STC 301, and *Debenhams Retail plc v Sun Alliance and London Assurance v Co Ltd* [2005] EWCA Civ 868, [2006] 1 P & C R 123. The answer is evident. It operates best, and quite naturally, by ignoring in the 2009 accounts the unrealised gain on acquisition and treating the loss which exists apart from that as the relevant figure for the purposes of clause 2.

24. No principle of construction insists that the words "group profit [or loss] before taxation … shown in the Audited Accounts" can only be satisfied by reference to a single line entry in accounts, however great and unforeseen the changes in law and accounting practice which have in the meantime occurred and whatever the consequences. On the contrary, it is not at all difficult to imagine that, if (as might have occurred between 1986 and 1991: see para 10 above) no single line could plausibly be identified as the "group profit before taxation" and it was necessary to refer to two or more lines to achieve a result marrying with the parties' originally contemplated scheme, the Foundation itself would then be urging that approach.

25. The proper approach as a matter of construction is to identify and use the figures in the consolidated income statement which show the group profit or loss before taxation in the sense intended by the Deed. That means realised profit or loss before taxation, and it excludes a wholly novel element which was included in the income statement by a change which was neither foreseen nor foreseeable and which, had it been foreseen when the Deeds were executed, would not have been accepted as part of the computation of profit or loss. The unrealised "gain on acquisition" thus falls out of account and the balance is the relevant group profit or (on the facts of this case) loss before taxation. In respect of the Accounting Reference Period to which the 2009 accounts relates, it follows that the Foundation receives only the minimum sum of £38,920, rather than the £3,543,333 which on their case results from the unrealised gain (after taking into account £135 million attributable to minority interests in the group).

Consequences of the opposing cases

26. The Dean of Faculty submits that this conclusion would create problems in later accounting periods. No such problems were suggested or investigated when the accountants gave expert evidence before the Lord Ordinary. I would discount the Dean's submission for that reason alone. But I am also in no way persuaded that the submission, now made in the abstract, has any weight. The item "gain on acquisition" is explained in detail in note 14 to the 2009 consolidated group accounts, and represents in the main receivables of HBOS, written down by relatively small (in percentage terms) amounts to what is said to have been a fair value, together with some other financial, tangible and intangible assets.

27. In any future accounts, there would have necessarily to be entries covering any further gain realised, or any further write-down or adjustment for impairment recognised, in respect of such items. This is so, whether the starting point taken is the "fair value" taken as at the balance sheet date of 31 December 2009 or the cost to Lloyds Bank of acquiring HBOS with such assets, which was about half the "fair value" figure. Either way, further profits could be made or further write-downs/impairment could fall to be recognised. So it will necessarily be possible to identify by reference to future accounts the amounts which will on Lloyds Bank's case logically have to be taken into account by way of profit or loss in future years, if the gain on acquisition in 2009 is ignored for the purposes of the Deed.

28. In contrast, the Foundation's case involves striking irrationality. On the Foundation's case, the Foundation is entitled to have the unrealised gains on acquisition of HBOS taken into account in looking for an appropriate figure for "group profit before taxation" in the 2009 accounts. The Dean of Faculty suggested that this was not unfair because, if the unrealised gains did not in fact materialise, that would inure to the Foundation's detriment in the calculation of group profit or loss before taxation in future accounts. But that is very far from the invariable case. First, the Foundation is guaranteed a minimum of £38,920 in every year. In any year when the Lloyds Bank group makes a loss or insufficient profit, and therefore cannot absorb some element of the original "gain on acquisition" realised in that year at less than its original "fair value" to an extent which still yields the Foundation at least £38,920, the Foundation will have benefitted from the original "gain on acquisition", and suffered no equivalent detriment.

29. Second, the unrealised gain was made on the acquisition of all of HBOS. It is logical therefore to examine the position which would arise if all or part of HBOS were sold a year or more later – a classic case of actual realisation of an asset. It is inconceivable that the parties could have intended the Foundation to derive from an unrealised gain a benefit it could not derive from a realised profit. Yet this is precisely what the Foundation's case achieves. If HBOS was sold at a

profit over and above the "fair price" which led to the "gain on acquisition" in the 2009 accounts, the Foundation would not be able to take advantage of that actual realised gain, but the exclusion in clause 3 of "any profits or losses arising on the sale or termination of an operation" would mean that it could keep the advantage of the covenanted payment due, on its case, at the earlier stage of the unrealised "gain on acquisition" of HBOS. Similarly, if the (probably much more likely) scenario arose of a disposal of all or part of HBOS at a price less than the "fair price" which led to the gain on acquisition, the exclusion would mean that the Foundation would not have to bring into account any part of the realised loss which had now replaced all or part of the unrealised "gain on acquisition" of HBOS. These incongruous consequences make to my mind completely untenable the Foundation's case that the phrase "group profit before taxation" must or can refer to a figure derived from an unrealised gain on acquisition.

Conclusion

30. The Lord Ordinary thought that the words "shown in the Audited Accounts" in clause 1 could simply be disregarded. The Inner House was correct to reject that approach. In some contractual contexts, words may have to be disregarded. But so radical an approach is both inappropriate and unnecessary to give effect to the intention of the 1997 Deed, when understood in its context and properly construed. As demonstrated above, the words "shown in the Audited Accounts" are well capable of catering for the present situation, and must on any view be understood as flexible enough to cover situations in which there is no single identifiable line in audited accounts describing "group profit [or loss] before taxation" or anything like it.

31. The Inner House itself failed properly to identify what the parties had in mind by "group profit [or loss] before taxation", at the times when the 1997 Deed and its predecessors were executed. It did not appreciate the significance of the legal and accounting context in which the Deeds were made, and it in effect assumed, contrary to all the indications and regardless of the consequences, that the contract must operate on an entirely literal basis by reference to a single line in whatever accounts might in future be produced in circumstances and under legal and accounting conventions entirely different from those in and for which it was conceived. As a result the Inner House thought that Lloyds Bank's construction would involve "re-writing" the Deed, when in fact it reflects the proper approach, of giving effect to the parties' original intentions in the radically different legal and accounting context which existed by 2009. The Inner House further failed to recognise the incongruity of the result for which the Foundation contends.

32. The issue has been extremely well argued on both sides. For the reasons I have given, I would allow the appeal, and restore the decision of the Lord Ordinary to grant decree of absolvitor, albeit for reasons different to those he gave.

LORD HOPE (with whom Lord Reed and Lord Carnwath agree)

33. Like Lord Clarke, I was inclined at the end of the argument to accept the Dean of Faculty's submission that the phrase "group profit before taxation … shown in the Audited Accounts" in Clause 1 of the 1997 Deed should be given its ordinary meaning. It was, as he said, a simple and straightforward point of reference, which left no doubt as to what was to be taken to be the pre-tax profits for the relevant accounting reference period.

34. But I have been persuaded by Lord Mance's judgment that these words must be read in the light of what a reasonable person would have taken them to mean, having regard to what was known in 1997 when the idea of introducing negative goodwill into the profit and loss account was unthinkable. Read in that context, the words do not have the weight that the Dean's argument would give to them. That would be to give them a meaning which no reasonable person would have dreamed of at that time. The words used are capable of meaning realised profit or loss before taxation, and of excluding elements which would not have been contemplated as having anything to do with the computation of profit or loss when the Deed was executed. On that reading I am left in no doubt that the argument for Lloyds Bank, which accords with the landscape at the time when the words were written, must prevail over that for the Foundation.

35. For the reasons that Lord Mance gives, therefore, I too would allow the appeal. I would recall the Inner House's interlocutor and restore the interlocutor of the Lord Ordinary.

36. Mr Barne for the Bank submitted that, should it fail on the issue of construction, the court should adjust the 1997 Deed by applying to it a doctrine referred to as equitable adjustment. The effect of applying that doctrine, he submitted, would be to exclude the sum brought in for negative goodwill from the calculation of the group's profit or loss before taxation. This would create a loss in the 2009 Audited Accounts, so the amount due to the Foundation for 2009 under clause 3 of the Deed would be restricted to £38,920.

37. The Lord Ordinary recognised, when this argument was before him in the Outer House, that the Bank's success on the issue of construction made it unnecessary for him to deal with it. He had held that the Foundation must fail in its

claim against the Bank in any event. But he dealt with the argument nevertheless and, having examined the authorities, he concluded that there was no such doctrine in Scots law: [2011] CSOH 105, 2012 SLT 13, para 89. The point was raised in the Inner House by way of a cross-appeal. As the First Division decided to reverse the Lord Ordinary on the issue of construction, it had to deal with it: [2011] CSIH 87, 2012 SC 259, para 22. In its view however there was no foundation for the equitable adjustment of contracts, as a generality, in Scots law. Lord President Hamilton recognised the existence of the doctrine, but he said it would be beyond the judicial power to develop it in a way that would assist the Bank in this case: para 29.

38. We are in the same position as the Lord Ordinary. The Bank's success on the main issue makes it unnecessary for us to decide whether a remedy by way of equitable adjustment is available. But the point was dealt with fully in the parties' written cases as well as in oral argument, and it is of some general interest. So I should like to say a word or two about it. Despite Mr Barne's able submissions to the contrary, I have reached the same conclusion as the judges in the Court of Session. I add these few words to explain why.

39. The proposition for which Mr Barne contended was that the doctrine was available where, as a result of supervening events, performance of a contract no longer bears any realistic resemblance to that which was originally contemplated. He made it clear in his written case that it was not his position that it would be impossible to implement the Deed if it were to be construed in the manner argued for by the Foundation. The contract had not been frustrated. Nor was it his case that the court had any general power to adjust or alter contracts to achieve what one or other of the parties might regard as an equitable result. His proposition was a narrow one, confined to a case where the alteration in the circumstances in which the contract came to be performed was affected in a material way by supervening events for which neither party was responsible. There had to be a supervening event which was not foreseen and was not foreseeable when the contract was made, and that event must affect the substance of the contract.

40. The Foundation, for its part, made it clear in its written case that it did not suggest that there was no concept of equitable adjustment in Scots law. It is to be found, for example, where the future performance of a contract is frustrated. The rule in Scots law is that the loss does not lie where it falls on the frustration of a contract. There must be, as *McBryde, The Law of Contract in Scotland*, (3rd ed, 2001), para 21-47 puts it, an equitable adjustment. That was what was done in *Cantiere San Rocco SA v Clyde Shipbuilding and Engineering Co* 1923 SC (HL) 105, [1924] AC 226, where it was held that the buyer was entitled to repetition of the instalment of the price that was paid on signature of the contract as, owing to the war, further performance of the contract had become impossible. As Lord Dunedin explained, at pp 126, 248-249, the remedy for frustration of the contract

was given "not under the contract or because of breach of the contract inferring damages, but in respect of the equitable (of course I am not using the words in the technical English sense) doctrine of *condictio causa data causa non secuta*." It should be noted that the term *causa data causa non secuta* is used today not to describe a remedy as such, but rather to describe one particular group of situations in which the law may provide a remedy because one party is unjustifiably enriched at the expense of the other: *Shilliday v Smith* 1998 SC 725, 728, per Lord President Rodger.

41. The situation that was discussed in *Cantiere San Rocco* is not the situation in this case, as it was not part of the Bank's argument that if the Foundation were to succeed on the interpretation argument its obligations under the Deed could not be implemented. But Lord President Cooper, *Frustration of Contract in Scots Law* (1946) 28 Journal of Comparative Legislation, at p 1, saw frustration of the contract as a by-product of a wider question

> "how the relations of two parties should be equitably readjusted by the Court when the one has been unintentionally enriched at the expense of the other."

He made it clear at pp 4-5 that in his opinion the principle of frustration was capable of being expanded in the future into other areas. In *James B Fraser & Co Ltd v Denny, Mott & Dickson Ltd* 1944 SC (HL) 35, 41, [1944] AC 265, 272, Lord Macmillan (who was counsel for the unsuccessful shipbuilding company in *Cantiere San Rocco*) said that the doctrine of frustration was so inherently just as inevitably to find a place in any civilised system of law:

> "The manner in which it has developed in order to meet the problems arising from the disturbances of business due to world wars is a tribute to the progressive adaptability of the common law."

In *Muir v McIntyre* (1887) 14 R 470 it was held that a tenant was not bound to pay the full rent where, due to no fault of his own, almost the whole of the accommodation on the farm was destroyed by a fire. Lord Shand at p 473 said that the principle on which the tenant was entitled to an abatement of his rent was "founded on the highest equity".

42. These observations provide the background to Mr Barne's submission that, while the concept of equitable adjustment overlapped with unjustified enrichment, it was broader in its application. It was a matter of degree, he said, whether the contract was discharged or was equitably adjusted. It all depended on the extent or

nature of the change. Cases such as *Muir v McIntyre* and *Sharp v Thomson* 1930 SC 1092, where the tenant was held to be entitled to an abatement of his rent upon the partial destruction of the subjects, showed how equitable principles could operate where the contract was not frustrated. It could continue on terms which were adjusted to reflect the changed circumstances. *Rankine, A Treatise on the Law of Leases in Scotland* (3rd ed, 1916), p 227 said that the court will not be confined in adjusting the rights of the parties by any artificial rule that the loss must either be total or at least *plus quam tolerabile*. In *Wilkie v Bethune* (1848) 11 D 132, due to the failure of the potato crop, the farm servant's employer was unable to deliver the potatoes to which the servant was entitled in addition to his money wages. The court fixed a sum which was regarded equitably as the money equivalent of the employer's obligation. The contract had not been frustrated, but the court applied an equitable construction and held the servant entitled, not to his potatoes, but to a sum which would purchase the equivalent of other food: *McBryde, The Law of Contract in Scotland*, para 21-21.

43. This is not the occasion to cast doubt on the ability of Scots law to find equitable solutions to unforeseen problems. Adaptability has a part to play in any civilised system of law, as Lord Macmillan recognised in *James B Fraser & Co Ltd v Denny, Mott & Dickson Ltd* 1944 SC (HL) 35, 41, [1944] AC 265, 272. The way that use has been made of civilian principles to develop the law of frustration of contract in Scots law is a powerful demonstration of that fact. So too is Reinhard Zimmermann's observation that the doctrine of *Wegfall der Geschäftsgrundlage* (collapse of the underlying basis of the transaction), which was formulated in response to the problems posed by the consequences of the First World War, has become part and parcel of the modern German law of contract: *The Law of Obligations*, p 582. It can also be seen in the way strict rules for the interpretation of contracts have been discarded in favour of giving effect to what a reasonable person would have understood the parties to have meant by the language used: see *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [2011] 1 WLR 2900, para 14 per Lord Clarke.

44. That development as to how contracts are to be interpreted is very much in point in this case. It would have created a very real problem for the Bank, had it been necessary for it to rely on an equitable adjustment. The assumption must be that it had to resort to this argument because it had lost on the issue of construction. In other words, the 1997 Deed had been held, by applying that principle of construction, to mean what the Foundation contends it means. The obligation that, so construed, it sets out is not impossible of performance. Can it really be said that it would be appropriate to resort to an equitable doctrine in order that the Deed should mean something else? None of the examples of equitable adjustment that are to be found in the reported cases go that far. And it is hard to see how this the enrichment can be regarded as unjustified, if including the sum for negative goodwill results from the meaning that must be given to the covenant.

45. In *Bank of Credit and Commerce International SA v Ali* [2001] UKHL 8, [2002] 1 AC 251, paras 55- 56, Lord Hoffmann drew attention to the way that 18th and 19th century English judges, when faced with rigid rules of construction which were productive of injustice, resorted to solutions based on what was referred to as an equitable doctrine. But, as he went on to say in para 60, judicial creativity of that kind was to be invoked only if it was necessary to remedy a widespread injustice. Otherwise there was much to be said for giving effect to what on ordinary principles of construction the parties agreed. Those are the principles that have been applied in this case. There surely is no need, if that approach is adopted, to strive to find a basis in equity for arriving at a different result. On the contrary, to do that would be to look for a result which was different from that which the parties must be taken, by placing the words used in their legal and accounting context at the date when the Deed was executed, to have agreed to.

46. There is a place for such a result where the contract has become impossible of performance or something essential to its performance has been totally or partially destroyed, as in the case of leases. But not, as the Lord Ordinary put it in para 92 of his opinion, where a contract is nearly frustrated but not quite. Moreover it could hardly be said that there is anything in this case that could reasonably be described as inequitable if the result were to come down in favour of the Foundation. As the Dean of Faculty pointed out, the unrealised gain on acquisition was due to Lloyds TSB Group's decision to acquire HBOS in January 2009 by which date IFRS 3 had already been issued. The situation which has resulted from this was described by the Bank's expert Mr Simmonds as "unthinkable" when the covenant was entered into. But the acquisition was a voluntary act. It was not something that was beyond the control of either party.

47. For all these reasons I would hold that the proposition that the court can equitably adjust a contract on the basis that its performance, while not frustrated, is no longer that which was originally contemplated is not part of Scots law. To hold otherwise would be to undermine the principle enshrined in the maxim *pacta sunt servanda* which lies at the root of the whole of the law of contract. I see no need for this and, as there is no need for it, I would reject the suggestion that the court should assume that function.

LORD CLARKE

48. I have found this to be a very difficult case. My mind fluctuated a good deal in the course of the argument. At the end of the argument I was inclined to accept the submissions made by the Dean of Faculty on behalf of the Foundation. It then seemed to me that the Deed set out a clear formula which was intended to apply to the relevant circumstances over very many years, that the parties must be taken to

have recognised that there would be likely to be changes in accounting standards over the years and that the purpose of the formula was to leave it to the auditors in each year to set out the "group profit before taxation" and the "group loss before taxation" in the Audited Accounts. It appeared to me that, in these circumstances, since it was clear that the group profit before taxation was the item described as "Profit before tax" in the Audited Accounts for 2009, it followed that the figure of just over £1 billion shown against that item was the "'group profit before taxation' shown … in the Audited Accounts" for the relevant period and that, following the formula set out in clause 2(1) of the Deed, the amount payable by Lloyd's Bank to the Foundation was £3,543,333. That seemed to me to be the result on the natural meaning of the deed.

49. However, having read Lord Mance's judgment, I have now reached the conclusion that that is not the correct result on the true construction of the Deed. I have done so essentially for the reasons he gives. The result is that the relevant amount payable by Lloyds Bank to the Foundation is based on the minimum figure of £38,920 set out in clause 2(1)(b) of the Deed. As Lord Mance explains, the difference between the parties depends upon whether the figure of just over £11.1 billion shown in the accounts as "Gain on acquisition" should be taken into account in arriving at the "group profit before taxation". If it is not taken into account the profit of just over £1 billion is turned into a significant loss of over £10 billion so that only the minimum amount is payable under the Deed.

50. In my opinion a critical aspect of the findings of fact made by the Lord Ordinary in this case, which was based on uncontradicted expert accountancy evidence, is that, when the Deed was entered into, it was unthinkable that the relevant accounting rules would require unrealised profits to be treated as part of "group profit before taxation". The difference between the issue of construction in this case and that in many other cases which have come before the courts is that here the problem is how to construe the contract in the context of changed circumstances which were unforeseeable when the contract was entered into.

51. A similar problem arose in *Debenhams Retail Plc v Sun Alliance and London Assurance Co Ltd* [2006] 1 P & C R 123, where the question was what was meant by "additional rent" on the true construction of a lease. It was common ground that that rent was a proportion of turnover. The question was whether, for the purposes of the lease, turnover included VAT. The problem was that the lease was negotiated in 1965 and VAT was not introduced until 1973 and the regime in force in 1965 was the different purchase tax regime. Mance LJ said this at p 130:

> "… no-one suggests that that the lease cannot or should not apply in the changed circumstances. We have to promote the purposes and values which are expressed or implicit in the wording, and to reach

> an interpretation which applies the wording to the changed circumstances in the manner most consistent with them."

I agree that that is a sensible approach both to that problem and to the problem we have here. I note that in *Bank of Credit and Commerce International SA v Ali* [2002] 1 AC 251 Lord Clyde said, at para 79:

> "Generally people will say what they mean. Generally if they intend their agreement to cover the unknown or the unforeseeable, they will make it clear that their intention is to extend the agreement to cover such cases."

52. Here the parties did not make it clear what the position would be if new accounting rules were made which required unrealised profits to be taken into account. They did not think of such a possibility because it was unthinkable. In my opinion, if, as Mance LJ suggested, we promote the purposes and values which are expressed or implicit in the wording of the Deed in order to reach an interpretation which applies the wording to the changed circumstances in the manner most consistent with them, the better construction of the Deed is that advanced by Lloyds Bank.

53. I will not repeat the detailed reasons given by Lord Mance for that conclusion. For the reasons he gives, I would allow the appeal. I add by way of postscript that I entirely agree with Lord Hope's judgment on the issue of equitable adjustment.