FIRST DIVISION, INNER HOUSE, COURT OF SESSION

[2022] CSIH 33
CA3/21

Lord President
Lord Woolman
Lord Pentland

OPINION OF THE COURT

delivered by LORD CARLOWAY, THE LORD PRESIDENT

in the commercial action

KEIRON DAVID PATERSON

Pursuer and Respondent

against

ANGELLINE (SCOTLAND) LIMITED

Defenders and Reclaimers

Pursuer and Respondent: MacLean; Blackadders LLP
Defenders and Reclaimers: Dean of Faculty (Dunlop QC); Morton Fraser LLP

21 July 2022

Introduction

[1] The pursuer was formerly a director of Keir Pharmacy Limited and its wholly owned subsidiary, A D Healthcare Limited. KPL owned and operated a pharmacy in Denny. ADHL owned and operated two pharmacies, one in Larbert and one in Plean. The pursuer owned 95% of KPL's shares. A senior employee owned the remaining 5%. The defenders acquired the KPL shares in terms of a share purchase agreement dated July 2019. This

reclaiming motion (appeal) concerns a dispute about the calculation of one element of the purchase price. The pursuer claims that it ought to have included the net current assets of each company. The defenders argue that the SPA only permitted the inclusion of the net assets of KPL.

[2] The pursuer pleads alternative cases, one based on an implied term, and the other on rectification.

[3] The commercial judge held that the pursuer had pled a relevant case. By interlocutor dated 12 October 2021, she allowed a proof before answer. She also dismissed a counterclaim which concluded for payment of the amount which would be due to the defenders, should the court reject the pursuer's contentions.

The Contract

[4] Discussions about the transaction took place between the parties in February and March 2019. On 10 May 2019, they agreed non-binding Heads of Terms. They included that the price for the KPL shares was to total £6.4 million made up of specified elements.

[5] Following further negotiations, the parties executed the SPA on 5 July 2019. It provided that the price was to consist of: (i) £5.2 million on completion; (ii) a further payment of £500,000, defined as the "Initial Deferred Consideration", about 7 days after completion; (iii) 60 monthly payments of £3,333.33 or thereby; and (iv) a "Final Deferred Consideration" of £1 million on the fifth anniversary of completion. Completion took place on 5 July 2019. The defenders paid the sums of £5.2 million and £500,000 to the pursuer. A dispute has arisen about the adjustment of the IDC.

[6] Clause 1 of the SPA defines a large number of terms, including:

"Accounts"	the unaudited financial statements of each Group Company comprising the balance sheet, profit and loss account and cash flow statement of the Company, the Group and the Subsidiary … for the financial period …. .
"Actual Net Current Assets"	the excess of Current Assets over the Current Liabilities as disclosed by the Completion Accounts …
"Actual Net Current Liabilities"	the excess of Current Liabilities over Current Assets as disclosed by the Completion Accounts ….
"Completion Accounts"	the balance sheet and profit and loss account of each Group Company for the period from the Last Accounts Date …
"Completion Accounts Statement"	the statement of Actual Net Current Assets or Actual Net Current Liabilities, as appropriate, prepared by the [pursuer's] Accountants derived from the Completion Accounts.
"Initial Deferred Consideration"	the consideration of £500,000 (as a payment to account of any adjustment to the Consideration in accordance with clauses 2.1 and 2.2 of Schedule 8) payable in accordance with clause 3.1.2.

The critical terms are:

"Company"	Keir Pharmacy Limited …
"Current Assets"	cash at bank, stock, trade debtors, prepayments, accrued income and other debtors in the normal course of trading of the Company.
"Current Liabilities"	those amounts due to trade creditors, accruals, corporation tax, VAT and PAYE/NI and other creditors in the normal course of trading of the Company.

[7] The Completion Accounts were thus to be prepared in respect of both KPL and ADHL. A Completion Accounts Statement was to be derived from the Accounts. The IDC was then to be adjusted in terms of Schedule 8 (cl 3.3), which provides:

> "2 ADJUSTMENT OF THE CONSIDERATION
>
> 2.1 If:
>
> 2.1.1 the amount of the Actual Net Current Assets as shown by the final and binding Completion Accounts Statement exceeds nil, then the Consideration shall be increased by an amount equal to the Actual Net Current Assets and the [defenders] shall satisfy payment of the amount of such increase (if any) … (after taking account of the payment of the Initial Deferred Consideration as a payment to account of such increase);
>
> …
>
> 2.1.3 the amount of the Actual Net Current Assets as shown by the final and binding Completion Accounts Statement is less that [*sic*] the Initial Deferred Consideration then the Consideration shall be decreased by the amount by which the Actual Net Current Assets is less than the Initial Deferred Consideration ("the **shortfall**") and the [pursuer] shall pay to the [defenders] the amount of such shortfall (if any) …".

[8] The defenders' accountants received the draft Completion Accounts and Completion Accounts Statement on 5 December 2019. These disclosed the following net assets:

	"Keir	ADH	Total
	229,682	619,914	849,596
Advance already paid			500,000
Balance			**349,596**".

On 5 February 2020, the accountants requested certain vouching. They did not object to the inclusion of the figures for ADHL. Agreement was reached on the Accounts on 22 May 2020.

The dispute

[9] ADHL's net assets were far greater in value than those of KPL. The pursuer contends that the parties intended that the IDC adjustment should take into account the net assets and liabilities of both companies. On the pursuer's account of events, he had explained to the defenders that he would obtain a tax benefit if the large amount of cash in "the business" were to be retained on sale but paid out to him as part of the price. It would then attract (lower rate) capital gains tax, rather than income tax. The overall deal was £6.35 million plus a sum for the net current assets of both companies as subsequently calculated.

[10] As is common in these transactions, there was a "travelling draft", which showed the current version of the SPA. In early versions, net current assets and liabilities were defined respectively as:

> "… cash, trade debtors, prepayments and accrued income in the normal course of trading of *each Group Company*" and
>
> "… those amounts due to trade creditors, accruals, taxation and deferred taxation payable by *each Group Company*" (emphases added).

"Group" was defined as "the Company and the Subsidiary" and "Group Company" meant "either one of them" (*sic*).

[11] On 3 July 2019 the defenders' solicitors sent a revised draft to the pursuer's solicitors. This proposed replacing the definitions of "Net Current" assets and liabilities with definitions of "Current" assets and liabilities. The definitions referred only to those of "the Company", which was defined as consisting only of KPL, and not "each Group Company" (ie KPL and ADHL). These tracked changes were easily identifiable. The pursuer maintains

that there had been no prior discussion or even a suggestion that the net assets of ADHL should be removed from the equation. On 5 July the principal deed, with the defenders' revisals incorporated, was executed. The parties' accountants proceeded to finalise the Accounts and Accounts Statement in respect of the assets of both companies. It was not until almost a year later that they raised the point that only KPL's assets were to be taken into account in the IDC adjustment.

[12] The pursuer contends that the definition of the Company, and thus the Current Assets, should be construed as meaning both KPL and ADHL. He has two fall-back positions. First, a term ought to be implied into the SPA to the same effect. Secondly, the court ought to rectify the SPA to include ADHL's assets.

[13] The defenders reply that the definition of "the Company" includes only KPL. They contend that this accurately reflects the parties' intention at the time of the SPA's execution. This would produce a downward adjustment of the IDC, on the basis of KPL's net assets alone, and result in a partial repayment. They resist the pursuer's alternatives.

The first instance decision

[14] The commercial judge determined that the pursuer had pled a relevant case on all three elements and was thus entitled to a proof before answer. The parties agree that she erred in law in dismissing the counterclaim.

[15] A number of principles lay at the core of her judgment. The court may have regard to surrounding circumstances when construing a contract (*Inglis* v *Buttery & Co* (1878) 5 R (HL) 87; *Luminar Lava Ignite* v *Mama Group* 2010 SC 310). The overarching task was to ascertain the objective meaning of the language which parties chose (*Wood* v *Capita Insurance*

Services [2017] AC 1173). That involved focusing on the words used in the context of the other provisions. Where one party invoked the factual "matrix", it was no answer to ignore it, or to seek to dismiss it under an exclusionary rule. Many contractual disputes could not be resolved by reference to the provisions alone (*Multi-Link Leisure Developments* v *North Lanarkshire Council* 2011 SC (UKSC) 53; *Aberdeen City Council* v *Stewart Milne Group* 2012 SC (UKSC) 240).

[16] The purpose of the SPA was to effect the transfer of the shares in KPL, as the parent company of ADHL, in return for payment of the consideration. It contained provisions to effect the transfer of the underlying assets of both KPL and ADHL. With the exception of the definition of Current Assets, in every other instance the provisions included references to both companies. The obligations imposed on the pursuer related to both companies.

[17] The defenders argued that the exclusion of ADHL's net assets from the Completion Accounts Statement protected the pursuer from any catastrophic decline in their value. This ignored the fact that ADHL was asset rich to the sum of £665,000. The defenders had suggested that ADHL's net current assets may have been accommodated in another component of the consideration. That invited the court to speculate on a matter for which evidence would be required. Subject to proof of the relevant context, the court was faced with a patent mistake in the drafting of the SPA.

[18] The pursuer had pled a relevant case for an implied term: that it had not been the parties' intention to omit the net assets of ADHL. The pursuer's averment, that it was industry practice to agree a consideration, but to make separate provision for the valuation of the net current assets of a business, had to be taken *pro veritate*. A construction of the SPA

as excluding a major portion of the business's net current assets was inconsistent with, or even frustrated, the commercial purpose of the SPA.

[19] The pursuer had pled a relevant case on rectification. In terms of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1985, s 8(1)(a)) a party must satisfy the court that a document, which was intended to express an agreement, had failed to express accurately the common intention of the parties. The pursuer had identified factors from the background preceding the SPA and from the Heads of Terms whereby the net current assets of both KPL and ADHL were to be included in the IDC. If the defenders' interpretation were to be given effect, there was no consideration for ADHL's assets. That was suggestive of the kind of arbitrary, irrational or commercially nonsensical outcome which was susceptible to rectification (*Patersons of Greenoakhill* v *Biffa Waste Services* 2013 SLT 729). It would be a surprising dereliction by the defenders or their professional advisors not to have immediately pointed out an apparent egregious misreading of the SPA on the pursuer's part in including ADHL's net current assets during the six month period during which the Completion Accounts and Completion Accounts Statement were under consideration.

Submissions

Defenders

[20] The case was a simple one which had been bedevilled by verbosity on the part of the pursuer and confusion on the part of the commercial judge. Without the principal action, there was no defence to the counterclaim. In those circumstances, the principal action ought to be dismissed and decree *de plano* granted in terms of the counterclaim.

[21] The definition of Current Assets was clear. It was not open to the court to construe the words in a manner contrary to their natural meaning, even if the outcome could be considered to be commercially improbable. The court should give effect to the words used where they were capable of only one meaning (*Arnold* v *Britton* [2015] AC 1619 at paras 17-18 and 108-109, citing *Rainy Sky* v *Kookmin Bank* [2011] 1 WLR 2900 at para 23), followed in *Global Port Services (Scotland)* v *Global Energy (Holdings)* [2015] CSIH 42 at para [30]). The principle, that the court may have regard to background circumstances when construing a contract, did not apply where the words used in the contract admitted only of one meaning. The words were clear. Any adjustment to the IDC was to be by reference only to KPL's assets and liabilities

[22] Pre-contractual negotiations are not admissible in construing a contract (*Chartbrook* v *Persimmon Homes* [2009] 1 AC 1101; *Dragados (UK)* v *DC Eikefet Aggregates* [2021] CSOH 117 at paras [15]-[16]).

[23] The pursuer had not averred a relevant case based on an implied term for two reasons. First, the test of necessity (*Marks & Spencer* v *BNP Paribas Securities Services* [2016] AC 742) was not met. A term could only be implied if the contract lacked commercial or practical coherence without it. Here the implied term only altered the assessment of the consideration. It was not needed for the contract to have practical effect. Secondly, the case for implying a term could only succeed if the pursuer failed on his primary argument on interpretation. An implied term cannot run counter to express terms.

[24] The requirements for rectification under section 8(1)(a) of the 1985 Act were not met (*FSHC Group Holdings* v *GLAS Trust Corporation* [2020] Ch 365 at para 176; considered in *Briggs of Burton* v *Doosan Babcock* [2020] CSOH 100 at paras [57]-[58]). There was no prior

concluded contract to which the SPA failed to give effect. There was no outward expression of accord to the effect that the parties understood one another to share the intention that ADHL's current assets were to be included in the consideration. On the contrary, the defenders' solicitors had altered the SPA using tracked changes to exclude them. It made no sense to say that there nevertheless remained a continuing common intention that they ought to be included. There was nothing to be gained from a proof.

Pursuer

[25] The SPA provided for the sale of the share capital of KPL and with it the whole of KPL, ADHL and the three pharmacies. A reasonable person in the position of the parties at the time of contracting would not have thought that the parties intended that the defenders would make no payment for the net current assets of ADHL and that the pursuer would almost certainly have to pay back part of the IDC upon adjustment. The court could only reach such a conclusion by reading the terms "Current Assets" and "Current Liabilities" in isolation.

[26] A commercially sensible construction should be applied (*Ashstead Plant Hire* v *Granton Central Developments* 2020 SC 244 at paras [9]-[20]). The context may suggest an alternative to the literal or ordinary meaning of the words (*Aberdeen City Council* v *Stewart Milne Group* at paras 17-22). The poorer the drafting of a provision, the greater the weight that ought to be given to context (*Wood* v *Capita Insurance Services* at para 10). Something had gone substantially wrong in this case. If the assets and liabilities referred only to those of KPL, the effort and expense incurred in the preparation and negotiation of the completion accounts for ADHL were obligatory but futile.

[27] In looking at the context, the court could look at the background circumstances, including market practices and expectations (*Ashtead Plant Hire* v *Granton Central Developments* at paras [19]-[20]). This was to establish parties' knowledge (*Bank of Scotland* v *Dunedin Property Investment* 1998 SC 657 at 665). It could demonstrate that there had been defective drafting (*Multi-Link Leisure Developments* v *North Lanarkshire Council* at paras 19-23). The background circumstances were not subjective evidence of one party's intention or a gloss on the contract terms, but relevant proof of the context in which the parties used the words selected (*Luminar Lava Ignite* v *Mama Group* (at paras [41]-[45]).

[28] The overall purpose of the SPA was to transfer the pursuer's whole business to the defenders. It was a two companies, three pharmacies group purchase. That was reflected in the pursuer's obligations to deliver documentation relating to both companies to the defenders. He had averred the various prior circumstances but the defenders say only that the revisals to the SPA were obvious.

[29] If the SPA could not be so construed, an implied term to that effect was necessary to give the SPA business efficacy. Otherwise it would lack commercial or practical coherence. An uncontemplated failure in consideration would be a lack of coherence (*The Moorcock* (1889) 14 PD 64 at 68). Such an implied term would not contradict the express terms of the SPA.

[30] For the statutory requirements to be satisfied, there had to be a prior agreement, but it need not be legally binding or enforceable (*Macdonald Estates* v *Regenesis (2005) Dunfermline* 2007 SLT 791 at paras [157]-[160]). The essentials of a contract need not have been agreed (*Patersons of Greenoakhill* v *Biffa Waste Services* (at paras 34-36). All that was required was evidence of a continuing common intention (*Chartbrook* v *Persimmon Homes* at

paras 48 and 59-66; *Patersons of Greenoakhill* at paras [79]-[82]). The existence of that intention was assessed objectively (*Macdonald Estates* at paras [161]-[176]). The parties' prior agreement arose from their continuing common intention that the net current assets of both KPL and ADHL would be included in the assessment of the consideration for KPL and the group.

[31] Both the pre and post-completion circumstances objectively demonstrated that the parties had a prior agreement. The same circumstances, which relied upon in support of the implied term, were relevant. Post-completion, the pursuer implemented his completion obligations, including the transfer of the whole business and both companies' assets. An inference, that the common intention continued after the revisions to the SPA, arose from the defenders' course of conduct after the execution of the contract in the preparation of the accounts. It was accepted that the pursuer's solicitors had "not noticed" the exclusion of ADHL's assets. No excuse for that could be proffered.

Decision

[32] The principles governing the construction of contracts are well-established. It is unnecessary to rehearse them in every case. They can be found in a series of authoritative decisions (*Rainy Sky* v *Kookmin Bank* [2011] 1 WLR 2900, Lord Clarke at paras 20-23; *Arnold* v *Britton* [2015] AC 1619, Lord Neuberger at para 15; *Wood* v *Capita Insurance Services* [2017] AC 1173, Lord Hodge at para 11; *Ashtead Plant Hire* v *Granton Central Developments* 2020 SC 244, Lord Drummond Young, delivering the opinion of the court, at para [12]); and *Network Rail Infrastructure* v *Fern Trustee 1* [2022] CSIH 32, LP (Carloway), delivering the opinion of the court, at para [28]).

[33] The construction of the contract in the present case is straightforward. The crucial parts of the Share Purchase Agreement are not ambiguous. Part of the price was to be the Initial Deferred Consideration, as a payment to account, subject to adjustment if the Actual Net Current Assets were lower than the £500,000 already paid. Critically, the references to current assets and liabilities are to those of "the Company", which is defined as Keir Pharmacy Limited. If the balance of KPL's assets and liabilities was below the sum paid, a repayment is required.

[34] There being no ambiguity, the pursuer's construction is rejected. It would involve rewriting the contract. The court cannot bolt on to the definition of "the Company" the words "and AD Healthcare Limited". That is impermissible. Prior negotiations and post execution conduct are irrelevant in these circumstances.

[35] Five conditions are required before a term will be implied into a contract (*BP Refinery (Westernport) Pty* v *Shire of Hastings* (1977) 180 CLR 266, cited in *Marks & Spencer* v *BNP Paribus Securities Services* [2016] AC 742). One is that it must be necessary to give business efficacy to the contract. No term will be implied where the contract is effective without it. The term sought to be implied by the pursuer falls foul of this condition. The contract is effective as it is; the changes from the earlier versions simply reduces the price and that by an amount which is relatively small in the context of a £6 million plus agreement. A second condition is that the term to be implied must be so obvious that it "goes without saying". That is not the situation in this case. For these reasons, the implied term averments are irrelevant and that case too falls to be dismissed.

[36] The court may rectify an agreement if it is satisfied that the agreement fails to express accurately the common intention of the parties when it was made: section 8(1)(a) of the Law

Reform (Miscellaneous Provisions) (Scotland) Act 1985. It is expressly provided that the court may have regard to all the relevant evidence. So far as is relevant, the section is identical to the one proposed in the draft Bill annexed to the Scottish Law Commission report (No. 79; 1983) that preceded the statute. Although the SLC considered (at para 3.4) the position in England, where the phrase "outward expression of accord" held sway, it chose not to use that wording. Where the origins of statutory or common law differ in a marked degree between the two jurisdictions, it will seldom be appropriate to transfer *dicta* from cases in England into the Scottish context (*Glasgow City Council* v *VFS Financial Services* 2022 SC 133, LP (Carloway), delivering the opinion of the court, at para [51])).

[37] Applying the words of the statute, the court must be satisfied that the SPA failed to express accurately the common intention of the parties when it was executed. That intention must be assessed objectively. Commercial contracts are made by what people say and not what they think in their inmost minds (*Muirhead & Turnbull* v *Dickson* (1905) 7 F 686, LP (Dunedin) at 694). The only evidence of the parties' intention at the time when the SPA was executed is the negotiated draft which was in circulation on 3 July 2019. This defined current assets as those of the Company (KPL) only. That being so, it is of no assistance to look at prior drafts when these had been superseded in writing after review by the parties, or at least their agents. That precludes rectification. It follows that this part of the pursuer's case also falls to be dismissed.

[38] The court will: allow the reclaiming motion; recall the commercial judge's interlocutor of 12 October 2021; sustain the defenders' first plea-in-law and dismiss the action; repel the pursuer's first plea-in-law to the counterclaim; sustain the defenders' plea-in-law to the counterclaim; and grant decree in terms of the counterclaim (and para 4 of the

joint minute) for payment by the pursuer to the defenders of £282,904 with interest at 4% above Barclays Bank plc, accruing daily and compounding quarterly, from 5 June 2020 until payment.