Privy Council Appeal No. 53 of 1994

Norwich Union Life Insurance Society *Appellant*

v.

The Attorney General *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL.
Delivered the 9th May 1995

Present at the hearing:-

Lord Goff of Chieveley
Lord Mustill
Lord Slynn of Hadley
Lord Nicholls of Birkenhead
Lord Hoffmann

*[Delivered by **Lord Hoffmann**]*

The State Insurance Office ("SIO"), an agency of the Crown in right of New Zealand, was privatised in 1990. On 28th June 1990, the Appointed Day under the State Insurance Act 1990, its assets vested in a Government-held company. At the same time, the Government sold the shares in the company to the Norwich Union Life Insurance Society ("Norwich"). Among the assets was a number of office buildings occupied in whole or in part by government departments. Few if any of these occupancies were the subject of formal leases. For the most part, the terms of occupation were recorded informally in correspondence. The Government agreed with Norwich to formalise these arrangements. Clause 3.4 of the Sale and Purchase Agreement read as follows:-

"The Crown will:

(a) use its best endeavours to procure that by the Appointed Day formal leases are executed in respect of the leasehold properties owned by State which are identified in Part A of Schedule 3 between State and the tenants of those properties

> on arms' length commercial terms and for the respective periods of tenure specified against those properties in that Schedule or such other periods of tenure as shall be agreed with Norwich."

Clause 3.5 said:-

> "The Crown will procure State to consult with Norwich on the detailed terms to be incorporated in the formal leases referred to in subclause 3.4 and to take account of all reasonable requirements of Norwich in relation to the terms to be included in those leases."

This appeal concerns the terms of the lease which the Crown was obliged by clause 3.4 to procure to be executed in respect of a part of the State Building in Wellington occupied by the Department of Internal Affairs. The terms had been negotiated between the SIO and the State Services Commission ("SSC") on behalf of the Department while the building was under construction between 1981 and 1985. The term was to be 23 years from 1 January 1985 at an initial annual rent of $662,066 with rent reviews after the first three years and afterwards at intervals of four years. A point of some debate between the SIO and the SSC was whether rent reviews should be upwards only, or in the phrase which has been used in this case, whether the rent should be subject to a ratchet. The SIO wanted a ratchet because their standard form of lease contained one. At a time of steadily rising rents, they did not feel that it was likely to be of great practical importance. The SSC, on the other hand, felt very strongly on the subject. It wrote on 4th February 1982:-

> "[the ratchet] negates the market rental principle by fine-print which allows rents to rise to any inflationary peak, but never to fall and is totally unacceptable..."

In the end the SIO gave way. It agreed that provided the rent did not fall to less than what it had been at the commencement of the lease, reviews could be up or down.

At the first review it was agreed that the annual rent from 1st January 1988 should be $1,911,000. The Third Schedule to the Sale and Purchase Agreement between the Crown and Norwich appears to have been rather hastily drafted, because it says that the rental is $2,055,993 and that the term is 21 years instead of 23 years from 1st January 1985. But nothing turns on these mistakes. It is accepted that the formal lease of which the Crown was obliged to procure the execution under clause 3.4(a) should have contained the actual rent and term which had been agreed. The dispute concerns the ratchet. The lease tendered by the Crown reflected the agreement between the SIO and SSC and did not include one. Norwich says that such a lease would not be "on

arms' length commercial terms". The evidence was that most commercial leases executed in the decade before the Appointed Day did have ratchets. Therefore a lease which complied with clause 3.4(a) should have had one. It was true that this was not what had been agreed between the SIO and SSC, but since both were emanations of the Crown, there should have been no difficulty about putting the matter right.

It is not suggested that clause 3.4(a) contemplated a complete renegotiation as at the date of the sale and purchase agreement or the Appointed Day of the terms of the leases. Norwich accept, indeed assert, that the term and rental should have stayed the same. But they say that the remainder of the leases should have contained "arms' length commercial terms". No doubt these would ***prima facie*** be the terms which had actually been agreed. But so far as such terms were not arms' length commercial terms, they should be replaced by ones which were, such as the ratchet in this case. And so far as, by reason of the informality of the arrangements, nothing had been expressly agreed, the *lacunae* should be filled by such terms as would ordinarily have been agreed between commercial parties bargaining at arms' length.

Their Lordships think that the fallacy in this argument was identified by Casey J. in the Court of Appeal when he said:-

> "A lease 'on arms' length commercial terms' is not the same as a lease on terms usually adopted in leases for similar tenancies, as Dr. Barton would have us accept."

Their Lordships consider that the phrase "on arms' length commercial terms" was not intended to provide a touchstone by which each clause in the lease could be tested in isolation. The intention was that the terms of the lease, taken as a whole and including the rental and term, should be such as would have been negotiated between commercial parties bargaining at arms' length. Thus the evidence that only a small minority of commercial leases negotiated in the open market did not have ratchets is not inconsistent with those leases having been on "arms' length commercial terms". The landlord may have taken the view that some other advantage in the terms of the lease or the strength of the tenant's covenant compensated for the absence of a ratchet.

The provision for consultation with Norwich in clause 3.5 seems to their Lordships to support this construction. It suggests that there might be a variety of possible combinations of detailed terms, all of which would satisfy the description "arms' length commercial terms". In those circumstances it would be appropriate to take into account the reasonable requirements of Norwich as to whether they would prefer swings or roundabouts.

Once one looks at the terms of the lease as a whole, it seems to their Lordships that there were no grounds for regarding them as anything other than arms' length commercial terms. They had in fact been negotiated as if between parties at arms' length and there was no evidence that any uncommercial concession had been made. In those circumstances, there was nothing to displace the *prima facie* assumption that the formalised leases should incorporate the terms actually agreed.

In these circumstances their Lordships' consider that even if the Crown's obligation under clause 3.4(a) was absolute instead of being to "use its best endeavours", the form of lease which it tendered complied with the clause. It is therefore unnecessary to discuss whether the obligation was less than absolute or whether the unity of the Crown meant that the reference to "best endeavours" applied only to the time of execution of the leases and not to their contents. Their Lordships will humbly advise Her Majesty that the appeal should be dismissed. The appellant must pay the respondent's costs before their Lordships' Board.