We are grateful to the authors, editors and publishers for their kind permission granted to post the respective articles on the Singapore Judicial College website. No article posted here may be circulated or reproduced without the prior permission of the author(s), editor(s) and publisher (where applicable).
*83 Introduction

Lloyds TSB Foundation for Scotland v Lloyds Banking Group Plc raised an interesting issue as to how the law should deal with the application of a contract in circumstances which were unforeseen at the time it was entered into but did not render the relevant obligation completely impossible to perform such that it amounts to frustration. Two avenues were explored. The first is, expectedly, by way of contractual construction. The second is through the recognition and application of the doctrine of equitable adjustment to allow judicial moderation of the relevant contractual obligation. Although this was an appeal from Scotland and concerned Scots law, these issues were, arguably, a matter of general interest to all. Ultimately, both avenues require...
us to consider more carefully the relevance of a radical change of circumstances to the performance of a contract.

**Facts and decisions of lower courts**

In the present case, pursuant to a deed agreed and executed in 1997 (the deed), Lloyds Banking Group Plc (Lloyds Bank) covenanted to pay Lloyds TSB Foundation for Scotland (TSB 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"."Pre-Tax Profits" and "Pre-Tax Losses" were defined in the deed as referring to "group profit before taxation" and "group loss before taxation" as shown in the audited accounts of Lloyds TSB group of companies (the Group) respectively. The purpose of the covenant was to allow TSB Foundation, a charitable foundation, to participate in the Group’s profits.

Crucially, the deed was executed at a time when the law and accounting conventions did not require unrealised profits and loss to be recognised in the accounts. Subsequently, pursuant to Regulation 1606/2002 adopted by the European Union, UK listed companies were required to prepare their consolidated accounts in accordance with International Financial Reporting Standards accounting period starting from January 1, 2005. In particular, this meant that UK listed companies*84 were required for the first time to recognise negative goodwill as a gain in the group consolidated income statement, notwithstanding that it is an unrealised gain. This development in 2002 brought about the present dispute between the parties in relation to the amount to be paid under the covenant on the basis of Lloyds Bank’s audited accounts in 2009. This dispute had come about because, in 2008, in an effort of corporate rescue, Lloyds Bank acquired a company for a consideration far below the fair value of the company’s net assets, thus generating negative goodwill which was recognised in Lloyds Bank’s 2009 audited accounts. Without this positive entry, the 2009 accounts would have reflected a loss of more than £10 billion instead of a profit of over £1 billion. For the purposes of determining the amount to be paid to TSB Foundation under the deed, if negative goodwill were taken into account, the amount payable would be £3,543,433. If negative goodwill were excluded, TSB Foundation would only receive the minimum prescribed sum of £38,920.

The principal issue thus was the construction of the words "group profit before taxation … shown in the Audited Accounts" in the deed in light of the unforeseen change in both the legal and accounting positions. Lloyds Bank argued that the words should be interpreted to refer to only realised profits and loss before taxation on the basis that the development in 2002 was not contemplated by the parties at the time the deed was agreed and executed. The figure for negative goodwill should be excluded for the amount payable to TSB Foundation under the
On the other hand, TSB Foundation contended that the figure for negative goodwill ought to be included. It submitted the words "group profit before taxation … shown in the Audited Accounts" should be interpreted to include any similarly phrased line which may from time to time appear in Lloyds Bank’s audited accounts, no matter how fundamentally different the basis on which the figures are arrived at as compared with the basis contemplated by the parties when the covenant was entered into. Alternatively, if Lloyds Bank failed on the issue of construction, it argued that the court should apply the doctrine of equitable adjustment to moderate the deed, with the result of excluding the sum brought in for negative goodwill from the calculation of the group’s profit or loss before taxation. TSB Foundation averred that this doctrine is not part of Scots law. In this regard, it is important to note that it was neither party’s case that the contract had been frustrated.

In the Outer House, the Lord Ordinary ruled that at the time of creation of the deed, the parties did not intend that a figure for negative goodwill should be included in the determination of the amount payable to TSB Foundation. He said that the phrase "group profit before taxation" in the deed could thus be disregarded. On the alternative claim based on the doctrine of equitable adjustment, the Lord Ordinary was of the view that there is no such doctrine in Scots law but said the point was in any event academic given his conclusion on the issue of construction. The Inner House overruled the Lord Ordinary’s decision on construction. It criticised the Lord Ordinary’s approach in disregarding the said phrase in the deed as illegitimate and "flying in the face of the clear and unambiguous wording" of the deed. The Inner House accepted TSB Foundation’s construction and rejected Lloyd’s Bank’s construction on the basis that it would involve "re-writing" the deed. Regarding the equitable doctrine of adjustment, the Inner House concluded that "there was no foundation for it, as a generality, in Scots law" and further commented that "it would be beyond the proper scope of judicial power to develop it in any way which would assist" Lloyds Bank in this case.

Decision of the Supreme Court

On the issue of construction, Lord Mance, with whom Lord Reed and Lord Carnwath agreed, pointed out that contracts are to be construed contextually and purposively. Using that approach, Lord Mance concluded that the deed was concerned with realised profits or losses before the taxation that would fall on group companies because that was the prevailing understanding at the time the deed was entered into. He held further that the change brought about by Regulation 1606/2002 was "wholly outside the parties’ original contemplation, and something which they would not have accepted, had they foreseen it." Lord Mance also thought that an alternative construction would involve "striking irrationality" because it would bring about "incongruous consequences" that would always be favourable to TSB Foundation.
Lord Hope and Lord Clarke, who were both initially inclined to follow TSB Foundation’s construction, were ultimately persuaded by Lord Mance’s judgment. Lord Hope emphasised that the relevant words must be read from the perspective of a reasonable person having regard to what was known in 1997 when the deed was executed. Since at that time it was unthinkable that negative goodwill would be introduced into the profit and loss account, TSB Foundation’s contended-for construction was therefore rejected. In this regard, Lord Clarke gave credence to the uncontradicted expert evidence.

On the issue of equitable adjustment of contract, in light of the unanimous conclusion on construction, only Lord Hope made some observations on the matter. He started off by observing that Lloyds Bank’s proposition is narrowly confined to a situation where a supervening event attributable to neither party had materially affected the performance of the contract but which otherwise did not amount to frustration. He further noted Lloyds Bank’s submission that the equitable adjustment, while overlapping with unjustified enrichment (the principles which determine the consequences of frustration of a contract), was broader in its ambit.

While Lord Hope did not doubt that Scots law could develop its equitable principles to address unforeseen circumstances, he did not think that the present case warranted such a development. To rely on the doctrine of equitable adjustment would mean that the proper construction of the deed required the figure for negative goodwill to be included in the calculation of the Group’s profit before taxation. However, this finding makes it difficult to justify judicial adjustment of the contract to mean something different from what the parties had intended it to mean. After all, the obligation is not impossible to perform, nor does its performance result in unjustified enrichment in this case. Moreover, judicial creativity should be exercised sparingly and only in cases concerning prevalent injustice. To allow equitable adjustment in this case would undermine the principle of *pacta sunt servanda*. For these reasons, Lord Hope concluded that the doctrine is not part of Scots law.

**Construction and supervening unforeseen events**

It is a commonplace problem that circumstances which arise after a contract has been concluded are not the circumstances contemplated by the parties at the time of contracting. The contract, as the governing instrument, is the place to look for a solution. Normally, supervening events ought not to affect the performance of the contract. Exceptionally, of course, the court may find that the future performance of the contract is frustrated. But frustration was not in issue in Lloyds TSB Foundation. The parties’ primary case was that the supervening events did not affect the performance of the covenant. Where they differed was whether the covenant could be interpreted to take into account certain figures that were arrived at on a different basis as a result of subsequent change in legal and accounting position from that
which was contemplated by the parties at the time the deed was executed.

In this regard, one must note that the fact that parties contemplated event "A" and not event "B" does not mean that the courts will automatically find that the agreement does not apply to event "B". Such a simplistic approach was rejected by the Court of Appeal in Bromarin AB v IMD Investments Ltd. As Chadwick L.J. explained in the case, the court’s task is to decide, "in light of the agreement that the parties had made, what they must have taken to have intended in relation to the event, event ‘B’". Chadwick L.J. had further acknowledged that this is a somewhat artificial exercise because the court is in effect attributing to the parties a positive intention they did not actually have in relation to an event that was not within their contemplation. This is, however, not objectionable as the aim is to ensure that commercial contracts do not fail at the slightest hint of inapplicability given the inability of contracting parties to foresee all possible circumstances at the time of contracting. In any event, the exercise of hypothesising is not done in the abstract and is to be anchored to the express contractual language, the internal and external contexts of the contract and, more broadly phrased, the contractual purpose.

In Lloyds TSB Foundation, the unforeseen developments in 2002 did not directly affect the operability of the covenant itself. Depending on the construction adopted, the developments only affected the basis of computation under the covenant, making it more expensive for Lloyds Bank to perform its obligation. Nonetheless, there is no reason that the aforementioned principle should not apply as a starting point. Taking a purely technical and literal reading of the covenant would have meant that negative goodwill ought to be taken into account. This approach may appear superficially simple by according with the literal meaning of the express words, but may not conduce towards discovering the parties’ intention. Indeed, the Supreme Court, in reaching its ultimate decision on construction, affirmed the principle of construing a contract contextually and purposively, the relevant context being the one at the time of contracting. On a more basic level, the present case therefore illustrates the literal-contextual tension in contract construction.

On a broader level, Lloyds TSB Foundation read with Bromarin tells us that, conceptually, there are two scenarios that can be distinguished. The first scenario is a case where the contract provides for a concrete purpose. A concrete purpose is where the author intends to reach a particular result in a given situation through the text created. The second scenario is a case where the contract provides for a broad purpose; the question is whether it extends to a new circumstance. The contract is meant to achieve a certain purpose but it does not require that a particular result must be achieved. In both scenarios, there is some positive intention that the court can utilise to discern what the parties would have done in light of the new circumstance. Whether the contract provides for a concrete purpose or a broad purpose, and how it
therefore applies to a new circumstance, is ultimately a matter of construction.

Lloyds TSB Foundation concerned the former scenario. The purpose of the deed was to enable TSB Foundation to participate in the Group’s trading profits in a more tax efficient way than through the issue of shares and declaration of the dividends.\textsuperscript{22} Dividends are paid out of a company’s realised profits. Taken together with the legal and accounting positions in 1997, "[t]he landscape, matrix and aim of the 1997 deed as well as its predecessors" were clear that they were only concerned with realised profits and losses before taxation which would fall on group companies.\textsuperscript{23} In a sense, the parties’ positive intention in relation to the application of legal and accounting standards as at 1997 was very specific. This level of specificity would suggest that the parties would not have intended for negative goodwill to be taken into account had they thought about it.

The case of Bromarin, on the other hand, concerned a contract providing for a broad purpose. The facts were fairly complex but, in essence, it concerned a contract for the acquisition of shares in a capital loss company for the purpose of allowing the purchaser to take advantage of the allowable losses. The consideration payable to the vendor was based on a certain formula and the computation was affected by a subsequent change in the law which prevented the purchaser from using the allowable losses. On the construction of the formula, the Court of Appeal found that the commercial purpose of the contract involved a risk that the law might have changed when the gains were to be realised. On the facts, the parties had foreseen at the time of contracting that some change in the law might take place. As the purchaser had sole control over the timing of disposals, it was held that the risk\textsuperscript{88} of the change of law was to be borne by the purchaser. Bromarin concerned a contract for a broad purpose because the combination of a contemplation of the possibility of change of law, together with the purchaser’s right to realise the gains in its own time meant that the amount which the purchaser would have to pay could be more or less. In other words, the contract provisions interpreted in its factual matrix does not show that the parties intended only for a particular result. In such circumstances, there is greater latitude to impute that the parties intended for the contract to cover the new circumstance.

\textbf{Doctrine of equitable adjustment}

Equitable adjustment, if recognised, sits uncomfortably between construction principles and the doctrine of frustration, since it would perform the task of recalibrating the allocation of risks in circumstances where the contract is technically capable of performance. Construction is an exercise that allows the court to determine how the risks are allocated, not based on what the parties actually intended but based on what a reasonable person in the parties’ circumstances would have taken the words to mean. Frustration, on the other hand, applies to supervening
events not covered by the contract, and which render performance impossible or materially destroys what is essential to performance, in whole or in part.Clearly, the doctrine of frustration depends on a construction of the parties’ intentions as to in what circumstances the contract is to operate, in order to determine whether the supervening event amounts to a frustrating event. As the doctrine of frustration discharges parties from further performance under the contract, it will not be lightly invoked by the Scottish courts or the English courts. This is in recognition of the inconsistency of the doctrine with the principle of preserving the sanctity of contract. Equitable adjustment is thus controversial for it further undermines this underpinning principle of contract law. It is no doubt a matter of "general interest". As the Lord Ordinary had said, he could not accept the argument that if the doctrine exists and is sound, it is one that is peculiar to Scots law but not in England and Wales or other jurisdiction.

At all tiers of the present case, it was found that the doctrine was not part of Scots law. TSB Foundation’s major obstacle was pointing to any authoritative source that affirms the existence of such a doctrine as applying in circumstances falling short of frustration. The most that can be gathered from the cases and commentary submitted by TSB Foundation is that there is scope for some equitable adjustment under Scots law in cases of frustration. Even within frustration, it remains controversial the extent that the courts may make adjustments. The next logical question is whether the common law ought to progressively develop such a doctrine, drawing inspiration from the doctrine of frustration.

There are, however, numerous difficulties with developing a doctrine of equitable adjustment in common law, whether Scots or English law. On a fundamental level, it is difficult to articulate the theoretical basis of this doctrine. Based on Lord Hope’s discussion as well as Lloyds Bank’s submissions, it appears that the doctrine may be explained on the same basis as the doctrine of frustration as providing a just solution to prevent unjustified enrichment. This theory draws support from Lord Wright’s comments in Imperial Smelting Corp Ltd v Joseph Constantine Steamship Line Ltd, where he said: "The Court is exercising powers, when it decides that a contract is frustrated, in order to achieve a result which is just and reasonable."

However, in relation to frustration, this theory has been criticised for asserting more than it explains. In relation to the putative doctrine of equitable adjustment, this "theory", if accepted, raises the question of why it would be "just and reasonable" to alter the meaning of the contract to one that is favoured by one of the parties to the dispute. That the parties might have made a different bargain had they thought about the matter at the time of contracting should not be a ground to invoke judicial intervention because what that bargain might have been is a matter for speculation. Moreover, there are many competing accounts for the doctrine of frustration, some of which cannot readily accommodate the doctrine of equitable adjustment if one were to link the two doctrines together.
Even if one were to take the view that the theoretical underpinning will become more obvious as the doctrine develops, there are policy concerns against such judicial creativity. Parties are free to terminate their agreement or vary their agreement in cases where the contract proves economically inefficient or realistically inoperable for either of them, provided they can come to an agreement on termination or the new terms. This is part of market forces and business negotiation. Judicial intervention in such circumstances will thus upset market forces and business practices, both of which are the cornerstone of a free market economy and are safeguarded by the principle of preserving the sanctity of contract.

Further, the scope of this putative doctrine is unclear, in particular in distinguishing the circumstances in which it applies from those which amount to frustration. Although frustration is often conveniently understood as being concerned with events that render performance impossible, in truth, it is more accurate to describe such events as rendering performance *impracticable* to perform. Ultimately, it is a matter of degree of impracticability. Difficult questions, such as when has an obligation become so onerous that it justifies equitable adjustment but not frustration, and when has an obligation become so onerous that it calls for frustration, will no doubt arise. There is also the issue of what principles the court should apply in determining the kind and extent of adjustment that ought to be made in each case. Words like "just and reasonable" are unhelpful and often mask sloppy judicial reasoning. This is particularly acute if the doctrine is meant to be of general application, going beyond cases of pricing mechanisms where one could look to market values for reference.

Finally, it has been suggested that, if the law of trusts can provide for change of circumstances through the doctrine of cy-près where charitable trusts are concerned, there appears no reason why the same cannot be done within the law of contract. Where contractual variations would be infeasible, it is said that such a development has the merit of preventing protracted and costly litigation. To note, the doctrine of charitable trusts cy-près enables the courts to alter the purposes of a charitable trust where they are impossible or impracticable to be carried out, provided that several conditions are met. It salvages a charitable gift in circumstances where it becomes frustrated. The objective is benevolent: to enable that property intended for public benefit shall, in so far as possible, be maintained for public benefit. It is difficult to see how this objective could underlie the doctrine of equitable adjustments that is to apply to contracts between private parties.

That said, Mulheron has persuasively argued that the modern cy-près doctrine has been applied to orders for *specific performance*, to achieve the outcome of substituted specific performance. In that sense, the term "specific performance" is a misnomer because the legal reality is that the order for specific performance often results in modification of the contractual stip-
ulations for performance, for example, time and place for performance or, more radically, the property to be transferred, as necessitated by circumstances. This has the effect of foisting on the parties (in particular, the innocent party) a contract that they did not make. On this basis, one might be tempted to think that the recognition of equitable adjustment is similarly unobjectionable. Nevertheless, substituted specific performance is part of the secondary, substitutionary remedies for breach of contract and, for this reason, provides a "useful middle ground" between the rarely available specific performance relief and the much more readily available substitutionary damages. Equitable adjustment, on the other hand, seeks to modify the bargain in circumstances where one party’s performance has become merely onerous, to avoid the breach of contract by that party for economic reasons and therefore the consequences that he has to answer. It is plainly difficult to see why the law should take on such responsibility.

Conclusion

Lloyds TSB Foundation illustrates a very real problem concerning unforeseen circumstances that have arisen after the conclusion of a contract. The law would be too simplistic if the answer is that just because a contract does not provide for the unforeseen circumstance, it does not apply. The correct approach is to construe the contract and ascertain what the parties intended in relation to that unforeseen circumstance. While such intention may not be directly provided, we can ascertain such intention if the contract either provides some indication of a concrete purpose when a particular result is intended, or a broad purpose, where several outcomes are possible. The process undoubtedly involves some degree of creativity, but such creativity is necessary to ensure that contracts are not rendered unworkable at the slightest hint of insufficient coverage, given the limitations of human foresight. Equitable adjustment, while seemingly attractive, suffers from problems of uncertainty and difficulty in application. Its recognition must therefore be strenuously resisted. Ultimately, where a contract does not provide for an unforeseen circumstance, the law must react in a way that, while recognising the practical difficulties, does not end up rewriting the contract for the parties.

Man Yip

Assistant Professor of Law, Singapore Management University

Yihan Goh

Assistant Professor of Law, National University of Singapore
13. Lords Reed, Carnworth and Clarke agreed with Lord Hope’s comments.
29. Lloyds TSB Foundation [2011] CSOH 105; 2012 S.L.T. 13 at [90]; Lloyds TSB Foundation [2011] CSIH 87 at 28]–[29]; Lloyds TSB Foundation (SC) [2013] UKSC 3; [2013] 1 W.L.R. 366 at [44] and [46] (Lord Hope). It should be noted that the Lord President (in the Inner House) also said that some of the cases relied upon by TSB Foundation’s counsel could be explained on other much more limited bases: see [25]–[29].

© 2015 Thomson Reuters.
31. Lloyds TSB Foundation (SC) [2013] UKSC 3at [41].
33. Save for differences in consequences of frustration, it has been noted that the Scots law on frustration is unlikely to be found by the courts to be different from English law. See James B Fraser & Co Ltd v Denny, Mott & Dickson Ltd 1944 S.C. (H.L.) 35at 41 (Lord Macmillan); and McBryde, The Law of Contract in Scotland (2007), para.21-02.
36. Treitel, Frustration and Force Majeure (2004), Ch.16.
39. The Charities Act 1960 widened the powers of the English court to apply cy-près. For an excellent exposition of the modern cy-près doctrine, see R. Mulheron, The Modern Cy-près Doctrine (UCL Press, 2006).
41. Mulheron, The Modern Cy-près Doctrine (2006), Ch.9.

END OF DOCUMENT