

COMMERCIAL & TECHNOLOGY

Audit clauses and contractual construction: *the (Paddington) bare facts*

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Paddington Bear, the friendly spectacled bear from “darkest Peru”, has a habit of getting into trouble. However, it was Paddington and Company Limited (the company that owned the intellectual property rights in Paddington Bear) (**Paddington**) and Pixdene Limited (a company which had a right to a share of the net merchandising income from the worldwide exploitation of the Paddington Bear merchandising rights) (**Pixdene**) that got into a sticky situation in relation to an audit clause in their contract.

The contract in question was a short four-page document consisting of just 9 clauses. It had been signed by the parties in 2013.

The clause in dispute was as follows:

5. Audit

During the term of this Agreement a third-party auditor may, upon prior written notice to Paddington and not more than once per every two year period, inspect the agreements and any other business records of Paddington with respect to the relevant records or associated matters during normal working hours to verify Paddington's compliance with this Agreement.

Despite its brevity (or, perhaps, because of it), the parties found they were unclear about the extent of the rights granted and the limitations imposed by the clause and, when they tried to agree the terms of an audit in 2019, they were unable to do so. The matter proceeded to court and, in 2022, the High Court found itself having to answer what it considered to be “a surprisingly large number” of questions in relation to the clause. These questions included the following:

1. Did Pixdene itself have a right to inspect Paddington’s documents?
2. Was Paddington required to provide Pixdene with copies of the documents inspected?
3. Was the audit inspection limited to:
 - i. a physical on-site inspection of documents
 - ii. in Paddington’s offices
 - iii. in the presence of Paddington’s representatives?
4. Could the auditor provide Pixdene with information derived from the audit inspection?
5. Was Paddington required to provide the third-party auditor with copies of the documents inspected as part of the audit?
6. Could Paddington redact its documents?

The Court answered these questions by reviewing and applying the established law in relation to contractual construction. In particular, it considered:

- how a court should **interpret** a contractual provision when the drafting was unclear; and
- when a court could **imply** a term into a contract.

Interpreting an unclear provision in a contract

When considering how a court should interpret an unclear term in a contract, the Court in *Paddington* approved the approach taken in a recent Supreme Court case (*Arnold v Britton & Ors* [2015]). In that case, the Court concluded that its role, in interpreting a contract, was to:

*“identify the **intention of the parties** by reference to what a **reasonable person**, having all the **background knowledge** which would have been available to the parties would have understood them to be using the language in the contract to mean.”*

In determining this, the hypothetical reasonable person should assess:

- the natural and ordinary meaning of the clause
- any other relevant provisions of the contract
- the overall purpose of the cause and the contract

- the facts and circumstances known or assumed by the parties at the time that the document was executed and
- commercial common sense as it would have been perceived at the date the contract was made (i.e., it is not to be invoked retrospectively).

Implying a term into a contract

In considering when a Court could imply a term into a contract, the Court in *Paddington* followed the principles set down in the recent cases of *Marks & Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] and *Yoo Design Services Limited v Iliv Realty Pte Limited* [2021]. In these cases, the courts made clear that implying a term into a contract was so “potentially intrusive” that the law had to impose “strict constraints” on the use of such an “extraordinary” power.

These constraints can be summarised as follows:

- a term should not be implied unless:
 - i. it is **necessary** to give business efficacy

to the contract (the “**business efficacy test**”); and/or

- ii. it is so **obvious** that “it goes without saying” (the “**obviousness test**”)
- a term should not be implied if it is inconsistent with an express term of the contract
 - the intention of the parties themselves is less important than that of notional reasonable people in the position of the parties at the time
 - hindsight should not be taken into account when deciding whether to imply a term
 - fairness and/or reasonableness are not, on their own, sufficient reasons to imply a term.

How did the Court apply these principles to the questions raised in the *Paddington* case?

In *Paddington*, the Court methodically worked its way through the questions raised by the parties in relation to the audit clause and applied the principles summarised above. The Court's reasonings and decisions are summarised below.

1

Question 1: Did Pixdene itself have a right to inspect Paddington's documents?

Could this be interpreted from the drafting of the clause?

No. The Court found that the use of the words "third party" in relation to the auditor were significant. They implied that the parties had wanted the person inspecting the documents to be independent. Consequently, the clause could not be construed as giving Pixdene a right of inspection.

Should such a term be implied?

No. The Court held that the use of the words "third party" suggested that the clause had been "deliberately drafted to keep Pixdene away from Paddington's documentation". As such, the implication of such a term was neither obvious nor necessary.

2

Question 2: Was Paddington required to provide Pixdene with copies of the documents inspected?

Could this be interpreted from the drafting of the clause?

No. For the reasons given by the Court to Question 1, the Court was satisfied that the parties' intention when drafting the clause was to keep Pixdene away from Paddington's documents.

Should such a term be implied?

No (again for the reasons given by the Court to Question 1). Issues of convenience or cost-effectiveness, which were put forward by Pixdene, were "not the point", in the Court's opinion. The Court found that to decide otherwise would "factually undermine the purpose for which clause 5 was constructed".

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Question 3: Was the audit inspection limited to: (i) a physical on-site inspection of documents; (ii) in Paddington's offices; (iii) in the presence of Paddington's representatives?

Could this be interpreted from the drafting of the clause?

- In relation to (i), yes. The Court held that the inclusion of the words "during normal working hours" indicated that the parties, at the time of agreeing the clause, envisaged a *physical* inspection of documents by the third-party auditor.
- In relation to (ii), the answer was 'partially'. The Court held that the clause did not specify the venue for inspection however, the words "during normal working hours" indicated that the venue had to be one "under Paddington's control which Paddington may reasonably choose".
- In relation to (iii), no. By specifying in the drafting that the inspection was to be carried out by a third-party auditor, who would naturally be subject to his or her own professional obligations, a reasonable person would, in the Court's

view, consider that such a person could be trusted to carry out the inspection without supervision.

Should such a term be implied?

Given the Court's findings to (i) and (ii) above, the Court only considered if (iii) should be implied. It decided that it should not as the requirement to supervise was neither necessary nor obvious. In fact, in the Court's view, it was quite normal for auditors (who are subject to professional obligations) to carry out their inspections without supervision.

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Question 4: Could the auditor provide Pixdene with information derived from the audit inspection?

Could this be interpreted from the drafting of the clause?

Partially. The Court found that the clause did not provide a "blanket right" for Pixdene to receive copies of documents inspected by the auditor. As discussed above, the wording used in the clause indicated that the parties' intention was to keep Pixdene away from Paddington's documents. However, the Court concluded that, given the purpose of the audit was to assess Paddington's compliance of its obligations under the contract, a reasonable person would have understood the clause to permit the auditor to disclose to Pixdene "such information gained from the inspection of documents as is necessary to report on these matters." The Court considered this entitlement would extend to confidential information of Paddington but not to legally privileged information.

Should such a term be implied?

Partially (in line with the limitations set out above). The Court held that such a term was necessary to give effect to the purpose for which inspection was given (i.e., to audit Paddington's compliance with the contract).

5

Question 5: Was Paddington required to provide the third-party auditor with copies of the documents inspected as part of the audit?

Could this be interpreted from the drafting of the clause?

No. The Court noted that the clause was silent on this issue (only referring to "inspection" of the documents, not copying).

Should such a term be implied?

Yes. The Court felt that, had the parties been asked at the time they were entering into the contract if the third-party auditor could "take such copies as he considers necessary to enable efficient and timely production of his audit report, and for the purposes of maintaining appropriate records of his work" the parties would have replied: "of course, that goes without saying". Consequently, the Court found that such a term should be implied as it satisfied the obviousness test. It also found that such a term was necessary to give commercial and practical efficacy to the clause.

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Question 6: Could Paddington redact its documents?

Could this be interpreted from the drafting of the clause?

No. The Court noted that the clause was silent on the issue of redaction.

Should such a term be implied?

Partially. The Court concluded that, as (i) the inspection needed to be carried out by a third party auditor who was subject to professional obligations (including obligations of confidentiality) and (ii) the auditor's ability to report to Pixdene was limited to verifying compliance by Paddington (as discussed in question 4 above), it was neither obvious nor necessary that the relevant agreements and business records disclosed for inspection should be redacted (even if they contained confidential information). However, the Court held that this position should not apply to legally privileged information, which could be redacted before release to the auditor.

Summary and takeaways

Paddington is a useful case as it illustrates, in a practical way, how a court will apply the law in relation to contractual construction. It summarises the issues a court will consider when deciding how to interpret an unclear term and provides examples of the (limited) circumstances in which a court might be prepared to imply a term into a contract. The decisions taken by the Court also provide useful guidance in relation to how audit clauses should, and should not, be drafted.

Takeaways for audit clauses:

- **Consider who can inspect:** in *Paddington*, Pixdene argued that it was entitled to inspect all the documents which *Paddington* was required to make available for inspection. *Paddington*'s situation was saved by the inclusion of the words "third party" which, in the Court's view, were "words of limitation" designed to keep Pixdene away from *Paddington*'s documents. To avoid uncertainty, an audit clause should expressly state who can, and who cannot, inspect the discloser's documents.
- **Consider the location of the inspection:** in *Paddington*, the Court placed great significance on the words "normal working hours". It concluded that they implied that the parties intended the inspection to be a physical one, as opposed to remote, and on-site in a location under *Paddington*'s control. Best practice would be to ensure the clause expressly states where and how the inspection is to take place.
- **Consider if the auditor should be supervised:** in *Paddington*, the Court decided that the third-party auditor could be trusted to undertake the audit inspection without supervision. If this is not agreed, the discloser should consider inserting a right for the auditor to be accompanied during the inspection process or include some other forms of protection (such as requiring the parties to jointly agree who the auditor should be).
- **Consider if confidential information should be redacted:** in *Paddington*, the Court held that the only information that could be redacted by *Paddington* was that which was legally privileged. If an audit is likely to require disclosure of commercially sensitive documents or information, the discloser may wish to include a right to redact information which falls outside the scope of the audit. For added protection, the discloser may wish to require the auditor to sign a Confidentiality Agreement in advance of the inspection taking place.

Takeaways for drafting in general:

- **Draft with clarity and precision:** *Paddington* underscores the importance of careful and considered drafting and the risks, and costs, of getting it wrong. Whilst it may not be possible or desirable to cover every possible outcome in a contract, it is important to ensure that the extent of rights granted, and the scope of any limitations imposed on those rights, are clearly expressed in the contract.
- **Stress test important terms:** many of the issues in the *Paddington* case could have been avoided if the parties had asked themselves some simple "what if" questions when the clause was being drafted. These questions could have included, "What if Pixdene asks to inspect my documents?", "What if the auditor asks to copy my documents?" or "What if *Paddington* redacts its documents?". Stress testing, i.e. the process of analysing the potential outcomes of a contract in a variety of scenarios, can be a useful way to identify and resolve drafting gaps and inconsistencies.

In *Paddington*, the dispute over the audit clause had a very detrimental effect on the parties' relationship. The Counsel for Pixdene noted that "the milk of human kindness has long since evaporated between them". A well drafted contract won't necessarily stop disputes arising, but it should provide clarity and certainty for the parties as to what they agreed when the contract was signed. In this regard, the words of Judge Stephen in *Re Castioni* [1891] are as true today as when they were written:

"It is not enough [for the contract] to attain to a degree of precision which a person reading in good faith can understand; but it is necessary to attain if possible to a degree of precision which a person reading in bad faith cannot misunderstand [or] pretend to misunderstand it."

If you have any queries about a commercial agreement, or anything raised in this article, please contact Keith Dunn, Senior Associate, or your usual Commercial & Technology Belfast team contact.

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