McLachlan & Ors v. Mercury Geotherm Limited & Ors (New Zealand) [2006] UKPC 27 (23 May 2005)

Privy Council Appeal No 36 of 2005
(1) Alistair Stuart McLachlan and Ava Marie McLachlan
(as Trustees of the Waiturutu Trust)
(2) Alistair Stuart McLachlan and Ava Marie McLachlan *Appellants*
v.
(1) Mercury Geotherm Limited (in receivership)
(2) Piohipi Land Limited (in receivership)
(3) Mercury Network Limited *Respondents*
FROM
THE COURT OF APPEAL OF
NEW ZEALAND

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JUDGMENT OF THE LORDS OF THE JUDICIAL
COMMITTEE OF THE PRIVY COUNCIL
Delivered the 23rd May 2006

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Present at the hearing:-

Lord Hoffmann

Lord Scott of Foscote

Lord Walker of Gestingthorpe

Baroness Hale of Richmond

Sir Martin Nourse

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*[Delivered by **Lord Walker of Gestingthorpe**]*

1. This appeal is concerned with the aftermath of an ambitious joint venture which unfortunately ended in heavy losses for the participants. The object of the venture was to build and run a geothermal power station near Taupo in North Island, using the area's natural geothermal resources for large-scale generation of electricity for supply to consumers in the Auckland district. The participants in the venture were the appellants, Mr and Mrs McLachlan (together with some family companies which they controlled) and Mercury Network Limited, later renamed MEL Network Limited ("Network") a subsidiary of a quoted company now known as Vector Limited ("Vector"). Two new companies were formed for the purposes of the joint venture, Mercury Geotherm Limited ("Geotherm"), owned as to 67% by Network and as to 33% by the McLachlans (either as trustees or beneficially); and Poihipi Land Limited ("Poihipi"), a wholly-owned subsidiary of Geotherm. Geotherm and Poihipi, both now in receivership, are the first and second respondents respectively; Network is the third respondent.

2. The joint venture was the subject of a preliminary written agreement entered into in 1994. This was later varied and a final consolidating agreement (called the second Poihipi joint venture agreement) was entered into on 15 December 1995. This agreement ("the master agreement") was supported by a large number of ancillary contractual documents, some but not all of them set out in schedules to the master agreement. They included a lease ("the lease") granted on 15 December 1995 by Poihipi and Geotherm as lessors to the McLachlans and Mr David Ross (then the trustees of a McLachlan family trust called the Waiturutu Trust) as lessees.

3. The failure of the joint venture has led to some complex and hard-fought litigation raising a number of different issues (some of those issues were remitted to the High Court by the Court of Appeal and the Board was told that they are now again on their way to the Court of Appeal). By contrast the issues before the Board are in quite a small compass, focusing on the correct construction of a right

of pre-emption in clause 16.1 of the master agreement, and on whether (if clause 16.1 does not get the appellants home) they can achieve the same or a similar result by relying on an implied duty of good faith. Mr Bryers (who appeared for the appellants before the Board, not having appeared below) also sought to make submissions on an unusual provision which appears in clause 10.1 of the lease, but (as explained below) it is not really an issue on this appeal.

4. The issues before the Board are therefore quite limited. Nevertheless it is necessary to sketch in, at least in outline, the commercial context in which the issues arise, and the course which the litigation has followed.

5. The McLachlans and their companies have owned land near Taupo since 1965, using it for rearing beef cattle and sheep, with a sideline in growing roses and (latterly) orchids, so making limited use of the geothermal resources which the power station was intended to exploit on a very much larger scale. They owned two adjoining areas of freehold land (referred to in the lease and in these proceedings as Land A and Land B) located between the Poihipi Road and the Tukairangi Road; Land A extended to about 76 hectares and Land B (to the south of Land A) to about 86 hectares. They also had options (granted in 1991) to acquire a further 287 hectares of freehold land (Land C) to the north and west of Land A. Lots 1 and 2 (which are at issue in the proceedings remitted to the High Court) are small areas adjacent to Land C. These figures for areas may not be precisely correct (there are some variations in different documents throughout the Record) but they serve to give a general indication of the position on the ground.

6. The general intention was that the McLachlans should contribute all this land to the joint venture, together with various regulatory licences which the McLachlans had negotiated, taking a leaseback (for farming purposes) of all the land except so much of Land A as consisted of the actual site of the power station. The freehold of Land A and Land B was transferred to Poihipi and the freehold of Land C was transferred to Geotherm, which is why they were both parties to the lease. The McLachlan interests received in return 33% of the shares in Geotherm and a substantial sum of cash (much of which was needed to pay off existing indebtedness to third parties).

7. As already noted, the power station site was to be excluded from the lease of Land A. However it is not easy to define the site of an as yet unbuilt power station using geothermal energy, as appears from the definition in the lease:

   "'Power Station Site' means the area of Land A which is intended to be occupied by the geothermal power station to be constructed under the Joint Venture Agreement including, without limitation, steamfield well pads, steamlines, piping, other steamfield works, access roads and the Poihipi Road planted area."

   The precise delimitation of the site was a major issue before Potter J and in the Court of Appeal, but it is not an issue before the Board.

8. The difficulties of predicting in advance the precise needs of the power station once it had been constructed, commissioned and put into production were also reflected in clause 10.1 of the lease:

   "If the Lessors require the Land for any purpose relating to the construction and operation of [Geotherm's] proposed geothermal power station or the Lessors reasonably believe the use of the Land (or part of it) for the permitted use conflicts with, or limits, that purpose, the Lessors shall have the right to unilaterally vary this Lease to alter the area of the Land which it relates to, to suspend the Lease in respect of all or part of the Land, and/or vary the Term in respect of part or all of the Land, provided the Lessor gives the Lessee not less than two months' written notice of its intention to vary or suspend this Lease. If the Lease is materially varied or suspended in accordance with this clause and such variation or suspension occurs following the date of Commissioning, the annual rent shall be reduced on a pro-rata basis in respect of the area of the Land which the Lessee is not permitted to use following the variation, or the period during which any suspension remains in force."

   The lease was, in relation to Land A, for a term of just under 20 years. No term was specified in relation to Land B and Land C. In relation to all the leased land there were (apart from clause 10.1) various provisions for termination of the lease, including termination if the lessees (or parties associated with them) ceased to be shareholders in Geotherm (see clauses 10.2, 10.3 and 11).

9. The other participator in the joint venture, Network, was to contribute capital and expertise in the construction and operation of the power station. Its rights and obligations are spelled out at some length in the master agreement, especially clause 4 (new articles [of Geotherm]), clause 5 (decision-making and control), clause 6 (funding) and clause 12 (operation of the power station). The details of these fairly complicated clauses do not matter, but they do show that the joint venture must be regarded as a sophisticated commercial agreement (or set of interlocking agreements) drafted by professionals who were aware that the interests of the participants might come into conflict in unforeseen ways.

10. Clause 6 of the master agreement envisaged that Network would initially finance the project, taking security in various forms including a first charge on Land A, Land B and Land C, but that this initial funding would be replaced by long-term loans from a suitable outside source. However that plan was overtaken by events. The power station was completed by December 1996 but for regulatory reasons it did not start generating electricity until September 1997. The McLachlans' case at trial was that in the course of 1997 Network's parent company decided to withdraw from the business of generating electricity, and that in March 1998 Network declined to provide further finance, despite Geotherm's need for more capital. It is not in dispute that on 11 December 1998 Network appointed joint receivers (Mr Lawrence Chilcott and Mr Peter Chatfield) in respect of both Geotherm and Poihipi. There were other proceedings, with which the Board is not concerned, alleging that the appointment of receivers was made in bad faith, and in breach of contractual and fiduciary obligations. The Board is concerned only with the actions taken by the receivers, especially in relation to the land comprised in the lease.

11. After the appointment of receivers the McLachlans wished to reacquire the freehold interest in all the land which they had contributed to the joint venture. Whether they had the financial resources to buy the power station may be in doubt; but for whatever reason, the receivers eventually declined to negotiate with the McLachlans and designated Contact Energy Limited ("Contact") as the preferred bidder. Contact was the new name of ECNZ, which had in the past opposed the McLachlans' plans for developing the geothermal potential of their land, and so the choice of Contact as preferred bidder must have added to the McLachlans' feelings of frustration. But if they could not acquire the whole power station, they wished at least to reacquire the freehold of Land B, Land C, and as much of Land A as was not within the power station site.

12. The lease contains in clause 16.1 a right of pre-emption which lies at the heart of this appeal. It is in the following terms:

    "In consideration of the mutual promises contained in this Lease and in the Joint Venture Agreement, the Lessors grant to the Lessee or its nominee a first right of refusal in respect of the Land or any part thereof, should the Lessors wish to sell or dispose of those parcels of land (together, the "Relevant Land") as are comprised in the Land, or in the property the subject of the Landcorp Property Agreement (as that term is defined in the Joint Venture Agreement) or in any other parcels of land which the Lessors may acquire after the date of this Lease."

    Clause 16.1 then proceeds to set out the detailed terms for exercise of the right of pre-emption.

13. The receivers and Contact and their advisers seem to have been well aware that clause 16.1 made it impossible to proceed with a sale to Contact of the whole of Land A, Land B and Land C. Conversely a sale of the power station site alone could not trigger clause 16.1, but might give rise to problems at some future time, if the new owners of the power station wished to secure the exercise by the lessors (that is, the two joint venture companies then in receivership), but for the benefit of the new owners, of the powers contained in clause 10.1 of the lease. Negotiations between the receivers and Contact produced what they regarded as a satisfactory solution, that is terms under which (i) Contact was to be granted a right of pre-emption over the leased land, but exercisable only after the expiration or sooner termination of the lease (and only if the land was then unsold), and (ii) the sale to Contact was to include various "easement interests" and "encumbrance interests" specified in a schedule to the sale agreement.

14. The sale agreement between the two joint venture companies (in receivership) and Contact was entered into on 24 December 1999. The right of pre-emption granted to Contact was set out in clause 10.7 in the following terms:

"Right of Refusal: If at any time the Deed of Lease is terminated (other than in circumstances contemplated by clause 16 of the Deed of Lease) and following such termination the Vendor, continues to own the fee simple of all or any part of the Easement Land, the Encumbrance Land and/or the Additional Land the Vendor shall, within 30 days of such termination, offer the fee simple to all or that part of the Easement Land, the Encumbrance Land and the Additional Land to the Purchaser for a price equal to the then government valuation of that land."

The "Additional Land" was defined so as to amount, in effect, to all the leased land other than that burdened under the sale agreement with easements or encumbrances. It is common ground that the "government valuation" basis would produce lower than current market value.

15. By the time that the sale agreement was entered into these proceedings were already on foot. The sequence of events leading to the sale was considered by Potter J (at paras 49-62 of her judgment) as relevant to "the crucial question, whether or not the receivers formed a wish to sell the leased land." Potter J accepted the evidence of Mr Chilcott, the more active of the receivers, that he acted independently of Network and Vector. She described him as a very experienced receiver who took independent legal advice and reached his own decisions.

16. Mr Chilcott issued a confidential information memorandum in July 1999 referring to the receivers as being mandated to sell the assets of Geotherm and Poihipi. But the assets listed for sale were the power station (together with some plant in storage at Taupo). The land to be sold was identified on a map as the whole of Land A, but Mr Chilcott said that that was a mistake. In arguing that the receiver had evinced an intention to sell the whole of the leased land the McLachlans relied particularly on a letter dated 21 June 1999 from Mr Chilcott to the trustees of the Waiturututu Trust, expressed as exercising the lessors' powers under clause 10.1 of the lease, and extending to the whole of Land A, most of Land B, and a part of Land C.

17. Potter J described this letter as "somewhat peremptory in tone and clearly erroneous in deeming all of Land A to be the Power Station Site and in the claims made by the Receivers in respect of Lands B and C in reliance on clause 10.1 of the lease." Nevertheless she held that the letter and the memorandum did not indicate a wish on the part of the receivers to sell the leased land. This part of her judgment was upheld by the Court of Appeal (ground 4, paras 41-47) and it is not as such a ground of appeal before the Board. It calls for mention only as demonstrating the limited nature of the first ground of appeal that is before the Board, which focuses on clause 16.1 of the lease and clause 10.7 of the contract for sale to Contact.

18. Mr Chilcott's letter of 21 June 1999 caused a sharp deterioration in the already strained relations between the parties. Mr McLachlan described it (in an affidavit which he swore on 29 February 2000 as an "arbitrary demand . . . to vacate our leased property"). The outcome was that on 28 October 1999 the McLachlans lodged caveats in respect of all the leased land, in order to protect the lessees' interests; and on 20 December 1999, a few days before the sale agreement was entered into, the receivers brought proceedings for the removal of the caveat. The sale agreement referred to the proceedings and contained provisions for retention in escrow of part of the total purchase price of $50.5m. The details of the retention are not relevant to this appeal. It is however noteworthy that the purchaser, Contact, was given the opportunity to become a party to these proceedings, but declined. The McLachlans did not themselves take any positive steps to have Contact joined as a party.

19. Potter J and the Court of Appeal decided that the inclusion of clause 10.7 in the sale agreement between the receivers and Contact did not trigger the lessees' right of first refusal under clause 16.1 of the lease, because clause 10.7 provided for the possibility of a sale to Contact only in circumstances in which the lessees' rights under clause 16.1 had already come to an end with the expiration or determination of the lease. In paras 63 to 72 of her judgment Potter J held that clause 10.7 did not operate "in derogation of" the lessees' rights (the expression used by Tipping J in *Motorworks Limited v. Westminster Auto Services Limited* [1997] 1 NZLR 762, 766). The freeholders had not done anything which put it out of their power to satisfy the lessees' rights so long as they existed. The Court of Appeal reached the same conclusion, expressing it quite briefly (para 33):

"As the Judge noted, the right of purchase granted to [Contact] was expressly conditional upon the Trust's right of purchase in its lease (clause 16.1) having been extinguished – by termination of the lease. Accordingly, there is nothing inconsistent with the Trustee's rights in the grant of the

conditional right of purchase. We agree with the reasons of the Judge to the same effect on this point."

20. Their Lordships see no error in the reasoning and conclusions of the courts below. The right of first refusal granted to Contact by clause 10.7 of the sale agreement was (no doubt advisedly) expressed as being contingent on the lease having come to an end without the lessees' right of first refusal having been exercised. In that event the price payable by Contact, if it exercised its rights under clause 10.7, was to be determined by a formula which was most unlikely to reflect its open market value at that time. Potter J and the Court of Appeal were right to hold that these deferred and wholly contingent rights granted by clause 10.7 of the sale agreement did not trigger the lessees' right of first refusal.

21. In argument before the Board both sides referred to the decision of the English Court of Appeal in *Pritchard v Briggs* [1980] 1 Ch 338. That decision is rather controversial (see Megarry & Wade, The Law of Real Property, 6th ed. (2000) pp.683-684), although most of the controversy has focused on points which are not in issue in this appeal. *Pritchard v Briggs* resembled the present case in that there were successive grants of contractual rights (what Stephenson LJ at p421E called "two promises") to two different potential purchasers: the first a right of pre-emption exercisable until the death of the survivor of the landowners, and the second an option exercisable after the death of the survivor. The Court of Appeal held that the grant of the option (the second promise) did not trigger the right of pre-emption (the first promise): see Templeman LJ at p419F and Stephenson LJ at p422B. To that extent the case provides some assistance to the respondents. The Court of Appeal also held that the option was not impliedly made conditional on the land remaining unsold at the death of the survivor of the landowners: see Goff LJ at p387F, Templeman LJ at pp.419H-420B and Stephenson LJ at p422D. The second promise was not therefore inconsistent with the first promise, but it "confined" the first promise (as Stephenson LJ put it at p421H; see also Templeman LJ at p420F-G). In the present case, by contrast, the second promise (in clause 10.7 of the sale agreement) was expressly made conditional and did not in any way confine (or derogate from) the first promise (in clause 16.1 of the lease).

22. There remains the appellant's argument based on an implied duty of good faith. This argument was raised before Potter J, who dealt with it in paragraphs 79 and 80 of her judgment:

    "The McLachlans seek an order from the Court that the plaintiffs do that which they should have done in good faith, namely offer the land to the McLachlans at government valuation. They contend that the steps for setting up the easements and encumbrances and the option given to Contact in clause 10.7 of the Contact agreement, so as to avoid triggering clause 16.1, was no less than an effort to deprive the defendants of the fruits of its contract and the mutual promises in the joint venture agreement.

    I have little difficulty in accepting that the joint venture agreement and the lease which is contemplated by that agreement annexed as Schedule 4 and executed on the same day (15 December 1995), are in the nature of a relationship contract. Clause 16.1 containing the right of first refusal in issue in these proceedings expressly links the lease with the joint venture agreement by stating that the provisions are in consideration of the mutual promises contained in the lease and the joint venture agreement. This was a long-term joint venture for a large scale, complex, commercial undertaking. The power supply agreement between Geotherm and Mercury/Vector was for 32 years. It would not be possible for contractual documents executed in 1995 to specify with particularity every facet of the arrangements which would impact on the joint venture and the parties to it in the years to come. There are necessarily to be implied mutual covenants on the joint venture parties to co-operate and proceed with good faith in the achievement of their agreed common purpose. But the agreed common purpose and their contractual obligations must be interpreted by reference to the contractual documents and the agreements of the joint venture parties expressed in those documents."

23. The judge then set out clause 10.1 of the lease and discussed the way in which the receivers had gone about the exercise of their powers, especially in relation to clause 10.1. She then made some observations (in para 86 of her judgment) about the right of first refusal: (the first sentence refers to "clause 10.1" but it is common ground that she must have meant clause 16.1):

"The McLachlans are correct in asserting that the Receivers acted so as to avoid triggering clause [16.1]. I find that they did so not in bad faith but pursuant to a commercial decision in furtherance of their legal duties as Receivers; they acted not to destroy or injure the "fruits of the contract" for the McLachlans (although consequentially clause 16.1 has not been triggered) but to preserve powers specifically vested in them by the lease. Later in this judgment under *Encumbrances* I hold that the Receivers are not entitled to register two proposed encumbrances against the fee simple titles to the leased land. The Receivers have misconceived the extent of their powers under clause 10.1 but that does not affect my determination that in acting so as to preserve their rights and powers under clause 10.1, the Receivers did not breach an implied duty of good faith to the McLachlans."

24. In the Court of Appeal (in which Mr McLachlan appeared in person) the judge's conclusion on this point was challenged by Mr McLachlan's fifth ground of appeal. As it was put in para 48 of the judgment of the court delivered by Gault P:

"The point repeatedly made, and formulated in differing arguments, is that having taken the land into the joint venture, the trustees were owed duties, over and above those expressed in their lease, translating into entitlements to have their offers to purchase the assets of the joint venture, including the power station, accorded some priority."

25. The Court of Appeal rejected that argument as misconceived (para 49):

"The reality is, as the Judge recognised, that the receivers' duties are to recover debt and to realise assets of the companies concerned to that end. They may do that to the extent that they are not constrained by legal obstacles. Potter J held that they cannot create the encumbrances over the leased land as they had undertaken to do. That would breach the lessees' rights of quiet enjoyment and derogate from their grant. But that aside, there is nothing in the various joint venture documents to prevent the course taken by the receivers. It was submitted that the Judge's conclusion that the steps taken by the receivers were commercially justified is no excuse for breach of fiduciary duties. That might be so if there were established duties not to do what they have done. It is not enough to say that parties are in a relationship which give rise to fiduciary obligations; it is necessary to identify those obligations. It is one thing to assert that in establishing and operating a joint venture the parties must act towards each other in good faith, but it is quite another thing to contend that in addition to the obligations they have assumed and must carry out in good faith, the law should impose further and separate duties of the kind suggested here."

26. Again, their Lordships can see no error in the reasoning and conclusions of the courts below (and in so far as the appellants emphasise and rely on the particular facts of the case, they are met by the formidable obstacle of concurrent findings of fact). The master agreement and its inter-linked contractual documents represented sophisticated commercial arrangements (negotiated, no doubt, with expert professional advice). These arrangements recognised the uncertainties of the venture and the possibilities of unforeseen conflicts of interest. Clause 16.1 of the lease was inserted in order to give the lessees certain rights in certain events. The sub-clause must be construed fairly in its commercial context, and that, in their Lordships' opinion, is what the courts below did. The rights conferred by the sub-clause, fairly construed, cannot be stretched so as to cover other events not specified in the sub-clause.

27. Mr Bryers wished to make submissions to the Board as regards some passages in the judgment of Potter J (para 125) and the Court of Appeal (paras 38 and 73) in relation to clause 10.1 of the lease. That may remain an issue in other parts of this complex litigation, but it is not an issue on this appeal to the Board. Their Lordships can only record without comment Mr Bryers' general submission that the passages just mentioned were not necessary to the decisions below, and are not correct.

28. For these reasons their Lordships will humbly advise Her Majesty that this appeal should be dismissed with costs before the Board (without disturbing the cost orders made below).