HERBERT SMITH FREEHILLS

INSURANCE AND REINSURANCE DISPUTES 2017 REVIEW

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2017 REVIEW

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Preface

Our Insurance Annual Review brings together various bulletins and briefings that we have produced over the last twelve months. We hope that this will be a useful single source of reference for our clients and contacts with an involvement or interest in relevant developments in the insurance and reinsurance market. All our articles as well as updates on other legal and regulatory developments are now available on our new Insurance Blog: https://hsfnotes.com/insurance/

As always, the articles in this Annual Review cover a broad range of issues, a number of which are very much hot topics in the sector at the moment including cyber insurance, driverless cars, Brexit and the extension of the Senior Managers and Certification Regime (**SMCR**).

We also examine the key insurance decisions that the English courts have looked at this year. Construction of policy wordings continued to be a ripe area for disputes between insurers and insureds. This year also saw two cases which looked for the first time at the new Third Parties (Rights Against Insurers) Act 2010 which came into force last year – *Redman v Zurich* and *BAE Systems Pension Funds Trustees Ltd v Royal & Sun Alliance Insurance Plc*. The wait continues for the first Insurance Act decision to reach the courts so watch this space in 2018.

2017 also saw the new provisions of the Insurance Act 2015 (brought in by the Enterprise Act 2016) come in to force giving policyholders, for the first time, the right to claim damages for late payment of insurance claims. Only time will tell what the impact of these new provisions will be.

More generally, the difficulties for corporates wishing to take legal advice with the benefit of privilege have continued to multiply over the past year. In February, there was news that the Supreme Court would not be hearing an appeal against the High Court's problematic decision in the *RBS Rights Issue Litigation* [2016] (which we covered in last year's review). Then, in the *SFO v ENRC* decision in May, the High Court not only endorsed the restrictive approach to legal advice privilege taken in *RBS*, but took a similarly narrow approach to the application of litigation privilege.

From a regulatory perspective, both (re)insurers and intermediaries are beginning to plan for the extension of the SMCR to all financial services firms. For (re)insurers, the new requirements build on the Senior Insurance Managers Regime which came into force in 2016, and are expected to apply from late 2018. The regime is entirely new for intermediaries but a later anticipated date for going "live" gives them until 2019 to make the necessary preparations. Otherwise, both (re)insurers and intermediaries are having to consider how to mitigate the loss of passporting rights that is expected to follow the UK's withdrawal from the EU, in some cases by establishing a new European "hub" for the conduct of their EEA business. Regulatory reforms mandated by the Insurance Distribution Directive, which also affect both carriers and intermediaries, are likely to take effect from October 2018.

We hope that you find our Annual Review of use. Should you need further hard copies (soft copies are available on the Herbert Smith Freehills website) then please contact me or any member of the insurance and reinsurance disputes team.

Paul Lewis
T +44 20 7466 2138
paul.lewis@hsf.com

Court of Appeal considers meaning of notification wording

Zurich Insurance Plc v Maccaferri Ltd [2016] EWCA Civ 1302

12 January 2017

The Court of Appeal has upheld a decision of the Commercial Court that found an insurer could not rely on a notification condition precedent to avoid liability under a public and product liability policy.

Background

An employee sustained an eye injury at work when using a Spenax gun to attach wire caging together and consequently sued his employer. Various claims ensued including a claim against the insured company (the insured) that had hired the gun to the employer.

The employee's accident occurred on 22 September 2011. The insured received a solicitors' letter almost two years later (dated 18 July 2013) informing it that a claim was to be brought against it. This prompted the insured to notify its public and product liability insurer, Zurich, a few days later on 22 July 2013.

The insurer declined to provide an indemnity arguing that the insured had failed to comply with the following condition precedent relating to notification:

"The Insured shall give notice in writing to the Insurer as soon as possible after the occurrence of any event likely to give rise to a claim with full particulars thereof."

The insurer sought to argue that the insured should have given notice to the insurer much earlier, either by October 2011 (shortly after the accident/event had occurred) or by June 2012 (for reasons which we do not need to go into here).

The insurer also argued that the use of the words *"as soon as possible"* indicated that the obligation to notify arises when an insured could with reasonable diligence discover that an event was likely to give rise to a claim. The insurer sought to argue for an extended meaning to the words *"as soon as possible"* which would import an obligation on the insured to be 'proactive' or would imply a duty of inquiry. It argued that this was supported by the obligation to provide the insurer *"with full particulars thereof"* which suggested that time may be required for those purposes.

First instance decision

At first instance, Mr Justice Knowles in the Commercial Court rejected the insurer's arguments and found there had been no failure by the insured to comply with the condition precedent. The insurer was, therefore, obliged to indemnify the insured under its public and product liability policy.

On the meaning of the words "*as soon as possible*", the Court held that this simply referred to the promptness with which notice was to be given once there had been an event likely to give rise to a claim. The words did not indicate an implied duty of reasonable inquiry as the Court held that there was "*no room…for…a continuing or 'rolling assessment' of claim likelihood to be required of a policyholder when the policy does not provide for it.*"

In considering the phrase "*likely to give rise to a claim*", the Court relied on previous authority and confirmed that this described an event with at least a 50% chance that a claim against the insured would eventuate. Applying the facts of this case, the Court found that when the accident occurred, there had not been at least a 50% chance that a claim against the insured would eventuate. It had been a possibility that the accident had involved a fault in the gun, but it was also possible that there had been a fault in the use of the gun, or no fault at all. The insured had not been blamed at the time. The Court also found that reference to the likely involvement of the Health & Safety Executive or to forensic testing on the gun after the accident did not indicate anything more than that a claim was a possibility but this was not enough. The 50% threshold had to be satisfied given the "*likely to give rise to a claim*" language. The Court broadly accepted the principle that a claim might still be "likely" even if it was a bad and vexatious claim, but on the facts of this case this did not aid the insurer.

Court of Appeal decision

The Court of Appeal upheld the decision of Knowles J.

The Court of Appeal rejected the insurer's submissions on the construction of the condition precedent set out above, noting "*[i]f Zurich wished to exclude liability it was for it to ensure that clear wording was used to secure that results. It has not done so.*" The Court went on to say "*given the nature of the clause the ambiguity must be resolved in favour of [the insured]. Clauses such as these need to be clear if they are to have effect.*"

Having considered the relevant authorities, the question for determination was whether, when the event occurred (an occasion not limited to the exact moment) it was likely to give rise to a claim. It was noted that that will depend on whether, in light of the actual knowledge that the insured then possessed, a reasonable person in his position would have thought that it was at least 50% likely that a claim would be made.

The Court of Appeal found that when the incident occurred, on the facts then known to the insured, it was not at least 50% likely that there would be a claim. In reaching this conclusion the Court considered the circumstances of the case, relevantly that the insured had not been informed that someone had been seriously injured. Clarke LJ also considered that the gun being at fault was "*no more than a possibility and there were many others.*"

The Court of Appeal quoted the decision of Knowles J at first instance: "*[t]rue the accident was very serious: someone had lost their sight. But that seriousness does not increase the likelihood that the allegation would be that there was a fault in the gun. At least in context, the likelihood of a claim cannot simply be inferred from the happening of an accident (Jacobs v Coster and Avon Insurance). A possibility of a claim is not enough to engage the obligation [to notify].*"

Comment

Although the insured in this case obtained a favourable outcome, notification clauses continue to remain a trap for the unwary and are often a source of dispute between insureds and insurers.

Both the appeal and the first instance judgments serve as a reminder that it is crucial that policyholders are aware of the notification provisions in their policies and when their obligations to notify are triggered. This is particularly so when obligations to notify are expressed to be conditions precedent to insurers' liability such that any failure to comply strictly with the wording of a clause will be fatal to a claim, regardless of whether insurers have suffered any prejudice. Insureds and their brokers should consider whether it would be possible to replace conditions precedent in their policies with bare conditions.

The appeal judgment also reminds insurers that should they wish to exclude liability they will need to ensure the provisions of the policy are clearly worded and without ambiguity.

In determining whether a notification obligation has been complied with, the wording used in the clause is important. By way of example, the outcome in this case may have been different if the phrase *"may give rise to a claim"* had been used in the policy instead of *"likely to give rise to a claim"*, as this entails a lesser threshold before the insured's notification obligations are triggered. Please see by way of example the comments of Mr Justice Rix (as he then was) in *J Rothschild Assurance Plc v Collyear.*

As a matter of practice, policyholders should ensure that they have clear reporting lines in place, especially within large organisations, to ensure that notification provisions can be complied with strictly. Policyholders may also wish to consider seeking wording in their notification clauses with which it is easier to comply (such as notification "as soon as reasonably practicable" rather than "immediately" or by reference to a fixed term).

Additional references

Zurich Insurance Plc v Maccaferri Ltd [2015] EWHC 1708 (Comm)

Jacobs v Coster and Avon Insurance [2000] Lloyd's Rep IR 506

J Rothschild Assurance Plc v Collyear [1999] Lloyd's Rep IR 6

Court of Appeal considers triggers for liability coverage when settlement is agreed by payment of monies into escrow account

(1) WR Berkley Insurance (Europe) Ltd and (2) Aspen Insurance UK Ltd v Teal Assurance Co Ltd [2017] EWCA Civ 25

25 January 2017

In *(1) WR Berkley Insurance (Europe) Ltd and (2) Aspen Insurance UK Ltd v Teal Assurance Co Ltd*, a Defendant in a construction dispute settled the dispute and paid a sum into an escrow account from which the Claimant could, under certain circumstances, draw down sums to pay for remedial works. At that stage was the liability ascertained? The Court of Appeal held that the Defendant's liability under the settlement agreement was quantified (and the Defendant was accordingly entitled to claim an indemnity under its professional indemnity policy) only when the Claimant drew down sums from the escrow account, not when the Defendant paid the sum into the account.

Background

This is the latest instalment in the long-running litigation between Teal Assurance Co Ltd (**Teal**) as Claimant and W R Berkley Insurance (Europe) Ltd and Aspen Insurance UK Ltd (together the (**Reinsurers**)) as Defendants. Teal is the captive insurer of Black & Veatch Group (**BV**), an engineering firm. BV's professional indemnity insurance programme for the period from 1 November 2007 to 1 November 2008 (the **Programme**) was structured as a "tower" of policies. The first four layers (the first underwritten by Lexington Corporation, the second, third and fourth underwritten by Teal) provided cover of USD60 million excess of BV's self-insured retention and deductible. Teal also underwrote a fifth layer (the **Top and Drop Layer**) providing cover of £10 million excess of the first four layers. The Top and Drop Layer was reinsured with the Reinsurers. The Top and Drop Layer and contract of reinsurance both excluded claims emanating from, or brought in, the USA or Canada.

The settlement of the Ajman Claim

A number of claims were brought against BV during the policy period. Two substantial, and several smaller, claims were brought in the US and would not fall to be indemnified under the Top and Drop Layer. One non-US claim was brought by Ajman Sewerage Private Company Ltd (**ASPCL**). The claim arose out of BV's process, design and construction of a waste water treatment plant for the emirate of Ajman (the **Ajman Claim**). In December 2010, BV agreed, with Teal's consent, to settle the Ajman Claim. As part of the settlement agreement, BV paid approximately US$13 million into an escrow account pursuant to an escrow agreement (**Escrow Agreement**). The settlement agreement provided that ASPCL could draw down the following sums to cover the costs of remedial work, subject to certain contingencies:

- US$1.4 million within 21 days of award of a new contract for the remedial work (if the contract for remedial works were not awarded by a certain date, the money in the escrow account would be distributed to BV);
- a further US$1.2 million within 52 days of commencement of work by the new contractor; and
- further amounts on completion of instalments of the remedial work (subject to independent verification of the value of the work performed and various time limits).

The settlement agreement also provided that interest accruing in the escrow account would be for BV's account and paid to BV. Any remaining funds would be distributed to BV.

First instance decision

It is well established that an insurer's liability to indemnify the insured under a professional indemnity policy arises only when the insured's liability is established and ascertained. Teal and the Reinsurers agreed that the settlement established BV's liability. The question before the High Court and Court of Appeal was whether BV's payment into escrow ascertained, or quantified, BV's liability to ASPCL, thereby triggering the relevant insurer's obligation to indemnify under the Programme.

Teal argued that the payment into escrow did not ascertain BV's liability to ASPCL. This was significant because the order in which BV's liabilities were ascertained affected BV's total recovery under the Programme. Put simply, if the US claims were ascertained before the Ajman Claim, they would fall to be indemnified under the layers below the Top and Drop Policy. If non-US claims were ascertained before the US claims and eroded the tower, the US claims would not fall to be indemnified under the Programme. The practical consequence was that if Teal's arguments were correct around US$11 million in respect of the Ajman Claim was payable by Teal under the Top and Drop Policy (and crucially Reinsurers would be liable to indemnify Teal under its reinsurance).

Mr Justice Eder, the judge at first instance, held that it was not automatic that all, or indeed any, of the funds paid into escrow would be paid to ASPCL and the settlement agreement did not quantify BV's liability. Although there were two quantified payments which would be paid in certain circumstances, ASPCL could not draw down further sums until the new contractor performed remedial work and the value of that work had been subject to independent certification.

The Reinsurers argued that the payment into escrow was analogous to an interim payment of damages. The Reinsurers cited *Cox v Bankside Members Agency Ltd*, in which Mr Justice Philips held that "*an interim payment order ascertains a quantified sum which is due and payable by way of damages*". Eder J rejected this argument and distinguished *Cox*. First, an interim payment order assessed the likely minimum amount of the Defendant's liability. There was no such assessment here. Secondly, there was no policy reason why the Programme should indemnify BV for a payment into escrow to which it agreed, rather than for draw downs from the escrow account.

Court of Appeal decision

The Court of Appeal upheld the judgment of Eder J and dismissed the appeal. The decision turned on construction of the settlement agreement and associated agreements.

First, the settlement agreement did not require BV to part irrevocably with its money.

- The payment into the escrow account was not a loss to BV. The money in the account had to be dealt with according to the terms of the Escrow Agreement. BV stood to benefit from any interest accruing on the money in the escrow account. The Court of Appeal accorded more weight than Eder J to the fact that the money was paid into escrow, rather than to ASPCL.
- The deposit was described as "*delivery of funds*" into the Escrow Agreement and was paid as security. Under certain circumstances, the sums paid into the escrow account would be released or repaid to BV. Payments out of the escrow account constitute compensatory damages, but the payment into the escrow account did not in itself compensate ASPCL.

Secondly, the sum deposited was the maximum amount of BV's liability (in contrast to an interim payment order which is based on the likely minimum extent of the Defendant's ultimate liability).

- BV and ASPCL did not agree that the amount paid into escrow was the amount of BV's liability, or the minimum amount of BV's liability. Payment out of the escrow account occurred on ascertainment of the extent of BV's liability, and it was this which constituted a loss to BV. The settlement agreement did not identify a specific sum which BV was, without more, required to pay ASPCL.
- This was analogous to judgment for damages to be assessed. The timing and extent of payment to ASPCL from the escrow account depended upon ASPCL's entry into a new contract for remedial work, performance of work under that contract, and certification of that work as provided for in the agreement.
- The Court did not consider that an analogy could be drawn between an order for an interim payment and payment under the settlement agreement, which was of a "*fundamentally different character*". Under the settlement agreement, payment would not be paid to ASPCL without more.

Case law also supported this conclusion:

- In *Burns v Shuttlehurst Ltd*, the Court of Appeal held that a judgment for liability with damages to be assessed does not ascertain the amount of damages and is therefore not sufficient to generate a right to indemnity under a typical liability policy.
- In *Enterprise Oil Ltd v Standard Insurance Co Ltd*, the High Court held that an insured could not demonstrate loss under a liability policy if it could not show the amount of liability to a third party by judgment, award or settlement.

The Court of Appeal considered insurers' consent to the settlement agreement irrelevant. The insurers did not agree to fund the payment into the escrow account, nor that the payment into the escrow account entitled BV to an indemnity in like amount.

It was clear from the wording of the settlement agreement that *Cox* did not apply to this case. The Court of Appeal therefore did not have to determine whether *Cox* was correctly decided. The Court indicated, however, that *Cox* did not intend to suggest that an interim payment was paid "*as damages*". Instead, an interim payment is a payment on account of and in anticipation of an award of damages. In any event, under the Programme the insurer's obligation only arose on "*final determination*" of liability. It was questionable whether an order for an interim payment constituted "*final determination*" of liability. If the policy in *Cox* had been subject to such a condition, the Court of Appeal said it was questionable whether Philips J would have reached the same conclusion.

Comment

Ultimately this case was one of contractual construction and turned on its unusual facts. For ascertainment purposes the Court of Appeal compared the escrow arrangement in this case to a judgment with damages to be assessed, but payments into court, interim payments on account of damages, and different settlement structures may be treated differently.

It should not be assumed that all structures will be treated in the same way when it comes to ascertainment and hence policy response. Each structure should be considered in light of the particular facts and the case law.

Additional references

WR Berkley Insurance (Europe) Ltd and (2) Aspen Insurance UK Ltd v Teal Assurance Co Ltd [2015] EWHC 1000 (Comm)

Cox v Bankside Members Agency Ltd [1995] CLC 180

Burns v Shuttlehurst Ltd [1999] 1 WLR 1449

Enterprise Oil Ltd v Standard Insurance Co Ltd [2007] Lloyd's Rep IR 186

Court orders payment of costs by non-party insurer

XYZ v Travelers Insurance Company [2017] EWHC 287

24 February 2017

In *XYZ v Travelers*, the High Court made an order for costs against an unsuccessful Defendant's insurer, under section 51 of the Senior Courts Act 1981. Even though the claims in issue were uninsured, the insurer had paid the costs of the defence and influenced the conduct of the claims. Further, the insurer had prevented the insured from disclosing its lack of insurance to the Claimants, which prolonged the Claimants' involvement in the litigation.

Background

In 2012, a number of claims were brought under a Group Litigation Order in respect of defective breast implants manufactured by the French company, PIP. Transform Medical Group (CS) Ltd (**Transform**), a private hospital which had supplied breast implants to a number of the Claimants, was one of several Defendants to the action.

Transform had a product liability policy in place for the period 31 March 2007 to 30 March 2011, insured through Travelers Insurance Company Ltd (**Travelers**). 197 of the 623 claims against Transform were covered under that policy. The remaining 426 claims against Transform were not covered – either because they fell outside the policy period, or because the claims concerned breast implants which had not ruptured.

By 2013, the solicitors for the Claimants had become aware that Transform was in financial difficulties and sought confirmation that it had adequate insurance cover in place. Transform did not provide the confirmation sought and the Claimants therefore sought an order to compel Transform to provide information as to the nature and extent of its liability insurance and/or a copy of its policy. Transform was ordered to provide a witness statement setting out whether it had adequate insurance to fund its participation in the litigation. In December 2013, the Chief Executive Officer of Transform provided a witness statement, which satisfied the Court that Transform had confirmed that it had insurance adequate to fund its participation in the litigation. The Claimants' advisers also inferred (incorrectly) from the statement that Transform was insured in respect of all the claims it faced.

Transform's insurance position was not revealed to the Claimants' solicitors until April 2014, by which time it was clear from expert evidence that the Claimants would be successful in the litigation.

The covered claims were settled in June 2015, with Travelers paying both damages and costs. The uncovered claims proceeded to trial. Judgment was entered against Transform in May 2016, by which time Transform was insolvent and unable to pay damages or costs. The Claimants therefore sought to recover their legal costs from Travelers.

Decision

The judge, Lady Justice Thirwall, sitting as a judge in the High Court, made an order that Travelers pay the Claimants' costs under section 51 of the Senior Courts Act 1981. Amongst other things, section 51 provides that the costs of and incidental to all proceedings in the High Court shall be in the discretion of the Court, and the Court has full power to determine by whom and to what extent the costs are to be paid.

The judge emphasised that there are no fixed rules to determine whether to award costs against a non-party, citing the Court of Appeal's post-script in *Deutsche Bank AG v Sebastian Holdings Inc CA*:

"We think it important to emphasise that the only immutable principle is that the jurisdiction must be exercised justly. It should also be recognised that, since the decision involves an exercise of discretion, limited assistance is likely to be gained from the citation of other decisions at first instance in which judges have or have not granted an order of this kind."

The judge also considered the existing line of cases in which courts have considered whether to award costs against an insurer. Those cases have largely focused upon the insurer's control of the litigation and whether the insurer paid appropriate regard to the interests of the insured as the key factors in determining whether to award costs against an insurer (see, for example, *Citibank NA v Excess Insurance Company Ltd*). However, the judge found such cases to be of little assistance. In this particular case, Travelers funded the unsuccessful defence of 426 claims, none of which it actually insured.

The judge found that the case was sufficiently exceptional to justify the making of a costs order against Travelers. Travelers had exercised influence over the conduct of the uncovered claims, even though it had no right to do so. The judge was satisfied that, but for Travelers' involvement: (i) Transform would have disclosed its insurance position to the Claimants at an early stage; and (ii) the claims would not have brought (or would have been discontinued), and therefore the costs in issue would not have been incurred by the uninsured Claimants.

In considering whether the making of an order was just, the judge also took account of the following two factors:

- Had the Claimants failed in their claims, they would have been liable for Travelers' costs. Travelers had the potential to

receive the benefit of a costs award in its favour, but would have taken no risk itself.

- Travelers would be paying what it had bargained for under the contract of insurance.

Comment

The mere fact that an insurer funds an unsuccessful defence of an insured claim under the terms of a liability policy is unlikely to be sufficient for an adverse costs award to be granted. However, this decision highlights the adverse costs risks for insurers of funding uninsured claims. The Court has discretion to make a costs award against an insurer, but must do so justly. In determining whether to make such an award, the Court will consider the insurer's conduct as a whole, including the level of influence exerted by the insurer over the litigation and, it appears, the extent to which it acted in its own interests, as opposed to (and potentially in conflict with) the interests of the insured. Notably, an order against an insurer under section 51 of the Senior Courts Act 1981 is made against the insurer itself and hence is not subject to policy limits.

There is also a lesson here for policyholders: Travelers had no legal basis to require Transform to continue to defend uninsured claims, thus putting Transform at risk of an adverse costs award. Had Transform settled the uninsured claims at an earlier stage, as was its right to do so (although it appears not to have appreciated that point), this situation would not have arisen.

One unusual aspect of the case was the apparent conflict between Transform and Travelers. In accordance with general principles, absent an allocation provision, Travelers was liable to pay the defence costs of the insured claims in full, notwithstanding that such costs would also inure to the benefit of the defence of uninsured claims (*International Energy Group Ltd v Zurich Insurance Plc (SC(E))*). However, Travelers was only liable to pay the insured proportion of the Claimants' legal costs (which were split between the Claimants equally). Thus, the higher the proportion of uninsured claims, the smaller Travelers potential adverse cost liability would have been (whereas it could expect to recover the defence costs it had funded in the event of success). It was therefore in Travelers' interests that the uninsured claims continued, whereas it was in Transform's interests that the uninsured claims be discontinued. This conflict, together with the *de facto* control of the defence of the uninsured claims exercised by Travelers, were the key factors to which the judge appears to have attached weight in determining that this was an 'exceptional' case in which it would be just to award costs against Travelers.

Additional references

Deutsche Bank AG v Sebastian Holdings Inc CA [2016] 4 WLR 17

International Energy Group Ltd v Zurich Insurance Plc (SC(E)) [2016] AC 509

Citibank NA v Excess Insurance Company Ltd [1999] 1 Lloyds Rep IR 122

Senior Courts Act 1981

No inducement: Court of Appeal upholds first instance decision

Axa Versicherung AG v Arab Insurance Group [2017] EWCA Civ 96

28 February 2017

The Court of Appeal has upheld the decision of the Commercial Court that a reinsurer failed to establish that material non-disclosure of past loss statistics induced it to enter into two reinsurance contracts.

Background

Axa Versicherung AG (**Axa**) entered into two "first loss" facultative/obligatory reinsurance treaties with Arab Insurance Group (**Arig**) (the **Treaties**). The first treaty covered the first US$500,000 of losses for any one accident or occurrence on Arig's book of inwards marine energy construction risks attaching between 1 January 1996 and 30 June 1997 (the **First Treaty**). The second treaty was a renewal of the First Treaty and covered risks attaching between 1 July 1997 and 30 June 1998 (the **Second Treaty**).

Axa sought to avoid the Treaties on the basis that Arig did not disclose, and misrepresented that there were no loss statistics relating to its book of inwards marine energy construction risks written between 1989 and 1995. Axa also sought to avoid the Second Treaty for Arig's alleged non-disclosure of its claims experience under the First Treaty.

First instance decision

Mr Justice Males held that Arig had not made a misrepresentation as to the existence of the earlier loss statistics, but had failed to disclose the statistics relating to its losses under the First Treaty.

Axa had however failed to establish that Arig's non-disclosure induced it to enter into the Treaties and was therefore not entitled to avoid the Treaties. If the broker had disclosed the loss statistics, they would also have explained the statistics and put them into context. For example, the broker would have pointed to a change in underwriting strategy since the earlier unfavourable loss statistics. There were also commercial reasons for Axa to subscribe to the risk, even if the loss statistics had been disclosed. Finally, the underwriter's evidence on what information would have been essential was not safe.

Court of Appeal decision

Axa appealed the decision on two grounds:

- Males J applied the wrong test by deciding what Arig's re-insurance broker, NMB, *could* have said if the relevant loss statistics had been disclosed to encourage Axa to subscribe to the First Treaty. The correct test was what NMB *would* have said.
- The judge's findings on inducement were based on a "hypothetical broke" which had no basis. The judge's findings on inducement were erroneous. Axa also submitted that the judge's finding on inducement was a product of procedural unfairness.

The appeal was dismissed on both grounds.

Would have, could have, should have?

In considering inducement, Males J found that, if the loss statistics had been disclosed to Axa, NMB "*would have been able to make some play*" of Axa's participation on an earlier quota share treaty as an indication of Axa's trust of Arig's ability to write construction risks. He also found that NMB would have been able to point to the fact that Arig had already written several risks which were to be ceded to the First Treaty and would therefore provide immediate premium to Axa under the First Treaty. The judge considered these would have been relevant to Axa's decision to enter into the First Treaty. In other parts of his judgment, however, the judge said NMB "*could have referred to particular factors*"; in others the judge expressly distinguished between "*could*" and "*would*".

Axa argued that the judge had applied the wrong test: the correct question was whether NMB *would* have relied on these factors to encourage Axa to subscribe to the Treaties.

The Court of Appeal rejected the suggestion that the incorrect test had been applied. People, including judges, do not always distinguish precisely between "would", "should", and "could". There were three situations in which the distinction between "*could*" and "*would*" may be relevant for the Court's analysis of an unfair presentation of the risk:

- The Court's determination of what needed to be said for a presentation of a risk to be fair is an objective question: what *should* have been said to the reasonable and prudent underwriter? A fair presentation does not simply require revelation of the (undisclosed or misrepresented) negative information: it may be necessary to provide some positive qualification of these risks to prevent the hypothetical presentation from being unfairly prejudicial.
- The question when considering factors relevant to the underwriter's decision but not material to the risk is what the broker/insured *would* have said. What a broker could have said is irrelevant if he would not in fact have done so. The Court would not presume that brokers would say everything good about the risk that could be said, "*but the court may need little persuading that a competent broker would have endeavoured to say as many good things about it as were open to him*".
- The Court may need to determine what considerations would have played a part in the mind of the person to whom the risk

was or would have been presented. The fact that the insurer could have been interested in something is irrelevant if he would not have been. The Court will also consider what the underwriter already knew and had in his mind.

Males J had, in refusing Axa's application for permission to appeal, clarified his intended meaning (as he was entitled to do). References in the judgment to what "*could*" have happened were to be treated as references to what "*would*" have happened.

The basis of the judge's findings on inducement

At first instance, Mr Holzapfel, the underwriter who decided to enter into the Treaties on behalf of Axa, gave evidence on inducement. At the end of Arig's cross-examination of Mr Holzapfel, Males J asked a series of questions based on what he would have considered to be a fair presentation of the risk (the hypothetical broke) Mr Holzapfel stated in response that he did not think he would have entered into the First Treaty. Males J nonetheless considered that Axa had not established inducement on the balance of probabilities.

Axa did not challenge the judge's findings of primary fact, but argued that he was not entitled to draw the conclusions he did from these findings. The Court of Appeal also rejected this argument concluding that Males J had correctly taken into account a number of factors when reaching his decision on inducement. For example:

- Mr Holzapfel had not inquired about the deductibles payable on claims made under risks ceded to the Treaties (which in other parts of his evidence he referred to as essential information). Axa also had an interest in cash flow from premiums paid on risks already written and to be ceded to the First Treaty. The judge was entitled to treat these as relevant factors when concluding that Axa would not have acted differently had the loss statistics been provided.
- The judge was entitled to conclude that Axa considered Arig a high quality reinsured, given that Axa was already participating on a quota share treaty with Arig, this would have been a relevant factor in Axa's decision if there had been a fair presentation.
- Although there was no direct evidence from NMB on the point, the judge was entitled to infer that the broker would on giving a fair presentation of the risk have explained that Arig had changed its underwriting philosophy since the period of the most negative loss statistics.
- Similarly, although there was no direct evidence from NMB or Mr Holzapfel that they were aware of bad market conditions in the period of the poor loss statistics, the judge was entitled to infer (based on expert evidence) that Mr Holzapfel would have known those years were unusually bad.

It was therefore open to the judge to consider that Axa had not proved that Arig's failure to disclose the loss statistics induced it to subscribe to the Treaties.

Alleged procedural unfairness

Axa also challenged Males J's decision on the basis of a number of alleged procedural irregularities. For example, the judge had not accepted parts of Mr Holzapfel's witness statement even though those aspects of his evidence were not formally challenged by Arig. The Court of Appeal, however, concluded that the procedure had not gone so awry that Males J's judgment must be set aside.

In a postscript to its judgment, the Court of Appeal stressed that the burden was on insurers to prove inducement where there had been a material non-disclosure or misrepresentation by the insured. In assessing whether there has been inducement, however, one must consider what additional matters might have been raised if the hypothetical fair presentation had been given. The evidential burden will be on the insured. The Court highlighted that it was undesirable for such points to be made for the first time at trial, rather than at an earlier stage, such as in the pleadings or witness evidence.

The Court of Appeal refused the appeal.

Comment

This decision illustrates several important points.

- The question in determining whether there has been a fair presentation of risk is what information *should* have been provided.
- In assessing whether there was inducement, it is also necessary to have regard to any positive information which would have been provided in the hypothetical situation where fair presentation has been given. This is necessary to avoid the presentation of risks in an unfairly prejudicial light.
- The Court will also consider other factors relevant to the (re) insurer's decision to accept the risk, including the parties' commercial relationship and wider commercial interests.
- The underwriter's evidence on inducement is critical. Insurers arguing that the provision or accuracy of certain information was essential will face an uphill struggle to establish inducement if they subscribed to similar risks without seeing such information.

Although the reinsurance contracts at issue predated the Insurance Act 2015, the judgment is also of relevance to insurance and reinsurance contracts governed by the new Act. The new proportionate remedies for breach of the duty of fair presentation will only be available if the (re)insurer is able to demonstrate inducement.

Additional references

Insurance Act 2015

Axa Versicherung AG v Arab Insurance Group [2015] EWHC 1939 (Comm)

Supreme Court construes aggregation provision in minimum terms and conditions of professional indemnity insurance

AIG Europe Ltd v Woodman & Ors [2017] UKSC 18

22 March 2017

In *AIG Europe Ltd v Woodman & Ors*, the Supreme Court allowed the appeal, and remitted the case back to the High Court. It held that determining the meaning of "*a series of related matters or transactions*" in the aggregation clause contained in the Minimum Terms and Conditions for solicitors' professional indemnity insurance necessitated a fact sensitive inquiry to be carried out. The relevant transactions or matters are to be viewed objectively and in the round. Lord Toulson, who gave the judgment of the Court, dismissed as not "*necessary or satisfactory*" the Court of Appeal's formulation that there must be an "*intrinsic relationship*" between the transactions or matters.

Background

The dispute related to underlying claims arising out of services provided by a solicitors' firm, The International Law Partnership (**ILP**), whose insurance cover for the relevant period was provided by AIG Europe Ltd (**AIG**).

ILP was engaged by an international property development company in connection with two holiday home developments, one in Turkey and another in Morocco. Investors in the developments provided funds to ILP under a loan or purchase agreement, with those funds being held in escrow by ILP until the developer had provided sufficient security to meet the "Cover Test". The Cover Test was to be applied by ILP. On release of the funds the investors became beneficiaries under a trust (set up in respect of each development), which was intended to hold security in respect of the relevant development. On various occasions ILP authorised the release of monies out of the escrow accounts. Ultimately, the developers were liquidated without the developments having been completed. 214 investors brought claims against ILP for the value of their lost investments, principally on the basis that the Cover Test had been incorrectly applied.

ILP's professional indemnity insurance with AIG had a limit of £3 million per claim. Clause 2.5 of the Law Society's Minimum Terms and Conditions (**MTC**) for solicitors' professional indemnity insurance governed the aggregation of claims under the policy. Clause 2.5 provided that:

"The insurance may provide that, when considering what may be regarded as one Claim for the purposes of the limits contemplated by clauses 2.1 and 2.3:

a) *all claims against any one or more insured arising from:*
   - (i) *one act or omission;*
   - (ii) *one series of related acts or omissions;*
   - (iii) *the same act or omission in a series of related matters or transactions;*
   - (iv) *similar acts or omissions in a series of related matters or transactions*

and

b) *all Claims against one or more Insured arising from one matter or transaction will be regarded as One Claim."*

AIG sought a declaration that the 214 claims were to be considered a single claim for the purpose of the policy because the relevant transactions arose from "*similar acts or omissions in a series of related matters or transactions*". If that declaration was granted, AIG's liability would be limited to £3 million. In the absence of such declaration, AIG was potentially liable to indemnify ILP for the full amount of the 214 claims, which collectively exceeded £10 million.

First instance decision

Mr Justice Teare in the Commercial Court refused to grant AIG the declaration sought. Teare J accepted that all the claims arose from "*similar acts or omissions*" on the part of ILP, but not that those acts or omissions occurred in a "*series of related matters or transactions*". Teare J held that "*the wording of the clause, 'a series of related matters or transactions', in its context appears to me to point to transactions which are, by reason of their terms, dependent on each other rather than independent of each other*". It was common ground that the transactions were not conditional or dependent upon each other. Teare J granted AIG permission to appeal.

Court of Appeal decison

Having heard the parties' and the Law Society's submissions, the Court of Appeal concluded that Teare J went too far in holding that the transactions had to be "*dependent on each other*" before aggregation could occur. Lord Justice Longmore, giving the judgment of the Court, considered that the word "*series*" usually implied some connection between events constituting the series, but the question then was what degree of connection was required for the purposes of the MTC aggregation clause. The Court of Appeal favoured the submission of the Law Society that there must be "*at least some intrinsic connection between the relevant matters or transactions, not merely a connection with some external common factor*".

In construing the critical words of the MTC aggregation clause, the Court of Appeal had regard to the published history and origin of the MTC aggregation clause, and the availability of both wide and narrow aggregation wording. In the latter regard, the Court of Appeal held that as the express language of the aggregation clause, "*related... transactions*", was both imprecise and deliberately avoided the available wide formulations, it was necessary to imply a unifying factor from the general context. That unifying factor was held to be the presence of an intrinsic relationship between the relevant transactions.

Supreme Court decision

Lord Toulson, giving the judgment of the Supreme Court, agreed with the Court of Appeal that use of the word "*related*" implied some inter-connection between matters or transactions, "*or in other words that they must in some way fit together*", but stated that the Court of Appeal's requirement for an intrinsic relationship was neither "*necessary or satisfactory*". He stated that the term "*intrinsic*" was elusive when used as a descriptor of a relationship between two transactions.

The Court noted that the Law Society had, after market negotiation, not sought expressly to limit the required relationship between matters or transactions by reference to a particular set of criteria. The absence of such limitation was said not to be surprising given the wide range of work solicitors carry out. Whether transactions were related therefore required a fact sensitive inquiry. Lord Toulson adopted Lord Justice Rix's articulation in *Scott v Copenhagen Reinsurance Co (UK) Ltd* that such an exercise involved "*an exercise of judgment, not a reformulation of the clause to be construed and applied*". The application of the aggregation clause was to be viewed objectively, taking the transactions in the round.

Viewed objectively, the Court concluded the claims of each group of investors arose from acts or omission in a series of related transactions. The transactions relating to the development in Turkey were "*connected in significant ways*", the same was said to be the case for transactions in relation to the Moroccan development. Each series of transactions "*shared the common underlying objective of the execution of a particular development project, and they also fitted together legally through the trusts under which the investors were co-beneficiaries.*"

The Court held that the case for aggregating claims in respect of both developments was "*much weaker*", commenting that they "*bear a striking similarity, but that is not enough*".

Comment

This case will be of keen interest to those operating in the solicitors' professional indemnity market. This series of judgments provides welcome authority and judicial commentary on the construction of the MTC aggregation clause. It may be thought that the Supreme Court's conclusion that the question whether matters or transactions are related requires an exercise of judgment means that there remains some uncertainty as to how the clause will operate. However, the real guidance offered by the decision is the way in which Lord Toulson applied the clause to the facts. First, it is necessary to identify and analyse the relevant matters or transactions carefully. Then, it is necessary to identify the relevant connections between them in order to be satisfied that they are connected in significant ways. In each of the two actions the critical relationship between the Claimants was that they were co-beneficiaries under a common trust. For the same reason the claims in both action were not to be aggregated together. Qualifying insurers will no doubt take some heart from this decision in dealing with multiple claims (e.g. involving mortgage fraud) but each case will involve a proper analysis and an exercise of judgment. On a more general level, these judgments illustrate the importance that parties in all markets should place on the choice of aggregation wording in their policies.

Additional references

AIG Europe Ltd v Woodman & Ors [2016] EWCA Civ 367

AIG Europe Ltd v Woodman & Ors [2015] EWHC 2398 (Comm)

Scott v Copenhagen Reinsurance Co (UK) Ltd [2003] Lloyd's Rep IR 696

High Court refuses to order pre-action disclosure of a defendant's public liability insurance policy

Peel Port Shareholder Finance Co Ltd v Dornoch Ltd [2017] EWHC 876

26 April 2017

In *Peel Port Shareholder Finance Co Ltd v Domach Ltd*, Peel Port Shareholder Finance Co Ltd (**Peel Port**) applied for pre-action disclosure of the Defendant's insurance policy under Civil Procedure Rule 31.16. Peel Port was not able to rely on the provisions in Third Party (Rights against Insurers) Act 2010 because the Defendant was not insolvent. Peel Port argued that it was highly probable that rights against insurers would be transferred to them under the 2010 Act in due course. They argued, therefore, that the Court should exercise its discretion to grant disclosure of the Defendant's insurance policy at this stage to help avoid litigation and wasted costs. Mrs Justice Jefford refused to exercise her discretion to grant disclosure in anticipation of such a transfer of rights.

Background

Peel Port owned a warehouse that was damaged by fire in January 2013. Peel Port alleged that the fire was caused by European Active Projects Ltd (**EAPL**). EAPL was insured under a public liability policy by Dornoch Ltd (**Dornoch**). As Dornoch were the correct insurers they were substituted as the respondent to this application.

Peel Port's position was that EAPL had no defence to the claim and had not articulated any defence in open correspondence. Peel Port therefore took the view that it was highly likely that any claim against EAPL would succeed. The claim would be for sums in excess of £1 million. If judgment for that amount was enforced, EAPL would not be able to meet the judgment and would be wound up.

EAPL's insurers denied cover on the basis that EAPL did not comply with conditions in a policy endorsement. Insurers set out the terms of the endorsement in correspondence with Peel Port but did not disclose the policy. Peel Port suggested that there might be issues as to the incorporation of the endorsement or the effect of the endorsement when construed in the context of the policy as a whole. They therefore sought pre-action disclosure of the policy.

Peel Port's argument

There are four limbs of the test for pre-action disclosure under CPR 31.16(3):

"(3) The court may make an order under this rule only where –

(a) *the respondent is likely to be a party to subsequent proceedings;*

(b) *the applicant is also likely to be a party to those proceedings;*

(c) *if proceedings had started the respondent's duty by way of standard disclosure, set out in rule 31.6, would extend to the documents or classes of documents of which the applicant seeks disclosure; and*

(d) *disclosure before proceedings have started is desirable in order to –*

   (i) *dispose fairly of the anticipated proceedings;*

   (ii) *assist the dispute to be resolved without proceedings; or*

   (iii) *save costs."*

Peel Port argued that they met the test because:

- Dornoch and Peel Port were likely to be parties to proceedings if they were commenced;
- the effect of the policy endorsement would be a key issue in any proceedings between Peel Port and Dornoch and therefore the policy would be disclosable in those proceedings; and
- disclosure before proceedings start is desirable because if Peel Port were satisfied that the endorsement was effective, it would not pursue EAPL (so avoiding putting EAPL into liquidation) and it would not pursue insurers. That in itself would avoid litigation and wasted costs.

Dornoch's defence

Dornoch accepted for the purposes of this application:

- that Dornoch and Peel Port were likely to be parties to proceedings if they were commenced because if EAPL were put into liquidation, Peel Port would be entitled to sue Dornoch directly under the Third Party (Rights against Insurers) Act 2010; and
- that the policy would be disclosable in such proceedings.

However, Dornoch did not accept that the judge should exercise her discretion to order disclosure of the policy because to do so would be to ignore the provisions of the 2010 Act.

Dornoch argued that where a claimant (A) sues a defendant (B), and B is insured, the general position is that the insurance

policy is not disclosable because it is not relevant to any issue in the case. Where the insured B is insolvent, however, A may have a direct claim against B's insurers under the 2010 Act. The 2010 Act contains a specific regime for the provision of information about B's insurance position. There would have been no need for Parliament to have made such provision if disclosure of B's insurance policy could be obtained under CPR 31.16. Additionally (or alternatively) the existence of this specific regime is a powerful reason why the judge should not exercise her discretion to order disclosure that does not fall within the 2010 Act.

Decision

Mrs Justice Jefford did not accept Dornoch's argument in relation to the 2010 Act. She agreed with Peel Port that there are two separate and distinct regimes:

- CPR 31.16 which gives the Court a power to order pre-action disclosure, exercising its discretion, if the threshold tests are met; and
- Schedule 1 of the 2010 Act which provides an express right to specific information in certain circumstances.

The existence of the latter did not preclude the operation of the former where the relevant test is met.

Jefford J therefore went on to consider the exercise of her discretion under CPR 31.16. In doing so, she took into account the statutory and procedural landscape and noted that:

- The provisions of Schedule 1 of the 2010 Act demonstrate that Parliament cannot have envisaged that CPR Rule 31.16 would or would commonly be used to obtain insurance policies from the insurers of insolvent insureds.
- There has never been an express statutory provision entitling a litigant to obtain the insurance policy of a solvent insured (because a litigant takes his defendant as he finds him).
- In proceedings against the insured CPR 31.16 does not provide a route for a prospective litigant to obtain the insurance policy of a solvent insured because the policy does not meet the test for standard disclosure.
- Attempts to deploy other provisions of the CPR to obtain the insurance policy of a solvent insured have failed.

Against this background she held that it would "*be curious if a potential claimant (A) could say that because the solvent insured might become insolvent and that he, A, might then have a claim against insurers, he should have disclosure of the policy under Rule 31.16*".

Peel Port submitted that the circumstances were exceptional because of the high probability that rights against insurers would be transferred to Peel Port. Jefford J did not accept that the circumstances were sufficiently exceptional for her to order disclosure of a solvent insured's insurance policy contrary to established practice.

Peel Port's application for pre-action disclosure of the policy was therefore refused.

Comment

In *Black v Sumitomo Corpn* the Court of Appeal said that when considering applications for pre-action disclosure, the Court does not have to consider the likelihood of there being future proceedings but whether the applicant and respondent are likely to be parties to such proceedings if they are commenced. Peel Port and Dornoch agreed that this test was met.

Jefford J's conclusion (as quoted above) suggests that she took a different view. She construed the subsequent proceedings narrowly as being a matter between Peel Port and EAPL. On this basis the insurance policy was not disclosable because it was not relevant to any issue in the case.

This narrow approach to defining the parties to the subsequent litigation may be justified on the basis that Peel Port was clearly seeking disclosure in relation to potential proceedings against EAPL, not against Dornoch itself. Dornoch had merely been substituted as EAPL's insurer. Indeed, Peel Port did not yet have any standing to bring a direct claim against Dornoch under the 2010 Act since EAPL was not yet insolvent. Therefore the fact that the policy would be disclosable in separate proceedings against Dornoch was not relevant to whether it was disclosable in the proceedings which were actually contemplated against EAPL.

Whether this is a departure from the Court of Appeal approach in *Black v Sumitomo* or is an exception in limited circumstances where the Claimant does not yet have a right to commence proceedings against the potential Defendant, is debatable and somewhat academic. This judgment clearly demonstrates the Court's support for maintaining the established practice that a claimant cannot obtain disclosure of a solvent defendant's insurance policy even if it is highly probable that the defendant will become insolvent. This is perhaps an unsurprising practice given that a claimant is not automatically entitled at a pre-judgment stage to obtain evidence of a solvent defendant's other assets (such as its credit balance at the bank). If that is the case, why should a claimant be able to obtain details of another asset of a solvent defendant – namely its insurance policy?

Interestingly, the judgment does leave open the possibility that pre-action disclosure of a defendant's insurance policy may be ordered under CPR 31.16 where the test is met. It is thought that disclosure will not be ordered unless there are exceptional or unusual circumstances. It remains to be seen how and in what circumstances disclosure is ordered.

Additional references

Third Party (Rights against Insurers) Act 2010

Black v Sumitomo Corpn [2001] EWCA CIV 1819

New right to claim damages for late payment of insurance claims comes into force

4 May 2017

New provisions in the Enterprise Act 2016 (the Act) which give policyholders a potential right to claim damages in the event of late payment of insurance claims, came into force on 4 May. The new law applies to every contract of insurance entered into after the provisions come into force.

Background

Damages for late payment of claims were not recoverable under English law. The Act amends the Insurance Act 2015 and introduces an implied term into every insurance contract that "*the insurer must pay any sums due in respect of the claim within a reasonable time*". Breach of this term can give rise to a claim for damages.

The Act does not provide prescriptive guidelines as to what constitutes a "reasonable time". Rather, it states that a reasonable time includes time to investigate and assess the claim, and provides a non-exhaustive list of matters which may need to be taken into account, including:

- the type of insurance;
- the size and complexity of the claim;
- compliance with relevant statutory or regulatory rules or guidance; and
- factors outside the insurer's control

The Act further provides a defence where the insurer can show that there were "*reasonable grounds for disputing the claim (whether as to the amount of any sum payable, or as to whether anything at all is payable)*".

The new legislation also allows parties to contract out of these provisions in respect of non-consumer insurance contracts, subject to the "transparency" requirements of the Insurance Act 2015. However, contracting out will not be effective where the insurer's breach is deliberate or reckless.

Claims for breach of the implied term must be brought no later than one year from the date on which the insurer has paid all the sums due in respect of the claim.

Comment

The relevant provisions came into effect on 4 May 2017, and will apply to contracts of insurance made after the provisions come into force.

In order to claim such damages, an insured must show that:

- The insured has a valid claim under the policy;
- The insurer has failed to pay within a reasonable time (including a reasonable time to investigate and assess the claim);
- The insured suffered loss, which was caused by the insurer's breach of the implied term; and
- The loss was foreseeable (i.e., the loss was in the reasonable contemplation of the parties at the date the contract was entered into).

Further, the insured will not be able to recover any loss which could have been avoided by taking reasonable steps.

There are conflicting views on what the impact of these new provisions will be. However, given the various elements a policyholder will need to prove in order to establish a successful claim for damages, it seems unlikely that the Act will lead to a flood of damages claims for late payment. What a court will consider a "reasonable time" within which to pay a claim will be highly dependent on the particular circumstances of the claim. Further, the impact of the provisions is likely to be limited by the "reasonable grounds" defence and the ordinary hurdles of establishing a claim for damages for breach of contract.

What seems more likely is that the provisions in the Act will affect the dynamics of negotiations between insurers and insureds in relation to claims.

Practical implications

Both policyholders and insurers should be aware that the following points may be relevant in any potential consideration of a claim for damages for late payment:

- Claims co-operation – insureds' responses to requests for information by the insurer (as the insurer must have the opportunity to investigate and assess the claim);
- Contracting out – whether insurers have successfully contracted out of the late payment provisions;
- Mitigation – whether insureds have taken steps to mitigate any losses suffered as a result of the insurer's delay (as damages for late payment are subject to the usual limitations of contractual damages); and
- Foreseeability – if there are particular circumstances which might cause the insured to suffer exceptional losses as a result of delayed payment whether these had been communicated to the insurer prior to the policy being placed.

We would also observe that damages for late payment are plainly not a substitute for business interruption cover and

should not be seen as such. Insureds should obtain appropriate business interruption cover if there is a risk that their business will be disrupted by an insured loss.

Finally, there are a number of steps which insurers and reinsurers can take to minimise the risk of facing unnecessary claims for damages for delay. Most of these are simply good claims handling practices, which insurers should already be familiar with:

- Keep clear records of claims handling procedures – Insurers should maintain clear records of the handling of each claim, including when information was received, steps taken to investigate the claim, and information requests submitted to the insured.
- Merits advice – In appropriate cases, insurers may wish to obtain written legal opinions on the merits of a claim prior to denying cover, in order to demonstrate that they had "*reasonable grounds for disputing the claim*". Insurers will need to monitor carefully any issues arising from potential waiver of legal privilege.
- Interim/part payments – Where appropriate, insurers should consider making interim or part payments to insureds.
- Reserves/premiums – Insurers should be aware of the prospect of damages for late payment when setting reserves and premiums.
- Reinsurance arrangements – Insurers should also be aware of the possibility of such damages when negotiating their reinsurance arrangements. As damages for late payment are not payable under the insuring clause of the contract, it seems unlikely that they would be recoverable under most current reinsurance agreements. Insurers may wish to consider revising their reinsurance arrangements to provide for the recovery of such damages.
- Settlement Agreements – Settlement Agreements for claims should contain a release of liability which is broad enough to encompass any claim for late payment.

Privy Council holds CAR policy covered project works and not original building structure

Sun Alliance (Bahamas) Ltd and Anor (Appellants) v Scandi Enterprises Ltd (Respondents) (Bahamas) [2017] UKPC 10

8 May 2017

The owners of a building damaged by fire sought unsuccessfully to argue that the original structure of a building was insured under a CAR policy (as opposed to just the project works).

Background

The insured, Scandi Enterprises, acquired a dilapidated building in Freeport, Grand Bahamas, with a view to extending and refurbishing it. The insured wanted to insure the building against physical risks. Due to the extreme state of disrepair of the building, the insurer refused to insure the building itself and recommended that the insured insure the works under a Contractors All Risks (**CAR**) policy. A year-long CAR policy was duly entered into on 31 July 1992 for an insured value of B$700,000. In December 1992, the building was severely damaged by fire.

The insured claimed B$700,000 from insurers on the basis that the CAR policy insured against all risks of loss or damage to the building, the Policy was a valued policy at B$700,000 and the building had become a total loss.

The Privy Council was asked to consider two questions:

- Whether the CAR policy covered the original building (or only the works to the property).
- Whether the CAR policy was a valued policy, entitling the insured to the full value of the policy without proving actual loss.

Decision

At first instance, the Bahamian trial judge held that the policy only covered the works (i.e. the extension and refurbished elements) and not the original structure of the building. He also found that the policy was not a valued policy and that the insured would need to prove their loss, which they did not do, in order to claim.

This decision was reversed by the Court of Appeal of the Bahamas which looked at the negotiations preceding the insurance contract and held that "Contract Works" in the policy was not limited to the renovation works. Essentially, this was because the figure of B$700,000 for the sum insured was too large to have represented only the value of the works and therefore must have represented the value of the buildings. The Court of Appeal then considered whether the policy was valued and again reversed the trial judge, holding it to be a valued policy.

The Privy Council reversed the Court of Appeal decision and found in favour of the insurers based on the express terms of the policy. Lord Sumption delivered the Privy Council's judgment. The policy described the Contract Works as the relevant construction activities and insured the Permanent Works as the structure to be created, but not the existing building due to be refurbished. The Privy Council declined to consider any extrinsic evidence including non-contractual confirmations of insurance and insurance documents from subsequent years as the contract itself was sufficiently clear.

Having concluded that the policy did not cover the loss, the Privy Council was not required to consider the point of whether the policy was a valued policy. However, for the sake of clarity, they chose to deal with this point. The Privy Council's starting point was that a contract of insurance is a contract of indemnity and in the ordinary course the insured must prove the amount of his loss. The Privy Council noted that an agreed valued (irrespective of the property's actual value) is not the same thing as the sum insured which is the maximum indemnity for the relevant property. It went on to note that an agreed value is unlikely to be a practical proposition in a CAR policy where the property is contract works whose value will necessarily increase over time. The Privy Council held that it was clear that the figure of B$700,000 in this policy was not an agreed value but merely the maximum sum insured.

Comment

As the Privy Council made clear, agreed value policies are unlikely (in general) to be a practical solution for CAR policies as the value of the property will increase over time and the values at risk will depend on how far the works have advanced when the casualty occurs. As a result the policyholder must prove its actual loss to secure an indemnity.

Subrogation and co-insurance: Supreme Court upholds Court of Appeal's decision

Gard Marine & Energy v China National Chartering [2017] UKSC 35

10 May 2017

The Supreme Court handed down judgment on 10 May 2017 giving important guidance on the effect of an obligation to insure on a joint names basis. In a split 3:2 decision, Lords Toulson, Mance and Hodge, obiter, held that joint insurance for the benefit of both the owner and demise charterer disallowed any claim by the owners of the vessel against the demise charterers and therefore no liability could be transferred to the time charterers. This precluded subrogation by insurers against the time charterers. Lords Sumption and Clarke dissented on the latter point, however, arguing that the payment of insurance proceeds from the insurer to the owner 'satisfied' but did not 'exclude' the demise charterer's liability. Therefore, they argued, a claim could be pursued by the demise charterer against a time charterer.

Background

The vessel was owned by Ocean Victory Maritime Inc (**OVM**) and demised to Ocean Line Holdings Ltd (**OLH**) by a charter dated 8 June 2005 for a period of ten years. The demise charterparty was in the form of an amended Barecon 89 Standard Bareboat Charter and stated that the vessel was to be employed "*only between good and safe ports*". By a time charterparty dated 2 August 2006, OLH chartered the vessel to China National Chartering Company Ltd (**CNC**). CNC then sub-chartered the vessel to Daiichi Chuo Kisen Kaisha (**DCKK**).

Gard Marine & Energy Ltd (**Gard**) provided marine and war risks insurance cover of $70,000,000 for the benefit of both OVM and OLH, as required by clause 12(a) of the demise charter between OVM and OLH, which obliged OLH to insure the vessel "*in the joint names of the Owners and the Charterers as their interests may appear*". In October 2006, the vessel ran aground attempting to leave the port of Kashima, Japan and was a total loss.

Gard indemnified OVM and OLH up to the policy limit and, as assignee of the rights of OVM and OLH, sued CNC for breach of the safe port warranty in the intermediate charterparty between OLH and CNC. CNC brought a third party claim against DCKK for a breach of a materially identical safe port warranty in the sub-charter between CNC and DCKK.

First instance decision

At first instance, Mr Justice Teare held that there had been a breach of the warranty as to the safety of the port at Kashima. Teare J confirmed that, generally, an insurer cannot bring a subrogated claim against a co-insured in the name of another co-insured. However, Teare J went further to state that if liability arises and an exclusion of such liability is not expressly set out in the underlying contract (i.e. the demise charter in this case), and then there is the possibility that the demise charterer will be liable despite being co-insured. Permission was granted to appeal the findings on the breach of the safe port warranty to the Court of Appeal.

Court of Appeal decision

Lord Justice Longmore handed down the Court of Appeal's judgment in January 2015; reversing the first instance judgment. Firstly, Longmore LJ held that the safe port warranty had not been breached. It was accepted by the parties that a port would be safe for the purposes of the relevant warranty if a ship could reach, use and leave it, in the absence of an abnormal occurrence, without being exposed to danger which could not be avoided by good seamanship and navigation. "Abnormal occurrence" was to be given its ordinary meaning. On the facts, the Court of Appeal held that the circumstances on the date of the loss (a particular combination of strong winds and wave conditions) amounted to an abnormal occurrence and therefore the safe port warranty had not been breached.

The Court of Appeal reaffirmed that subrogated claims are generally not permitted by an insurer against a co-insured party as this would negate the insurance cover the party paying the insurance premium was entitled to expect, following *The Evia (No. 2)*. In terms of the question of liability, the Court of Appeal (obiter) reinforced the importance of construing the underlying contact carefully. Longmore LJ cited *Tyco Fire and Integrated Solutions v Rolls-Royce Motor Cars* in support of the necessity for clear wording in an agreement to exclude liability but went further to determine that OVM and OLH had contractually agreed to look exclusively to the insurance proceeds and not to each other in the event of a total loss under the terms of clause 12(a) of the demise charter. Under clause 12(d) of the demise charter, in the event of a total loss, the demise charter would be terminated on the date of such loss. The Court of Appeal held

that once the insurance had been paid, the contractual scheme had been accomplished. As no liability fell on OLH, there was in turn no liability to be passed on through the intermediate charter or the sub-charter to either CNC or DCKK.

Supreme Court decision

The Supreme Court dismissed Gard's appeal against the Court of Appeal's judgment, deciding the safe port warranty had not been breached. However, the members of the Supreme Court gave their views, obiter, on the joint insurance issue which was a matter of general interest. The Supreme Court was split in respect of the effect of the joint insurance provisions in the demise charter. The Supreme Court unanimously agreed that it was absurd to permit an insurer to bring a subrogated claim against a co-insured whom they would be liable to indemnify against having to meet the claim and that the source of this conclusion lay in an analysis of the underlying contract, here the charterparty. Nevertheless, Lord Mance (with whom Lords Toulson and Hodge agreed) held (obiter) that "*both repairs and losses fall to be dealt with in accordance with [clause 12], rather than by litigation to establish who might otherwise be responsible for undertaking them, for bearing the risk of their occurrence or for making them good*." In effect, he agreed with the Court of Appeal's judgment that in the event of loss or damage, the co-insured parties had agreed to turn to the insurance proceeds as the means of recourse, not each other.

Conversely, Lord Clarke (with whom Lord Sumption agreed) stated that there was "*nothing in clause 12 which provides that the demise charterers have no liability for breach of clause 29 [the safe port warranty] and I see no basis for such a necessary implication*". Lord Clarke stated that any exemption of such liability must be clearly expressed in the charterparty. Therefore, if such exclusion was not clearly stated, OLH would remain liable to OVM for breach of the safe port warranty, despite being a beneficiary under the joint insurance in place.

Lord Sumption discussed the relevance of this position regarding third party claims; he argued that in this case, Gard's payment to OVM *"satisfied"* but did not *"exclude"* OLH's liability. As a result, if no payment was made, OVM could claim against OLH and, moreover, if a payment was made, Gard could still bring a subrogated claim on behalf of OLH against a sub-charterer.

On the other hand, Lord Mance argued that "*there is no basis for treating payment of the vessel's value under her marine or war risks insurance as "discharging" pro tanto any liability existing between owners and demise charterers […] [it] cannot be treated as satisfying, at one and the same time, any liability (if there were any) which charterers had to owners*." Lord Mance asserted that, in the event of loss, under the co-insurance scheme it was "understood implicitly" between OVM and OLH that the parties would turn to the insurance proceeds instead of bringing a claim against each other. Lord Mance held that this view applied even if insurance proceeds were not paid; the understanding would be that no further liability would exist upon eventual payment of the proceeds. Lord Mance (with whom Lord Toulson and Lord Hodge agreed) held that clause 12 was intended to evidence this intention. As a result, Lord Mance decided that permitting a subrogated claim by Gard on behalf of OVM against OLH "*makes no sense in the context of co-insurance such as this*", citing *Hopewell Project Management Ltd v Ewbank Preece Ltd* in support of this conclusion.

Lord Toulson quoted the House of Lord's decision in *Co-operative Retail Services Ltd v Taylor Young Partnership Ltd*: "*it cannot have been the parties' intention that parties who were jointly insured under a contractors' all risk policy could make claims against one another in respect of damage covered by the insurance, or that the insurers could make a subrogated claim in the name of the owners […] and that the court would if necessary hold that there was an implied term to such effect*". Lord Toulson confirmed the Supreme Court's majority view that the co-insured parties had agreed to an insurance funded result, upholding the Court of Appeal's conclusion. Lord Toulson reasoned that "*[t]he commercial purpose of maintaining joint insurance in such circumstances is not only to provide a fund to make good the loss but to avoid litigation between them, or the bringing of a subrogation claim in the name of one against the other.*"

The Supreme Court also discussed, obiter, whether or not charterers would have been entitled to limit their liability if a liability had arisen. The issue had not been raised by the lower courts as they were bound by the Court of Appeal decision in *CMA CGM SA v Classica Shipping Co Ltd (The CMA Djakarta)*. To determine the issue, the Supreme Court interpreted the Convention on Limitation of Liability for Maritime Claims 1976 (the **Convention**). The court decided that the definition of "shipowner" in the Convention was wide enough to include charterers. The court held that liability can be limited in respect of "*loss or damage to property … in direct connection with the operation of the ship*" (Article 2(1) of the Convention) and the term "property" referred to external property, not the vessel herself, thereby approving *The CMA Djakarta*. The charterers were therefore unable to limit their liability in the event of a total loss of the vessel.

Comment

The Supreme Court reinforced the commonly held understanding that, generally speaking, an insurer cannot bring a subrogation claim against a co-insured party on behalf of another co-insured party benefitting under the same insurance. Lord Mance added that this was especially true for co-insureds in the same group and under the same ultimate beneficial ownership. In the event of a loss being suffered, co-insureds will be assumed to have agreed to an insurance funded result instead of the innocent co-insured party bringing a claim against the guilty co-insured party. Nevertheless, Lord Sumption held (obiter) that despite this position, a co-insured may still bring a claim against a third party at fault who was not a co-insured.

The majority view held by the Supreme Court distinguished between short term and long term charters. For long term charters, the Supreme Court concluded that clause 12 of the unamended version of Barecon 89 was more suitable; it was understandable that in cases where a vessel was subject to a demise charter, the obligation and cost of insurance should lie with the demise charterer. Conversely, in the case of shorter term time charters, the court saw clause 13 of the unamended Barecon 89 as more appropriate. Clause 13 expressly excludes an owner's or insurer's right of recovery or subrogation respectively and the cost of procuring insurance lies with the owner. This difference, the Supreme Court felt, explained the lack of an express exclusion in clause 12 – an express exclusion was not necessary as it could not have been the parties' intention that OLH's exposure to liability should be greater under clause 13. The exclusion in clause 13 was a "*confirmation rather than a negation*" of such an exclusion in clause 12.

Although this type of analysis is limited to shipping, it is important to note the court's distinction between different types of charters, especially from an insurer's point of view.

Moreover, the majority view of the Supreme Court is that insurers will be the primary means of recovery for co-insureds (both benefitting under the insurance policy) who have contractually agreed to procure such insurance. That said, the onus is on policyholders to ensure that where they intend that insurance shall provide the sole remedy in the event of losses of a particular type, this is made abundantly clear in the drafting, including an appropriately broad waiver of subrogation, so as to avoid altogether the potential for lengthy and expensive subrogation proceedings by insurers seeking to recoup sums paid out under the policy.

Additional references

Gard Marine & Energy v China National Chartering [2015] EWCA Civ 16

Gard Marine & Energy v China National Chartering [2013] EWHC 2199 (Comm)

The Evia (No. 2) [1983] 1 AC 736

Tyco Fire and Integrated Solutions v Rolls-Royce Motor Cars [2008] 1 CLC 625

Hopewell Project Management Ltd v Ewbank Preece Ltd [1998] 1 Lloyd's Rep 448

Co-operative Retail Services Ltd v Taylor Young Partnership Ltd [2002] 1 WLR 1419

CMA CGM SA v Classica Shipping Co Ltd (The CMA Djakarta) [2004] 1 Lloyd's Rep 460

High Court considers misrepresentation and material non-disclosure under the 1906 Act

Dalecroft Properties Ltd v Underwriters subscribing to Certificate Number 755/BA004/2008/OIS/00000282/2008/005 [2017] EWHC 1263 (Comm)

26 May 2017

The High Court has considered whether insurers were entitled to avoid a policy when the insured had misrepresented the state of the insured property and failed to disclose an order requiring evacuation of the residential parts of the property. In the same case, the insurers advanced an argument for breach of warranty, as the insured failed to comply with the Commercial Un-occupancy warranties within the policy. As the events in issue took place prior to August 2016, the High Court considered the rules relating to misrepresentation and non-disclosure under the Marine Insurance Act 1906.

The Court considered, obiter, the application of the Insurance Act 2015 to the case, finding that the application of the old law presented no injustice to the insured, who made no real effort to disclose the risks or to comply with the conditions of the insurance. The Court was satisfied that if fair presentation of the risk had been made under the provisions of the Insurance Act 2015, the insurers would have declined the risk, and consequently would have also been entitled to avoid the policy under the new law (though the insurers may have been obligated to return any premium paid to the insured).

Background

Dalecroft Properties Ltd (**Dalecroft**) was the owner of mixed use commercial and residential premises in Margate, Kent (the **Property**). Dalecroft insured the Property with the Defendants (the **Underwriters**) under a property owner's policy.

When providing information to obtain the insurance in August 2007, Dalecroft indicated that the Property was in good condition and had never been subject to vandalism. In October 2007 an inspection revealed that the Property was in a very poor state of repair. In June 2008 the local authority issued an emergency prohibition order (**EPO**) requiring immediate evacuation of the residential parts of the Property. In July 2008 a police officer was attacked at the Property while investigating a flood.

When renewing the policy in August 2008, Dalecroft provided the same information regarding the Property as it provided in 2007, except to state that the residential units were currently vacant in preparation for refurbishment. A new policy was duly issued. In November 2008 the policy certificate was replaced by a further certificate incorporating various amendments.

In May 2009 a fire caused severe damage to the Property. Dalecroft made a claim under its insurance policy but the Underwriters purported to avoid the policy on grounds of misrepresentation and non-disclosure. The Underwriters also argued that Dalecroft had breached various Un-occupancy warranties.

The Underwriters asserted that the policy in issue was that of August 2008, as the November certificate merely gave effect to amendments to that policy, and therefore the material time for considering allegations of misrepresentation and non-disclosure was the date of the August 2008 renewal. Dalecroft sought to rely on the November 2008 certificate as the policy in force at the time of the fire, arguing that the Court therefore only needed to consider alleged misrepresentations made in relation to the November 2008 certificate.

Decision

In respect of the relevant policy at the time of the fire, Mr Richard Salter QC found for the Underwriters; the policy in force at the date of the fire was that issued in August 2008 and as such the material time for considering the allegations of misrepresentation and non-disclosure was at the date of renewal. In support of this finding, the judge referred to the fact that: (i) in November 2008 the broker had requested "the following amendments", not a new policy; (ii) the premium shown on the new certificate was £0.00; and (iii) the new certificate ran from November 2008 – July 2009 to tie in with the expiry of the extant August 2008 policy.

Non-Disclosure

As the insurance policy in question incepted prior to August 2016 the Marine Insurance Act 1906 applied. Under the 1906 Act, a would-be insured is required to disclose every material circumstance in full when the contract is formed and on each renewal or variation. In order to avoid the contract on grounds of material non-disclosure, the insurer must demonstrate that the non-disclosure was material to its decision to underwrite the policy and that the non-disclosure induced it to enter the policy on the relevant terms. Mr Richard Salter QC considered that the

relevant obligation on Dalecroft was to disclose matters which ought to have been disclosed at the contract's inception or at any previous renewal of the policy where those facts remained relevant, but unknown to the Underwriters.

The Underwriters argued that they were entitled to avoid the policy as Dalecroft had failed to disclose the existence of the EPO when renewing, arguing that the materiality of the EPO is not just relevant to an underwriter's assessment of property risk, but also what it says about the insured's attitude to risk management. Dalecroft argued that the EPO had become immaterial, as the building was now vacant and refurbishment was planned. Mr Richard Salter QC preferred the evidence of the Underwriters, finding that the disclosure of the EPO would have affected the underwriting decision.

Misrepresentation

A would-be insured is also under a duty not to misrepresent material facts. Mr Richard Salter QC restated the principle that if the statement made is one of fact and is not substantially correct, it is no defence that the misrepresentation was made innocently. Akin to the law on non-disclosure, the misrepresentation must have induced the insurer to have entered the policy on the relevant terms.

The first contested representation made by Dalecroft at renewal was that the Property was in a "*good state of repair*". The Court heard evidence that the Property had "*windows broken... roof leaking... in a very poor state of repair*". Mr Richard Salter QC held that, a representation as to the state of a property is a statement of fact, and in the present case this could not properly be described as a "good state of repair" even taking into account the relevant context i.e. the nature and location of the Property and the fact that it was vacant. The judge also accepted the evidence of the Underwriters that this answer induced them to underwrite the Property, and that had the answer been anything other than "good" the insurer would have declined the renewal.

The second contested representation made was that the Property did not have a flat roof. Joint expert evidence found that 50.3% of the roof areas of the Property were flat. Therefore Dalecroft's answer was "*plainly incorrect*". Mr Richard Salter QC also accepted the evidence that had a truthful answer been given, the Underwriters would have applied one of their available flat roof endorsements and increased the premium. Accordingly the Underwriters were induced by the misrepresentation.

The third contested representation indicated that the Property had not been subject to malicious acts or vandalism. Numerous contemporaneous and corroborated reports demonstrated that intruders were common in the Property and that the theft of water tanks and copper pipes had caused considerable damage. A police officer was attacked by a trespasser while investigating these thefts. The judge felt no compunction in describing these as malicious acts, stating that the distinction between "theft" and "malicious acts" which Dalecroft tried to draw was a "*specious*" one. The judge again accepted the evidence of the Underwriters that this misrepresentation induced them to enter the policy; if they had known of the true state of affairs they would have declined to cover the risk.

Breach of warranty

Mr Richard Salter QC also restated the principles in relation to contractual warranties: promissory terms whereby the insured promises that a given state of affairs existed prior to the date of inception of the insurance or will continue to exist throughout the period that the insurer is on risk. Such warranties must be closely complied with; under the 1906 Act a breach discharges the insurer from liability under the policy from the time of breach, regardless of whether the loss had any connection with the breach.

The Underwriters alleged that Dalecroft was in breach of the Commercial Un-occupancy warranties in that Dalecroft failed to ensure that: (i) the basement was free of combustible materials; (ii) the disco building was free of combustible materials; (iii) the charity mailbox was sealed; and (iv) all three unoccupied areas were properly secured. On the evidence presented to the Court, the judge found that Dalecroft was indeed in breach of these warranties and therefore the Underwriters were also discharged from liability under this head.

Summary of the Court's conclusions

On this basis, Mr Richard Salter QC found that the Underwriters were entitled to avoid the policy and refuse all of the claims brought by Dalecroft on the grounds that Dalecroft misrepresented: (i) the state of repair of the Property; (ii) the area of flat roof; and (iii) the acts of vandalism. In addition the Underwriters were entitled to avoid the policy on grounds of non-disclosure arising from the EPO. Finally, Dalecroft were in breach of the Commercial Un-occupancy warranties in numerous respects.

For completeness, Mr Richard Salter QC also considered whether his judgment would differ should he have found that the relevant policy was the November 2008 certificate. He found that in November 2008 the Property was still in a poor state of repair, the roof remained flat and that the acts of vandalism were ongoing and therefore Dalecroft would still have made three material misrepresentations of fact to the Underwriters. In addition, Dalecroft would still not have disclosed the EPO. Therefore the Underwriters would have been entitled to avoid the November 2008 policy in precisely the same way.

Comment

Much of this case turns on its particular facts but the decision helpfully reaffirms the principle that an insured's duty of utmost good faith arises not only when the contract of insurance is first concluded, but also whenever an insured seeks to vary or renew the contract. The duty generally ends when the contract is concluded; there is no general duty to inform the insurer of changes to the risk while the contract subsists (although policies may impose specific duties of disclosure throughout the term).

This highlights the importance of timing for a would-be insured. When negotiating renewal terms or variations, the insured must remember that the duty of utmost good faith reattaches and the duty of disclosure arises afresh so long as the subject remains relevant to the insurance. The same is true of any representations made.

It is also interesting to note Mr Richard Salter QC's obiter comments on the likely application of the Insurance Act 2015 to this case. The evidence showed that Dalecroft made "*no real effort*" to present the facts fairly to the Underwriters and the judge was satisfied that if fair presentation of the risk had been made the Underwriters would not have entered into the policy at all. Therefore, under the new legislation the Underwriters would still have been entitled to avoid the policy, but may have had to return to Dalecroft any premium they had paid (subject to the success of any arguments that Dalecroft's breaches were deliberate or reckless). He acknowledged that the old law operates "*harshly to the detriment of the insured*" but stated that "*the application of the pre-2015 Act law makes no injustice to Dalecroft in the present case*". The misrepresentations and non-disclosures by Dalecroft were sufficiently severe that application of the insured-orientated 2015 Act would not have rescued them.

Additional references

Insurance Act 2015

Marine Insurance Act 1906

Summary judgment for insurers: late notification issues bite again

Amlin Corporate Member Ltd v Baby Basics Ltd and Vital Innovations (Israel) Ltd [2017] EWHC 2047

9 June 2017

In *Amlin v Baby Basics*, the Commercial Court considered whether the insureds could access cover under a products liability policy for third party claims related to the sale of unsafe spoons for infants in view of alleged breaches of notification and claim requirements; and, even if they could, whether compensation claims for "negative feelings" and "loss of autonomy" were within the scope of cover.

Background

The First Defendant, Baby Basics Ltd, designed and manufactured baby products, including spoons intended for use by infants. The Second Defendant, Vital Innovations (Israel) Ltd, was a subsidiary or associate of the First Defendant that distributed Baby Basics products in Israel. In November 2015, spoons manufactured by the First Defendant and distributed by the Second Defendant in Israel were found not to comply with the required safety standards, and two class actions were subsequently brought against the Defendants in Israel. The Claimants in the class actions sought damages for "negative feelings" and "loss of autonomy".

The Claimant, Amlin Corporate Member Ltd (on behalf of Lloyd's of London Syndicate 2001), brought proceedings in the Commercial Court against the Defendants seeking a declaration that it was not liable under the policy for losses arising from the defective spoons. The Claimant subsequently made an application for summary judgment.

The two key issues before the Court were: whether the Defendants were deprived of cover by reason of an alleged breach of a condition precedent to liability in relation to the insureds' notification obligations; and a "fundamental" question relating to the ambit of coverage for claims of this nature – which, asserted the Claimant, were not for any head of loss recognised by English law.

The CEOs of both Defendants appeared to accept that there was no cover for the claims to which the declaration related. While the Defendants had accordingly not taken any action in the claim and were not present or represented at the hearing, the judge nevertheless thought it appropriate – and of practical utility – to determine the coverage afforded by the policy, including whether the Defendants had complied with the terms of the policy as regards notification, because of the possibility of third party claims being made pursuant to the Third Party (Rights against Insurers) Act 2010 or similar provisions.

Decision

In deciding to grant the Claimant's application for summary judgment, the judge considered whether the Defendants had complied with the notification requirements set out in the policy and the scope of the products liability cover afforded by the policy.

Notification Issues

Claims condition 2 of the policy required the insureds to notify insurers by telephone "*immediately*" on discovery of an incident which may give rise to a claim under the policy, and subsequently to follow up in writing "*as soon as practicable*". Claims condition 3 of the policy provided the insurers "*will not pay claims under this policy unless you have complied with the terms of condition 2*". The policy also contained a sweep-up ('observance') clause which purported to make compliance with all of the terms of the policy a condition precedent to insurers' liability.

The judge found that the Second Defendant had learned by 8 December 2015 of adverse findings made by the Israeli Commissioner for Standards about the spoons. In January 2016 the Second Defendant was ordered to implement a product recall and a recall notice was published on 21 January 2016. In early February 2016 the Defendants received notice that they were being sued in at least one class action. It was not until 4 April 2016, some 56 days later, however, that the Claimant was notified of this matter under the policy.

The judge found that "*extensive periods of time had elapsed prior to notification*" and that the Claimant's contention that it was not liable to pay claims arising out of the defective product because of the Defendant's failure to notify in time was "unanswerable" by the Defendants. In that regard, the judge characterised the notification obligations as a condition precedent to liability.

Ambit of Policy Coverage

The judge also considered the scope of the cover afforded by the products liability section of the policy. That section provided an indemnity for damages, costs and expenses in the event of accidental bodily injury. Bodily injury was defined as "*death, injury, illness, disease, or nervous shock*". The damages sought in the class actions were for "*negative feelings*" or "*loss or autonomy*". The judge held that "*nervous shock*" does not include "*negative feelings*" under English law and repeated the definition provided by Lord Keith in *Page v Smith*, in which it was stated that "*nervous shock*" required "*some serious mental disturbance outside the range of normal human experience, not merely the ordinary emotions of anxiety, grief or fear*". The Defendants, therefore, did not have a realistic prospect of arguing

successfully that they were entitled to an indemnity under the policy in respect of the class actions brought against them in Israel.

Comment

This case is yet another salient reminder of the dangers for policyholders of not complying promptly with the notification obligations under a liability policy. The relevant terms in this case were not expressly characterised as conditions precedent to liability, but they nonetheless took effect as such in light of the other provisions of the policy, including the provision that insurers would not pay claims absent compliance with the notification obligation and the sweep-up clause which converted all provisions to condition precedents to liability. The key takeaways for policyholders are straightforward: notify claims or circumstances quickly and beware that, in light of the terms of the policy as a whole, the impact of breach of a notification obligation may be more serious than at first blush it may appear.

The case was also of note because it shows that, even in circumstances where the insured is not maintaining its claim under the policy, the Courts may be willing to determine the coverage afforded by a policy in view of potential third party rights under the Third Party (Rights against Insurers) Act 2010 or similar provisions.

Additional references

Page v Smith [1996] 1 AC 155

Third Party (Rights against Insurers) Act 2010

Exclusive jurisdiction clauses will not bind a third party victim bringing a direct action against an insurer

Assens Havn v Navigators Management (UK) Ltd C-368/16

13 July 2017

In *Assens Havn v Navigators Management (UK) Ltd* the European Court of Justice (**ECJ**) ruled that an agreement on jurisdiction between the insured and the insurer will not bind a third party victim bringing a direct action against the insurer. The ECJ decided the case under Council Regulation (**EC**) No 44/2001 (the Brussels Regulation). The relevant provisions interpreted by the ECJ are reproduced in identical form in the replacement Council Regulation EC 1215/2012 (the Recast Brussels Regulation).

Background

Skaden Entreprenad Service AB (the **Insured**) was in charge of the transportation of sugar beet to a factory in Denmark. Part of the journey was carried out by ship from Assens (Denmark) to Nakskov (Denmark) and the Insured chartered a number of tugs and lighters. In respect of one of these vessels, the Insured took out liability insurance with Navigators Management (UK) Limited (the **Insurer**). The relevant vessel arrived at Assens Havn (the **Third Party Victim**), where damage was caused to the quay installations. The Insured subsequently went into liquidation and the Third Party Victim brought an action directly against the Insurer in the Maritime and Commercial Court, Denmark.

Exclusive Jurisdiction Clause

The underlying policy entered into between the Insured and the Insurer contained an English choice of law and jurisdiction clause whereby the parties agreed to submit to the exclusive jurisdiction of the courts of England and Wales. Further, the Insurer's conditions of insurance stated that the insurance was subject to the "*exclusive jurisdiction of the High Court in London [United Kingdom]*".

The Maritime and Commercial Court in Denmark dismissed the action brought by the Third Party Victim on the grounds that the Danish Court did not have jurisdiction. The agreement concluded by the Insured and the Insurer was binding on the Third Party Victim.

The Brussels Regulation

An appeal was submitted to the Danish Supreme Court who referred a question to the ECJ, asking whether the Brussels Regulation (which applied as the proceedings were commenced prior to 10 January 2015) should be interpreted such that an exclusive jurisdiction clause can bind a third party who is permitted under national law to bring a claim directly against an insurer.

Under Section 3 of the Brussels Regulation, dealing specifically with insurance matters, Article 9 (1) provides that "*an insurer domiciled in a Member State may be sued in the courts of the Member State where he is domiciled, or in the case of actions brought by the policyholder, the insured or a beneficiary, in the courts for the place where the plaintiff is domiciled*". Article 10 provides that "*the insurer may in addition be sued in respect of liability insurance in the courts of the Member State where the harmful event occurred*". On the facts of *Assens Havn* the place where the harmful event occurred was Denmark. Article 11(2) confirms that these provisions apply to actions brought by the injured party directly against the insurer where such direct actions are permitted in the jurisdiction.

The Danish Supreme Court questioned whether these provisions applied to allow Danish jurisdiction, notwithstanding the jurisdiction agreement and Article 13(5), which allows for the departure from Section 3 by agreement where a contract of insurance covers one or more of the risks detailed in Article 14. These include specified marine and aviation risks and all "large risks" as defined in Council Directive 73/239/EEC as amended by Council Directives 88/357/EEC and 90/618/EEC.

Decision

The ECJ held that the exclusive jurisdiction clause did not apply as a result of the operation of Articles 9(1) and 10 allowing an insurer to be sued where the plaintiff is domiciled or where the harmful event occurred. The departure from Section 3 allowed for by Article 13(5) did not apply to these provisions which remained to protect the Third Party Victim.

The ECJ referred to the underlying objectives of Section 3, noting that it establishes an autonomous system for the conferral of jurisdiction in matters of insurance. It added that actions involving insurance are often characterised by an imbalance between the parties, which Section 3 seeks to correct by giving the weaker party (in this case, the Third Party Victim) the benefit of more favourable rules on jurisdiction.

In this context, it noted that while Article 11(2) transfers the rights under Articles 8, 9 and 10 to third parties and explicitly refers to those Articles, it does not refer to Article 13 which allows departure from those rights by agreement. The ECJ concluded that it was not apparent from the scheme that Articles 13 and 14 did apply to those rights.

Comment

This decision may come as a surprise to marine and aviation insurers and insurers of "large risks" in particular, who may have interpreted Article 13 and the risks set out in Article 14 as allowing them to derogate from the provisions on jurisdiction in insurance matters. Article 13 provides generally for the departure by agreement from the provisions of Section 3 which include Article 11 relating to direct actions and then sets out specifically which types of agreement are permitted. The plain reading of Article 13 would suggest that exclusive jurisdiction clauses remain binding on third parties who bring direct actions against insurers.

The ECJ had previously declared an exclusive jurisdiction clause to be inapplicable to a named third party beneficiary in *Societe Financiere et industrielle du Peloux*. In *Assens Havn* the ECJ noted that a third party victim is even further removed from the contractual relationship than a third party beneficiary and held that the principle ought also to apply therefore to third party victims. However, in *Societe Financiere* the exception on which the insurer sought to rely related to an exclusive jurisdiction clause seeking to confine jurisdiction to the Member State in which the parties were both resident (Article 13(3)). In these circumstances, the ECJ reasoned that the exception only applied to disputes between the parties themselves and the beneficiary must be entitled to bring proceedings in the courts of their own domicile. The ECJ decision in *Assens Havn* should be seen as a further extension, given that the exception in Article 13(5) does not attract the same reasoning as in *Societe Financiere* and insurers of marine and aviation and "large risks" are more justified in requiring the certainty provided by an exclusive jurisdiction agreement binding also on third parties. It is now difficult to envision any circumstances in which exclusive jurisdiction clauses will apply against third party victims or named beneficiaries bringing direct actions against insurers. This may encourage the greater use of arbitration clauses in insurance contracts which are not subject to the Brussels Regulation (or Recast Brussels Regulation).

The ECJ decision gives third party victims similar protection to that which is already available in consumer insurance. It will apply to all Member States where direct actions against the insurer are permitted, including the United Kingdom, France, Norway, Denmark and Finland. The consequences could be particularly far reaching in jurisdictions where the insured need not be insolvent before a direct action is brought.

Those following this issue closely will be aware of the later decision in *BAE Systems Pension Funds*, where the English court (the Technology and Construction Court) stayed proceedings brought by a third party beneficiary on the basis that the clause in the underlying insurance contract gave exclusive jurisdiction either to the French courts or an arbitration panel. This apparent contradiction with the ECJ decision should be viewed in light of the fact that it came only one day after the ECJ decision in *Assens Havn* and without reference to it. Further, the English Court granted a stay in order to avoid limitation issues, noting the possibility that the appropriate forum may later be determined as the English court, notwithstanding the exclusive jurisdiction clause.

Additional references

Societe Financiere et industrielle du Peloux, C-112/03

BAE Systems Pension Funds Trustees Ltd v Royal & Sun Alliance Insurance Plc [2017] EWHC 2082 (TCC)

Court provides guidance on the Third Parties (Rights against Insurers) Act 2010

BAE Systems Pension Fund Trustees Ltd v Royal & Sun Alliance Insurance Plc [2017] EWHC 2082 (TCC)

14 July 2017

The Third Parties (Rights against Insurers) Act 2010 (the **2010 Act**) greatly simplifies the position of a claimant seeking to satisfy a judgment against an insolvent defendant that held insurance. Under the old Third Parties (Rights against Insurers) Act 1930 (the **1930 Act**) it was necessary for a claimant to establish liability against the insured before bringing a separate set of proceedings against the insurer. The 2010 Act now does, in one step, what the 1930 Act did in two so that a claimant can now bring a single set of proceedings to establish liability both against the insured and the insurer.

This case explores the threshold of the 2010 Act. In a sensible decision the Court held that a claimant does not have to establish, as a precondition to bringing proceedings under the 2010 Act, that there is valid coverage in place. All that a claimant has to do to bring proceedings is to claim that coverage exists. The 2010 Act then sets out the mechanism by which disputes as to coverage are resolved.

This case also considers how arbitration or foreign jurisdiction clauses contained in the relevant insurance policy should be dealt with for the purposes of the 2010 Act and highlights some of the practical difficulties that claimants may face in such situations.

Background

The Claimant, a pension fund trustee, brought proceedings against a number of Defendants in respect of the negligent design and construction of a warehouse. One of the proposed Defendants collapsed into administration but held a policy with Royal & Sun Alliance Insurance Plc (**RSA**).The Claimant applied to join RSA to proceedings pursuant to Section 2 of the 2010 Act with a view to determining RSA's liability.

RSA resisted the application on two grounds. First, it argued first that the 2010 Act did not apply because the insured was not covered by the policy. In other words it was necessary to establish coverage as a precondition to even bringing proceedings under the 2010 Act. Secondly, it argued that the Court had no jurisdiction over the proceedings (given certain jurisdiction clauses in the policy) such that no declaration could be given by the Court.

Decision

The Court began by setting out the relevant provisions of the 2010 Act that – in broad terms – transfer the rights of an insured to a third party upon the occurrence of certain events i.e. insolvency. Section 2 of the 2010 Act provides that where such a transfer has taken place, a claimant may bring proceedings for a declaration as to the liability of either/both the insured or the insurer. Section 2 (1), (2) and (7) provide as follows:

"***2 Establishing liability in England and Wales and Northern Ireland***

- *This section applies where a person (P)—*
  - (a) *claims to have rights under a contract of insurance by virtue of a transfer under section 1, but*
  - (b) *has not yet established the insured's liability which is insured under that contract.*
- *P may bring proceedings against the insurer for either or both of the following—*
  - (a) *a declaration as to the insured's liability to P;*
  - (b) *a declaration as to the insurer's potential liability to P.*

...

(7) *Where a person applying for a declaration under subsection (2)(b) is entitled or required, by virtue of the contract of insurance, to do so in arbitral proceedings, that person may also apply in the same proceedings for a declaration under subsection (2)(a)*"

RSA argued that the Claimant was unable to bring proceedings under the 2010 Act because the insured was not covered. It argued this on the basis of a clause in the policy that excluded cover in the event that the insured knew of the damage (here the defect to the construction of the warehouse) prior to the policy being taken out.

However, the Court held that Section 2(1) of the 2010 Act is engaged in circumstances in which cover is disputed. All that a claimant must do is to claim that such coverage exists. Accordingly Section 2 provides the machinery for establishing liability – not just determining it. The result is that a claimant will not need to bottom out coverage issues prior to bringing proceedings against an insurer under the 2010 Act. Rather, coverage will be determined as part of those proceedings.

RSA raised a number of objections to this construction of Section 2 and in particular the fact that a claimant could join in any insurer with impunity even insurers who were not on risk during the relevant period.

However, the Court held that proceedings brought under Section 2 of the 2010 Act that were simply fanciful were liable to be struck out. The upshot is that proceedings brought under the 2010 Act cannot be fanciful but neither do they have to bear much judicial scrutiny in order to pass the relevant threshold.

The second ground of resistance concerned whether the Court had any jurisdiction to grant the declaration as to the liability of RSA in circumstances in which the policy had a jurisdiction clause. In this case the policy contained jurisdictional clauses the effect of which was that the matter had to be decided under French law and determined in arbitration or the French courts. The Court held that where clauses of this type exist, it was not be open to the Court to determine the insurer's liability under the policy and therefore the appropriate course was to stay the 2010 Act proceedings until the coverage issue has determined either by the foreign courts or the arbitration. Although the availability of the 2010 Act was unaffected, the Court was unable therefore to resolve the dispute pending resolution of the arbitration or French proceedings. Until those proceedings were resolved, the Claimant was unable to advance the 2010 Act proceedings.

Comment

The decision of the Court with respect to the proper construction of Section 2 of the 2010 Act is plainly the correct one. As the language of Section 2 makes clear, in order to bring proceedings all that a claimant must do is to claim that coverage exists. The question as to whether coverage does in fact exist is a separate question to be determined at a later stage in the proceedings. The practical upshot is that a coverage issue does not have to be determined in order to bring proceedings in the first place. This should considerably ease the burden on those seeking to claim against insurers in insolvency situations.

However, the result was something of a pyrrhic victory for the Claimant given that the Court was unable to deal with the 2010 Act proceedings until the foreign court/arbitral proceedings had been concluded. Accordingly the reality of the position was that the Claimant was no further forward in terms of obtaining a judgment against RSA and could not bypass the foreign court/arbitral clauses. Potential claimants will therefore wish to check that no such clauses exist in the circumstances of their case otherwise they might find that although the 2010 Act is engaged, the Court cannot resolve their dispute.

Additional references

Third Parties (Rights against Insurers) Act 1930
Third Parties (Rights against Insurers) Act 2010

Third Parties (Rights against Insurers) Act 1930 continues to apply to claims where the insured's liability and insolvency occurred before 1 August 2016

Redman v Zurich Insurance Plc [2017] EWHC 1919 (QB)

26 July 2017

The Third Parties (Rights against Insurers) Act 1930 (the **1930 Act**) was seen as procedurally clunky in that a claimant could only sue an insurer when the insolvent insurer's liability and the amount of the loss had been formally established by judgment, declaration or otherwise. In addition, in the case of any company which had been dissolved, it was necessary to restore the insolvent insured to the register. These problems were solved by the introduction of the 1930 Act's modern successor, namely the Third Parties (Rights against Insurers) Act 2010 (the **2010 Act**) which allows claimants to enforce rights against insurers without having to establish the insolvent insured's liability; it also removed the need for a dissolved company to be revived. Unfortunately for claimants, the 1930 Act continues to apply where the liability and the insolvency of the insured occurred before 1 August 2016. The 2010 Act does not apply retrospectively.

Background

The case concerned an insurance claim by the widow and administratrix of Mr Redman who worked for a company known as ESJS1. Mr Redman was exposed to asbestos throughout his employment and unfortunately died of lung cancer on 5 November 2013. ESJS1 was wound up 30 January 2014 and eventually dissolved on 30 June 2016. Accordingly both the liability and insolvency of the insured occurred prior to the coming into force of the 2010 Act on 1 August 2016.

Mrs Redman brought a claim under the 2010 Act hoping to circumvent the more stringent procedural requirements of the 1930 Act (i.e. having to restore ESJS1 to the register and undergo the two stage liability process). The Court first set out the transitional provisions in the 2010 Act. In short, these provide that the 1930 Act continues to apply where two conditions are satisfied, namely where the liability and the insolvency of the insured occurred prior to 1 August 2016. The Court then turned to address whether those conditions had been satisfied.

Decision

Mrs Redman had initially sought to argue (somewhat bravely) that the insured had not incurred a liability for the purposes of the 1930 Act. Rather liability would only be incurred when Mrs Redman obtained judgment against the insured (or otherwise established a right to compensation). On this basis the 2010 Act should apply.

However, this line of argument was abandoned before the Court in light of the clear judgment of Lord Denning in *Post Office v Norwich Union Fire Insurance Society Ltd* in which he held (in a celebrated passage) that liability is incurred for the purposes of the 1930 Act (and by extension the 2010 Act) when the damage to the Claimant is caused and not when a right to compensation is established by judgment or otherwise.

Accordingly Mrs Redman was forced to concede that the 1930 Act applied. However, she argued that the transitional provisions of the 2010 Act did not preclude the parallel operation of the 2010 Act, i.e. claims which had fallen exclusively within the scope of the 1930 Act could nonetheless be brought under the 2010 Act. Not only did this line of argument ignore the express wording of the transitional provisions in the 2010 Act, it would also mean that there were, in effect, no transitional provisions and it would be impossible to identify circumstances in which the 1930 regime would have primacy over the 2010 regime. Again the Court had little difficulty in rejecting Mrs Redman's interpretation.

Comment

Although the 2010 Act offers a much more user friendly regime compared to its predecessor, claimants will not be able to take advantage of it in circumstances in which the insured's liability and insolvency pre-date 1 August 2016. While this is in one sense unfortunate, the legislation points irrevocably to this answer.

Additional references

Post Office v Norwich Union Fire Insurance Society Ltd [1967] 2 Q.B. 363

Court of Appeal explores the duty to speak

Ted Baker Plc & Anor v (1) Axa Insurance UK Plc & Ors [2017] EWCA Civ 4097

11 August 2017

In this case the Court of Appeal dismissed an appeal arising out of an insurance claim for business interruption losses resulting from goods stolen by an insured's employee, as it could not establish quantum of loss. Before reaching its conclusion, the Court of Appeal explored the "duty to speak" and whether a failure by the insurer to comply with this duty could found an estoppel. Whilst something of a pyrrhic victory given the overall result, in determining that an estoppel could be founded, the Court of Appeal overturned what might be regarded as a somewhat harsh finding by Mr Justice Eder, at first instance, that the claim fell to be rejected for the insured's failure to comply with a claims co-operation clause.

Background

Ted Baker (**TB**) was the subject of a campaign of theft by a trusted employee who, between 2003-2008, stole a large amount of stock from TB's warehouses in London. The employee was caught, convicted and imprisoned.

TB held a series of policies with the respondents (the **Insurers**) and advanced a claim in respect of business interruption (**BI**) losses said to have arisen from the thefts of stock.

TB's combined commercial policy contained a term which provided that:

"15 Condition Precedent

It is a condition precedent to any liability on the part of the Company under this Policy that…the terms hereof so far as they relate to anything to be done or complied with by the Insured are duly and faithfully observed and fulfilled by the Insured and by any other person who may be entitled to be indemnified under this Policy."

The BI Section of the policy also contained Special Conditions relating to claims co-operation:

- Claims Condition 2(b)(i) stated that, *"in the event of a claim being made under this Section, the Insured at their own expense shall (not later than 30 days after the expiry of the Indemnity Period or within such further time as the Company may allow) deliver to the Company in writing particulars of their claim…"; and*
- Claims Condition 2(b)(ii) also required TB to "*deliver to the Company such books of account and other business books, vouchers, invoices, balance sheets and other documents proofs information explanation and other evidence* ***as may be reasonably required*** *by the Company for the purpose of investigating or verifying the claim*." (emphasis added)

The Special Conditions were subject to the following provision:

"*If the terms of this condition have not been complied with no claims under this Section shall be payable*."

In assessing the claim the Insurers requested a 'shopping list' comprised of various categories of documents. One of the categories of documents (the **Category 7 Documents**) was TB's management accounts. It was common ground between the parties that, without more, a failure to provide the Category 7 Documents amounted to a breach of a condition precedent to the insurers' liability under the policy

TB was reluctant to provide the documents sought in the shopping list, at least pending confirmation of cover given the time and expense in providing some of them, and believed that the Category 7 Documents were subject to a "Professional Accounts Clause" (the **PAC**). The PAC required the Insurers to pay TB's accountants fees for producing the management accounts. TB never supplied the Category 7 Documents believing that the PAC applied and that Insurers had agreed to consider "parking" the request for the Category 7 Documents as a result.

However, the Insurers never reverted back either way on whether, in light of what was said about the PAC, the Category 7 Documents should be supplied. The time for supplying the Category 7 Documents passed and the Insurers denied the claim on the basis that the failure to supply the Category 7 Documents was a breach of condition precedent (the remainder of the shopping list was either supplied or struck down at trial as being unreasonable).

At trial TB argued, in high level terms, that it was entitled to withhold the Category 7 Documents on the following overlapping bases:

- **First**, TB argued that the items on the shopping list were covered by the PAC (save for Category 1 that was supplied). Given that the Insurers failed to comply with the PAC it followed that TB was entitled to withhold the relevant categories on the shopping list (including the Category 7 Documents);
- **Second**, that the parties had agreed, pending confirmation from the Insurers, to "park" the shopping list. Although the Insurers never reverted with confirmation either way TB argued that their failure to confirm their position amounted to

a representation estopping the Insurers from relying on the condition precedent with respect to Category 7; and

- **Third** and finally, it argued that in circumstances in which the Insured knew that there was no agreement to "park" the request for the Category 7 documents (i.e. that the request was "live") **but that TB thought otherwise** there was a duty on the Insurers to speak and to point out to TB that the Category 7 documents were outstanding.

At first instance Eder J held that the PAC did not cover the Category 7 Documents and that there had been no agreement to "park" the request for the Category 7 Documents that could amount to a representation. He also held that the Insurers were not under a duty to speak.

Decision

Although the Court of Appeal dismissed TB's appeal (by reason of it not being able to support its quantification of the claim) it did uphold TB's argument that the Insurers were under a duty to speak. It is this aspect of the Court of Appeal's judgment that is of most interest particularly given the fact that Eder J's decision was premised on the duty to speak only arising in circumstances in which the insurer knowingly misleads the insured. Given that Eder J found that the Insurers did not knowingly mislead TB he did not explore whether the duty could arise in broader circumstances i.e. where there was no misleading conduct. The focus of the Court of Appeal's enquiry was whether the duty could arise even in circumstances in which there was no misleading conduct.

Having held that there was no representation to the effect that the Category 7 documents would not be supplied, Sir Christopher Clarke (who gave the lead judgment in respect of the duty to speak), nonetheless held that the Insurers should have spoken out to remind TB of its obligation to supply the Category 7 Documents.

In holding that a duty to speak existed Sir Christopher Clarke analysed the "slender" amount of insurance case law on the duty of good faith arising (i) after a contract of insurance has been formed and (ii) operating to the benefit of the insured. However, he referred in particular to the judgment of Lord Clyde in *Manifest Shipping Co. Ltd v Uni-Polaris Insurance Co Ltd* [2003] where he stated:

"*But once it is recognised that in a contract of insurance, and indeed in certain other contracts, an element of good faith is to be observed, and that that element may impose certain duties particularly of disclosure between one party and the other, duties which may vary in their content and substance according to the circumstances, then a question may arise as to the utility of the concept of an utmost good faith or an uberrima fides. In my view the idea of good faith in the context of insurance contracts reflects the degrees of openness required of the parties in the various stages of their relationship. It is not an absolute. The substance of the obligation which is entailed can vary according to the context in which the matter comes to be judged. It is reasonable to expect a very high degree of openness at the stage of the formation of the contract, but there is no justification for requiring that degree necessarily to continue once the contract has been made.*"

Sir Christopher Clarke then considered a number of commercial cases in which a duty to speak had arisen for consideration. The key authority in this respect is the judgment of Blair J in *Starbev GP Ltd v Interbrew Central European Holdings BV* [2014] where he held (as summarised by Sir Christopher Clarke) that:

"a duty to speak….may arise on the particular facts where one party is proceeding on the assumption that something is agreed, whereas the other party knows that it is in dispute. In such a case the duty to speak may arise because a reasonable man would have the expectation [that the other party would make the true facts known]."

Crucially the duty to speak is not dependant on there being actual dishonesty. Rather the duty can arise where one party elects to remain silent in circumstances in which an honest man would have expected that party to speak up and make the true facts known. Although the duty to speak was not dependant on their being a duty of good faith between the parties it was much easier to establish where there was such a duty (as exists in an insurance context).

In applying these principles to the facts the Court of Appeal held that the Insurers knew that TB was under the impression that the Category 7 Documents were subject to the PAC and that TB was waiting for confirmation that its accountants' fees would be paid for. In such circumstances TB was entitled:

"to expect that if the insurers regarded the Category 7 material (alone) as outstanding, due, and unparked, then, acting honestly and responsibly, they should have told [TB]. Not to do so was misleading."

In concluding that the failure to speak had given rise to an estoppel, Sir Christopher Clarke stated:

"An estoppel of this nature in a contract of this kind does not require dishonesty or an intention to mislead; nor any impropriety beyond that inherent in the conclusion that the insurers should have spoken but did not. In the circumstances to which I have referred the insurers were, in my view, under a duty to tell TB that the Category 7 material was indeed outstanding and was required before the upshot of any instructions was revealed. If they had done so the documents would no doubt have been supplied. Since they did not do so it would be unjust and unconscionable to allow them to escape any liability on the ground of non-compliance with a condition precedent in relation to the Category 7 material."

On this basis the Court of Appeal overturned the first instance decision that the claim should be rejected for breach of a condition precedent in the claims co-operation clause and held that the Insurers had failed to comply with their duty to speak giving rise to an estoppel preventing them from relying on the condition precedent.

However, TB's victory proved to be a pyrrhic one given that the Court of Appeal refused to overturn the first instance decision with respect to quantum. The Court of Appeal held that it was not the function of an appellate Court to interfere with a trial judge's conclusions in relation to primary facts unless they were "plainly wrong". It therefore did not disturb the trial judge's findings to the effect that TB had failed to properly quantify its claim. As a result the appeal was dismissed.

Comment

There is now clear authority for the proposition, in an insurance context, that an insurer is under a duty to speak. It is also important to remember that the duty is not contingent on there being some sort of dishonesty or wrongdoing. Rather the duty will arise where a reasonable man would expect the silent party to speak up and correct the other party's misapprehension. It is clear from the judgment that the precise scope of the duty will turn on the facts and circumstances of the particular case. However, insurers should take notice that there may be circumstances where they will be reasonably expected to act honestly and responsibly and make their position clear to insured parties.

Although this case might appear to be good news for policyholders, were it not for the somewhat unusual facts of this case TB would not have escaped the consequences of being in breach of the co-operation clause (that was construed as a condition precedent by virtue of there being a sweep-up provision that treated all obligations under the Policy as conditions precedent). Further, the Court of Appeal may also have had some sympathy with the insured's position on this point in order to remedy a first instance decision that Eder J felt obliged to reach albeit that he did so "without any great enthusiasm".

We would note finally that whilst this case was determined on the basis of a pre-Insurance Act 2015 policy, the analysis would likely be the same under a post- Act policy on the same terms; and policyholders should take note of the risks inherent in sweep-up provisions being included in wordings.

Additional references

Manifest Shipping Co. Ltd v Uni-Polaris Insurance Co Ltd [2003] 1 AC 469

Starbev GP Ltd v Interbrew Central European Holdings BV [2014] EWHC 131

Construction of exclusions in insurance policies

Crowden and Crowden v QBE Insurance (Europe) Ltd [2017] *EWHC 2597 (Comm)*

19 October 2017

In *Crowden and Crowden v QBE Insurance (Europe) Ltd*, the Commercial Court found in favour of the Defendant insurer on the disputed construction of an "insolvency" exclusion in a professional indemnity insurance policy. The case is a useful reminder of the approach which the English Courts take to the construction of exclusions in insurance contracts.

Background

The Claimants (husband and wife) were the trustees of a self-administered pension scheme and the sole beneficiaries thereunder. The claim arose out of two investments made by the Claimants (a husband and wife) on the advice of a firm of professional financial advisers, Target Financial Management Ltd (**Target**).

Target was insured at the relevant time under a professional indemnity policy (the **Policy**) issued by QBE. The Policy afforded Target the usual professional indemnity cover but, crucially, included an exclusion (the **Insolvency Exclusion**) in the following terms:

"*This Insured section excludes and does not cover any claims, liability, loss, costs or expenses:*

...

arising out of or relating directly or indirectly to the insolvency or bankruptcy of the Insured or of any insurance company, building society, bank, investment manager, stockbroker, investment intermediary, or any other business, firm or company with whom the Insured has arranged directly or indirectly any insurances, investments or deposits"

The investment products in which the Claimants were advised to invest were known as the "Keydata Bond" into which the Claimants invested £200,000 in 2009 and the "Meteor Plan" into which the Claimants invested £150,000 in 2008. Keydata defaulted on payment returns and subsequently entered administration in June 2008. Under the Meteor Plan the Claimants acquired securities issued by Lehman Bros which entered into insolvency proceedings in the US in September 20008. It was alleged that the Claimants had suffered losses of £150,000 on the Keydata Bond and losses of £50,000 on the Meteor Plan.

In 2009, rather than pursuing Target, the Claimants first made complaints and applied for compensation to the Financial Services Compensation Scheme (**FSCS**) in respect of the two investment products (not in respect of Target). In respect of the Keydata Bond the Claimants' claim was upheld in the amount of £84,642.92. It was a condition of the payment by the FSCS that the Claimants would assign all rights against Target in respect of the Keydata Bond to the FSCS (although the extent of that assignment was in issue). The Claimants' complaint in respect of the Meteor Plan was not upheld by the FSCS.

In August 2011 the FSCS purported to reassign to the Claimants the rights which had been assigned as a condition of the payment in respect of the Keydata Bond.

At the end of 2011 Target entered administration and in February 2012 the Claimants made a further complaint to the FSCS in respect of Target (as opposed to the specific investment products). That second complaint was also upheld (as regards Keydata) and the Claimants received £77,598.11 from the FSCS. Again the payment was conditional on an assignment of the Claimants' rights against Target. No decision was reached by the FSCS on the Claimants' complaint against Target in respect of the Meteor Plan.

On 30 May 2013 Target entered liquidation. In May 2014 the Claimants commenced proceedings against Target. Target's liquidators did not defend the claim and judgment was entered for the Claimants in the sum of just under £200,000 in February 2015 (the **Target Judgment**). Importantly, QBE had declined to take over conduct of the defence of the claims against Target on the basis that it was not obliged to indemnify Target under the Policy.

The Proceedings

In August 2016 the Claimants issued proceedings directly against QBE under the Third Parties (Rights Against Insurers) Act 1930 (the **1930 Act**). The fact that Target entered insolvency proceedings and incurred a liability to the Claimants prior to 1 August 2016 meant that the Third Parties (Rights Against Insurers) Act 2010 (the **2010 Act**) did not apply.

The Claimants alleged that Target's liability to the Claimants was established by the Target Judgment and that accordingly Target's right to an indemnity from QBE was assigned or transferred to the Claimants.

QBE defended the claims on two principal bases, namely:

- that by virtue of the Insolvency Exclusion the Claimants' claims against Target were not covered under the Policy (the **Exclusion Point**); alternatively
- that as a result of the Claimants having assigned their claims against Target to the FSCS the Claimants did not have *locus* to bring the claim against QBE under the 1930 Act (the **Assignment Point**).

QBE applied for strike out or alternatively summary judgment in respect of the Exclusion Point and the Assignment Point.

Argument

Exclusion Point

QBE's case on the Insolvency Exclusion Point was that the Insolvency Exclusion was widely drafted and clear in its application:

- The Claimants' claims (and Target's liability) were "*arising out of or relating directly or indirectly to*" either (i) the insolvency of Keydata and Lehman; or (ii) the insolvency of Target. There was no need for the insolvency to be a proximate cause of the claims. Thus the Claimants' claims (and Target's liability) were sufficiently causally connected with the insolvency either of the "*Insured*" (Target) or "*any other business, firm or company with whom the Insured has arranged directly or indirectly any... investments or deposits*" (Keydata or Lehman).
- The Insolvency Exclusion was incorporated into Target's insurance cover immediately following the 2008 global financial crisis. This evidenced that Target's and QBE's intention was for QBE's exposure to losses connected with the insolvency of financial institutions to be limited.
- The expiring insurance wording for the year prior to the Policy incorporated a different insolvency exclusion which was much more narrowly drafted. This evidenced that Target and QBE had intended for there to be a change in the scope of QBE's exposure to losses connected with insolvency under the Policy.

The Claimants argued that the Insolvency Exclusion did not apply to the Claimants' claims against Target.

- On its proper construction the Insolvency Exclusion (i) did not apply to negligent investment advice given by Target; and/or (ii) was intended to apply only to investments made by Target for its own account and not for or on behalf of its customers.
- QBE's construction of the Insolvency Exclusion would have the effect of excluding "*wide tracts of ubiquitous financial business from the scope of the Policy*".
- The Policy was designed to afford Target the minimum level of cover specified under the FSA Handbook (Chapter 13 of IPRU) and did not do so by virtue of the Insolvency Exclusion.
- The change in the scope of the Insolvency Exclusion compared to the equivalent exclusion in the expiring cover was not brought to Target's attention.
- "Insolvency" should be construed as meaning a formal insolvency process. Keydata had not entered such a process when the Claimants' cause of action against Target accrued.

Assignment Point

QBE's case on the Assignment Point was that, notwithstanding the Target Judgment, the Claimants had not established Target's liability to them. The true position was that the Claimants had assigned any cause of action against Target (in respect of the Keydata Bond) to the FSCS and thus the proceedings leading to the Target Judgment were an abuse of process.

The Claimants' counter arguments were as follows:

- The assignment of the Claimants' rights to the FSCS only applied in respect of losses which were actually paid to the Claimants and the Claimants had not been reimbursed in full by the FSCS.
- The FSCS had acknowledged that it had reassigned the relevant rights of action to the Claimants. Alternatively in the absence of a legal reassignment, the facts established an equitable assignment.
- QBE was not entitled to go behind the Target Judgment to dispute Target's liability to the Claimants.

Decision

Peter McDonald Eggers QC (sitting as a judge of the London Circuit of the Commercial Court) found in favour of QBE on the Insolvency Exclusion Point but declined to express a view on the Assignment Point. Accordingly QBE was given leave to enter summary judgment against the Claimants.

Exclusion Point

The judge drew a distinction between exclusion clauses in an insurance contract and clauses which purport to limit or exclude liability in other commercial contracts. The construction of insurance exclusions had to be considered in light of the Supreme Court decision in *Impact Funding Solutions Ltd v Barrington Support Services Ltd.* The Supreme Court decision made clear that the purpose of an exclusion in an insurance policy may be simply a way of delineating the scope of the insurer's primary liability. Accordingly there was no basis on which to follow a *contra preferentem* approach in reliance on the line of authorities arising from *Canada Steamship Lines Ltd v The King* in the context of non-insurance contracts.

Turning to the parties' respective arguments on construction:

- The judge noted that the "*language of the Insolvency Exclusion*" was relatively clear and that accordingly "*the causative effect of the relevant insolvency need not be as strong or efficient so as to constitute a proximate cause.*"
- He rejected the Claimants' arguments for a more restricted scope, noting that for the Insolvency Exclusion to be applicable to negligent acts only would give the exclusion an odd effect (protecting Target from acts over which it had control but not from acts over which it had no control).
- He did not accept that the Insolvency Exclusion was intended only to deal with Target's own investments – the use of the word "*arranged*" in the Insolvency Exclusion suggested Target acting on behalf of a third party. Moreover this construction was supported by the wording of the exclusion in the expiring policy which included a "carve-back" for claims which were arose directly from Target advising a third party to invest in the relevant insolvent entity.
- There was no basis for construing "*insolvency*" narrowly – the parties could have defined the term as denoting only a formal insolvency process but had not done so.
- The effect of the Insolvency Exclusion was not so wide ranging that it would deprive Target of substantial cover under the Policy.
- Nothing on the face of the Policy or the surrounding factual matrix evidenced that QBE and Target intended the Policy to discharge Target's regulatory obligations and, in any event,

the Insolvency Exclusion arguably did not put Target in breach of such obligations.

Assignment Point

The factual background to the Assignment Point was complex and, given his view on the Insolvency Exclusion Point, the judge was not minded to express a view in the context of an interlocutory hearing on whether the Claimants had retained a cause of action against Target following the payments made by the FSCS.

However, the judge did express some *obiter* views on the question of whether the Target Judgment was binding on QBE. Referring to *AstraZeneca Insurance Co Ltd v XL Insurance (Bermuda) Ltd* the judge noted that the established position is that an insurer is entitled to contest the existence of its insured's liability, notwithstanding that there has been a court judgment or other award against the insured. The judge endorsed this approach, but noted that in his view there might be two circumstances in which an insurer might be bound by a third party obtaining judgment against the insured, namely:

- Where the insurance policy contains a term requiring the insurer to be bound by a judgment; or
- Where the insurer was a party to or otherwise privy to the proceedings which led to the judgment in question.

The judge noted that in the present case QBE had been given the opportunity to participate in the Claimants' claims against Target but had refused to do so on the basis that QBE was not liable to indemnify Target in any event. The judge's view was that this refusal to participate would entitle QBE to refuse to accept the Target Judgment as evidence of the existence of Target's liability to the Claimants.

Comment

The judgment is a useful restatement of the law on the interpretation of exclusion clauses in insurance contracts and the differences between such clauses and clauses in other commercial contracts which seek to exclude or limit liability. It also serves as a reminder to policyholders that they should not assume, simply because an exclusion is very widely drafted, that it will not be upheld by the courts in the event of a dispute.

The case also sounds a note of caution for policyholders and their brokers in relation to insurance renewals and changes to the terms and conditions of the policy. Policyholders and their brokers should ensure that they understand the rationale behind any change in the wording of key terms (in particular insuring clauses, conditions and exclusions). Brokers should ensure that the impact of any such changes is brought to the attention of their clients.

Finally, the judge's *obiter* comments about the circumstances in which an insurer might not be entitled to challenge its insured's liability to a third party, although they do not change the law, are nonetheless of interest. In particular, the judge envisaged an insurer being bound by a finding against its insured where the insurer participated in or was privy to the proceedings brought by the third party. Although the claim was made under the 1930 Act, the judge also noted that under the 2010 Act, it is now open to the third party claimant to establish the relevant liability by obtaining a declaration in the proceedings against the insurer that the insured is liable to the third party.

Additional references

Third Parties (Rights Against Insurers) Act 1930

Impact Funding Solutions Ltd v Barrington Support Services Ltd [2016] UKSC 57

Canada Steamship Lines Ltd v The King [1952] AC 192

AstraZeneca Insurance Co Ltd v XL Insurance (Bermuda) Ltd [2013] EWCA Civ 1660

High Court removes arbitrator on the basis that he did not possess necessary qualifications

Tonicstar Ltd v Allianz Insurance and Sirius International Insurance Corporation [2017] EWHC 2753

06 November 2017

The High Court considered an application under Section 24 of the Arbitration Act 1996 (**the Act**) for the removal of an arbitrator on the basis that he did not satisfy the contractual stipulation as to relevant experience. This judgment is of particular interest given that questions of the removal of arbitrators do not often come before the courts (because they are, in institutional arbitration, typically decided by arbitral institutions so are not usually public). The Court decided to remove the arbitrator on the basis that he had experience of insurance and reinsurance law, rather than required experience in the business of insurance and reinsurance. This decision highlights the importance of the careful drafting of arbitration clauses which specify characteristics of an arbitrator. It also serves as a reminder of the importance of precedent in the English judicial system.

Background

A dispute arose between the parties under a contract of reinsurance dated 12 February 2001 (the **Contract**) which incorporated the "Joint Excess Loss Committee, Excess Loss Clauses". These were a set of standard form clauses, published in January 1997 under the instructions of The Institute of London Underwriters.

The arbitration clause in the Contract provided for the appointment of three arbitrators and specified that "*unless the parties otherwise agree the arbitration tribunal shall consist of persons with not less than ten years' experience of insurance or reinsurance*".

The dispute was referred to arbitration pursuant to the Contract.

The issue

The Claimant applied pursuant to s24 of the Act to remove the Respondents' nominated arbitrator, Mr. Schaff QC. Whilst the Claimant accepted that Mr. Schaff had considerably more than ten years' experience of insurance and reinsurance *law*, it argued that he did not have more than ten years' experience of insurance or reinsurance within the meaning of the arbitration clause, as the clause required experience in the *business* of insurance or reinsurance.

The Claimant relied on *Company X v Company Y* (unreported) in which the Court had decided the exact same question of whether a QC with considerable experience as a lawyer in insurance and reinsurance disputes was qualified to act as an arbitrator within the meaning of the same Joint Excess Loss Committee arbitration clause. In that case, the Court noted that this construction of the clause was supported by the fact that the default appointment bodies specified in the clause were the Chairman of the Lloyd's Underwriters' Association and the Chairman of the International Underwriting Association, both of whom were unlikely to be in a position to identify appropriate lawyers.

The Respondents submitted that the decision in *Company X v Company Y* was obviously wrong, as the ordinary and natural meaning of "experience of insurance or reinsurance" included experience acquired by working with or on behalf of the insurance and reinsurance industry. Such a construction offered the parties the flexibility to nominate an arbitrator whose particular experience made them most suitable for the dispute in question. If the parties had wished to confine their choice of arbitrators to persons working within the insurance or reinsurance industry, they could have used language which made such intention clear.

As a separate and secondary issue, the Respondents also argued that the Court had no power to grant the relief sought, as the Tribunal itself should first rule on its own jurisdiction pursuant to the following two provisions of the Act:

- Section 30(1)(b), which provides that the arbitral tribunal may rule on its own substantive jurisdiction as to whether the tribunal is properly constituted; and
- Section 24(2), which provides that if there is an arbitral or other institution or person vested by the parties with power to remove an arbitrator, the court shall not exercise its power to remove the arbitrator unless satisfied that the applicant has first exhausted any available recourse to that institution or person.

Decision

No departure from precedent

As a starting point, the Court went back to first principles concerning the importance of case precedent, referring to *Willers v Joyces* in which it was held that where there is a previous decision at first instance, a first instance judge should generally follow that decision unless there is powerful reason for

not doing so. The previous decision on the same issue in *Company X v Company Y* was made 17 months previously (with no subsequent challenge), just 7 months before the Contract was signed and in circumstances where the Joint Excess Loss Committee had produced a revised draft of the Excess Loss Clauses in November 2003 which did not alter the wording of the arbitration clause. The Court also noted that the decision must have been fairly well-known in the reinsurance market and concluded that there would have to be a very powerful reason for the Court not to follow the decision in *Company X v Company Y*.

The Court concluded that the decision in *Company X v Company Y* was not *"obviously wrong"*, as it could be supported by reference to the context of the clause, given it was drafted by a trade body. Therefore the Court granted the application despite Mr Schaff QC's undoubted experience of insurance and reinsurance derived from acting as counsel in those fields.

Secondary issues

The Court found that it did have the power to grant the application. The two arbitrators appointed by the parties did not have the power to remove one of them, as the power to rule on questions of jurisdiction is different from the power to remove an arbitrator.

In light of the removal of Mr Schaff QC, the Court also determined as a practical matter that the contractual procedure regarding the respondent's appointment of an arbitrator could also apply to the re-appointment, albeit with "some manipulation" of the contractual wording. It therefore ordered that the Respondents had 30 days from the Court's decision to appoint a new arbitrator to fill the vacancy.

Comment

This decision emphasises the importance of precise drafting if an arbitration clause specifies particular characteristics required of arbitrators. In particular, the clause should be clear not as to the relevant experience of the arbitrators, but also the capacity in which such experience has been obtained. This may mean amending standard form clauses. Such attention to detail at the drafting stage should minimise the risk of incurring the delay and costs associated with an arbitrator challenge.

This case also serves as a reminder, especially to those parties from civil law systems, of the importance of judicial precedent in English law. It is clear that the primary factor in the Court's decision was the previous judgment on the issue. This was the case even though the Court appeared to follow the judgment with some reluctance, concluding that absent the previous decision it may have decided that "*the ordinary and natural construction of the phrase in question did not limit the fields in which experience of insurance or reinsurance could be acquired and that the "context" argument was not sufficiently strong to justify implying the suggested limitation that the relevant experience be acquired in the business of insurance or reinsurance*".

Interestingly, the Joint Excess Loss Committee appears to have already responded to this decision in a practical way. The model form arbitration clause in the Joint Excess Loss Clauses has now been amended so that it expressly allows the parties to appoint lawyers or professional advisers to as arbitrators provided they have at least 10 years' experience of the industry. The new arbitration clause will be effective from 1 January 2018. Parties with contracts which incorporate the previous version of the Joint Excess Loss Clauses may wish to amend their arbitration clause to reflect this change, before any dispute arises.

Additional references

Company X v Company Y, unreported (17 July 2000)

Willers v Joyces [2016] UKSC 44

Insurance requirements in commercial contracts – how does cyber fit in?

This Article was first published in the December 2017 issue of PLC magazine

Cyber risks are rarely out of the news at the moment. Cyber incidents have the capacity to cause many different types of loss. While most people are familiar with ransomware attacks such as WannaCry which caused widespread disruption to many organisations worldwide including the NHS, there are also examples of cyber-attacks resulting in physical damage to property, such as when hackers disrupted the control systems of a blast furnace at a steel mill in Germany, causing significant damage. The increasing use of technology to control plant/ operations remotely means that these risks are likely to remain very much live. There is also the risk of direct financial loss, such as the successful $81 million Bank of Bangladesh cyber heist in 2016, as well as losses resulting from large scale data breaches, such as the one recently affecting Equifax from May to July 2017.

Insurance coverage exists for at least some aspects of cyber risks in the UK market. Given the range and diversity of risks which may arise, there are some key issues for businesses to consider when it comes to insuring against cyber risks in commercial contracts.

Purpose of insurance

It is common for commercial contracts to require that one or more parties obtain insurance. Of course, the fact that a contract requires insurance to be taken out does not mean that the insurer will necessarily pay out on the occurrence of a particular event. However, the existence of insurance cover can be a good start to managing a variety of risks, including that one party cannot:

a) meet third party claims and the claims are therefore redirected at the other party's business;

b) afford to rebuild their damaged property or plant and are therefore unable to perform its side of the contract;

c) meet a damages claim made by the other party's business.

A party to a contract that does not comply with a requirement to procure insurance could face a claim for breach of contract, and possibly contract termination, even if no loss has yet occurred. This should incentivise parties to comply with the contract. In addition, as a matter of practicality, the availability of insurance is likely to assist survival of the contract/project in the event of a major incident, parties should be incentivised to comply with the contract.

The more onerous the insurance requirements, however, the greater the cost to one, or both, parties. Accordingly, when it comes to cyber risks, it is important to consider with some care what insurances should be required and how specific the requirements should be.

Defining the cover

Some types of insurance are well understood. For example, if a contract provides that "Public Liability" cover is to be obtained then a party can be reasonably confident that the cover would include third party cover for legal liability for damage to persons, property, or both but it is likely to exclude or limit liability for strict contractual liability or pure economic loss. It is likely that this type of policy will include loss or damage within the policy period so that there is no imperative to require that the insurance be held for any period after the contract is completed.

Equally, "Professional Indemnity" cover will usually cover legal liability to third parties arising from professional services, and will usually cover claims made in the relevant policy period, so it is usual to see a requirement that the policy cover will be kept in place for either six or 12 years following the end of the contract, depending on whether liability arises from a simple contract or deed.

First party property cover is again generally well understood to cover physical loss or damage within the policy period.

In each of the above types of cover, it should be fairly straightforward to draft the contractual provisions setting out the key acceptable terms and exclusions for each type of cover, and there is unlikely to be much cross-over or overlap between the different insurances.

Cyber risks defy such neat categorisation. A cyber incident could give rise to a whole raft of different losses, both first party and third party, such as:

- The first party losses could including loss of physical data (if the data is destroyed), loss of funds (if they are diverted into other bank accounts), physical damage to property, pollution or injury to personnel (for example if access is obtained to centrally controlled plant or equipment, resulting in breakdown or fire) and loss of business either directly resulting from a loss of data or due to an outage following property damage or from reputational damage flowing from the security breach.
- The third party losses might including: liability to third parties if their data are made public or if the loss of data causes financial losses to them (either of which could result in a class

action), liability to owners of neighbouring property if a collapse or fire at the property causes damage; or liability through breach of contract if the insured is unable to honour its obligations to third parties in the event of a cyber incident.

- Legal costs and fines arising from regulatory breaches.
- Costs arising from claims by shareholders in any acts or omissions of directors and officers in managing the risk have resulted in losses to the business.

Determining which risks are the most likely will depend on a range of factors, including the likely mode of attack, resilience in the systems, extent and sensitivity of data held and the plant and machinery used and their location and mode of control. The reality is that reputational fallout from a data breach raises a quite different risk profile to the losses which could flow from an explosion at a plant in a densely populated area.

Cover for cyber risks might accordingly be found in a number of different insurance policies. Depending on the applicable exclusions, it might form part of both first party property and third party liability policies. There may also be a free-standing cyber policy which seeks to provide cover for some of the cyber risks to which an entity may be exposed. Depending on the nature of the cyber incident, any cover or exclusions for terrorism or war or similar risks may also be relevant to whether the insurance will pay out on a particular claim.

Setting out what is required

To manage these risks, businesses should consider setting out in a reasonable amount of what types of risks the parties are expecting the cyber insurance to cover.

It is important to keep in mind that the market is continuing to develop in this area. Accordingly, what is available on economic terms may be different now than in a couple of years' time. For a short-term contract this may not be problematic, but for longer-term contracts it may be prudent to build in some review points. While it is not unusual for contracts to provide that insurance need only be obtained "*so far as reasonably available on commercial terms*" that may not be a complete solution in circumstances where what is available in the market may increase rather than diminish over time.

The alternative to setting out precisely what is required at the contract stage is to provide that the terms of such insurance must be acceptable to Party A, and that it is for Party A to accept or reject Party B's proposed insurance cover.

The difficulties with this approach are that:

a) There may well be sensitivity over the disclosure of Party B's full policies to Party A, or the policies may be subject to confidentiality provisions which prohibit such disclosure; and

b) Unless careful drafting is used this approach may mean that Party A has in effect decided whether or not the insurance is adequate, and in doing so relieved Party B of its obligations to obtain compliant cover.

Insurance is of course only one aspect of the management of cyber risks, but whether a business is the one required to take out insurance or the one requiring another to do so, careful thought is needed to ensure that both parties are clear on what is required.

Example insurance scenario

In the following example, a contract simply mandates that "*annual cyber cover be obtained by Party A in the sum of £10million.*" This clause may leave open a range of questions, such as:

a) Whether the insurance required to cover:
   - the loss of data needed to complete the contract;
   - the loss of third party data;
   - damage to property needed for the contract;
   - damage to third party property; and
   - regulatory fines and costs

b) The period for which cover should be obtained

c) Whether it is sufficient if this cover is part of cover afforded by various policies, or whether must be ring-fenced cover for £10million

d) What terms, conditions and exclusions are acceptable

The parties may have very different ideas as to what the contract requires. The result may be that:

a) uninsured losses arise which endanger the contract;

b) Party B may be unable to prove a breach of the contractual requirement to obtain such insurance. This may affect Party B's termination rights as well as damages claims;

c) Party B may be deprived of the chance to identify and manage the risk by an alternative method;

d) The price of the contract may be increased because A interprets the requirements very widely.

Supreme Court considers liability of advisers

BPE Solicitors and another v Hughes-Holland (in substitution for Gabriel) [2017] UKSC 21

22 March 2017

The Supreme Court found that a firm of solicitors that had negligently drafted loan documentation was not liable to their client for the losses the client suffered as result of the decision to enter into the transaction. Relying on the distinction drawn in *SAAMCO*, the Supreme Court held that the solicitors in this case did not owe a duty to advise on the course of action to be taken by their client, they had simply been instructed to draft the documentation.

Background

Richard Gabriel and Peter Little were friends. Mr Gabriel was a semi-retired businessman and Mr Little was a builder and developer who operated through a self-owned company, High Tech Fabric Maintenance Ltd (**High Tech)**.

In November 2007 Mr Little informed Mr Gabriel that he was looking to borrow £200,000 to invest in a disused heating tower in Gloucestershire. Mr Gabriel took from the conversation that Mr Little owned the building or was owned by a company that he controlled. Mr Little stated that planning permission had been granted and £200,000 was required for development costs. Mr Gabriel assumed the money lent would be used to finance the development. Mr Gabriel visited the site and formed the view that the building was worth £150,000 and that following the development would be worth around £400,000. On this assessment, Mr Gabriel concluded that the project was viable and would lend the money to his friend.

The reality of the situation was different from Mr Gabriel's understanding. The building was owned by High Tech but was subject to a charge in favour of a bank which secured a loan of £150,000. It was intended that the building be transferred to a special purpose vehicle to carry out the development. This new entity, Whiteshore Associates Ltd (**Whiteshore)**, was to pay £150,000 to High Tech, which would be used to discharge the charge and underlying loan. The £200,000 borrowed from Mr Gabriel was to fund the purchase price and the remaining amount was to be applied to the VAT. The trial judge found Mr Gabriel knew nothing of this and that there were in effect no funds to be applied to the redevelopment.

The solicitors acting for Mr Gabriel received their instruction to act via a voicemail message from Mr Little. He explained that he intended to sell the building to Whiteshore and that Mr Gabriel was to lend him the money. No further instructions were provided or clarifications sort. By error, and a coincidence that confirmed Mr Gabriel's misunderstanding, the solicitor used a facility letter from a previous transaction which included wording that stated that the loan monies *"will be made available as a contribution to the costs of the development of the property"* and that the purpose of the loan was to *"assist with costs of the development of the property"*. It was at the completion meeting that Mr Gabriel discovered that the building was owned by High Tech and charged to the bank. However, he was not told that his loan was to be used to fund the sale of the property and discharge the charge.

The redevelopment was ultimately a failure and Mr Gabriel lost his money. No significant construction work was carried out. In late 2009, Mr Gabriel took steps to exercise his power of sale. In July 2010 the property was sold however, the sale price simply covered the expenses of sale. Mr Gabriel received nothing save for £8,191.56 paid by Mr Little personally.

Mr Gabriel sued Mr Little, Whiteshore and High Tech for fraud and negligent misrepresentation. He also commenced an action against the solicitors for dishonest assistance in a breach of an implied trust of the loan moneys to apply them to the cost of redevelop ent, and for negligence.

Mr Gabriel was adjudicated bankrupt in March 2014 and the appeal was brought by his trustee in bankruptcy, Mr Hughes-Holland (the Appellant).

First instance decision

The judge at first instance dismissed all claims against Mr Little, Whiteshore and High Tech. He also held that no implied trust of the loan monies existed.

On the case against the solicitors, the judge held that *"there was no duty to advise Mr Gabriel about the commercial risks associated with the project, but* [the solicitor] *should have explained to him that the funds would be applied for Mr Little's benefit and that in reality he was not putting anything into the project"*. The trial judge found in favour of Mr Gabriel, who had argued that he would not have entered into the transaction if he had been informed about the use of the funds and was therefore entitled to damages representing the entire loss suffered by the transaction.

Court of Appeal decision

The Court of Appeal allowed the appeal brought by the solicitors. The leading judgment found that "[t]*here was no positive evidence to the effect that, if £200,000 had been spent on developing the property, its value would have been such as to ensure recovery of Mr Gabriel's loan or, in other words, that the transaction was viable"*. The Court of Appeal held that the entirety of the loss was attributable to Mr Gabriel's misjudgements rather than the negligence of the solicitors and reduced the damages to nil. The Court of Appel also held that had there been any recoverable loss, it would have been reduced by 75% for contributory negligence.

Supreme Court decision

The single judgment of the Court, given by Lord Sumption (with whom Lord Neuberger, Lord Mance, Lord Clarke and Lord Hodge agreed), outlined the two grounds on which the Court of Appeal decision was appealed:

- The Court of Appeal was not entitled to substitute its own assessment of the viability of the development project for that of the judge.
- Even if it was entitled to do so, Mr Gabriel was entitled in law to the whole loss flowing from a transaction into which he would not have entered but for the solicitor's negligence.

Viability of the development project

The Supreme Court found that there was sufficient evidence that the value of the property would not have been enhanced by the expenditure of £200,000. The Court of Appeal was entitled to reach this finding.

Whether Mr Gabriel was entitled to the whole loss flowing from the transaction

The judgment outlined the principles set out in the House of Lords *SAAMCO* decision (*South Australia Asset Management Corpn v York Montague Ltd* [1997]). In that case, a valuer was not liable for that proportion of the lender's loss on the loan which was attributable to the fall in the market after the valuation date. He was only liable for the difference between his valuation and the true value of the property. The House of Lords in *SAAMCO* drew a distinction between a duty to provide information for the purpose of enabling someone else to decide upon a course of action and a duty to advise someone as to what course of action he should take. In the latter scenario, if the adviser is negligent, he will be responsible for all foreseeable loss flowing which is a consequence of the course of action having been taken. In the former, if the adviser is negligent, he will be responsible for all the foreseeable consequences of the information being wrong.

In this case, the Supreme Court found that the solicitors had not assumed responsibility for Mr Gabriel's decision to lend the money. Their instructions were to draw up the documentation and nothing more.

The solicitors were only responsible for confirming one of many assumptions Mr Gabriel had in determining his assessment of the project. The Court then considered what if any loss was attributable to that assumption being wrong. The Court found that Mr Gabriel would still have lost his money because the expenditure of £200,000 would not have enhanced the value of the property. Protecting Mr Gabriel from the losses suffered was not within the scope of the solicitors' duty. The loss arose from Mr Gabriel's commercial misjudgements which were of no concern to the solicitors.

Comment

This decision is a useful reminder of the important *SAAMCO* distinction between an adviser providing information on the one hand and advising on a course of action on the other. This distinction defines the scope of an adviser's duty and the losses for which they may be liable.

The case will provide some comfort to professionals and their insurers that in providing information to a client, you are not necessarily liable for all the losses that flow from the client's decision to proceed with the transaction.

Additional references

South Australia Asset Management Corpn v York Montague Ltd [1997] AC 191

BPE Solicitors and another v Hughes-Holland (in substitution for Gabriel) [2013] EWCA Civ 1513

Supreme Court finds lender could not recover damages from negligent accountants where loss avoided by borrower's repayment

Lowick Rose LLP (in liquidation) v Swynson Ltd & Anor [2017] UKSC 32

11 May 2017

The Supreme Court has held that the loss suffered by a lender due to its accountants' breach of duty was extinguished when the loan was repaid by the borrower. It unanimously allowed an appeal against the majority judgment of the Court of Appeal, which had held that the repayment did not need to be taken into account on the basis that it was collateral to the loss, as it was not made in the ordinary course of business.

The repayment was funded by the lender's indirect owner, who had acquired an interest in the borrower. The Court of Appeal and Supreme Court agreed that if the owner had provided funds directly to the lender, to make up the shortfall caused by the borrower's failure to repay the loan, this would have been a collateral payment that should be ignored in assessing damages. The majority of the Court of Appeal considered that to hold differently because the payment was made through the borrower would be a triumph of form over substance.

The Supreme Court disagreed, finding that the repayment could not be regarded as collateral, because it discharged the very liability whose existence represented the lender's loss. The fact that the funds came from the owner was not relevant. The Court also rejected alternative arguments based on transferred loss and equitable subrogation.

Background

The Claimant lent money to a borrower (**EMSL)** in reliance on a due diligence report prepared by the Defendant firm of accountants.

The Claimant's owner, Mr Hunt, later became the majority owner of EMSL. This meant that the debt between the Claimant and EMSL became a debt between two connected entities, resulting in unfavourable tax treatment for the Claimant. Because of this, and to avoid the Claimant having an impaired debt on its books, Mr Hunt arranged for EMSL to repay the loans (the **Refinance**), using monies lent to EMSL by Mr Hunt. The loan provided by Mr Hunt to EMSL to fund the Refinance was not repaid.

The Claimant brought proceedings against the Defendant seeking damages for the full amount of the loans. The Defendant admitted negligence but argued that the Claimant's damages must be reduced by the extent to which the loans had been repaid.

At first instance, the judge (Mrs Justice Rose) awarded damages for the full amount of the loans (subject to a contractual cap on liability) on the basis that the repayment effected by the Refinance was collateral to the loss caused by the Defendant's breach of duty. Mr Hunt was also a Claimant in the action, but the judge found that the Defendant did not owe a duty of care to Mr Hunt and this finding was not appealed.

The Defendant appealed and a majority of the Court of Appeal upheld the first instance decision. It held that although the Refinance may have resulted from the Defendant's breach of duty, it did not arise in the ordinary course of business, largely because Mr Hunt would not have funded the Refinance for any other company. If Mr Hunt had given the funds directly to the Claimant this would have amounted to an act of benevolence and to hold differently because the payment was made through EMSL would be a triumph of form over substance. It dismissed the Defendant's submission that to look behind the source of the funds would be to pierce the corporate veil, finding instead that it was "merely to disregard technicalities".

A strong dissenting judgment was delivered by Lord Justice Davis, who argued that the form of the transactions could not be ignored or regarded as a mere technicality.

Decision

The Supreme Court unanimously allowed the Defendant's appeal. In a rather scathing opening paragraph, Lord Sumption, delivering the lead judgment, referred to the fact that the distinct legal personalities of companies had been a fundamental feature of English commercial law for a century and a half but that this had *"never stopped businessman from treating their companies as indistinguishable from themselves."* He commented that Mr Hunt was not the first businessman to make this mistake and "doubtless he will not be the last."

Collateral loss

Lord Sumption held that the Refinance could not be regarded as collateral. The fact that Mr Hunt was the source of the funds for the Refinance was no more relevant than if the funds had been borrowed from a bank or obtained from some other unconnected third party. In view of the fact that the Defendant did not owe any relevant duty to Mr Hunt, there was nothing special about the fact that Mr Hunt provided the funds.

Lord Sumption acknowledged that, had Mr Hunt lent money directly to the Claimant to strengthen its financial position following EMSL's default, the payment would have been collateral. It would have had no effect on the damages recoverable from the Defendant as the payment would not have discharged EMSL's debt. However, in circumstances where the Refinance discharged the very debt representing the Claimant's loss, the Refinance could not be regarded as collateral. Mr Hunt's loan to EMSL was a distinct transaction between himself and EMSL which was made for valuable consideration and could not be regarded as an indirect repayment to the Claimant, even though the payment ultimately reached it.

Both Lord Mance and Lord Neuberger (delivering concurring judgments) referred to the principle laid down by Lord Reid in *Parry v Cleaver* that the question whether such a transaction should be ignored depends on its "intrinsic nature" rather than on the identity of the source of the payment. Lord Mance said there was "all the difference" between a benevolent act which benefits a claimant collaterally in an amount equivalent to a loss which it has incurred and satisfaction of the Claimant's loss by repayment of the loan which represents that loss.

Similarly, Lord Neuberger commented that the Refinance was not a gift and that, had the Refinance been funded by someone other than Mr Hunt, the repayment of the loan by EMSL would plainly not have been collateral. Whilst the funds could have been made available to the Claimant in a way that would not have resulted in the Claimant's loss being avoided, that could not justify the conclusion that the actual transaction must be treated as if it had that effect. The fact that a transaction could have been differently arranged does not mean that it must have the same consequences (in law and in commercial reality) as if it had been differently arranged.

Alternative grounds

The Court also considered two alternative grounds upon which the Claimant submitted that the decision in the Court of Appeal should be upheld:

- The Claimant was entitled to recover on the principle of transferred loss.
- The Defendant had been unjustly enriched by Mr Hunt's provision of funds to effect the Refinance and Mr Hunt should be subrogated to the Claimant's claims against the Defendant to prevent the unjust enrichment.

The Court rejected both of these grounds.

The Court confirmed that the principle of transferred loss is a limited exception to the general rule that a claimant can recover only loss which it has itself suffered. The principle should only apply in circumstances where a transaction is intended to benefit a third party and there is a breach of duty or contract that causes the third party to suffer loss.

The Court referred to both the "narrow" application of the principle (where the third party suffers loss as the intended transferee of property affected by the breach) and the "broader" application (where the contracting party has an interest in ensuring the third party receives the benefit it was intended to have). However, Lord Sumption emphasised that, whether in its broader or narrower form, it is an essential feature of the principle that the recognition of a right in the contracting party to recover the third party's loss should be necessary to give effect to the object of the transaction and to avoid a "legal black hole", in which the only party entitled to recover would be different from the only party that could be treated as suffering loss.

The Court held that neither the broad nor the narrow version of the principle was of any assistance to the Claimant. It was clear the Claimant did not contract with the Defendant for the benefit of Mr Hunt. Mr Hunt's loss was attributable to his funding the Refinance which had nothing to do with the Defendant and did not arise out of its breach of duty.

The Court also unanimously rejected Mr Hunt's argument that he should be entitled to rely on the principle of equitable subrogation to prevent the unjust enrichment of the Defendant. The focus of all three judgments was on the question of whether any enrichment was unjust and, if so, whether subrogation was the appropriate way of addressing that.

Lord Sumption noted that the cases on the use of equitable subrogation to prevent or reverse unjust enrichment were all cases of defective transactions. In such cases the enrichment was unjust because the Claimant paid money on the basis of an expectation which failed. The purpose of equitable subrogation was "to replicate some element of the transaction which was expected but failed".

Here, however, the Refinance was not a defective transaction, as Mr Hunt achieved the whole of the benefit which he was expecting to achieve (namely repayment to the Claimant by EMSL and a right to recover his loan from EMSL). The fact that the Refinance had the indirect consequence of extinguishing the Claimant's loss did not render the transaction defective.

Comment

It was evident that the majority in the Court of Appeal was motivated by a desire to achieve what it considered to be a "just" result in providing Mr Hunt with compensation for his loss in circumstances where it had been found that he was owed no duty of care. In doing so, it was prepared to overlook what it described as "mere technicalities" and (arguably) wrongly pierced the corporate veil.

The Supreme Court decision clarifies that considerations of "justice" are the basis upon which the law has arrived at the legal principles relating to avoided loss and not, as Lord Sumption put, *"licence for discarding those principles, and deciding each case on what may be regarded as its broader commercial merits."*

As a result, the Supreme Court was not prepared to disregard the distinct legal personalities of the claimant and Mr Hunt, nor was it prepared to ignore the nature of the transactions involved and, essentially, equate Mr Hunt's and the Claimant's loss.

The decision suggests that the Supreme Court will adopt a strict approach to the application of the legal principles involved, regardless of whether this may result in a windfall to the Defendant.

The decision reinforces the need for caution in taking steps which might have the unintended consequence of reducing the Claimant's loss (while of course bearing in mind that a Claimant's damages might equally be reduced where it fails to take appropriate steps to mitigate its loss).

Additional references

Parry v Cleaver [1970] AC 1

Lowick Rose LLP (In Liquidation) v Swynson Ltd [2017] EWCA Civ 629

Court of Appeal confirms no tortious duty of care owed to customers in connection with the FCA past business review

CGL Group Ltd & Ors v Royal Bank of Scotland Plc & Ors [2017] EWCA Civ 1073

24 July 2017

Cameron Developments (UK) Ltd v National Westminster Bank Plc & Ors [2017] EWHC 1884 (QB)

26 July 2017

Over the past two years, the courts have grappled with the novel claimant argument that financial institutions owe duties of care in tort directly to their customers in connection with their conduct of the past business review of interest rate hedging product sales announced by the FCA (then FSA) in 2012 (the **Review**). There have been a number of contradictory High Court decisions.

However, in good news for financial institutions, the Court of Appeal has now clarified – in three conjoined appeals – that such claimants have little prospect of bringing such claims against the banks conducting that Review.

The Court of Appeal found it was not even arguable that the Defendant banks in the three linked cases owed tortious duties to the Claimants to conduct the Review with reasonable skill and care. This was primarily because such a duty would undermine the statutory and regulatory regime, which grants customers rights to bring claims against financial institutions only in certain defined circumstances. Such claims should now be amenable to summary judgment.

In addition, the separate High Court decision in *Cameron Developments (UK) Ltd v National Westminster Bank Plc & Ors* suggests that customers who accept "basic redress" under the Review will be treated as having settled all claims relating to the way in which the bank conducted the Review, where the settlement wording is sufficiently broad. This provides another reason why such customers should be prevented from bringing claims in connection with the Review.

The combined effect of these two cases should spell an end for any similar claims regarding the Review.

CGL Group Limited v Royal Bank of Scotland

Background

In *Suremime Limited v Barclays Bank Plc*, the High Court found that it was arguable (for the purposes of a summary judgment application) that the Defendant bank owed a tortious duty to the Claimant to conduct the Review with reasonable skill and care. However, in the subsequent first instance decision in *CGL Group Limited v Royal Bank of Scotland*, the High Court expressly declined to follow *Suremime* and instead found such duties were unarguable. CGL Group appealed this decision, and the appeal was heard together with the appeals of two other cases in which claims based on such tortious duties had been struck out.

The principal issue before the Court of Appeal was whether it was arguable that the Defendant banks owed the alleged tortious duty of care in connection with the Review.

Decision

In a detailed judgment, the Court of Appeal found that the alleged tortious duty of care was not arguable. The Court's decision was based on the following factors in particular:

- The alleged tortious duty would undermine the regulatory and statutory regime, which provides for recourse only in certain circumstances (under section 138D Financial Services and Markets Act 2000 or through the Financial Ombudsman Service). In particular, the Court held that the framework for consumer redress schemes provides a clear pointer against the imposition of a duty of care, as it was the deliberate intention of Parliament that only the FCA was to have the power to require the banks to comply with a consumer redress scheme and that no individual could enforce such schemes or sue for breach. The alleged tortious duty would undermine Parliament's intention to confer a private law cause of action only on a limited class in defined circumstances. The Court did not consider that it was relevant that the Review was undertaken pursuant to contractual agreements between the FCA and the banks (and was not established under any of the FCA's official stautory powers, such as its consumer redress scheme powers, such as its consumer redress scheme provisions). The Court found that the Review was nevertheless clearly part of the regulatory

scheme, as the FCA and the banks agreed the Review as an alternative to enforcement proceedings. If a bank failed to comply with the terms of the Review agreement, the Court considered that it would be the responsibility of the FCA to bring enforcement proceedings.

- The Court rejected the Claimants' submissions that the correspondence in which the banks invited customers to participate in the Review evidenced a voluntary assumption of responsibility by the banks. In particular, the banks were obliged to carry out the Review under their agreements with the FCA, so it could not be said that the banks were acting "*voluntarily*".
- In addition, the appointment of an independent reviewer as a "*skilled person*" who would be examining the decisions of the Review made it "*difficult to argue*" that the banks had assumed responsibility to customers. As the independent reviewer could not have owed a duty of care to customers, the Court said it would be "*surprising*" if the bank owed a duty.
- Imposing the alleged tortious duty would, in effect, allow customers to circumvent the limitation period for the original mis-selling of the product, as the limitation period would re-start at the date of the Review. It would thus allow time-barred claims via a back door.
- The existence of a conflict of interest is another factor weighing against the imposition of the duty. The conflict of interest between the banks and their customers arises because the banks were being asked to assess whether they had acted in breach of their regulatory duties and to pay out redress if so.
- The customers could not demonstrate reliance on the banks conducting the Review with reasonable skill and care, as it remained open to them to pursue a claim in mis-selling.

The Court considered the above factors under the umbrella of the three classic tests used to determine the existence of a tortious duty of care in respect of economic loss. As has become customary, the Court considered the tests together in the round and used them as cross-checks on each other. These tests are: (1) "*assumption of responsibility*"; (2) the three-fold test in *Caparo Industries Plc v Dickman* (forseeability, proximity and whether it is "*fair, just and reasonable*" to impose a duty); and (3) the incremental test (whether the addition to existing categories of duty would be incremental rather than indefinable).

Cameron Developments v National Westminster Bank Plc

Background

The Claimant entered into an interest rate swap with the Defendant bank in March 2010 (the **Swap)**. The sale of the Swap was considered as part of the bank's Review. In September 2014, the bank's Review offered the Claimant *"basic redress"*, which offered to cancel the Swap (at no cost) and replace it with an interest rate cap and also to refund the difference between the net payments made under the Swap and the payments that the Claimant would have made if it had entered into the cap at the outset.

The Claimant accepted the basic redress in October 2014. The acceptance form included a full and final settlement of claims connected with the Swap, save that claims for *"consequential losses"* were carved out and not settled (the **Settlement**).

In April 2015, the Review rejected the Claimant's consequential loss claims. The Claimant subsequently issued a claim for these losses, alleging:

- Mis-selling claims in respect of the original sale in March 2010 (the **Mis-selling Claims**).
- Breach of a tortious duty of care to conduct the Review with reasonable skill and care (the **Tort Claims**).
- Breach of an alleged separate contract, entered into at the time of the Settlement, to assess the consequential loss claims within the Review (the **Contract Claims**).

The bank sought summary judgment over the Tort Claims and the Contract Claims on the basis that they had been settled by the terms of the Settlement. The bank accepted that the Claimant was entitled to bring the Mis-selling Claims in order to claim consequential losses allegedly incurred as a result of entering the Swap.

Decision

The Court found that the Settlement settled both the Tort Claims and Contract Claims and, accordingly, granted summary judgment. Some key factors in the decision were:

- The wording in the Settlement covered claims "*arising under or in any way connected with the sale*" of the Swap. This was sufficiently broad to cover claims in relation to the Review, which the Court found are "*connected with*" the sale of the Swap, in the ordinary sense of the words.
- Whilst the parties had not considered the possibility of the Tort Claims or Contract Claims at the time of entering the Settlement (and the Claimant did not know at that time it was giving up those claims), the Settlement wording was sufficiently broad to capture future, unknown claims (covering "*past, present or future claims ... regardless of whether or not you are aware of them at the date of this letter*").
- The parties agreed that the carve-out for "consequential losses" in the Settlement would not apply to the Tort Claims or Contract Claims, following the decision on this point in *Elite Property Holdings Limited & Anr v Barclays Bank Plc*. The carve-out applied only to claims that the mis-selling caused consequential loss, and did not apply to claims that the alleged breaches of duty by the Review caused consequential loss.

Comment

These two judgments will be welcomed by financial institutions. The uncertainty caused by the conflicting first instance decisions in *Suremime and CGL Group* has now been resolved, and any existing claims against banks alleging duties of care in connection with the Review are now at risk of summary judgment. Claimants who had brought Review claims may still be able to pursue mis-selling claims (if they are not time-barred), although this will of course require them to prove breach of duty at the time of the original sale.

Significantly, the Court of Appeal's reasoning is likely to apply to other past business reviews and redress exercises conducted by financial institutions with regulatory oversight by the FCA. In that context (and whilst any review would need to be considered by reference to its individual circumstances), financial institutions are likely to be assisted by the finding that the overall regulatory regime for consumer redress schemes provides a clear pointer against the imposition of a duty of care (even where the Review in this case was not undertaken pursuant to any official statutory power). The appointment of an independent reviewer to oversee a review further weighs against the imposition of a duty of care. This suggests that claimants may find it difficult to establish such tortious duties in connection with other consumer redress exercises overseen by the FCA.

Additional references

Suremime Limited v Barclays Bank Plc [2015] EWHC 2277 (QB),

Elite Property Holdings Limited & Anr v Barclays Bank Plc [2016] EWHC 3294 (QB)

Caparo Industries v Dickman [1990] 2 WLR 358

Bank references: High Court confirms narrow application of duty established by the court of appeal in *So v HSBC*

Chudley v Clydesdale [2017] EWHC 2177 (Comm)

24 August 2017

The Court has recently revisited the question of whether a bank providing a reference owes a duty to a third party relying on that reference.

The facts in *Chudley* were very similar to the notable Court of Appeal decision in *So v HSBC Bank Plc & Anor.* In both cases, the Court held that letters produced by the respective banks setting out an intention to open and operate segregated client accounts amounted to false representations. And in both cases, third party investors transferred monies to the banks which – not being held in a segregated client account – were removed without the investors' knowledge. Yet in *So*, the Court of Appeal found that a duty of care was owed by HSBC Bank Plc (**HSBC**) to third party investors, whereas in *Chudley*, the High Court held that such a duty of care could not be imposed on Clydesdale Bank Plc (**Clydesdale**) for lack of proximity.

Chudley follows established principles and is not in that sense new law. However, it helpfully confirms the narrow application of the (potentially problematic) duty of care found in *So*, which is positive news from the perspective of banking institutions. The case demonstrates that finding a bank owes a duty of care to third parties relying on a bank reference is finely balanced in practice, and it follows the trend to apply the duty narrowly (*Playboy Club London Ltd & Ors v Banca Nazionale Del Lavoro SPA*).

The below discussion considers the critical distinction between *Chudley* and *So*, and the implications for future cases of this type.

Background

The relevant facts in *Chudley v Clydesdale* and *So v HSBC* are near identical. In both cases:

- The bank received and acknowledged a letter of instruction (**LOI**) to open and operate a segregated client account for third party investors' monies.
- The bank took no steps to open the segregated account referred to in the LOI.
- The bank also signed a letter of reference in favour of the customer, making reference to the segregated account having been opened by the bank and providing reassurance as to the customer's character.
- Third party investors deposited monies in an account operated by the bank, but which was not a segregated account. These investors were defrauded of their funds by the bank's customer.
- The Court found that the bank's letters amounted to false representations about its intention to open and operate a segregated client account.

Decision

In both *So* and *Chudley*, the Court applied the three-fold test of foreseeability, proximity and fairness, required for a duty of care to exist in cases of economic loss (established by the House of Lords in *Caparo Industries v Dickman*.) In both cases, the Court found that it was reasonably foreseeable that the letters would be shown to third parties for the purpose of investing the funds, which resulted in the third party investors' losses.

However, the reason a duty of care was not established in *Chudley*, but was in *So*, turned on the "notoriously elusive" concept of proximity. In *Chudley*, Clydesdale had no details of the proposed investment, and in terms of the third party investors, *"did not know their identity"*. While the Court considered that the letters might be shown to any potential investors (i.e. the world at large) this did not create a sufficiently special relationship between Clydesdale and those potential investors to establish a duty of care in negligence. Whereas in *So*, the necessary proximity was created because the third party investors (Mr So and Mrs Lu) and their proposed investment of US$30 million were named in the documents.

Accordingly, the negligent misstatement claim failed in *Chudley* as the Claimants were unable to establish that Clydesdale owed them a duty of care. Despite establishing such a duty of care in *So*, the claim still failed on the basis of reliance: the negligent misstatement did not actually cause the loss, because the Claimants relied on the fraudsters' assurances rather than the bank's representations.

Comment

The implication for future claims in negligent misstatement in the context of bank references, is that a bank is unlikely to owe a duty of care at large to a host of potential investors who might place reliance on its statements, without more being done to identify those customers (and also possibly details of the investment itself).

Additional references

So v HSBC Bank Plc & Anor [2009] EWCA Civ 296

Caparo Industries v Dickman [1990] 2 WLR 358

Playboy Club London Ltd & Ors v Banca Nazionale Del Lavoro SPA [2016] EWCA Civ 457

Causation in valuers' negligence claims: reliance on earlier valuations

Tiuta International Ltd (in liquidation) v De Villiers Surveyors Ltd [2017] UKSC 77

29 November 2017

In a decision that will be of interest to professional indemnity insurers as well as financial institutions and valuers, the Supreme Court has overturned a decision of the Court of Appeal and found in favour of the Defendant valuer in a professional negligence claim.

The Supreme Court held that where a lender advanced money on the basis of an initial valuation, then refinanced the facility (effectively repaying and replacing the original loan) on the basis of a second negligent valuation, the liability of the negligent valuer was limited to the 'top up' element of any additional lending. The valuer was not liable for the whole loss attributable to the entire amount of the second loan.

Background

The claim related to a residential development (the **Property**). In early 2011, the Claimant (the **Lender**) advanced funds of some £2.475 million to the borrower on the strength of a valuation carried out by the Defendant (the **Valuer**) in February 2011 (the **First Valuation**). The First Valuation valued the Property (in its then-current state) at £2.3 million, with a gross development value (**GDV**) of some £4.5 million. By November 2011, the sum outstanding had risen to some £2.5 million.

In December 2011, the borrower sought to extend the loan and borrow an extra £500,000 from the Lender. A second valuation of the Property was undertaken by the Valuer (the **Second Valuation**) which valued the Property at £3.25 million in its then-current condition, with a GDV of £4.9 million. On the strength of the Second Valuation, the Lender agreed to extend the loan. This was structured as a re-financing arrangement – the Lender made a new facility of just under £3.1 million available to the borrower which was used to repay the amount outstanding under the original loan. By June 2012, the borrower had drawn down £2.84 million of the funds available under the loan facility. The borrower failed to repay the loan and the Lender appointed receivers to realise the value of the property. It was estimated by the receivers that the property would, in fact, realise only some £2.14 million on sale, and the Lender sought to claim the balance of the loan due and the cost of funding from the Valuer, on the basis that the Second Valuation was negligent. The Lender made no allegation of negligence in respect of the First Valuation.

The Valuer applied for summary judgment on the Lender's claim. The Valuer's case was that by the time the second loan was made to the borrower, the Lender already faced an unavoidable loss of £2.5 million in respect of the sums advanced under the first loan. Given the Lender had already lent that sum to the borrower at the time of the Second Valuation, it would have been exposed to that indebtedness of the Lender in any event. Those sums had been advanced on the basis of the First Valuation, which was not criticised in the claim.

In answer, the Lender's position was that the monies advanced on the basis of the Second Valuation were a completely new and separate loan, on different terms and subject to a further facility fee. That loan was used to discharge in full the existing indebtedness of the borrower, which was replaced with the new loan. Thus, the Lender claimed that the whole of the money due from the borrower was advanced in reliance on the (impugned) Second Valuation.

As the matter had proceeded by way of a summary judgment application, it had been necessary to proceed on the basis of two fundamental assumptions: (i) that the Valuer was negligent in over-valuing the property in the Second Valuation; and (ii) that the effect of the second transaction was to discharge the debt owing on the original loan.

First instance decision

The judge at first instance, Mr Timothy Fancourt QC, found in favour of the Valuer. Fancourt J held that the "*but for*" test for causation was applicable and that on the facts of the case the Lender was exposed to a £2.5 million liability even if the Second Valuation had not been negligent. The Valuer was therefore only liable for any loss caused by the additional lending and summary judgment was granted in favour of the Valuer.

Court of Appeal decision

By a majority of two to one, the Court of Appeal allowed the Lender's appeal. The Court of Appeal unanimously agreed that the "but for" test should be applied but disagreed as to how. The leading judgment was delivered by Moore-Bick LJ. He criticised the first instance decision on the basis that it had "*failed to take into account the fact that the transaction was structured in such a way that the second loan was used to pay off the first*". His view was that the fact that the second loan stood alone and was used to repay the first loan in full released the Valuer from any potential liability in respect of the First Valuation. On this basis, there was nothing unfair in holding the Valuer liable in accordance with its own valuation for the purposes of the second loan. As a result, Moore-Bick LJ concluded that "*the basic comparison for ascertaining the appellant's loss is between the*

amount of that second loan and the value of the security". He further stated that this conclusion would have been the same had different valuers carried out the relevant valuations.

Supreme Court decision

The Supreme Court unanimously overturned the Court of Appeal decision and agreed with the judge at first instance. Lord Sumption, in delivering the judgment of the Supreme Court, held that the basic measure of damages was that which was required to restore the claimant as far as possible to the position that he would have been in if he had not sustained the wrong. In the case of a negligent valuation where but for the negligence the lender would not have lent, this involves what Lord Nicholls called the 'basic comparison' in *Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd (No. 2)*. In assessing loss caused by the defendant's negligence the relevant comparison is:

"...*between (a) what the plaintiff's position would have been if the defendant had fulfilled his duty of care and (b) the plaintiff's actual position.*"

Applying that comparison, Lord Sumption held that even if the Second Valuation had not been negligent and the second loan had not been advanced, the Lender would in any event have been exposed to a loss of £2.5million in respect of the sums advanced under the first loan. The Lender did not intend to advance the second facility in addition to the original loan.

Comment

Whilst the principles governing causation in valuer negligence cases are well established in leading authorities, this case has shown that unusual facts continue to raise potentially novel points. Whilst the facts of this case were relatively straightforward, there is plainly scope for complex loan structures (and multiple valuations) to continue to cause difficulty for potential claimants.

The Supreme Court's conclusion follows the well-established principles on causation, and seems to reflect the Court seeking to achieve broad fairness between the positions of the Claimant and the Defendant.

Additional references

Tuita International Ltd (in liquidation) v De Villiers Surveyors Ltd [2017] UKCA Civ 661

Tuita International Ltd (in liquidation) v De Villiers Surveyors Ltd [2015] EWHC 773 (Ch)

Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd (No. 2) [1997] 1 WLR 1627

High Court finds clause allowing landlord to terminate side letter and insist on payment of higher rent in lease falls foul of rule on penalties

Vivienne Westwood Ltd v Conduit Street Development Ltd [2017] EWHC 350 (Ch)

27 February 2017

In *Vivienne Westwood Ltd v Conduit*, the High Court has held that a clause in a side letter, which allowed a landlord to terminate the side letter and insist on payment of the higher rent set out in the lease, was a penalty and therefore unenforceable.

This is one of the few decisions to have struck down a clause as penal since the Supreme Court substantially rewrote the law on penalties in its decision in *Cavendish v Makdessi*. That decision replaced the traditional test of whether a clause is (or is not) a "genuine pre-estimate of loss" with a test of whether it is out of all proportion to the innocent party's legitimate interest in enforcing the counterparty's obligations.

Background

The Claimant and Defendant were, respectively, tenant and landlord of retail shop premises (the Defendant having acquired the landlord's interest some time after the grant of the lease). The lease provided for a term of 15 years from 18 November 2009 at an initial yearly rent of £110,000 (payable quarterly in advance) subject to "upwards only" rent reviews to the open market rent in 2014 and 2019.

At the same time as entering into the lease, the Claimant and the original landlord also entered into a side letter by which the landlord agreed to accept yearly rent at a lower rate from the Claimant, stepped from £90,000 in year 1 up to £100,000 in year 5 and then capped at £125,000 for the next 5 years if the open market rent was higher. The agreement to accept a lower rent was expressed to be personal to the Claimant and not by way of variation of the lease. The side letter provided a right for the landlord to terminate the agreement contained in the side letter with immediate effect if the Claimant breached any of the terms and conditions in the side letter or any term of the lease. In the event of termination, it provided that "*the rents will be immediately payable in the manner set out in the lease as if this agreement had never existed*".

After the Claimant missed a payment of rent in June 2015, the Defendant wrote to the Claimant asserting a breach of the terms of the lease and gave notice terminating the agreement in the side letter with immediate effect. The Claimant then paid the rent arrears in full, which the Defendant accepted as part payment only pending the first rent review which remained outstanding. Ultimately the rent review was determined at a yearly rent of £232,500, and both parties agreed that this would be the amount payable if the side letter had been validly terminated.

The principal question the Court had to determine was whether the right for the landlord to terminate the side letter on any breach by the Claimant, so that the full rent reserved by the lease became payable, was an unenforceable penalty.

Decision

The High Court (His Honour Timothy Fancourt QC sitting as a deputy judge) held that the right to terminate was penal and therefore unenforceable.

The judge referred to the Supreme Court's comprehensive review of the law of penalties in *Makdessi*, commenting that although the judgments of the different Justices revealed differences of approach on the application of the principles to the facts of that case, the main principles were clearly restated. He summarised them as follows:

- Whether or not a contractual provision is a penalty is a question of interpretation of the contract, and the real question is whether it is penal or punitive in nature (paras 9, 31, 243).
- In English law, a penalty clause can only exist where a secondary obligation is imposed upon a breach of a primary obligation owed by one party to the other. It is to be distinguished from a conditional primary obligation, which depends on events that are not breaches of contract (paras 14, 32, 258).
- Whether a clause imposes a secondary liability upon a breach of contract is a question of substance and not of form (para 15).
- A provision that in substance imposes a secondary liability for breach of a primary obligation is penal if it imposes on the party in default a detriment out of all proportion to any legitimate interest of the innocent party in the performance of the primary obligation (para 32), or (using traditional language) which is exorbitant, extravagant or unconscionable in comparison with the value of that legitimate interest (paras 152,255).
- The onus lies on the party alleging that a clause is a penalty to show that the secondary liability is exorbitant, extravagant or unconscionable (para 143).

- Since the penalty rule is an interference with freedom of contract, it is not lightly to be concluded that a term in a contract negotiated by properly advised parties of comparable bargaining power is a penalty (paras 33, 35).

Threshold test

The first question that had to be determined, therefore, was what the judge referred to as the "threshold test" of whether the obligation to pay rent at the higher level reserved by the lease was a secondary obligation engaged upon breach of a primary obligation. Only then would the law of penalties be engaged.

The Claimant (tenant) argued that in substance the primary obligation was to pay rent at the lower level specified in the side letter (as well as performing the other obligation in the lease). On breach of any of those primary obligations, the Claimant was obliged to comply with a secondary obligation, namely to pay rent at the higher level.

The Defendant (landlord) argued, to the contrary, that the primary obligation was to pay rent at the higher level set out in the lease, and the side letter gave the Claimant a right to a discount which was conditional on the Claimant's prompt performance of its obligations under the lease and side letter.

The judge concluded that the Claimant's argument was to be preferred. The true bargain was that, in return for having a tenant of the Claimant's reputation, the landlord would accept a reduced level of rent. The Claimant's obligations under the lease and the side letter together were to pay the lower amount of rent and otherwise comply with all the obligations of the lease. Given the terms of the side letter, there was no primary obligation to pay rent at the higher rate reserved by the lease. The primary obligation was to pay rent at the lower rate, and the obligation to pay at the higher rate was a secondary obligation engaged on breach. The threshold test was therefore satisfied and the law of penalties was engaged.

The judge acknowledged that the Defendant's argument had some support from the conclusions of Lords Neuberger, Sumption and Carnwath in *Makdessi* that the loss of a valuable right to money as a result of a breach of contract would not engage the law of penalties because it was, in substance, a price adjustment clause. He said, however, that care must be taken when applying that reasoning to the very different facts of this case, in particular because here the rent was increased because of any failure by the tenant, regardless of its impact, whereas in *Makdessi* the price reduction occurred on breach of a centrally important non-competition obligation.

The judge added:

"*As to the conditional right argument, it is easy to envisage a case in which a primary obligation to pay is then qualified by an agreement to accept a lesser payment, conditional on various matters including the due performance by the payor of the obligation. If the conditions are not satisfied, the discount does not apply. ... But where the obligation is from the outset in substance an obligation to pay the lesser amount, the conditional right analysis does not apply and the primary obligation is to pay at the lesser rate.*"

Whether or not the provisions of the side letter were a penalty therefore depended on whether the secondary obligation to pay the higher rent was exorbitant or unconscionable compared with the landlord's legitimate interest in having the Claimant comply with its obligations in the lease.

Legitimate interest in performance

The Defendant argued that as landlord it had a substantial legitimate interest in having the Claimant perform all its obligations promptly, both because of the cash flow implications and because of the impact on the investment value of the landlord's reversion (i.e. because a tenant in default will be seen as being of lesser value than a performing tenant). Accordingly, the Defendant argued, it had a legitimate interest in seeing the rent revert to the full market rent, to counteract the impact of the breach on the investment value.

The judge rejected this argument. He accepted that, in theory, a tenant's failure to perform was capable of impacting on the value of the reversion in a way that could go beyond cash flow benefits and financial compensation for delayed performance. However, that was only likely in the case of serious breaches of covenant. The Defendant's main difficulty was that the financial adjustment provided for by the side letter was substantial regardless of whether a breach was "*one-off, minor, serious or repeated*" and without regard to the nature of the obligation broken or its consequences. Although it was not conclusive, he said, that had "*long been recognised as one of the hallmarks of a penalty*".

The Defendant had to establish that it had a greater interest in the Claimant's performance than would be compensated by interest, damages and costs that were otherwise recoverable for the tenant's breach of covenant, bearing in mind that the lease provided for interest at 4% above base rate on overdue rent and for the landlord's costs to be paid on an indemnity basis.

Termination for "any breach"

Before determining whether the obligation to pay the higher rent was exorbitant or unconscionable, the Court had to assess how onerous the obligation was. This gave rise to two issues relating to the interpretation of the side letter:

- Whether the right to terminate for "any breach" was to be interpreted as requiring a "material" breach – he concluded that it was not, but that the breach would have to be more than trivial or *de minimis* to trigger the right to terminate. The judge's reasoning is outlined below.
- Whether the termination would have retrospective as well as prospective effect – he concluded that it would be retrospective, on the natural reading of the relevant provision, as it referred to the rents being "*immediately payable in the manner set out in the Lease as if this agreement had never existed*".

On the "any breach" point, the judge noted that terms are only implied into professionally drafted contracts where it is necessary to give the contract business efficacy and/or it is obviously what the parties meant to provide. He doubted whether it could ever be right to imply a term that would cause uncertainty or difficulty in the operation of a contract that was otherwise unambiguous in its terms, and said he considered it unclear how the materiality of any breach should be judged.

On the other hand, given that the reduced rent was part of the substantial bargain made between the parties, he did not think they could have meant that a trivial breach would allow the landlord to impose the higher rent. He said that if the side letter was to have any sensible commercial effect, it was necessary to exclude a trivial, or *de minimis*, breach from triggering the landlord's right to terminate. However, it was not necessary that a breach would have to be "material" or "substantial", in the colloquial sense, as opposed to just being more than trivial. He added:

"*Although there may be a dispute about whether a particular breach is trivial, there is no real difficulty in applying such a test, whereas the test of materiality is fraught with conceptual uncertainty.*"

Exorbitant or unconscionable

The next question was whether, on the true interpretation of the side letter, the consequences of termination for any non-trivial breach were "*exorbitant and unconscionable, having regard to the disparity with the loss likely to flow from any breach*".

The judge said he was in no doubt that the obligation to pay rent at the higher rate retrospective to the commencement of the lease, regardless of the nature and consequences of the breach and when it occurred, was penal in nature.

He was conscious that one should not lightly infer a penalty in a contract freely negotiated by two advised parties of equal bargaining power. However, particularly given that the higher rent was payable in addition to the other remedies the landlord had for the breach, including generous interest and costs provisions, it was out of all proportion to the landlord's legitimate interest in having the Claimant comply with its obligations.

The judge said that, if he had held that the clause had only prospective effect, the issue would be less clear cut, but he would still have concluded that the provision was penal in nature.

Comment

The latest decision is of particular interest for its discussion of whether a clause is in substance a secondary obligation which takes effect on breach of a primary obligation, so that the rule on penalties is engaged, or whether it is a conditional primary obligation and therefore falls outside the rule. In *Makdessi* itself, a number of the Justices found that a clause depriving the seller of a business of deferred consideration in circumstances where he breached a non-compete provision was, in reality, a price adjustment clause – i.e. a primary rather than a secondary provision, which was not susceptible to the rule on penalties. (In any event, the Supreme Court found that the clause was not out of proportion to the seller's legitimate interest in enforcing the non-compete provisions, and was therefore enforceable).

The present decision gives a further illustration that the distinction between a conditional primary obligation and a secondary obligation is a rather fine one. The practical message is that, whenever a clause takes effect on breach, it would be prudent to assume that the rule on penalties may be engaged. The question of whether it is enforceable will then come down to whether the clause is out of all proportion to the innocent party's legitimate interest in performance of the contract.

The decision also suggests that the question of whether a clause provides for the same consequences irrespective of whether a breach is minor or serious, which the judge said had long been a hallmark of a penalty clause, remains an important consideration post-*Makdessi*.

The case is also of interest for its discussion of the meaning of a clause allowing termination for "any breach" of contract. In a number of cases, such a clause has been interpreted as requiring a breach that is repudiatory at common law, on the basis that a broader interpretation would flout business common sense. Here, however, the judge was not prepared to imply even a term requiring a "material" breach, commenting that the test of materiality is "*fraught with conceptual uncertainty*" – which may come as a surprise to many, given the frequency with which commercial parties agree provisions allowing termination for "material" breach.

While it may not be straightforward to draft a clause so as to ensure that it cannot be struck down as a penalty, some practical steps can be taken to reduce the risk, including the following:

- Consider if the clause can be drafted as a conditional obligation or right, where (if possible) the relevant condition does not involve a breach of contract.
- Look at the circumstances in which the clause is triggered and whether there should be a materiality threshold or whether it can be limited to breaches of particular provisions.
- Consider setting out expressly in the agreement: the nature of the relevant party's legitimate interest in enforcing the relevant primary obligation; and why the parties have determined that the secondary obligation is proportionate to that interest. If these points are not addressed in the agreement, it would be prudent to document them so that, if the provision is challenged in the future, there is contemporaneous evidence of its intent.

Additional references

Cavendish v Makdessi [2015] UKSC 67

High Court finds obligation to use "all reasonable endeavours" to reach agreement with third party was enforceable

Astor Management AG v Atalaya Mining Plc [2017] EWHC 425 (Comm)

06 March 2017

In *Astor Management AG v Atalaya Mining Plc*, the High Court has upheld a contractual provision requiring a party to use "all reasonable endeavours" to obtain a senior debt facility agreement, rejecting arguments that the clause was too uncertain to be enforced. It is a well-established principle that English law will not enforce a mere "agreement to agree" since, in the absence of objective criteria regarding the agreement to be reached, there is no way to determine what the parties are obliged to do. In *Dany Lions Ltd v Bristol Cars Ltd*, for example, the Court declined to enforce an obligation in a settlement agreement to use reasonable endeavours to enter into a third party contract (for the restoration of a classic car), as the Court could not evaluate whether it was reasonable to refuse to agree to any particular terms on offer.

Background

The Defendants purchased the Claimants' interest in a dormant mining project under an agreement dated 30 September 2008.

The majority of the consideration was deferred and would only become payable (in a number of instalments) once the Defendants had (i) received the necessary permits to restart mining activities and (ii) secured a senior debt facility sufficient to restart the mining operations.

The agreement contained an obligation on the Defendants "*to use all reasonable endeavours*" to obtain a senior debt facility and to procure the restart of mining activities on or before 31 December 2010.

In June 2015, the Defendants raised the necessary funds to resume mining activities by issuing shares in their parent company instead of obtaining the senior debt facility. They received the necessary permits in July 2015, and mining activities restarted at the end of that month.

The Claimants sought payment of the deferred consideration. Their primary argument was that the obligation to pay the deferred consideration had been triggered, on the proper interpretation of the agreement, regardless of whether a senior debt facility had been put in place. In the alternative, the Claimants argued that the Defendants were in breach of the "*all reasonable endeavours*" obligation and, if they had complied with it, a senior debt facility would have been put in place. As a variant of that case, they argued that the Defendants had acted in breach of implied obligations of good faith.

The Court had to consider, amongst other matters, whether there was a legally enforceable obligation to use "*all reasonable endeavours*" to obtain the senior debt facility, or alternatively whether there was an implied duty of good faith.

Decision

The High Court (Mr Justice Leggatt) held that the obligation to pay deferred consideration had not been triggered, as no senior debt facility had been put in place. Although the "*all reasonable endeavours*" clause was enforceable, the Defendant was not in breach of this obligation on the facts. There was no need to imply a requirement to act in good faith to obtain senior debt finance, as such a requirement was subsumed within the express obligation to use all reasonable endeavours.

The Court's reasoning in relation to the endeavours and good faith issues are considered below.

Was the endeavours obligation enforceable?

The Defendants submitted that an endeavours obligation would only be enforceable if (a) the object of the endeavours was sufficiently certain and (b) there were sufficient objective criteria by which to evaluate the reasonableness of the endeavours. They relied on comments in *Dany Lions* to the effect that it was likely to be only in "exceptional" cases that these requirements could be satisfied if the object was a future agreement with a third party. The Defendants argued, in particular, that requirement (b) was not satisfied here because there were no objective criteria by which the Court could judge the reasonableness of any endeavours to obtain a senior debt facility.

Leggatt J rejected these submissions, saying he could not agree with suggestion *in Dany Lions* that the requirements of certainty of object and sufficient objective criteria are difficult to satisfy and will not usually be satisfied where the object of an undertaking to use reasonable endeavours is an agreement with a third party. He went on to say:

"*Far from being 'exceptional', I would say that it should almost always be possible to give sensible content to an undertaking to use reasonable endeavours (or 'all reasonable endeavours' or 'best endeavours') to enter into an agreement with a third party.*"

The object of the endeavours is sufficiently certain, as there is no difficulty in assessing whether or not an agreement had been entered into. Whether the relevant party has endeavoured to make such an agreement is a question of fact within the Court's capacity to decide.

Leggatt J noted that a lack of objective criteria could make it difficult to prove a failure to use sufficient endeavours. However, this was not sufficient to make the clause unenforceable. Where the parties have adopted a test of "reasonableness", they are inviting the Court to make a value judgment.

In the present case, the fact that there may have been many different forms which the senior debt facility could take did not make the object of the endeavours insufficiently certain or excuse the Defendants from making any effort at all to obtain any form of senior debt finance.

Nor did the Court accept that there were no objective criteria by which the reasonableness of the endeavours could be judged. Leggatt J commented that a court would be very slow to second-guess a commercial party on matters of commercial judgment, and therefore in many circumstances it may be extremely difficult or impossible to show that a party ought reasonably to have taken steps it did not take. But that did not mean the obligation was unenforceable.

Was there a breach of the endeavours clause?

On the facts, the Court held that the Defendants had not breached the obligation.

The extent to which a party can have regard to its own financial interests when using best (or all reasonable) endeavours depends on the terms of the agreement. Here, it was clearly in the Defendants' financial interests to fund the restart of the mining operations without obtaining a senior debt facility, as this would avoid triggering the payment of deferred consideration. But this could not in itself be a legitimate reason to do so, as it would frustrate the purpose of the endeavours clause.

However, it did not follow that financial considerations were irrelevant and the Defendants were required to try to obtain a senior debt facility at any cost – for example if it would make the project commercially unviable. On the facts, there was no evidence that there was a viable funding option that the Defendants should have identified and pursued. Accordingly, the Claimants had not established a breach of the endeavours obligation.

Was there a breach of an implied duty of good faith?

The Claimants argued that the agreement contained an implied duty on the Defendants to act in "good faith" in using all reasonable endeavours to obtain a senior debt facility.

Leggatt J referred to his discussion of implied duties of good faith in *Yam Seng Pte Ltd v International Trade Corp Ltd* – a decision that is generally seen as the high water mark for implied duties of good faith in English law. However, he commented, this case was not the occasion to explore the question further.

He said that a duty to act in good faith, where it exists, is a modest requirement, which does no more than reflect the expectation that a contracting party will act honestly and not seek to frustrate the purpose of the contract. That is less onerous than a positive obligation to use all reasonable endeavours to achieve a specified result. On this basis, any implied requirement to act in good faith was subsumed in the express requirement to use all reasonable endeavours.

Comment

The present case suggests a greater willingness to enforce an endeavours obligation where the object of the endeavours is a contract with a third party. It does however suggest that the courts will be slow to find that such an obligation has been breached.

Given the uncertainty surrounding these issues, commercial parties negotiating a clause of this sort would be well advised to ensure that the object of the endeavours is clearly defined – so that, so far as possible, there are agreed parameters as to what any agreement should look like – and there is also clarity as to the steps that are (or are not) required to comply with the obligation.

Additional references

Yam Seng Pte Ltd v International Trade Corp Ltd [2013] EWHC 111 (QB)

Dany Lions Ltd v Bristol Cars Ltd [2014] EWHC 817 (QB)

Court of Appeal decision may mean higher awards of interest for claimants who make well-judged part 36 offers

OMV Petrom SA v Glencore International AG [2016] EWCA Civ 778

27 March 2017

The Court of Appeal has held that a Defendant should have been ordered to pay enhanced interest on both damages and costs at the maximum rate of 10% above base rate where it failed to accept the Claimant's Part 36 offer, overturning a High Court decision awarding a lower rate.

Background

The Claimant made a Part 36 offer on 9 April 2014 offering to settle its claim for US$35 million (inclusive of interest). The Defendant did not respond or make any counter-offer. Instead, as the judge said, it "*defended the claim up hill and down dale at a lengthy trial*". On 13 March 2015 the Claimant was awarded damages of some US$40 million plus interest.

Under the relevant provisions of CPR Part 36, where a claimant obtains a judgment that is more advantageous than its own Part 36 offer, the Court must (unless it considers it unjust to do so) order that the claimant is entitled to certain benefits, including:

- an additional amount of up to £75,000 (calculated as 10% of the first £500,000 awarded and 5% of the next £500,000);
- indemnity costs from expiry of the relevant offer period; and
- enhanced interest on both damages and costs, at up to 10% above base rate, for some or all of the period following that date.

In this case, the High Court (Mr Justice Flaux) awarded interest on the judgment sum at a rate of US$ LIBOR plus 2.5% up to the end of the offer period, and at a rate 3.5% higher from that point onwards. Interest on costs (which were payable on the indemnity basis) was awarded at 2.5% up to the end of the offer period, and 4.5% thereafter. Referring to previous case law (in particular *Petrotrade v Texaco and McPhilemy v Times Newspapers Ltd*, the judge concluded that the Court could not penalise the Defendant for the way it conducted the case by awarding the Claimant more by way of uplift on interest than would legitimately compensate it for the disruptions and difficulties the litigation had caused.

The Defendant appealed against the rates of interest awarded from expiry of the offer period, claiming that interest should have been awarded on both damages and costs at the maximum rate specified in Part 36, namely 10% above base rate.

Decision

The Court of Appeal overturned the first instance decision on interest, concluding that Flaux J had been wrong to conclude that an award of interest under Part 36 was entirely compensatory. The comments in *Petrotrade* and *McPhilemy* had been obiter, so not binding, as to the basis of awarding enhanced interest on damages. The Court was bound by *McPhilemy* to decide that the rate of interest on costs (as opposed to damages) should be such as to achieve a fairer result for the Claimant than would otherwise have been the case, but that did not mean it had to be purely compensatory.

In the Court of Appeal's judgment, the Court undoubtedly has a discretion to include a non-compensatory element to the award of interest, but the level of interest awarded must be proportionate to all the circumstances of the case, including the length of time before judgment, whether the Defendant took entirely bad points or behaved unreasonably in continuing to defend the litigation despite the offer, and what level of disruption was caused by the refusal to negotiate or accept the offer.

In some cases, a higher rate will be needed to provide the appropriate incentive to defendants to engage in reasonable settlement discussions, to settle litigation at a reasonable level and at a reasonable time, and to mark the Court's disapproval of any unreasonable or improper conduct. The Court added:

"*The culture of litigation has changed even since the Woolf reforms. Parties are no longer entitled to litigate forever simply because they can afford to do so. The rights of other Court users must be taken into account. The parties are obliged to make reasonable efforts to settle, and to respond properly to Part 36 offers made by the other side. The regime of sanctions and rewards has been introduced to incentivise parties to behave reasonably, and if they do not, the Court's powers can be expected to be used to their disadvantage. The parties are obliged to conduct litigation collaboratively and to engage constructively in a settlement process.*"

Here the relevant circumstances were the Defendant's refusal to engage in settlement discussions or to respond to the Part 36 offer, the fact that the eventual award was very significantly greater than the Part 36 offer itself, and "perhaps most of all" the Defendant's conduct of the litigation, including that it was guilty of lying. The Court commented that it was "*hard to imagine a case in which there would be greater justification for the award of a 10% enhanced interest rate*" on the damages. The sum of US$2.6 million that the Defendant would be required to pay

might be 6.5% of the ultimate award, which did not seem excessive or disproportionate, even taken in conjunction with the other three orders being made (as to indemnity costs, the £75,000 additional amount, and an enhanced interest award on the costs). The Court noted, however, that if the period had been five years instead of 10½ months, things might well have been different.

It was also appropriate to award the maximum rate of enhanced interest on costs, largely for the same reasons, as this was "*a very bad case of the defendant simply ignoring a proper offer and running up the costs thereafter*".

Comment

This decision gives guidance on how the Court should exercise its discretion to award interest at up to 10% above base rate where a claimant beats its own Part 36 offer, disagreeing with suggestions in previous case law that an award of enhanced interest under Part 36 should be purely compensatory. Instead, an award may be pitched at a level designed to incentivise defendants to act reasonably in seeking to settle litigation and to mark the Court's disapproval of any unreasonable or improper conduct.

The judgment makes it clear that the level of interest must be proportionate to the circumstances of the case, and that 10% above base rate should not be regarded as a starting point. However, the recognition that an award of enhanced interest under Part 36 need not be entirely compensatory may mean that the Court is prepared to award higher levels of interest than previously where a claimant beats its own Part 36 offer, particularly where the defendant has acted unreasonably.

The Court of Appeal did however stress that appeals on issues of this kind should in future be rare, as the judge's discretion as to the appropriate rate of enhanced interest is a wide one and the Court of Appeal would not often be persuaded to interfere with it.

Additional references

OMV Petrom SA v Glencore International AG [2015] EWHC 666 (Comm)

Petrotrade v Texaco [2000] EWCA Civ 512

McPhilemy v Times Newspapers Ltd [2001] EWCA Civ 871

Supreme Court on contractual interpretation: striking a balance between the language used and the commercial implications

Wood (Respondent) v Capita Insurance Services Ltd (Appellant) [2017] UKSC 24

29 March 2017

In *Wood (Respondent) v Capita Insurance Services Ltd (Appellant)*, the Supreme Court has unanimously dismissed an appeal relating to the construction of an indemnity clause.

Background

This appeal concerned an indemnity clause in a share purchase agreement (the **SPA**), for the sale and purchase of the entire issued share capital of Sureterm Direct Ltd (the **Company**), a car insurance broker. The sellers of the Company were its managing director Mr Wood (together with other minor shareholders) (the **Sellers**). The buyers of the Company were Capita Insurance Services Ltd (the **Buyer**).

After the acquisition, the Company conducted a past business review in response to concerns that had been raised by its employees in relation to its sales processes and potential misselling of its products in the period prior to completion of the SPA. In accordance with its regulatory obligations, the Company then reported these findings to the FSA. This ultimately led to the FSA determining that the Company's customers had been misled and that it should conduct a customer remediation exercise, which it did, resulting in the payment of £1.35 million in customer compensation.

The Buyer then brought a claim against the Sellers for losses they had suffered as a result of the misselling, relying upon the following indemnity in the SPA (the **Indemnity**):

"*The Sellers undertake to pay to the Buyer an amount…to indemnify the Buyer… against all actions, proceedings, losses, claims, damages, costs, charges, expenses and liabilities suffered or incurred, and all fines, compensation or remedial action or payments imposed on or required to be made by [the Company] following and arising out of claims or complaints registered with the FSA, the Financial Services Ombudsman or any other Authority against [the Company], the Sellers or any Relevant Person and which relate to the period prior to the Completion Date pertaining to any mis-selling or suspected mis-selling of any insurance or insurance related product of service.*"

The Sellers claimed that this loss was outside the scope of the Indemnity given that the requirement to remediate customers had not arisen as a result of a claim by the customers or a complaint by those customers to the FSA (but rather arose from the Company self-reporting the misselling).

At first instance, Mr Justice Popplewell held that the Indemnity required the Sellers to indemnify the Buyer even if there had been no claim or complaint by a customer, primarily on the basis that it did not make business common sense for the clause to operate to exclude those claims. The Court of Appeal disagreed and found that liability under the Indemnity could not arise in the absence of any actual claim or complaint by a customer.

The Buyers appealed to the Supreme Court.

Decision

The Supreme Court unanimously upheld the Court of Appeal's decision, finding that the Sellers were not liable under the Indemnity given there had been no actual claim by customers or any complaint registered with the FSA in relation to the misselling.

In the lead judgment given by Lord Hodge (with whom the other Justices agreed) the Court held that its primary task in contractual interpretation is to ascertain the objective meaning of the language in the contract.

Citing the Supreme Court's decision in *Arnold v Britton* (which confirmed the approach in *Rainy Sky SA v Kookmin Bank*) the Court noted that where there are rival constructions, the Court may have regard to business common sense as an aid to deciding between them. However, in striking a balance between indications given by the language used and the implications of the rival constructions based on business common sense, the Court must consider the quality of drafting of the clause and must also be alive to the possibility that one party has struck a bad bargain.

Striking this balance involves an iterative process of considering each suggested interpretation against the provisions of the contract and its commercial consequences (Arnold citing *Re Sigma Finance Corpn*). Lord Hodge said, interestingly, that to his mind it did not matter whether this analysis begins with an examination of the plain language or with the factual background and implications given by rival constructions, so long as the Court balances the indications given by each.

Lord Hodge emphasised that both the language and the commercial implications should be used as tools to ascertain the objective meaning of the agreement, and their use will vary according to the circumstances of the particular agreement. Some contracts can be successfully interpreted principally by textual analysis (because of their sophistication, or because they have been negotiated and prepared by skilled

professionals), whereas others will require a greater emphasis on the factual matrix (because of their informality, brevity or the absence of skilled professional assistance).

The Indemnity

In applying these principles to the Indemnity, the Court took the view that it was poorly drafted and its meaning was therefore "*avoidably opaque*". It was therefore necessary to adopt the iterative process in order to examine the clause both through a textual analysis of the words in the context of the contract as a whole, and to consider whether the wider relevant factual matrix could provide guidance as to its meaning in light of the commercial effect of rival interpretations.

The Court gave considerable emphasis to the contractual context in this case. In particular, the Court appears to have been influenced by the existence of warranties which, subject to a two year limitation, would have provided for compensation for losses which arose from the FSA redress scheme. The Court observed that two years after completion was not an unreasonably short period of time in which to conduct an internal review for any relevant misselling/regulatory breaches in order to bring a claim under the warranties. The Court considered that it is not contrary to business common sense for parties to agree wide-ranging warranties, which are subject to a time limit, and in addition to agree a further indemnity, which is not subject to any such limit but is triggered only in limited circumstances.

In this context, the Court made interesting observations about the utility of business common sense to aid the construction of a contract which has plainly been the subject of negotiation by sophisticated parties:

"*Business common sense is useful to ascertain the purpose of a provision and how it might operate in practice. But in the tug o' war of commercial negotiation, business common sense can rarely assist the court in ascertaining on which side of the line the centre line marking on the tug o' war rope lay, when the negotiations ended.*"

While the agreement may have become a bad bargain for the Buyer, given their failure to bring a claim in time under the warranties, it is not the Court's role to construe the Indemnity in a way that improves their bargain.

Accordingly, the result may have been different had the Indemnity stood on its own (i.e. if the contract did not contain the warranties). In that event, it may have been anomalous to exclude loss caused by regulatory action that was prompted otherwise than by a customer claim or complaint (i.e. from the Company self-reporting). This reinforces the importance of construing the contract as a whole, within its wider context.

Comment

While the Supreme Court has sought to emphasise that it was not intending to restate the recent key authorities underpinning the common law position in relation to contractual interpretation, the Court's application of those principles in this case suggests a more balanced consideration of both the textual approach (focusing on the plain language of the contract) and the purposive approach of looking at the factual context to consider the commercial implications of the rival meanings. Perhaps the possible shift in emphasis is explained by the fact that, unlike in *Arnold*, the Supreme Court concluded very clearly that the clause was poorly drafted, which created difficulties both in the interpretation of the meaning of the plain language as well as the rival interpretations and their practical consequences.

However, the fact that yet another case of contractual construction has reached the highest appellate courts highlights the difficulty in applying to individual clauses what the courts treat as the settled principles.

Additional references

Wood (Respondent) v Capita Insurance Services Ltd (Appellant) [2015] EWCA Civ 839

Arnold v Britton [2015] AC 1619

Rainy Sky SA v Kookmin Bank [2011] 1 WLR 2900

Re Sigma Finance Corpn [2010] 1 All ER 571

High Court takes restrictive approach to both litigation privilege and legal advice privilege

SFO v Eurasian Natural Resources Corporation Ltd [2017] EWHC 1017 (QB)

08 May 2017

In *SFO v Eurasian Natural Resources Corporation Ltd*, the High Court applied a strict approach to litigation privilege in the context of criminal proceedings, finding that litigation was not in reasonable contemplation (so the first limb of the test for litigation privilege was not met) even though a criminal investigation by the SFO was reasonably contemplated.

Background

The issues relating to privilege arise in the context of an ongoing criminal investigation by the Serious Fraud Office (**SFO**), which began in late April 2013, into the activities of ENRC, its subsidiaries, officers and employees. The investigation is focused on allegations of fraud, bribery and corruption in two foreign jurisdictions. ENRC denies the allegations. The decision notes that, depending on the outcome of the investigation, it may or may not lead to criminal prosecutions being brought.

As part of its investigation, the SFO issued notices under section 2(3) of the Criminal Justice Act 1987 against various parties, including ENRC, to compel the production of four categories of documents (the **Disputed Documents**):

- Notes taken by ENRC's lawyers (**Dechert**) of interviews they conducted of various individuals, including employees and former employees of ENRC, before the SFO's investigation began (prompted by allegations of a whistleblower). ENRC claimed that these documents were subject to litigation privilege, as the dominant purpose of the interviews was to enable Dechert to obtain relevant information and instructions and to provide ENRC with advice in connection with anticipated criminal litigation. In the alternative, it claimed legal advice privilege including on the basis that the notes could be characterised as lawyers' work product.
- Materials generated by forensic accountants as part of reviews of ENRC's books and records, with a focus on identifying controls and systems weaknesses and potential improvements. ENRC asserted litigation privilege over these documents on the basis that their dominant purpose was to identify issues which could likely give rise to prosecution by the SFO and to enable ENRC to obtain advice and assistance in connection with such anticipated litigation.
- Documents containing the factual evidence presented by the relevant partner at Dechert to ENRC's Nomination and Corporate Governance Committee and/or the ENRC Board. ENRC claimed that these documents were subject to legal advice privilege, but asserted litigation privilege in the alternative.
- Documents which independent counsel had determined did not attract privilege, including documents which essentially fell within category 2 above as well as two emails between a senior ENRC executive and Mr Ehrensberger, a qualified Swiss lawyer who was at that time ENRC's Head of Mergers and Acquisitions, but had previously been its General Counsel and subsequently resumed that role.

The SFO applied for a declaration that the Disputed Documents were not subject to legal professional privilege.

Decision

The High Court (Mrs Justice Andrews) granted the declaration sought, rejecting the claims to privilege, in respect of all the Disputed Documents save for category 3. The judge's exposition of the relevant legal principles is summarised below, together with her application of those principles to the Disputed Documents.

Litigation privilege

Communications will attract litigation privilege only if, at the time they are made, the following conditions are satisfied:

- Litigation is in progress or reasonably in contemplation.
- The communications are made with the sole or dominant purpose of conducting that anticipated litigation.
- The litigation must be adversarial, not investigative or inquisitorial.

Litigation in reasonable contemplation

The judge found that ENRC had failed to establish that, at the time any of the Disputed Documents were created, litigation was in reasonable contemplation.

The judge accepted that ENRC anticipated that an SFO investigation was imminent. However, the investigation itself was not adversarial litigation; only the criminal prosecution was litigation for these purposes.

She rejected the submission that once a criminal investigation was reasonably contemplated, so too was a criminal prosecution. She noted that it is always possible that an investigation might lead to a prosecution, but said unless the person who anticipates the investigation is aware of circumstances that (once discovered) make a prosecution likely, there is not necessarily a real risk of prosecution. As the judge put it,

"*... prosecution only becomes a real prospect once it is discovered that there is some truth in the accusations, or at the very least that*

there is some material to support the allegations of corrupt practices. In this case, there is no evidence that there was anything beyond the unverified allegations themselves."

The judge accepted that, in a civil context, a party may reasonably contemplate litigation, irrespective of the outcome of any investigation. However, she said the situation is different in a criminal context, due to the prosecutor's duty to be satisfied that there is a sufficient evidential basis for prosecution before bringing proceedings.

Dominant purpose of litigation

The judge accepted that advice given in connection with the conduct of litigation may include advice relating to settlement of that litigation once it is in train. So for example the privilege would protect an expert report on quantum to assist solicitors to advise the client on whether to accept or reject an offer made under CPR Part 36.

However, she rejected ENRC's submission that, by parity of reasoning, litigation privilege extends to third party documents created to obtain legal advice on how best to avoid contemplated litigation, even if that entails seeking to settle the dispute before proceedings are issued. She stated:

"*There is no authority cited in support of that proposition, and it self-evidently contradicts the underlying rationale for the privilege. Equipping yourself with evidence to enable you to conduct your defence free from the risk that your opponent will discover how you are preparing yourself, and to decide what evidence you are planning to call if the case goes to court, and what tactics to employ, is something entirely different from equipping yourself with evidence that you hope may enable you (or your legal advisers) to persuade him not to commence proceedings against you in the first place.*"

Here, the judge said, even if litigation was in reasonable contemplation when the Disputed Documents were prepared, they were not prepared for the dominant purpose of deployment in, or obtaining legal advice relating to the conduct of, such litigation.

In relation to the category 1 and category 3 documents, the primary purpose of the investigation was to find out if there was any truth in the whistleblower's allegations and, if there was, to decide what to do about it. Even if the purpose was (as ENRC claimed) to advise in relation to a criminal investigation leading to a prosecution, and minimise the risk of that happening, this was not sufficient. In the judge's view, documents prepared for the avoidance of litigation, rather than its conduct, were not protected.

Moreover, the judge said, where a document is created with the intention or understanding that it will be shown to the prospective adversary (e.g. a position statement prepared for a mediation) it cannot be subject to litigation privilege. This principle also prevented privilege arising in most of the documents in these categories, as at the time the Disputed Documents were created, ENRC intended and expected that they would be shared with the SFO.

In relation to the category 2 documents, the dominant purpose of the documents generated by the forensic accountants was to meet compliance requirements or obtain accountancy advice on remedial steps as part of the books and records review. That had little or nothing to do with the preparation of a defence to, or obtaining legal advice in respect of, prospective criminal litigation.

Legal advice privilege

Legal advice privilege attaches to all communications passing between the client and its lawyers, acting in their professional capacity, in connection with the provision of legal advice. There is no need for litigation to be contemplated.

The "client" for privilege purposes

The judge endorsed the decision of Mr Justice Hildyard in *RBS Rights Issue Litigation* regarding the proper scope of the "client" for privilege purposes in a corporate context, agreeing that the "client" comprises only those who are authorised to seek and obtain legal advice on behalf of the company. In particular, and in common with Hildyard J, she rejected the submission that the "client" extends to those who are authorised to provide information to the lawyers on behalf of the company. She noted:

"*If the client had been an individual, and the solicitor carried out evidence-gathering or fact-finding investigations by speaking to that individual's current employees, his communications with those employees would not be subject to legal advice privilege simply because he was obtaining the information from them for the purpose of giving legal advice to their employer. It makes no difference whether the employees have been authorised to speak to him or not.*"

She added that there is no reason in principle for a corporate client to be in any better position than an individual just because a corporation can only act through its officers and employees.

The judge said she expressed no view on Hildyard J's further observations tentatively supporting the proposition that only individuals constituting part of the "directing mind and will" of the corporation could be treated as the client for privilege purposes.

In terms of who is likely to be the "client" in a given case, the judge commented that one would expect a company's Board of Directors to have authority to obtain legal advice on behalf of the company, though they might well delegate authority to another group or person. It might also be persuasively argued that the company's in-house lawyers or general counsel would have the necessary authority, by virtue of their office, to seek and obtain external legal advice. Whether they, or any other employees, had such authority in a given case was, she said, a question of fact to be determined on the evidence.

On the facts of the present case, the judge said the short answer to the alternative claim for legal advice privilege in respect of the category 1 documents was that there is no evidence that any of the interviewees were authorised to seek and receive legal advice on behalf of ENRC, and the communications between those individuals and Dechert were not communications in the course of conveying instructions to Dechert on behalf of the corporate client.

Lawyers' working papers

The judge found that privilege will also attach to a lawyer's working papers if (and only if) they would give the opposing party a clue to the advice which had been given.

She rejected ENRC's submission that working papers are privileged simply by virtue of their being made by the lawyer for his own use in his client's business or for the client's use. On the contrary, the protection exists only if they would betray the trend of the advice.

She also rejected a submission that the notes inevitably represented the work of the lawyer's mind and the lawyer's selection of what should be written down, so inevitably gave a clue to the trend of the advice. She noted that a similar claim for privilege was made and rejected by Hildyard J in the *RBS* case, albeit that it appeared the evidence in that case was of a better quality than in the present case. Here, she said, the evidence did not establish that the notes would give a clue as to any aspect of the legal advice given to ENRC.

Continuum of communication

The judge noted that information which would not ordinarily be privileged, even information which is already in the public domain, may fall under the umbrella of legal advice privilege if it is part and parcel of the continuum of confidential communication between lawyer and client whose purpose is the giving or receiving of legal advice.

On this basis, the judge concluded that the category 3 documents were plainly privileged, as they were prepared by Dechert for the specific purpose of giving legal advice to ENRC, even if they made reference to factual information that would not otherwise be privileged. As the judge put it, they were part and parcel of the confidential solicitor-client communication.

The "lawyer" for privilege purposes

In relation to the emails in category 4, the judge rejected ENRC's submission that they recorded "*requests for and the giving of legal advice by a qualified lawyer acting in the role of a lawyer*".

Although Mr Ehrensberger was a qualified lawyer, he was engaged by ENRC at the relevant time not as a lawyer but as a "man of business". The judge commented that Mr Ehrensberger may well have felt he was acting as a lawyer "*because M&A work will often have a legal dimension to which he could bring the perspective of a qualified lawyer*". But that was not good enough for privilege to attach; his professional duty was not to act as a legal adviser to ENRC. The documents were not privileged.

Comment

The decision suggests it is likely to be easier to establish that litigation is in reasonable contemplation in the context of civil proceedings than criminal proceedings. However, the decision contains unhelpful comments regarding the second limb of the test for litigation privilege – whether a document has been prepared for the dominant purpose of litigation – which would appear to apply equally to civil proceedings. The decision also endorses a restrictive view of who is the "client" for legal advice privilege, as recently applied by the High Court in the *RBS* case.

Key points of interest arising from the present decision include:

- The Court found that the test of whether litigation is in reasonable contemplation is *not* met just because a criminal investigation is contemplated. Only a prosecution, not an investigation, amounts to "litigation" for these purposes, and the contemplation of a criminal investigation does not necessarily equate to the contemplation of a prosecution. Prosecution only becomes a real prospect once it is discovered there is some truth in the allegations, or at least some material to support them.
- The Court commented that the situation is different for civil proceedings. There may be reasonable grounds to contemplate that litigation will be commenced by (say) a commercial counterparty even where there is no proper foundation for a claim. In contrast, criminal proceedings cannot be brought unless the prosecutor is satisfied that there is a sufficient evidential basis for prosecution. It is therefore likely to be easier to establish the first limb of the test for litigation privilege in the civil context.
- The decision takes a strict approach to whether documents have been prepared for the dominant purpose of litigation, finding that even if litigation was in reasonable contemplation at the time the documents in question in this case were prepared, they were not prepared for the purpose of that litigation. The Court found that the primary purpose here was to find out if there was any truth in allegations made by a whistleblower and (if there was) to decide what to do about it, and this was not sufficient.
- Even if the purpose was to obtain advice in relation to a criminal investigation and minimise the risk of it happening, the Court said this would not mean the documents were covered by litigation privilege. The Court accepted that the purpose of conducting litigation includes the settlement of litigation once it is in train. However, it rejected the submission that litigation privilege extends to documents created to obtain legal advice as to how best to *avoid* contemplated litigation, even if that entailed seeking to settle the dispute before proceedings were issued. This seems a fine distinction, and an arbitrary one, which may give rise to significant problems in practice.
- The Court rejected an alternative claim for legal advice privilege over certain of the documents, which comprised lawyers' notes of interviews with their clients' employees, on the basis that there was no evidence that the interviewees were authorised to seek and receive legal advice on behalf of the client company. The decision strongly endorses the narrow approach to the question of who is the "client" for the purposes of legal advice privilege (as applied in the *RBS* case) which excludes those who are authorised only to communicate relevant facts to the lawyers, rather than seeking and obtaining advice on the company's behalf. The Court comments that the decision in *RBS* is "plainly right" and there is no justification for departing from it. It does not however endorse the judge's *obiter* suggestion in *RBS* that the "client" may be restricted even further to comprise only those who are the "directing mind and will" of the organisation.
- The Court also rejected an argument that the lawyers' notes were privileged on the basis that they were lawyers' working papers, endorsing the decision in *RBS* that lawyers' working papers are privileged only if they would betray the trend of the legal advice.

- The Court accepted that a lawyer's summary of the facts, including information in the public domain, will be privileged if it is part of the continuum of communications between solicitor and client for the purpose of giving or receiving legal advice. This is consistent with the High Court's decision in *PAG v RBS*.
- The decision suggests that privilege is unlikely to attach to communications with individuals who are qualified lawyers but are not employed in a legal role, even if they are in fact giving legal advice. Here privilege was denied to advice given by ENRC's Head of Mergers and Acquisitions, even though he was a qualified lawyer, had previously been ENRC's General Counsel, and subsequently reverted to that role.

Additional references

RBS Rights Issue Litigation [2016] EWHC 3161 (Ch)
PAG v RBS [2015] EWHC 3187 (Ch)

Court of Appeal reiterates need for care when settling with one of a number of defendants

Vanden Recycling Ltd v Kras Recycling BV [2017] EWCA Civ 354

17 May 2017

The Court of Appeal has held that a Claimant who settled a conspiracy claim against one Defendant by recording the terms in a consent order, which was satisfied, could not continue its claim against another Defendant who was liable for the same damage. However, the settlement did not prevent the Claimant pursuing claims against the other Defendant in relation to separate losses or for remedies other than damages, such as injunctive relief.

Background

The Claimant brought proceedings against three Defendants in respect of allegations that: (a) the first Defendant, who was an employee of the Claimant, was providing confidential and commercially sensitive information to the other Defendants; and (b) all three Defendants had conspired to divert business away from the Claimant and set up the first defendant in a competing business.

The Claimant settled with the first and second Defendants, and consent orders were made in relation to both claims. The consent order with the first Defendant recorded that the first Defendant admitted all the allegations of misconduct against her and provided for judgment to be entered against her for damages to be assessed. The consent order with the second Defendant provided that the second Defendant would pay £275,000 in full and final settlement of the claims made against it (for inducing breach of contract, breach of confidence and conspiracy) and that the proceedings would be stayed save for the purposes of enforcing compliance with the terms of settlement, as set out in the order.

The third Defendant then applied for the claims against it to be struck out on a number of grounds, including that the consent order with the second Defendant amounted to a judgment by consent which fixed the measure of the Claimant's loss, and satisfaction of that judgment extinguished the Claimants' claims.

The first instance judge, Mr Justice Cox, granted the application and struck out all of the claims against the third Defendant.

The Claimant appealed to the Court of Appeal.

Decision

The Court of Appeal (Lady Justice Black and Lord Justice Hamblen) allowed the appeal in part. The central issue for the Court was the interpretation of the consent order between the Claimant and the second Defendant.

Did the consent order prevent the Claimant from pursuing claims against the third Defendant?

The Court noted that it is clear that satisfaction of a judgment against one Defendant ordinarily bars claims against other tortfeasors who are liable for the same damage. On the other hand, satisfaction of a settlement agreement will only have this effect if, on the proper interpretation of the agreement, the sum agreed and paid was intended to fix the full measure of the Claimant's loss (*Heaton v Axa Equity & Law Life Assurance Society Plc*).

The Court of Appeal agreed with the judge that the consent order with the second Defendant should be treated as a satisfied judgment for these purposes rather than a settlement agreement.

The consent order was expressed in similar to terms to a Tomlin order in that it referred to the second Defendant being required to pay sums *"in full and final settlement of the Claimant's claims"* and purported to stay the proceedings *"except for the purpose of enforcing and carrying out the terms of the settlement"*.

However, in substance, the consent order was not a Tomlin order. It was not staying the proceedings to give effect to a contractual settlement agreement, but instead ordered the second Defendant to pay a specified sum in respect of the Claimant's claims. It had the same effect as an order that would be made following a judgment.

In these circumstances the consent order was a bar to claims against the third Defendant for the same damage. It was not necessary to consider whether the sum agreed was intended to fix the full measure of the Claimant's loss. That was its effect regardless of what was intended.

Which claims did the consent order prevent the Claimant from pursuing?

The Claimant claimed various forms of injunctive relief against the third Defendant, e.g. for delivery up of the confidential information, and it was accepted that these claims could not be barred by satisfaction of a damages claim. The third Defendant argued that the injunctions sought would be of no practical utility in light of undertakings that the third Defendant had already provided but the Court of Appeal did not consider this a sufficient reason for summarily dismissing the claim for injunctive relief.

As regards the claims for damages, the Claimant was prevented from pursuing the conspiracy claim against the third Defendant but it was not prevented from pursuing the claims for inducing breach of contract and breach of confidence.

The conspiracy claim related to a single conspiracy causing the same damage. In contrast, the claims for inducing breach of contract and breach of confidence were made individually against the second and third Defendants and the Claimants provided separate particulars for each breach. The losses occasioned by these claims were not necessarily the same and did not necessarily fall within the alleged conspiracy.

Comment

The decision underlines that where a claimant settles a claim against only one or more of multiple defendants the settlement needs to be carefully structured. In particular, where the terms of settlement are recorded in a consent order, this is likely to be treated as a judgment by consent which fixes the full amount of the claimant's loss, whether or not that was the parties' intention. Where such a judgment has been satisfied, this will prevent the claimant from pursuing other defendants who are liable for the same damage.

If the claimant wishes to preserve its right to sue other defendants who are liable for the same loss, the settlement terms should not be recorded in the body of a consent order. Instead the parties should enter into a freestanding settlement agreement, or alternatively a Tomlin order – i.e. a consent order staying the proceedings on agreed terms and granting the parties permission to apply to the Court for the purpose of enforcing those terms, which are set out in a schedule or separate agreement referred to in the order. The agreement should expressly reserve the claimant's right to sue the other defendants, which will be particularly important where the liability is joint.

Additional references

Vanden Recycling Ltd v Kras Recycling BV [2015] EWHC 3616 (QB)

Heaton v Axa Equity & Law Life Assurance Society Plc [2002] UKHL 15

Court of Appeal decision casts doubt on principles requiring narrow interpretation of exclusion clauses

Persimmon Homes Ltd v Over Arup & Partners Ltd [2017] EWCA Civ 373

25 May 2017

The Court of Appeal has found that an exclusion clause in an engineering services contract was effective to exclude any liability on the part of the Defendant engineers for identifying and reporting on asbestos on a development site. This was based on the clear wording of the clause and commercial common sense. The traditional principles or canons of construction relating to exclusion clauses had no part to play.

Background

The Claimant developers brought a claim against the Defendant engineers alleging that they had negligently failed to identify and report on asbestos on their development site. The Defendant relied on exclusion clauses in the development contract and associated warranties (with identical wording).

Each of these clauses was found in a section of the relevant contract headed "Professional indemnity insurance" which provided that the Defendant would maintain professional indemnity insurance of not less than £5 million per event. The relevant clauses stated that the Defendant's liability for pollution and contamination would be limited to £5 million in the aggregate and that: *"Liability for any claim in relation to asbestos is excluded."*

The question of whether the exclusion clauses excluded liability for the claims was tried as a preliminary issue. The High Court found that they did, essentially on the basis that the clauses represented an agreed allocation of risks between the parties, their meaning was clear, and the courts should give effect to that meaning. The Claimants appealed.

Decision

The Court of Appeal dismissed the appeal, Jackson LJ giving the lead judgment with which Beatson and Moylan LJJ agreed.

The Court rejected the Claimants' argument that the exclusion clauses should be interpreted as covering only liability for causing pollution or contamination, or the spread of asbestos, rather than a failure to identify it. This conclusion was based on both the natural meaning of the words used and application of business common sense since, as the court put it, it would be nonsensical for the parties to have agreed that the defendant was not liable if asbestos was moved from one part of the site to another, but liable if it was left in place. It was also supported by the fact that the relevant clauses were clearly intended to limit the Defendant's liability to the extent of the insurance cover. In that context it was absurd to read the exemption clauses as confined to claims for moving contamination from one place to another (given that the Defendant was engaged to investigate and advise on contamination).

The Claimants contended that, even if the exclusion clauses were not limited to causing the spread of asbestos, they were not wide enough to exempt the defendant from liability. They relied on the *contra proferentem* rule and the so-called *Canada Steamship* guidelines, which essentially provide that clear words are required to exclude liability for negligence, and that the courts will not interpret a clause to cover negligence if there is some other head of damage it might realistically have been intended to cover (e.g. strict liability in relation to a statutory duty). The Court of Appeal rejected the Claimants' argument on both bases.

Firstly with regard to *contra proferentem*, the Court commented that in relation to commercial contracts, negotiated between parties of equal bargaining power, that rule now has a very limited role. The Court referred to recent Court of Appeal authorities which suggest that the words used commercial sense and the documentary and factual context should normally be enough to determine the meaning of a contract term; see *K/S Victoria Street v House of Fraser* and *Transocean Drilling v Providence Resources*. Here, the Court said, the meaning of the clauses was clear, and the *contra proferentem* rule had no impact.

In relation to the *Canada Steamship* guidelines, the Court commented that since the Privy Council's decision in *Canada Steamship Lines v The King*, there had been a long running debate as to the effect of the decision and the extent to which it was still good law. The Court commented that in recent years the courts had softened their approach to both indemnity clauses and exemption clauses. Jackson LJ said his impression was that, at any rate in commercial contracts, the *Canada Steamship* guidelines (in so far as they survive) are now more relevant to indemnity clauses than exemption clauses – as he noted, there is a difference between excluding liability for your own negligence and agreeing to compensate another party for the consequences of its negligence. The guidelines were, he concluded, of very little assistance in the present case. But even if that was wrong, it did not help the Claimant. There was no non-negligent ground of claim relating to asbestos that the parties might realistically have had in mind in agreeing the clause.

Comment

In interpreting exclusion clauses, the courts have traditionally applied certain principles which tend toward a narrow construction, in particular: (i) the *contra proferentem* rule, which provides that any ambiguity should be resolved against the party who put the clause forward and relies upon it; and (ii) the *Canada Steamship* guidelines.

In recent years, however, the courts have tended to cast doubt on the extent to which these principles remain applicable, at least where the clause is clear and unambiguous. This decision continues that trend, emphasising that the words used, the relevant context, and commercial common sense should normally be sufficient in determining the meaning of a contract term. The decision suggests that the tendency to assume exclusion clauses must be construed narrowly may be seen by the courts as outdated. As the Court of Appeal commented:

"In major construction contracts the parties commonly agree how they will allocate the risks between themselves and who will insure against what. Exemption clauses are part of the contractual apparatus for distributing risk. There is no need to approach such clauses with horror or with a mind-set determined to cut them down."

However, for those who want to ensure their clause is effective, the practical advice remains to use clear and unambiguous drafting, rather than seeking to rely on general wording.

Additional references

K/S Victoria Street v House of Fraser [2011] EWCA Civ 903

Transocean Drilling v Providence Resources [2016] EWCA Civ 372

Canada Steamship Lines v The King [1952] AC 192

Court of Appeal clarifies when parties are dealing on written standard terms of business so that the UCTA reasonableness test will apply

African Export-Import Bank v Shebah Exploration & Production Company Ltd [2017] EWCA Civ 845

28 June 2017

In *African Export-Import Bank v Shebah Exploration & Production Company Ltd*, the Court of Appeal has upheld an order for summary judgment for sums due under a facility agreement which was based on a Loan Market Association (LMA) model form. It rejected the Defendants' argument that (i) the parties were dealing on the lenders' written standard terms of business and therefore (ii) a term in the facility agreement that prohibited set-off needed to satisfy the reasonableness requirement under the Unfair Contract Terms Act 1977 (UCTA).

Background

The Claimants (an Egyptian financial institution and two Nigerian banks) entered into a Facility Agreement with the first Defendant, Shebah (guaranteed by the second and third Defendants), under which they agreed to lend Shebah US$150 million. The Facility Agreement was based on the LMA model form which was then further negotiated by the parties. Shebah defaulted on its obligations under the Facility Agreement and the Claimants accelerated the debt.

The Defendants contended that they had counterclaims which they were entitled to set off against the sums claimed. The Claimants argued that set-off was prohibited under a clause of the Facility Agreement. The Defendants argued that, because they were dealing on the Claimants' written standard terms of business, pursuant to section 3 of UCTA, the set-off clause could be relied on only insofar as it satisfied the requirement of reasonableness.

The High Court (Mr Justice Phillips) granted summary judgment, finding that the Defendants did not have a realistic prospect of establishing at trial that they were dealing on the Claimants' written standard terms of business pursuant to section 3 of UCTA.

Decision

The Court of Appeal (Lord Justice Longmore and Lord Justice Henderson) dismissed the Defendants' appeal. Longmore LJ noted that, for section 3 of UCTA to apply, the party relying on UCTA must prove that:

- the term is written;
- the term is a term of business;
- the term is part of the other party's standard terms of business; and
- the other party is dealing on those written standard terms of business.

Ordinarily, as in this case, the first two requirements would not be in dispute. The third and fourth requirements were considered by the Court of Appeal in more detail. It concluded, having reviewed the relevant authorities:

- In determining whether a term is part of the other party's standard terms of business, the test is whether or not the other party habitually uses those terms of business. It is not sufficient that the terms are sometimes used and sometimes not, nor is it sufficient that the terms form part of a model form. In that scenario, the question is whether the model form was habitually used.
- As to whether the other party is dealing on its standard terms of business, a relevant question is whether there have been more than insubstantial variations to the terms which otherwise have been habitually used. If there have been, a party seeking to rely on UCTA would be unlikely to be able to prove that it was contracting on the other's written standard terms of business.

On the facts, the Court held that the Defendants had not made out an arguable case that the Claimants were dealing on the Claimants' standard terms. The Defendants had filed no evidence to the effect that they believed the agreement was made on the Claimants' standard terms, and it was difficult to see that they could have had any such belief when they were dealing with three different parties in a syndicated loan agreement. Longmore LJ emphasised that a party who contends that it is arguable that a deal was done on standard business terms must produce some evidence that that was likely.

In any event, because detailed negotiations took place to finalise the final form of the Facility Agreement and substantial amendments were made, it was impossible to conclude that the agreement or its terms constituted the Claimants' standard terms of business, regardless of the fact that a model form was used as a starting point for the agreement.

The Court of Appeal did not rule on the Claimants' submission that a contract based on an LMA model form could never be made on standard business terms because there is always a need for amendment (as confirmed by the LMA's own user guide, which emphasises that it is impossible to use the model form without amendments and additions). Longmore LJ said he suspected this submission went too far; if a lender habitually used a particular LMA form and refused to countenance any amendment, it would be difficult to say that the deal was not done on that lender's standard business terms. But that was a question for another day.

Finally, it is worth noting that Longmore LJ did not accept that the decision in Commercial Management had any relevance to the present case. He pointed out that both Commercial Management and the case of *Pegler v Wang* (on which Mr Justice Edwards-Stuart relied in Commercial Management) were cases involving a "battle of the forms", and so were directed largely at determining which terms were actually part of the contract. He added, "*But once it was decided what were the terms of the contract, it was not difficult to decide whether the terms being relied on were standard business terms of that party and, in any event, no difficulties of the sort encountered in Pegler v Wang are present in the current case*". It is therefore not clear what impact this decision will have on the principles discussed in those earlier cases.

Comment

The Court held that, in determining whether parties are contracting on standard terms of business, it is not sufficient that the terms derive from the use of a model form. The essential questions are:

- whether the relevant party habitually uses those terms; and
- whether there have been more than insubstantial variations to the terms.

The decision suggests that, where a party habitually uses a standard form document but its terms are then negotiated, it is unlikely to be seen as contracting on standard terms for the purpose of UCTA, at any rate where the negotiations result in "*more than insubstantial variations*" to that standard form. Each case will however turn on its facts.

The decision may be seen as casting doubt on the recent High Court judgment in *Commercial Management (Investments) Ltd v Mitchell Design and Construct Ltd* which suggested that parties could be contracting on standard terms even if the standard terms comprised only a small proportion of the terms of the contract – although its precise impact on that decision is not clear.

Additional references

Pegler v Wang [2000] BLR 218

Commercial Management (Investments) Ltd v Mitchell Design and Construct Ltd [2016] EWHC 76 (TCC)

Supreme Court clarifies principles for determining when benefits enjoyed by a claimant following a breach of contract will be treated as collateral

Globalia Business Travel SAU (formerly TravelPlan S.A.U) of Spain v Fulton Shipping Inc of Panama [2017] UKSC 43

28 June 2017

The Supreme Court has ruled that the owners of a ship that was redelivered early in breach of a charterparty did not have to give credit for the benefit they obtained by selling the vessel for a higher price upon its early redelivery, rather than at the end of the contractual term of the charterparty when the vessel was worth significantly less. In doing so, the Supreme Court overturned the unanimous decision of the Court of Appeal and re-instated the order of the High Court, which had itself disagreed with the tribunal's ruling on this issue in the underlying arbitration.

Background

The Claimant shipowners chartered a cruise ship to the Defendant charterers. The owners alleged that, pursuant to an oral amendment to extend the charterparty, the charter was due to expire on 2 November 2009. The charterers disputed that they had entered into the oral amendment and asserted that they were entitled to redeliver the vessel on 28 October 2007. The owners treated the charterers as being in anticipatory repudiatory breach, which they accepted as terminating the charterparty. They went on to sell the vessel for US$23,765,000 just prior to its redelivery on the original expiry date in October 2007.

The owners claimed for loss of earnings for the period of the extension to the charterparty. It was found in arbitration that the parties had indeed extended the period of the charterparty by oral agreement, so the charterers were in breach by not continuing the charter until November 2009. The arbitrator also found that the value of the vessel had reduced to US$7 million by November 2009, when the vessel would have been redelivered had the charterparty run its course (due to the global financial crisis having occurred in the intervening period).

The charterers submitted that by selling the vessel in October 2007, rather than November 2009, the owners had enjoyed a benefit of US$16,765,000. The arbitrator found that the owners had to give credit for this benefit in calculating damages, as the sale of the vessel was caused by the charterers' breach and was a step taken in reasonable mitigation of damage. The credit was worth more than the owners' loss of profit claim, so they were not entitled to any damages.

The owners were granted permission to appeal to the High Court and the case was subsequently appealed to the Court of Appeal and then the Supreme Court.

First instance decision

In his judgment, Mr Justice Popplewell considered what the authorities said regarding the question of whether a benefit received by the innocent party should be taken into account to reduce recoverable damages. He noted that the search for a general rule which determines whether a wrongdoer should obtain credit for a benefit accruing to the innocent party is "elusive", but nevertheless distilled the following principles from the authorities:

- Generally speaking, it is a necessary condition that the benefit is caused by the breach.
- In determining causation, all the circumstances should be taken into account, including the nature and effects of the breach and the nature of the benefit and loss, the manner in which they occurred and any pre-existing, intervening or collateral factors which played a part in their occurrence.
- It will not satisfy the causation test if the breach merely provided the occasion, trigger or context for the innocent party to obtain the benefit. Nor is it sufficient that the benefit would not have been obtained but for the breach.
- It should make no difference whether the question is treated as one of mitigation of loss, or measure of damage. They are logically distinct approaches, but the factual and legal inquiry and conclusion should be the same.
- A mitigating step may be a reasonable and sensible business decision, taken to reduce the impact of the breach, but that does not of itself mean it is sufficiently caused by the breach. A reasonable response, designed to reduce loss, may be triggered but not legally caused by the breach.
- A mitigation analysis requires a sufficient causal connection between the breach and the mitigating step. It is not sufficient merely to show in two stages that there is a causative nexus

between: (a) breach and mitigating step, and (b) mitigating step and benefit. Benefits flowing from a step taken in reasonable mitigation of a loss are to be taken into account only if and to the extent that they are caused by the breach.

- It is suggestive that the breach is not sufficiently causative of the benefit where and to the extent that the benefit arises from a transaction which the innocent party would have been able to undertake irrespective of the breach.
- It is not necessary that the benefit is of the same kind as the loss claimed or mitigated. However, such a difference may indicate that the benefit is not legally caused by the breach.
- Subject to these principles, whether a benefit is caused by a breach is a question of fact and degree which must be answered by considering all the relevant circumstances, forming a common sense overall judgment.
- Even where the causation test is satisfied, considerations of justice, fairness and public policy may nonetheless preclude the benefit from being taken into account.

In particular, benefits which are the fruits of something the innocent party has done or acquired for his own benefit should not be taken into account where it would be contrary to fairness and justice for the wrongdoer to be allowed to appropriate them for his benefit.

On these principles, Popplewell J decided that the owners did not have to give credit for the benefit gained by selling the vessel. The benefit was not legally caused by the breach, as the vessel was an asset which the owners could have sold at any time at the prevailing market rate and irrespective of the breach. The fact that it would have been worth less in November 2009 was a result of the financial crisis, which occurred irrespective of the charterer's breach.

In addition, as the owners had taken the commercial risk of acquiring the vessel and selling it when they did, it would have been contrary to public policy to allow the contract breaking charterers to appropriate the result of the owners' business acumen.

Court of Appeal decision

The Court of Appeal unanimously overturned Popplewell J's decision, finding that the benefit gained by the owners had arisen from the consequences of the breach and should have been taken into account in calculating their loss.

The Court said that if a claimant takes a mitigating measure which arises out of the consequences of the breach and which is in the ordinary course of business, any benefit to the claimant should normally be brought into account in assessing loss – though it recognised an exception where the measure is wholly independent of the relationship of the Claimant and the Defendant.

Lord Justice Longmore noted that in cases where there is an available market for a replacement transaction, questions of collateral benefit should not arise as the innocent party would be confined to claiming the difference between the contract and market rate of hire. If he were to wait before taking a replacement charter, the resulting loss or gain would not be caused by the wrongdoer's breach, but by his decision not to take advantage of the available market.

In contrast, where there is no available market, the prima facie measure of loss is the difference between the (lost) contractual hire and the (avoided) cost of earning that hire (crew wages, cost of fuel, etc.). However, it would not usually be reasonable, Longmore LJ said, for the owner to claim that measure if he is able to mitigate the loss by trading the vessel if opportunities to do so arose. Any profits made would have to be taken into account in calculating damages.

Equally, Longmore LJ said, the owner may decide to mitigate the loss not by spot chartering the vessel but by selling it. If he did so, the benefit obtained from that act of mitigation would need to be taken into account just as much as any benefits secured by spot chartering the vessel.

Supreme Court decision

Lord Clarke gave the judgment in a unanimous decision, overturning the Court of Appeal's decision and finding in favour of the owners.

Lord Clarke said that the question is not whether the benefit is of the same kind as the loss caused by the wrongdoer; he agreed in particular with the eighth principle identified by Popplewell J (see above). His reasoning instead focused on the causation test, saying that for the benefit to be brought into account, it must be caused either by the breach or by a successful act of mitigation. Lord Clarke said that *the "essential question is whether there is a sufficiently close link"* between benefit and breach. The relevant link is causation, which is a broad and flexible test as illustrated in particular by Popplewell J's second and ninth principles (see above).

On the facts of this case, the Court held that there was an insufficient link between the benefit and the breach in order for the causation test to be met.

In particular, Lord Clarke noted that there was nothing about the termination of the charterparty which necessitated the vessel's sale. It could have been sold during the term of the charterparty. The termination was merely the occasion for selling the vessel – and indeed there was no reason to assume it would have been sold when the vessel was redelivered in November 2009, if the charterers had honoured the full term of the charterparty. The owners' commercial decision, taken at their own risk, to dispose of their interest in the vessel was no part of the subject matter of the charterparty and had nothing to do with the charterers.

That was also the reason why the owners could not have claimed the difference in the market value of the vessel if it had risen between October 2007 and November 2009. The owners equally could not be required to bring into account the benefit gained by the fall in value.

Lord Clarke also said that the sale of the vessel was not, on the face of it, a successful act of mitigation. If there had been an available charter market, the correct calculation of loss would have been the difference between the actual charterparty rate and the assumed substitute contract rate. The sale of the vessel would have been irrelevant. Where there is no available charter market, the measure of loss is the difference between the

contract rate and what was or ought reasonably to have been earned from employment of the vessel under shorter charterparties. The relevant mitigation in those circumstances, he said, would have been securing an alternative income stream. He concluded that the sale of the vessel was not an act of mitigation because it was incapable of mitigating the loss of the income stream.

Lord Clarke noted that if the vessel were sold part way into the period when it would have been employed under the repudiated charterparty, the sale would or might be relevant for some purposes, including to shorten the period during which the owners could claim to have lost the income stream under the old charterparty. If it could be shown that the owners received less for the vessel than they could have done by selling it with the benefit of the charterparty, the difference might also be recoverable. But none of those considerations would make the sale of the vessel itself an act of mitigation.

Comment

The Supreme Court's decision lays down an important precedent and establishes that there is no straightforward litmus test to determine whether a benefit enjoyed by an innocent party will be taken into account to reduce the damages payable following a breach of contract, or alternatively treated as a collateral benefit which is ignored for these purposes. The key question will be whether the benefit was caused either by the breach or by the innocent party's act of mitigation, taking into account all the circumstances.

If no such causation is found, recoverable loss will not be reduced by the benefit. Importantly, it will not satisfy the causation test if the breach merely provided the occasion or context for the innocent party to obtain the benefit, nor is it sufficient that the benefit would not have been obtained but for the breach. Determining causation in this sense is not a straightforward question, and reasonable views may differ – as illustrated by the opposite conclusions reached in unanimous decisions of the Court of Appeal and Supreme Court in this case.

Additional references

Globalia Business Travel SAU (formerly TravelPlan S.A.U) of Spain v Fulton Shipping Inc of Panama [2015] EWCA Civ 1299

Globalia Business Travel SAU (formerly TravelPlan S.A.U) of Spain v Fulton Shipping Inc of Panama [2014] EWHC 1547 (Comm)

Recent decisions show continuing trend for tough approach to rule breaches

Griffith v Gourgey [2017] EWCA Civ 926

Lakhani v Mahmud [2017] EWHC 1713 (Ch)

Redbourn Group v Fairgate Development [2017] EWHC 1223 (TCC)

ADVA Optical Networking v Rotronic Instruments [2017] EWHC 1813 (TCC)

Apex Global Management v Global Torch [2017] EWCA Civ 315

Kimathi v The Foreign & Commonwealth Office [2017] EWHC 939 (QB)

This year has seen a number of decisions in which the English courts, both at first instance and on appeal, have re-emphasised the message that those who fail to comply with procedural rules should expect little sympathy, at least where they fail to take prompt steps to put matters right.

Over the past few years the courts have backed off from the excessively draconian approach seen immediately following the high-profile *Mitchell* decision in November 2013. This more measured approach was prompted in particular by the Court of Appeal's decision in *Denton* in July 2014 which "clarified" the *Mitchell* guidelines.

However, since *Denton* we have continued to see cases which illustrate that the courts remain willing to take tough decisions against those who flout the rules. The decisions outlined below are consistent with that trend, and arguably mark an uptick in the frequency with which such decisions are being made in a wide variety of contexts. The obvious overall messages for litigating parties are:

- ensure compliance with rules and orders so far as possible;
- make an early application for more time where it appears a deadline cannot be met; and
- apply promptly for relief from any applicable sanction where things have gone wrong.

A second application for relief

Griffith v Gourgey

This case acts as a reminder that parties will not be given a second bite at the cherry when it comes to relief from sanctions. The Court cannot hear a second application for relief unless there has been a material change of circumstances since the first application was determined. That will be the case whether the first application was refused outright or was granted on conditions which have not been fulfilled.

Background

A consent order was made requiring the Defendants to respond by a particular date to CPR Part 18 requests for further information in respect of their defences to unfair prejudice petitions. The Defendants failed to do so. An "unless order" was made (by Mrs Justice Rose) requiring them to file and serve their response by 22 April 2014, failing which the defences would be struck out.

The Defendants purported to serve their response shortly before the deadline, but the petitioners alleged that this response was deficient and therefore the defences stood struck out for a failure to comply with the unless order. The Defendants applied for relief from sanctions.

The Court (His Honour Mr Monty QC sitting as a High Court judge) granted relief on strict conditions, including that the Defendants would serve a full and complete response by 4 December 2014. The order provided that if the Defendants complied with those conditions the defences would be *"reinstated"*.

The Defendants served a further response, but the petitioners alleged that this response was still deficient and so the defences remained struck out. The Defendants made a further application for relief from sanctions, which was refused by the High Court (Mr Justice Simon). The Defendants appealed.

Decision

The Court of Appeal (Lord Justice Longmore and Lord Justice Sharp) dismissed the appeal. They agreed with Simon J that the second application for relief could not be entertained by the Court unless there had been a material change of circumstances since the first application was refused.

The Court referred to *Thevarajah v Riordan* in which the Supreme Court held that a second application for relief was, in substance, an application under CPR 3.1(7) to vary or set aside the previous order refusing relief and so, applying established principles, should not have been granted unless there had been a material change of circumstance since the previous order was made.

That applied equally to the present case. Mr Monty QC's order did not apply a new sanction different from the strike-out sanction imposed by Rose J. It granted conditional relief from that sanction, but the original sanction was activated when the Defendants failed to comply with those conditions. There was no relevant difference between a refusal to grant relief and a decision to grant relief on conditions which have not been fulfilled.

Accordingly, Simon J could not entertain the second application for relief unless there had been a material change of circumstances since Mr Monty QC's order was made. No such change of circumstances had been established.

Late costs budgets

Lakhani v Mahmud

This is another example of the courts imposing the so-called "*Mitchell*" sanction for filing a costs budget late, namely that (under CPR 3.14) the party is treated as having filed a budget limited to court fees. It acts as a reminder that where the rules require a budget (or anything else) to be filed a certain number of days before a hearing, this should be "clear" days, meaning that the first and last day of the time period are excluded from the calculation. This means that the deadline may well be a day earlier than it first seems.

The decision also shows that in some cases it may be better for a party to accept there has been a breach and make a prompt application for relief, rather than seeking to argue (on weak grounds) that there has in fact been compliance. It also shows that in most cases it will be difficult to appeal successfully against a first instance judge's decision as to whether relief should be granted.

Background

In the present case, the parties were required to file and serve their costs budgets 21 days before the costs and case management conference (**CCMC**) scheduled for 10 January 2017. The Claimants served their budget on 19 December 2016, the correct day. The Defendants' budget was filed a day late, on 20 December (being 21 calendar days before the deadline, but not 21 "clear days" as the rules require).

The Defendants initially argued in correspondence that the budget was in time, but ultimately accepted that it was not. They did not make an application for relief from sanctions until just before the CCMC. The circuit judge refused the application and the Defendants appealed.

In considering an application for relief from sanctions, the Court will apply the three-stage test set out in *Denton*, namely: (i) the seriousness and significance of the breach; (ii) whether there was good reason for the breach; and (iii) all the circumstances of the case, giving particular weight to the two factors set out in CPR 3.9(1), i.e. (a) the need for litigation to be conducted efficiently and at proportionate cost and (b) the need to enforce compliance with rules, practice directions and orders.

Decision

The Court (His Honour Mr Daniel Alexander QC sitting as a deputy High Court judge) dismissed the appeal. He noted that it was common ground that the appeal was a review not a rehearing and the Court should not interfere with a case management decision of this kind unless satisfied the judgment was plainly wrong and fell outside the generous ambit of the trial judge's discretion.

The Court rejected the contention that the circuit judge had erred in assessing the seriousness of the breach. He noted that other judges might have taken a different approach, and this was in his view "on the borderline" of sufficient seriousness to warrant refusal of relief, but the Court could not properly interfere with the circuit judge's decision on this point.

The judge noted that the evaluation of seriousness or significance of a breach is not a binary question of primary fact, but a "multifactorial question of degree". It is impossible to list the full range of factors that may be relevant, but the judge included within this list:

- The absolute and relative amount of time lost by missing the deadline – here although the budget was only a day late, that delay was more significant because the time period for seeking to agree the budgets was already limited by closure of the Defendants' solicitors' offices for much of the Christmas and New Year period.
- Whether the delay affected the litigation or was likely to do so – although here the parties had been able to comment on the budgets of the opposing party despite the delay, the judge was not obliged to treat that as a conclusive factor on the question of seriousness. A court is entitled to consider the risk of difficulty that a failure to meet a deadline has created, even if it has been possible to perform the task required despite the breach.
- The direct consequences of missing the deadline and how it was addressed – here the circuit judge was entitled to take into account the distraction caused by the debate over what the time limit was and whether there was a breach, rather than the Defendants taking prompt steps to minimise its impact.

The judge also said there was no basis for challenging the circuit judge's conclusion that there was no reasonable excuse for the default. The Defendants' solicitors only started to prepare the costs budget after receiving the Claimants' costs budget, so on any basis the work was done at the last minute. While some judges might have taken a more charitable view as to the error in calculation of time, and whether days had to be "*clear days*", it could not be said the circuit judge's evaluation was clearly wrong.

Interestingly, the judge also noted that the circuit judge's decision did not operate to deprive the Defendants of a trial altogether. He commented that, if that had been the case, the situation would have merited more detailed scrutiny than the judge gave it. In the circumstances, the judge said it was hard to criticise the decision as disproportionate.

Preventing or setting aside default judgment

Two recent decisions of Mr Justice Coulson, outlined below, illustrate how the Court's approach to relief from sanctions is relevant where a defendant has missed the deadline to file a defence or acknowledgement of service.

Redbourn Group v Fairgate Development acts as a reminder that an application to set aside default judgment under CPR 13.3 is also an application for relief from sanctions, as the setting aside results from a failure to comply with the deadline for filing an acknowledgement of service or a defence.

Therefore, the Court will not only consider the factors set out in CPR 13.3 (essentially, whether the defendant has a real prospect of successfully defending the claim and whether the application to set aside has been made promptly), but must also consider the three-stage test set out in *Denton*.

The decision in *ADVA Optical Networking v Rotronic Instruments* shows that, even where default judgment has not been entered, a defendant who wishes to file a defence or acknowledgement will need to meet the *Denton* test.

Redbourn v Fairgate Development

Background

The Claimant obtained judgment in default against the Defendant on the basis of the Defendant's delay in serving its defence.

The defence was originally due on 25 January 2017. At the Defendant's request for a 28 day extension, the Claimant offered an extension to 1 February. The Defendant did not accept the offer but applied on 1 February for an extension to 22 February. However, it failed to fix a hearing date for that application or to serve the defence before 22 February. On 23 February the Claimant applied for judgment in default, which was entered on 9 March.

On 14 March, the Defendant applied to set aside the default judgment under CPR 13.3.

Decision

Coulson J dismissed the application to set aside. He noted that there had originally been some debate as to whether CPR 3.9 (governing relief from sanctions) is relevant to an application under CPR 13.3. However, it had since become clear that it is, as endorsed by the Court of Appeal decision in *Gentry v Miller* – an important decision which he noted was not referred to in the note in the White Book under CPR 13.3 (an omission he said should be rectified in the next edition).

Accordingly, on an application to set aside default judgment, the Court must consider the three-stage test set out in *Denton* after considering the elements set out in CPR 13.3.

Here, on the basis of CPR 13.3, the Court concluded that it should not set aside the judgment in default. The Defendant had no realistic prospect of defending the claim, and had not acted promptly after judgment was entered, in particular because they had not attached the draft defence and counterclaim to their application to set aside. The draft was not provided until 11 May (a week before the hearing on 19 May).

In case the judge was wrong on either of the two elements under CPR 13.3, he went on to address the *Denton* test – i.e. the seriousness of the failure, the reason for it, and all the circumstances of the case.

Here Coulson J was satisfied that the failure in allowing judgment in default to be entered was serious, there was no explanation at all for the failure, and a consideration of all the circumstances of the case (including the Defendant's repeated failure to provide information it had promised to the Claimant) also led to a conclusion adverse to the Defendant.

Accordingly, even if the judge was wrong in his assessment under CPR 13.3, he would have concluded that relief from sanctions should be refused and so the application to set aside would still have failed.

ADVA Optical Networking v Rotronic Instruments

Background

The Defendant was due to file an acknowledgement of service or defence by 24 March 2017. No default judgment was entered, but at a CMC held on 16 June the Court (Mr Justice Carr) ordered that if the Defendant wanted relief from sanctions it had to issue its application no later than 23 June. (The claim was related to a separate set of proceedings, and the CMC was held in respect of both actions.) On the last day, 23 June, the Defendant applied for an extension of time for service and/or relief from sanctions.

Decision

Coulson J said there had been some suggestion that the Defendant did not require relief at all, but that had (rightly) not been pursued. He added:

"The correct approach is that a retrospective application for an extension of time to serve or file a document should be dealt with on the same principles as a claim for relief from sanctions."

However, he granted relief from sanctions on the unusual facts of this case, saying this was one of those "relatively rare" cases of serious default where it was appropriate to grant relief.

Although he was satisfied that the breach was serious and there was no good reason for it, the third stage of the test led him to conclude that he should grant relief. This was in particular because (i) the delay had not had any real effect on the course of the proceedings because of amendments that had been made in the related proceedings, and (ii) the claim against the Defendant was contingent, and would only give rise to liability if the Claimant was found liable in the related proceedings (contrary to its case in those proceedings). The judge said he was uncomfortable about a situation where the Defendant would be made the subject of a judgment which (as things stood) the Claimant did not need and which was contrary to its primary case.

Challenges to jurisdiction

Apex Global Management v Global Torch

This case suggests that, where a party may wish to challenge the Court's jurisdiction in some circumstances that is a point that should be raised early – even where the basis for challenge will only arise if the party's primary case is unsuccessful. Otherwise the Court may find that the right to challenge jurisdiction has been lost due to the delay in making the application.

Background

In the underlying dispute, the parties each brought unfair prejudice petitions against one another. They relied on competing versions of a share sale and purchase agreement (**SPA**), each alleging that the other version was forged.

The Court ultimately entered judgment in favour of the respondent on its counterclaim, having found that the version of the SPA relied on by the respondent was the true version. The petitioner then applied for a stay of execution of the judgment on the basis that the respondent's version of the SPA contained an exclusive jurisdiction clause in favour of the courts of Saudi Arabia. It argued that once the judge had reached that conclusion, he should have declined jurisdiction on the basis of the clause.

The judge refused the application for a stay of execution and the petitioner appealed.

Decision

The Court of Appeal (Lady Justice Gloster and Lady Justice Black and Sir Christopher Clarke) dismissed the appeal on various bases, including on the basis of the petitioner's lateness in challenging jurisdiction.

Under CPR Part 11, a party who wishes to challenge the Court's jurisdiction must make an application within 14 days after filing an acknowledgement of service. A party who fails to do so is deemed to have accepted that the English court has jurisdiction.

A late application for a stay was in substance an application for relief from sanctions and so had to be determined in accordance with the three-stage test established in *Denton*. In the Court's judgment, the application of this test clearly resulted in a refusal of the application. The decisive factor was the lateness of the petitioner's jurisdiction challenge.

The Court rejected the petitioner's argument that the proper time to make the application in relation to the jurisdiction clause was after the judge had handed down judgment; it was open to the petitioner to seek to reserve its position in relation to jurisdiction, even while disputing that the true contract contained any such jurisdiction clause.

The petitioner could not, in the Court's view, remain silent about the effect of the jurisdiction clause until after judgment had been given on the basis of not extant issues relating to jurisdiction. The Court added:

"The obvious but fundamental point is that challenges to jurisdiction must be made as early as possible."

Group Litigation Orders

Kimathi v The Foreign & Commonwealth Office

This case illustrates the application of the *Denton* principles in the context of group litigation, in particular where claimants have missed the cut-off date for adding their claims to the group register. It suggests that, where a Group Litigation Order (**GLO**) has been made to enable relatively modest claims to be managed together so that costs are not disproportionate, the Court may give even more weight than usual to the need to enforce compliance with rules, practice directions and orders.

Background

On 30 November 2016, 32 Claimants applied for an order granting relief from sanctions and permitting their claims to be added to the group register for the Kenyan Emergency Group Litigation, despite having failed to comply with the "cut-off date" in the GLO for claims to be added to the group register without permission of the Court (30 May 2014).

By the time of the application, the trial was well underway, having started in May 2016, but it was not expected that final submissions would finish before spring 2018.

It was said that the applicants had instructed GT Law solicitors to claim in the GLO. GT Law went into administration in November 2015 and its claims were transferred to IC Law, but the applicants were apparently not aware of that. They had confirmed to their current solicitors (Hugh James) that from the date of signing or marking the retainer with GT Law they heard nothing from either GT Law or IC Law.

Decision

The Court (Mr Justice Stewart) refused the application.

A number of the 32 applicants were claiming wholly or in part as personal representative of a relative who had died. Claims brought on behalf of deceased family members were not within the GLO, unless personal claims had been made and entered on the register and the person had since died. Applications by those claiming on behalf of estates of those who had died therefore could not succeed.

As the judge said, to add this new type of claim nearly three years after the cut-off date would be wholly wrong in all the circumstances of the case, including because all solicitors involved in the litigation had abided by the decision that such claims would not be litigated, and there were no test claimants in this category.

In respect of the other applicants, there was some limited information on the few GT Law files that had been received, which showed that there may be reasons these claims had not been entered onto the group register initially (i.e. because they did not suffer any injuries).

It was therefore not possible for the Court to assume that the default in not registering the applicants was entirely that of GT Law rather than the applicants personally. In any event, in the judge's view, there was no good reason for the default, whether caused by the solicitors or the applicants.

The judge then went on to consider all the circumstances of the case, giving particular weight to the need:

- for litigation to be conducted efficiently and at proportionate cost – the Court noted that the efficient conduct of the litigation would not be affected by adding the personal injury claims but would by adding the estate claims (which were not to proceed in any event as noted above); and
- to enforce compliance with rules, practice directions and orders – i.e. that the old lax culture of non-compliance is no longer tolerated.

The judge also took into account the fact that the application was far from prompt, as well as his conclusions that the breach was serious and significant and there was no good reason for it. In conclusion he said the application should not be granted, commenting that to do so would undermine the discipline of the litigation and render the cut-off date meaningless.

Additional references

Denton v TH White Ltd [2014] EWCA Civ 906
Thevarajah v Riordan [2015] UKSC 78
Gentry v Miller [2016] EWCA Civ 141

Ghosh dishonesty disapproved: dishonesty to be assessed solely against the standards of ordinary reasonable and honest people

Ivey v Genting Casinos (UK) Ltd t/a Crockfords [2017] UKSC 67

25 October 2017

The Supreme Court has held that the correct test for dishonesty is whether or not the defendant's conduct is dishonest by the objective standards of ordinary reasonable and honest people. Albeit that the Court did not need to rule on the point, the judgment would remove the second limb of the previous two-phase objective and subjective test for dishonesty as set out in R v Ghosh. The Court also concluded that the tests for dishonesty in criminal and civil proceedings should be the same.

Background

Mr Ivey (a professional gambler) used a highly specialist technique called "edge-sorting" to improve his odds of winning at Punto Banco Baccarat (a game of chance). This technique relies on the fact that there are slight differences in the pattern on the back of certain playing cards. Over the course of the game, Mr Ivey and his accomplice directed a croupier to rotate cards which had already been revealed in a certain manner so that he could more accurately guess the value of the card when they were shuffled, placed face down and the deck was used to play again. The croupier was entirely unaware of the motivation behind Mr Ivey's request that the cards be oriented in a certain way. Over the course of two days in 2012, Mr Ivey won just over £7.7 million using this technique.

After reviewing the CCTV, Genting Casinos' investigators spotted what Mr Ivey had done and refused to pay him his winnings on the grounds that the game had been compromised. Both parties agreed that there was an implied term that neither party to the game would cheat. Genting Casinos argued that Mr Ivey had breached this implied term and, as such, was not entitled to his winnings. Mr Ivey sued, arguing that "edge-sorting" was "legitimate gamesmanship" and not cheating.

At first instance, Mitting J held that the implied term had been breached and Mr Ivey was not entitled to his winnings. The majority of the Court of Appeal dismissed Mr Ivey's appeal, agreeing that the technique amounted to cheating.

Decision

The Court unanimously held:

- **Dishonesty is not a necessary legal element of cheating in the context of games and gambling**. Although some forms of cheating will involve deception, this is not always the case – the Court gave the (perhaps surprising) examples of purposefully tripping up an opponent, deliberately wasting time or intentionally knocking over a table to force a hand of cards to be dealt again as instances of cheating which are not (in the Court's opinion) necessarily dishonest.
- The proper test for dishonesty is whether or not the defendant's conduct is dishonest by the objective standards of ordinary reasonable and honest people. As such, the two-limbed test from *R v Ghosh* (which, in addition to the test set out above, required the jury to assess whether, subjectively, the defendant realised that ordinary, honest people would regard his behaviour as dishonest) is no longer good law. The Court noted that this subjective test previously meant that *"the less the defendant's standards conform to what society in general expects, the less likely he is to be held criminally responsible for his behaviour."*

In the case at hand, the Court held that "edge-sorting" amounted to cheating on the basis that Mr Ivey had taken positive steps to fix the deck, having staged *"a carefully planned and executed sting."* He had therefore breached the implied term not to cheat, and was not entitled to his winnings.

As such, the only question requiring the Court's attention was whether dishonesty was an essential legal element of cheating (which was answered in the negative); the Court nonetheless took the opportunity to revisit the test for dishonesty in criminal proceedings on the basis that there had been a deception of the croupier and that this could potentially be dishonest.

The Court identified a number of serious problems with the second limb of the rule adopted in *R v Ghosh*, including that:

- It had the unintended effect that the more warped a defendant's standards of honesty, the less likely that he would be convicted of dishonest behaviour;
- It set a test which jurors and others often found *"puzzling and difficult to apply"*;
- It led to an unprincipled divergence between the tests for dishonest in criminal and civil proceedings.

The test as set out in *Ivey* is as follows:

"When dishonesty is in question, the fact-finding tribunal must first ascertain (subjectively) the actual state of the individual's knowledge or belief as to the facts… When once his actual state of mind as to knowledge or belief as to facts is established, the question whether his conduct was honest or dishonest is to be determined by the fact-finder by applying the (objective) standards of ordinary decent people."

It should be noted that although there is no longer any subjective test as to whether or not the Defendant's conduct was dishonest, the jury must still consider, subjectively, what the Defendant's knowledge of the wider situation was: what did the Defendant know or believe *"about the facts affecting the area of activity in which he was engaging"*? The Court used the hypothetical example of a visitor to England who fails to pay a bus fare because he believed public transport was free, as it was in his imagined home country: *"Because he genuinely believes that public transport is free (i.e. knowledge of the wider situation), there is nothing objectively dishonest about his not paying on the bus (i.e. his specific conduct)."* This subjective assessment of a defendant's knowledge will be of continued importance in circumstances where a defendant had insufficient information about a general situation to understand the impact of his conduct.

Comment

It is interesting that this decision affecting the test for dishonesty in criminal cases should come in the context of a civil action. As a result of the decision in civil proceedings, the test for dishonesty in criminal and civil matters is now the same, the Court holding that *"it would be an affront to the law if [the meaning of dishonesty] differed according to the kind of proceedings in which it arose."* Although the burden and standard of proof will continue to differ between criminal and civil proceedings, it is now the case that *"if by ordinary standards a defendant's mental state would be characterised as dishonest, it is irrelevant that the defendant judges by different standards"* (*Barlow Clowes International Ltd v Eurotrust International Ltd*).

Although the effect in criminal cases remains to be seen, it is possible that the decision will generally be welcomed by prosecutors as, by removing one limb of the dishonesty test, arguably it reduces the hurdles to conviction. An alternative view is that the revised test may reflect a reality that jurors who had struggled with *"the idea that something which is dishonest by ordinary standards can become honest just because the defendant thinks it is,"* may have in practice simply rejected the evidence that a defendant did not view himself as dishonest.

The ruling affects a number of offences which require a prosecutor to demonstrate the presence of dishonesty, including the prosecution of crimes often seen in a corporate context such as fraud, conspiracy to defraud, money laundering and cheating the public Revenue. The removal of the reference to a defendant's personal standards of honesty may have most impact in cases in a particular industry, with defendants unable to rely on *R v Ghosh* to argue that they mistakenly but honestly believed that conduct was consistent with standards of their business peers. The Court noted: *"There is no reason why the law should excuse those who make a mistake about what contemporary standards of honesty are, whether in the context of insurance claims, high finance, market manipulation or tax evasion."*

The Court cautioned against any attempt to define dishonesty, deferring to the jury as to whether conduct may be construed as dishonest or not. It provided little guidance as to how defendants (and indeed, society in general) can learn more about what *"contemporary standards of honesty"* are. While the judgment noted that the purpose of the criminal law is to *"set the standards of behaviour which are acceptable"*, such standard setting will, therefore, continue to be by means of the judgment of conduct after the event.

Additional references

R v Ghosh [1982] QB 1053

Barlow Clowes International Ltd v Eurotrust International Ltd [2005] UKPC 37

High Court grants non-party broad access to documents relied on at trial despite case having settled before judgment

Dring v Cape Distribution Ltd [2017] EWHC 3154 (QB)

5 December 2017

In a recent decision, a High Court Master has taken a broad view of the documents that should be made available to a non-party where a case settled after trial.

This issue is topical, as the rules relating to open justice in CPR 39 are currently being considered by a sub-committee of the Civil Procedure Rule Committee (CPRC). The sub-committee's preliminary note filed for the CPRC's October meeting suggests it is considering possible amendments to strengthen the rules and help promote awareness that parties cannot waive the public's right to open justice.

Background

The Applicant acts for a group which provides help and support to asbestos victims, as well as lobbying and promoting asbestos knowledge and safety. He sought access to documents filed in the course of product liability proceedings against manufacturers of asbestos insulation boards, in circumstances where those proceedings had settled after a lengthy trial.

The application was made principally under CPR 5.4C, which provides that a non-party to litigation may, if the court gives permission, obtain from court records a copy of "any other document" filed by a party (i.e. other than a statement of case or judgment or order made in public, which are generally available without the need for permission).

The Applicant intended to make use of the material in various ways including: to make it publicly available; to promote academic consideration as to the science and history of asbestos and asbestolux exposure and production; to clarify the extent to which the defendant was or was not responsible for product safety issues; and to assist court claims and the provision of advice to asbestos disease sufferers.

The Defendant resisted the application, including on the basis that the Court had no jurisdiction to make the order sought because the case had settled.

Decision

The High Court (Master McCloud) granted the application, save in respect of documents appearing only in an electronic trial bundle (Bundle D, which comprised the totality of the parties' disclosure documents whether or not relied on at trial) and the parties' disclosure statements.

The decision gives a helpful summary of the principles relevant to an application for public access to court documents, including the following:

- CPR 5.4C is the primary means by which the court administers its common law power to allow public access to court documents but "the common law is the master and not the servant of the rules".
- Where documents are filed on the court record they fall within the scope of CPR 5.4C(2). (If documents are removed from court, *Blue v Times Newspapers Ltd*, may provide a basis for saying that the court can require them to be returned.) Served documents which are not on the court record do not fall within CPR 5.4C but may be disclosed under the court's common law powers.
- Documents filed on the court record which are read or treated as read in court are subject to a default position in favour of the principle of open justice, if the applicant has a legitimate interest. However, the court must still conduct a balancing exercise in relation to any harm to other parties' legitimate interests when deciding whether to allow access.
- Documents on the court record which are **not** read or treated as read are subject to a more stringent test, namely that there must be strong grounds for thinking that access is necessary in the interests of justice.

The Master found, contrary to the Defendant's submission, that the principle of open justice was engaged even where a case settled before judgment. The principle applies to documents which are read to or by the court, or treated as so read, or which have featured in proceedings in open court.

She was satisfied that the paper trial bundles had been filed and so their contents were on the court record for the purposes of CPR 5.4C. Bundle D had not been filed, but merely made available to the court in electronic form; there was no provision for filing documents electronically in the Queen's Bench Division, where the case was proceeding (as opposed to the Rolls Building jurisdictions). She was also satisfied that documents such as submissions and skeletons, which were not in the paper bundles but were handed up to the judge in court and retained in court at the end of trial, were also filed for these purposes. If that was wrong, those documents would fall within the courts' common law powers and the Master would not have reached a different conclusion as a result of them not being filed on the court record.

As to whether the documents had been read or treated as read by the judge so as to give rise to a starting point of openness, the Master noted that one must take into account that modern practice encourages judges to pre-read bundles. Here the paper bundles were deployed in court and placed before the judge including after he retired to consider his decision. They were therefore subject to the "default position" that access should be given on the open justice principle. The same applied to other documents provided to the judge, namely submissions, skeletons and transcripts.

In contrast, the judge had not been invited to consider the documents which appeared only in Bundle D. The parties' intention was that, where documents from Bundle D were referred to, they would be copied across to the paper bundles. The residue of the contents of Bundle D, therefore, was not material which featured in the decision-making process or was read or treated as read by the court.

In respect of those documents which were read or treated as read by the judge, the Master was satisfied that the applicant had a legitimate interest in obtaining the documents. There was a strong public interest in facilitating a better understanding of these matters, and a legitimate interest in ensuring the deployed material was available to courts and legal advisers "in the interests of both consistency of decision making and provision of advice as to merits or lack thereof" and to enable the public to consider how the material in the case led to a settlement.

In terms of the court's balancing exercise, the Applicant had expressed a valid concern that refusing access would risk the courts proceeding without relevant material in future cases. The Master emphasised that the courts are not a private dispute resolution forum but rather play a public role in informing other cases both as to law and procedure and as to "facts and knowledge in specialist areas".

The Master was not persuaded by any of the Defendant's arguments regarding a risk of harm due to disclosure. She accepted that if parties were concerned that "dirty washing" or trade secrets etc contained in documents considered at trial would all become public even in the event of a settlement, that might discourage settlement (though conversely it might encourage ADR out of court in the first place). There are however ways of dealing with such concerns, through seeking non-disclosure orders or orders that part of a trial be held in private. In essence, the Master had little sympathy for parties that had "gone public" in court and then later decided to settle on confidential terms. The defendant had not put forward any particulars of harm it was likely to suffer as a result of publication.

In relation to the unfiled and unread material in Bundle D, although there was jurisdiction to order access to it at common law, the Master did not see any grounds for doing so. Parties should be encouraged to make such material available to the court, as the parties had done in this case, without them being easily amenable to public access. It was only at the point where documents played a role in the proceedings that the principle of open justice would apply.

Comment

The decision draws a clear line between documents which are read or treated as read by the judge, which are subject to a default position in favour of granting access so long as the applicant has legitimate interest in the documents – though the court must stull conduct a balancing exercise in relation to any harm to other parties' legitimate interests. In contrast, where documents are not read or treated as read by the judge, there must be strong grounds for thinking that access is necessary in the interests of justice. The obvious question is which documents are treated as read by the judge. Here the Master took a broad view, essentially finding that the entirety of the paper bundles should be treated as read, though not documents which appeared only in an electronic bundle that was made available for the reference in court on the basis that any documents relied on would be copied across to the paper bundle.

The decision emphasises that the courts do not merely provide a public service to the parties to a particular case; previous cases also form the basis of advice to other parties. That means that litigating parties have legitimate concerns regarding sensitive material, they should take steps to protect it before it is ventilated in court, for example by seeking an order that the court sir in private for the relevant part of the hearing. The present decision suggests that where parties do not take such steps, the court may have little sympathy if they reach a settlement on confidential terms and then seek to prevent material put before the court becoming publicly available.

Additional references

Blue v Times Newspapers Ltd [2017] EWHC 1553 (Comm)

Choice of law, jurisdiction and enforcement of judgments post Brexit: where are we now?

The UK's rules on choice of law, jurisdiction and enforcement of judgments are in large part dependent on reciprocal arrangements set out in EU Regulations. So what will happen post Brexit when these Regulations no longer apply automatically?

This article looks at the UK Government's paper published in August this year, "Providing a cross-border civil judicial cooperation framework", which responds to the EU Commission's "Position paper on Judicial Cooperation in Civil and Commercial Matters", published in June 2017.

The UK Government's paper gives, we believe, cause for quiet optimism.

Background

In short, there should be very little change post Brexit.

At present, the Rome I Regulation ((EC) No 593/2008) governs the applicable law in contractual matters in all EU Member States other than Denmark, and Rome II ((EC) No 864/2007) governs the applicable law in non-contractual matters.

Post Brexit, a court in a remaining EU Member State, Germany for example, will still apply those Regulations to determine the applicable law, which as before may be the law of an EU or non EU country. So, if such a court would have found that English law was the applicable law before Brexit, it should continue to do so post Brexit.

In the UK, the Government's August paper sets out its intention that Rome I and Rome II will be incorporated into UK domestic law at the point of exit. Nothing is said in the paper about how the former Regulations will be interpreted, but presumably, pursuant to clause 6(3) of the Withdrawal Bill, courts other than the Supreme Court should apply CJEU decisions pre-dating exit day. The Supreme Court will not be bound by those decisions, but it must apply the same test as it would in deciding to depart from its own case law. UK courts would be free to ignore post Brexit CJEU decisions, but they may well look at that case law to assist in interpretation, in the same way that they might look at an Australian decision where the same principles apply in both countries.

The EU Commission's June paper focuses on the position at the point of exit, rather than proposals regarding a future arrangement. Indeed it is so concerned to stick to that approach that it does not mention that the Rome Regulations apply as between EU countries and third countries just as much as between EU countries. It proposes that choices of law entered into before the withdrawal date should continue to be given effect in accordance with current rules. As explained above, however, the UK Government is prepared to incorporate the Rome Regulation into its domestic law as "retained EU law" thus keeping EU and UK rules in line.

Jurisdiction and enforcement of judgments

The position here is more complicated, but the UK Government's willingness to take into account CJEU judgments suggests that, from its perspective at least, a deal can be negotiated which ensures a continuation of the current rules, or something similar.

At present, the recast Brussels Regulation ((EU) 1215/2012) allocates jurisdiction as between EU Member States and governs enforcement of most judgments from those countries. CJEU decisions on the recast Brussels Regulation are binding on all Member States. Similar rules are in place between the EU and the European Free Trade Association members, Norway, Switzerland and Iceland, under the Lugano Convention 2007. CJEU decisions are not binding on the EFTA countries but they must "pay due account" to those decisions.

In its August paper, the UK Government states that it will seek to participate in the Lugano Convention. It therefore appears to be prepared for UK courts to take CJEU decisions into account in reaching decisions. A similar message comes through in the Prime Minister, Theresa May's, speech in Florence on 22 September 2017 where she said she wanted the UK courts to be able to take judgments of the CJEU into account with a view to ensuring consistent interpretation of EU legislation.

There is no requirement that the UK becomes a member of EFTA in order to join the Lugano Convention. Membership of the Convention is possible with unanimous agreement from the contracting states.

If the UK were to participate in Lugano, without reaching any other agreements, then the position on jurisdiction and enforcement of judgments would be very similar to the current position. The UK would however be unable to take advantage of the improvements made in the recast Brussels Regulation, at least until Lugano catches up with the recast Regulation and makes similar improvements, which seems likely in time. Some of those advantages are significant and were hard won. In particular the change in the rules which ensures precedence is given to the Court chosen in an exclusive jurisdiction clause over the Court first seised of a dispute.

The UK Government is, it seems, hoping to go beyond Lugano and will be seeking an agreement with the EU that allows for close and comprehensive cross-border cooperation on a reciprocal basis "which reflects closely the substantive principles of cooperation under the current EU framework". So, presumably something akin to the recast Brussels Regulation,

although without giving precedence to the CJEU. The Lugano Convention would then continue to apply, as at present, just to Norway, Switzerland and Iceland.

What is the view of the EU Commission? That isn't clear from its paper, which as referred to above, focuses on the position at the point of exit (as to which more below) rather than proposals regarding a future arrangement. However, the jurisdiction and enforcement rules benefit all countries, so it is to be hoped that common ground can be found.

A final point to make is that the UK Government's paper makes clear its intention to participate in the Hague Convention on Choice of Court Agreements 2005, which sets out jurisdiction rules where there is an exclusive choice of court agreement. The UK is currently a party to the Convention by virtue of its EU membership, but would have to join in its own right to continue to take the benefit of the Convention post Brexit. It is possible to sign up to Hague without agreement from the EU so this is a step which can be taken very quickly after Brexit. The UK Government has been extensively lobbied to make clear its intention to join the Hague Convention post Brexit, so this is a welcome statement.

Separation terms

The Government paper comments on the EU Commission's proposals on the terms of separation, in the event no agreement has been reached on the applicable rules going forward. There is significant agreement here, although the UK Government's proposals go further than the Commission's in some respects:

Applicable law	The existing EU rules on applicable law for contractual and non-contractual obligations should continue to apply to contracts concluded before the withdrawal date and, in respect of non-contractual liability, to events giving rise to damage that occur before the withdrawal date. There is agreement on this, although the UK Government's proposals go further to ensure continued common rules on applicable law, as explained above.
Jurisdiction	The existing EU rules governing jurisdiction should continue to apply to all legal proceedings instituted before the withdrawal date. Again, there is agreement on this.
Choice of court	Where a choice of court has been made prior to withdrawal, the current rules should continue to apply to establishment of jurisdiction and recognition and enforcement of any resulting judicial decision, regardless of whether the relevant dispute arises/ judgment is given before or after withdrawal. This would give a long tail to the operation of the current rules, even if no other agreements were reached. The EU proposal is narrower, merely suggesting a choice of court in a contract entered into before withdrawal should continue to be given effect in accordance with current rules. Nothing is said about the resulting judgment.
Recognition and enforcement of judicial decisions	The existing EU rules should continue to apply where *proceedings* were instituted before the withdrawal date. The EU proposal in contrast is that the current rules would apply where *judgment* was given before the withdrawal date.
Judicial cooperation procedures and requests for information	Those pending on the withdrawal date should continue to be governed by existing EU rules. The most significant difference between the UK Government's separation proposals and those of the Commission is that, under the UK Government's proposals, certain judicial decisions given after the withdrawal date would continue to be enforced under the current rules. They would therefore be subject to a more generous enforcement regime than would otherwise apply under the laws of each remaining EU Member State. In contrast, under the Commission's proposal, the current rules on enforcement would only apply to judicial decisions given before the withdrawal date.

Insurance Block Exemption expiry

The EU Insurance Block Exemption Regulation (**IBER**) expired on 31 March 2017 and will not be renewed. This means that insurance agreements must be analysed for compliance with general competition law guidelines and principles, as they will no longer benefit from an industry-specific exemption.

The practical implications for the industry should, however, be minimal, as the scope of the IBER was already reduced considerably following a review in 2010. Expiry of the IBER does not mean that agreements become unlawful, but simply that they will need to be assessed on a case-by-case basis, against relevant guidance issued by the EU Commission.

Background

The IBER (Regulation 267/2010) was first introduced in 1992. It avoided the need for notification of certain standard industry agreements in order to obtain an individual exemption under Article 101(3) of the Treaty on the Functioning of the European Union (**TFEU**). Following decentralisation of the EU competition law enforcement regime and removal of the notification process, the IBER was nevertheless renewed in 2003 and 2010, to assist the insurance industry with the assessment of certain common co-operation agreements which were recognised as benefiting consumers.

The IBER originally applied to four categories of agreements and practices in the insurance sector:

- Joint compilations, tables and studies enabling the exchange of statistical information
- Joint establishment of standard policy conditions
- Joint establishment and management of insurance pools
- Joint testing and acceptance of security devices

In 2010, this was reduced to just two of those four categories, namely to joint compilations and insurance pools. Agreements on standard policy conditions and on security devices were no longer seen as specific to the insurance sector and could therefore be examined under the general competition rules and guidelines.

Assessment of the current regime

The 2010 IBER expired on 31 March 2017. Between 2014 and 2016, the Commission conducted an assessment of whether an industry-specific block exemption Regulation remained the most appropriate instrument to deal with certain cooperation agreements in the insurance industry.

Joint compilations, tables and studies

The Commission recognises that certain data exchanges are specific to the insurance industry and are necessary to price risks properly. In January 2011, it published guidelines on the applicability of Article 101 TFEU to horizontal co-operation agreements (the **Horizontal Guidelines**). For the first time, these included guidance on how to assess the exchange of sensitive information between competitors in the context of Article 101(3) TFEU.

The Commission has concluded that the Horizontal Guidelines, which expressly refer to the insurance sector, now overlap and coexist with the IBER and remove the need for a specific exemption for joint compilations, tables and studies. Instead, these agreements are to be assessed according to the principles set out in the Horizontal Guidelines.

Insurance pools

The Commission found that there is a lack of clarity in the market as to which pools qualify under the IBER and benefit from the insurance pools exemption. Only a small number of insurance pools actually qualify under the IBER (mainly for catastrophic or aggravated risks) and market share thresholds apply (combined market share of the participating undertakings no more than 20% in the case of co-insurance pools and no more than 25% in the case of co-reinsurance pools). A number of insurance companies were mistaken in relying on the IBER.

The Commission also found that over the last decade the insurance market has developed more flexible and competitive co- or reinsurance solutions, which are viable alternatives to the pools exempt under the IBER. The Horizontal Guidelines provide helpful guidance on the assessment of co-operation agreements between competitors which will assist with the case-by-case analysis of insurance pools.

The commission's decision

The Commission concluded that *"although there are indications of an enhanced need for co-operation in the areas covered by the IBER, the strict conditions for maintaining the exemption seem no longer to be met"*. It thought that a case-by-case self-assessment of joint compilations and insurance pools on the basis of the Horizontal Guidelines would secure the same benefits.

The need for a sector specific regime applicable to the insurance sector therefore became redundant and the Commission concluded there was no need to renew the IBER after 31 March 2017.

Impact on business

Although for certain agreements the benefit of an automatic exemption under the EU competition rules will be lost, expiry of the IBER does not imply that those co-operation agreements between insurers are now in breach of Article 101(1) TFEU. It simply means that this limited category of agreements will need to be assessed on a case-by-case basis, taking guidance in particular from the Commission's Horizontal Guidelines. The Commission has indicated that it will continue to monitor developments in the market and evaluate how insurers adapt to the change.

PRA adopts questionable approach to regulatory compliance

Comments made by Sam Woods, CEO of the PRA, published in July 2017 about the PRA's approach to supervision are worrying. A speech prepared for a conference earlier in the year (but not actually delivered) is relevant to all authorised firms, not just building societies. Parts of the speech are specifically directed at insurers.

In summary:

- The PRA argued that it is not enough for firms to meet the requirements of the regulatory regime; they must also comply with the "spirit" of the rules.
- The PRA will form its own judgement about what this means for firms, despite the UK's obligations under EU law.
- Mr Woods' failure to acknowledge EU constraints on the content of the applicable rules, and therefore the PRA's use of its supervisory powers, appears to confirm that the PRA is willing to "gold-plate" EU legislation despite saying on many occasions that it would not.

We consider below the implications of Mr Woods' comments for insurers, including the PRA's apparent objection to the redesign of unit-linked products to reflect new contract boundary rules set by Solvency II. The speech was not delivered, because of election purdah, but was actually published by the PRA in July 2017.

Approach to supervision

The PRA has previously referred to its intention to supervise firms according to the "spirit" of the regulatory regime, without expressly suggesting that this would be sufficient as a basis for enforcement proceedings. Its apparent willingness to challenge behaviour which does not meet the "spirit" of the rules even though it is "*compliant with the letter of the regulation*" (the words used by Mr Woods) does not, however, draw this distinction. Of course, for all practical purposes insurers are interested only in the supervisory approach. It is no real comfort to them that formal enforcement proceedings might properly recognise the constraints of EU law if on a day-to-day basis the PRA adopts a gold-plated approach to supervision.

For insurers, the PRA's expectation appears to go beyond taking the purposive approach to Solvency II legislation that is followed by the ECJ. It also appears to go beyond drawing on relevant EU guidance and the wider acquis to understand how the legislation is intended to apply. Mr Woods argues that insurers hoping to amend product terms to achieve a particular outcome under the new Solvency II rules on contract boundaries must be prepared to defend actions which may meet the letter of the regulation (i.e. they are compliant with the rules) but which "are designed to circumvent the spirit".

Specific comments made by Mr Woods that relate to the contract boundary under Solvency II are discussed below. We think the broader approach to supervision described in Mr Woods' speech raises particular concerns, however, when UK rules implement a regime developed and adopted by the EU. In particular:

- The text of EU legislation and EU principles of interpretation determine the meaning of that legislation.
- It is not open to the PRA to apply a different interpretation of the legislation or to overlay the EU meaning with its own judgement.
- Where EU legislation is intended to be maximum harmonising (as is the case for Solvency II), the position is even clearer. Member States are not entitled to set standards that differ from, or go beyond, the rules that have been set by the EU.

For the PRA to discuss its approach to supervision without mentioning these fundamental principles of law is, in our view, disappointing.

When firms interact with the PRA on prudential issues arising under Solvency II, the absence of any realistic practical way of challenging the PRA's approach makes it particularly important for firms that the PRA's approach is justifiable in law.

Judgement-based supervision vs maximum harmonisation

According to Mr Woods, "*supervision cannot be a narrow, tick-box, compliance exercise*". Instead, the PRA's supervisory approach "*relies on a healthy dose of judgement*".

Throughout its life, the PRA has made much of its judgement-based approach to insurance supervision. As an approach, its effectiveness depends on supervisory teams being staffed by individuals with the right expertise and experience of the insurance sector. Equally important, however, is a supervisory framework that gives supervisors the flexibility they need to deal with risks effectively and that does not place unnecessary limits on what they can do.

There is a clear tension, therefore, between judgement-based supervision and EU legislation that is maximum harmonising. The same tension exists more widely with the PRA's overall approach based on "Fundamental Rules" supplementing specific rules derived from EU legislation. Until the UK has completed its exit from the EU, the PRA is bound by the constraints of the Solvency II regime irrespective of whether this undermines its ability to deal with issues flexibly. It cannot simply rewrite, or interpret, the EU legislation in a way that suits it better. Changes need to be negotiated within the relevant EU forum and cannot be made unilaterally by a dissatisfied Member State.

The shape of UK regulation and the PRA's powers after Brexit remain to be defined but changes to the rules at that point, or subsequently, should be the subject of the normal UK consultation process.

The fact that this is understood by the PRA seems to be evident whenever it discusses the possibility of relaxing undesirable aspects of the Solvency II legislation – see, for example, its evidence to the Treasury Select Committee in its investigation of Solvency II. It seems much less evident when the PRA is considering whether it can, through its supervisory approach, impose more onerous regulation – whether in this speech or in its "Approach to Insurance Supervision" (which mentions "spirit" on no fewer than five occasions).

"Gold-plating"

In January 2015, Paul Fisher, then Deputy Head of the PRA, said:

"We ... recognise and respect that Solvency II is a maximum-harmonising Directive with a key objective of promoting supervisory co-operation. The PRA is committed to upholding this valued objective and will implement the Directive as intended. We can't and won't gold plate."

The PRA has repeated this message on other occasions. Despite this, the approach to contract boundaries described by Sam Woods in May, and the invocation of the "spirit of the regulations" more generally, can only be described as "gold-plating". It is not open to the UK, as a matter of law, to set higher standards than are prescribed by the Solvency II regime.

In the context of Brexit, there has been a great deal of speculation about whether the PRA will relax aspects of the Solvency II regime once it is free from EU constraints. Firms should, however, recognise that the PRA may also take the opportunity to impose higher regulatory standards once it is no longer bound by the requirements of maximum harmonisation.

Fundamental Rules

Similarly, Mr Woods argues that the PRA's Fundamental Rules aim to "bake" the spirit of the law into the letter of the regulation. However, the PRA is not entitled to apply the Fundamental Rules in breach of EU law and should not read its statutory objectives set by the UK Parliament as giving it authority to do so.

Contract boundaries

According to Mr Woods:

- Some innovation by firms is "*pure regulatory arbitrage*" – that is, action taken to reduce specific regulatory requirements without any commensurate reduction in their risk.
- Changes to insurance products in order to extend the contract boundary "*might meet the letter of the regulation, but they are designed to circumvent the spirit*".
- In most cases seen by the PRA, amendments have involved "*the addition of free marginal insurance benefits that are of questionable value to policyholders and which are (arguably) not economically discernible*".
- Firms are failing to recognise the additional risks that such proposals to amend contracts carry.

Whether the comments in the third proposition above are correct in any given case will, of course, depend upon the particular changes that are proposed to be made to the policy. It also goes without saying that, where the addition of benefits to a unit-linked policy introduces risk, that risk must be recognised according to the rules in Solvency II.

In our experience, there are circumstances where the additional benefits proposed to be provided to policyholders do have a discernible value, as is required under the relevant EU regulation and EIOPA guidance on contract boundaries. The guidance and associated EIOPA Q&A recognise this possibility and should be taken into account by the PRA consistent with its obligation to "comply or explain".

There is also a good argument that insurers are simply reversing an unrealistic aspect of the Solvency II legislation which puts all future premium payments under unit-linked policies outside the contract boundary, notwithstanding that this treatment is far from economic reality. It is far from clear why this sort of proposal is one which the PRA feels it must challenge or, indeed, why it is the best insurance-related example it could find to illustrate the wider point which is made by the speech.

The fact that firms are choosing to adapt products to ensure that a more realistic economic outcome is recognised under the Solvency II regime, consistent with the rules, should also not be susceptible to challenge simply because the PRA disagrees with how the boundary is drawn in the legislation. This is not regulatory arbitrage but applying the rules as they were intended. The PRA should be required to do the same, irrespective of any concerns it might have about the quality of capital resulting from the extension of the contract boundary.

FCA consults on extending the SMCR to insurance intermediaries

The FCA has published proposals to extend the Senior Managers and Certification Regime (SMCR), which already applies to banks, to other financial services firms. The new rules, which are designed to make individuals more accountable for their actions, will affect insurance intermediaries and their employees.

Key points include:

- The SMCR replaces the Approved Persons Regime (APR).
- Most firms will need to meet certain core standards, although some will benefit from a lighter touch regime.
- For a few, larger firms, the compliance burden will be significantly greater.

Our experience from working with our banking and insurance clients suggests that projects to implement the SMCR should begin now rather than waiting for the outcome of this consultation. We have suggested some next steps for firms to be thinking about now.

The FCA's consultation ended on 3 November 2017. The new requirements are expected to apply from some time in 2019.

This article considers the implications of the FCA's proposals for insurance intermediaries and their employees.

Who is affected by the proposals?

The FCA's consultation (CP17/25) affects all FCA-authorised insurance intermediaries and their employees. In particular, new rules on the certification of individuals will extend to a much wider group of employees than are caught by the APR. New Conduct Rules will apply to all employees other than those on a limited list of "ancillary" staff.

CP17/25 contains separate proposals to apply the SMCR to incoming branches of EEA and non-EEA firms. This aspect of the consultation is not covered in this briefing.

The regime already applying to insurers (the Senior Insurance Managers Regime (**SIMR**)) includes aspects of the SMCR, but has also been designed to meet Solvency II requirements. Because of this, insurers are dealt with under separate consultations issued by the PRA and the FCA and are not covered here.

Timeline for introduction of the SMCR

Although the date for final implementation of the SMCR is unclear, the following timeline is based on FCA comments. One concern for firms is the possibility of a relatively short period between finalisation of the rules and their coming into force. This highlights the importance for firms to begin work now.

One or more further consultations are expected. Outstanding issues include:

- the application of the SMCR to Appointed Representatives;
- operational aspects of the regime, including how firms will transition into it, changes needed to forms and processes for submitting information to the FCA; and
- applying existing guidance on enforcing the duty of responsibility in banks to other financial services firms (see below).

The FCA aims to apply principles of simplicity and proportionality when considering how to transition firms to the new regime. This should, for example, minimise the need for new approvals for individuals already caught by the APR. In practice, however, this is not where the bulk of the work in implementing the SMCR will lie.

Basic requirements of the SMCR – the core regime

The FCA proposes to establish a baseline of requirements, which together make up the "Core Regime". These comprise:

- the Senior Managers Regime;
- the Certification Regime; and
- Conduct Rules.

Most firms will only be subject to the requirements of the Core Regime. However, larger firms (known as "Enhanced Firms") will need to satisfy additional requirements; other, "Limited Scope Firms", will be subject to fewer rules.

The Senior Managers Regime

The **Senior Managers Regime** focuses on the most senior people in the firm. The FCA will define which roles are "Senior Management Functions" depending on the type of firm involved. Anyone who holds a Senior Management Function needs to be approved by the FCA before they start their role, as is the case under the APR. Firms also need to make sure that Senior Managers are suitable to do their jobs, i.e. that they are "fit and proper".

The FCA proposes the following Senior Management Functions for all firms (except Limited Scope Firms):

	GOVERNING FUNCTIONS
SMF9	Chair
SMF1	Chief Executive
SMF3	Executive Director
SMF27	Partner
	REQUIRED FUNCTIONS
SMF16	Compliance Oversight
SMF17	Money Laundering Reporting Officer

A single individual may perform more than one of these functions but approval must be obtained from the FCA for each. Approval may be given on a conditional basis and may be subject to time limits.

In contrast to the APR, the FCA is not proposing to pre-approve all non-executive directors (NEDs), but only (in the case of the Core Regime) the Chair. This is consistent with the approach already taken to banks and insurers.

There is no territorial limitation on who should be appointed as a Senior Manager, and on the obligations Senior Managers have. The rules will apply to anyone who performs a Senior Manager role in respect of the UK business, whether they are based in the UK or overseas.

Each Senior Manager will need to be given a "Statement of Responsibilities" and will have a "duty of responsibility".

Statement of Responsibilities

A Senior Manager's Statement of Responsibilities will be a single document setting out their role and the responsibilities. Firms will need to give the FCA this statement when a Senior Manager applies to be approved, and whenever there is a major change to their responsibilities. The FCA intends to consult separately on the template that should be used for a Statement of Responsibilities and on the method for their submission.

Duty of responsibility

The new misconduct test created by legislation applying to banks will also apply to Senior Managers. Known as the "duty of responsibility", it means that where a breach of the FCA rules is identified within a firm, the Senior Manager responsible for that area of the business will have committed misconduct if the FCA can show that he or she failed to take reasonable steps to prevent (or, if it began before the individual was in role, stop) the breach.

When the FCA is deciding whether to take action against an individual based on the duty of responsibility, it will look at all of the circumstances of the case, including:

- the seriousness of the breach;
- the person's position, responsibilities and seniority; and
- the need to use enforcement powers effectively and proportionately.

The FCA will decide in each case whether action should be brought against an individual or against the firm itself. Action may be brought against both. Decisions will be based on criteria set out in the FCA's Decision and Procedure and Penalties Manual (DEPP). The FCA has issued final guidance on enforcing the duty of responsibility in banks and expects to apply this guidance to firms under the expanded SMCR. However, it will formally consult on these plans.

Allocation of Prescribed Responsibilities

The FCA also proposes, as with the banks' SMCR and the SIMR, to require a defined list of "Prescribed Responsibilities" to be allocated to a Senior Manager. They are designed to ensure that Senor Managers are accountable for the SMCR and for key conduct and prudential risks.

The following Prescribed Responsibilities will apply to all insurance intermediaries other than Limited Scope Firms:

1	Performance by the firm of its obligations under the Senior Managers Regime, including implementation and oversight
2	Performance by the firm of its obligations under the Certification Regime
3	Performance by the firm of its obligations in respect of notifications and training of the Conduct Rules
4	Responsibility for the firm's policies and procedures for countering the risk that the firm might be used to further financial crime
5	Responsibility for the firm's compliance with CASS (if applicable)
6	Responsibility for ensuring the governing body is informed of its legal and regulatory obligations

Enhanced Firms will be assigned additional Prescribed Responsibilities, as described below.

Certification Regime

The **Certification Rules** apply to employees of firms who are not Senior Managers (or NEDs), but whose role means it is possible for them to cause significant harm to the firm or its customers. People performing Certification Functions do not need to be approved by the FCA, but firms will need to check and certify their suitability to do their job at least once a year. The roles that are Certification Functions are very similar to those applying to banks. In the case of insurance intermediaries, the following will be relevant:

- significant management function;
- CASS oversight function;
- functions that are subject to qualification requirements;
- client dealing function;
- material risk takers; and
- anyone who supervises or manages anyone performing one of the functions above.

A firm will need to issue an annual certificate to each employee stating that the firm is satisfied that the person is fit and proper to perform the function the certificate relates to, and setting out what aspect of the firm's affairs the person will be involved in as part of performing their function.

The Certification Regime will only apply to those individuals based in the UK, unless they are dealing with a UK client from outside of the UK, in which case employees based abroad will need to be certified.

Implementation of the Certification Regime, including the annual review of an individual's fitness and propriety for the role they perform, is likely to have a significant impact on HR processes within firms.

Fit and proper test

A key feature of the SMCR is the need for firms to make sure that all Senior Managers and people performing Certification Functions are **fit and proper** to perform their roles. This must be done on appointment to the role and at least once a year.

Criminal records checks will need to be undertaken for Senior Managers. Although they are not caught by the Senior Managers Regime, the same checks will be needed for NEDs.

In addition, regulatory references will be required in relation to Senior Management Functions and Certification Functions (including the requirement to use a standard form template). Conduct Rules, the Fit and Proper Requirements and rules on regulatory references will also apply to all NEDs, even if they are not a Senior Manager. Firms will therefore need to consider how they monitor and oversee the behaviour of NEDs (without them being treated like employees) and ensure their reference processes will cover them.

Conduct Rules

The **Conduct Rules** will apply to every employee with the exception of certain listed "ancillary" staff, such as cleaners, post-room staff or receptionists. The aim is to improve the behaviour and conduct of all employees in financial services firms.

The rules are the same as those applying to bank employees under the current SMCR but have a slightly narrower application. They will apply to behaviour which relates to the firm's regulated and unregulated financial services activities, including any related ancillary activities (rules for banks apply to everything someone does on behalf of a banking firm).

The following Conduct Rules apply to all such employees:

1	You must act with integrity
2	You must act with due care, skill and diligence
3	You must be open and cooperative with the FCA, PRA and other regulators
4	You must pay due regard to the interests of customers and treat them fairly
5	You must observe proper standards of market conduct

An additional set of Conduct Rules apply to Senior Managers, as follows:

SC1	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively
SC2	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system
SC3	You must take reasonable steps to ensure that the delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively
SC4	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice

Training and notification requirements

A key part of the new regime for firms will be ensuring that staff understand the new obligations that apply to them in the context of their particular role. The need for training to differentiate between the various roles held by employees will require some thought when firms are devising programmes to meet the requirements of the new regime.

Firms must also meet additional notification obligations when there has been disciplinary action taken for breach of the Conduct Rules. For Senior Managers, this particular notification must be made within seven business days. This is annually for other staff (although other notification obligations under the FCA Handbook may be triggered earlier). The FCA will be able to take action for misconduct against individuals for breach of the Conduct Rules.

Requirements applying to enhanced firms

Some extra requirements will only apply to the largest and most complex firms, defined as "Enhanced Firms". The category of Enhanced Firms is expected to be relatively small but will include "a firm with total intermediary regulated business revenue of £35 million or more per annum" (approximately 75 firms in total are expected to meet this test).

Enhanced Firms will need to apply all of the requirements under the Core Regime, as well as rules on:

- Additional Senior Management Functions;
- Overall responsibility;
- Additional Prescribed Responsibilities;
- Responsibilities Maps; and
- Handover procedures.

Additional Senior Management Functions

Additional Senior Management Functions must be allocated to a Senior Manager wherever the firm has a person performing that role. The following categories have been created:

SMF 2	Chief Finance Function
SMF 4	Chief Risk Function
SMF 5	Head of Internal Audit
SMF 14	Senior Independent Director
SMF 12	Chair of the Remuneration Committee
SMF 10	Chair of the Risk Committee
SMF 11	Chair of the Audit Committee
SMF 13	Chair of the Nominations Committee
SMF 7	Group Entity Senior Manager
SMF 24	Chief Operations Function
SMF 18	Other Overall Responsibility

The addition of these functions under the Enhanced Regime reflects the fact that larger, more complex firms are likely to allocate responsibility for their performance to different people within the organisation. The FCA takes the view that these individuals should be brought into the Senor Managers Regime.

Overall responsibility

SMF18, described as "other overall responsibility", has been carried across from the SMCR applicable to banks. This means that the "no gaps" principle applies: the FCA says that firms must ensure that every "activity, business area and management function" must have a Senior Manager responsible for it. Activities covered include all unregulated financial services activities and ancillary activities. This individual can either be an existing Approved Person or a new person appointed as SMF18.

Because understanding the precise scope of SMF18 can be difficult, the FCA has provided some guidance in CP17/25. Nonetheless, we expect that some firms, at least, will find defining the scope of this role challenging.

Additional Prescribed Responsibilities

There will be more Prescribed Responsibilities that Enhanced Firms will need to assign to a Senior Manager:

8	Compliance with the rules relating to the firm's Responsibilities Map
9	Safeguarding and overseeing the independence and performance of the internal audit function
10	Safeguarding and overseeing the independence and performance of the compliance function
11	Safeguarding and overseeing the independence and performance of the risk function
12	If the firm outsources its internal audit function, taking reasonable steps to ensure that every person involved in the performance of the service is independent from the persons who perform external audit, including; • supervision and management of the work of outsourced internal auditors • management of potential conflicts of interest between the provision of external audit and internal audit services
13	Developing and maintaining the firm's business model
14	Managing the firm's internal stress-test and ensuring the accuracy and timeliness of information provided to the FCA for the purposes of stress testing

Responsibilities Maps

Enhanced Firms will need to prepare and maintain a single document that sets out the firm’s management and governance arrangements. For more complex firms, this is likely to involve a considerable amount of work.

Handover procedures

Enhanced Firms will need to make sure that a person who is becoming a Senior Manager has all the information and material that they could reasonably expect in order to do their job. Enhanced Firms will be required to put in place a policy explaining how they comply with this requirement and maintain adequate records.

Core Firms can apply to the FCA to "opt up" to the Enhanced Regime if they wish. Firms might consider doing so if, for example, it would be more appropriate to reflect senior responsibilities through use of the SMF18 function.

Limited Scope Firms

The FCA proposes that a reduced set of requirements should apply to a group of firms defined as "Limited Scope" firms. This covers all firms that are already subject to limited application of the APR, including:

- sole traders; and
- insurance intermediaries whose principal business is not insurance intermediation and who only have permission to carry on insurance mediation activity in relation to non-investment insurance contracts.

Next steps

Firms will need to undertake a significant amount of preparation and forward-planning to be ready for the transition from the APR to the SMCR. While fewer individuals are likely to require regulatory approval (as Senior Managers), more individuals are likely to fall into the Certification Regime and many employees will be subject to individual regulatory provisions for the first time with the Conduct Rules.

Some early steps that can be taken include the following:

- Mapping the current business structure, including the legal entity structure;
- Identifying the expertise needed to facilitate delivery, including legal, compliance, risk, audit, training and development, and human resources;
- Briefing the board, board committees, and executive management;
- Identifying the current population of Approved Persons/ gathering existing senior management role descriptions;
- Planning an approach to internal communications during the implementation phase; and
- Planning tailored training programmes for Senior Manager and Certified cohorts and on Conduct Rules compliance for all relevant staff.

Lessons can be drawn from the implementation of the SMCR for banks and from the implementation of the SIMR. We have considerable experience of both and would welcome the opportunity to discuss working with insurance intermediaries on their SMCR projects.

Regulatory

Extending the SMCR to insurers

A guide to the proposed regime

September 2017

The UK **Senior Managers and Certification Regime (SMCR)** is being extended to all financial services firms

- PRA and FCA proposals for insurers build on the **Senior Insurance Managers Regime (SIMR)** although the transition to the SMCR is complicated by the need to satisfy overlapping **Solvency II requirements**
- The rules described in this guide are set out in PRA CP14/17 and FCA CP17/26. They will apply to Solvency II firms and large non-Directive firms **(NDFs)** i.e. insurers that fall outside the scope of Solvency II but with an asset value of at least £25 million

Key elements of the SMCR	Differences from SIMR
1. Senior Managers Regime	
• Individuals (**Senior Managers**) who perform **Senior Management Functions** (**SMFs***) must obtain regulatory approval before taking up their roles • A number of **Prescribed Responsibilities** must be specifically assigned by firms to a Senior Manager • Each Senior Manager must be given a "**Statement of Responsibilities**" or "**SoR**" (previously known as a "Scope of Responsibilities" document) setting out their areas of responsibility • Rules on **fitness and propriety** and regulatory references apply * The term "SMF" is used in FSMA and by the FCA for all types of firm, but the PRA applies the term "S(I)MF" to insurers	• The FCA's Approved Persons Regime (**APR**) is being replaced, with the introduction of **FCA-designated SMFs** for the first time • Expanded list of **Prescribed Responsibilities** • A new "**duty of responsibility**" imposed on Senior Managers aims to make them **individually accountable** for the performance of their duties • "Governance Maps", which describe a firm's governance and management arrangements and how responsibilities are allocated to individuals, will become "**Responsibilities Maps**" (**FCA**) or "**Management Responsibilities Maps**" (**PRA**)
2. Certification Regime	
• Applies to individuals who are not Senior Managers, but whose role means that they could expose the firm or its customers to **significant harm**: ◦ **PRA** – Key Function Holders (**KFHs**) who are not also Senior Managers, and other "Material Risk-Takers" (**MRTs**), will be caught. ◦ **FCA** – Designated functions include "significant management" roles that can seriously impact the way in which the firm conducts its business • **Annual certification** (by firm) of **fitness and propriety** • Rules on regulatory references apply	• Extending the Certification Regime to insurers for the first time is the **area of greatest** change for insurers • Certification Regime is likely to catch **many more members of staff** than fall within the SIMR • Implementation of the new rules, including the annual review of an individual's fitness and propriety for the role they perform, is likely to have a **significant impact** on HR processes within firms • **Early planning** for this aspect of the new regime is particularly important
3. Conduct Rules	
• Conduct Rules will apply to **all staff** other than those performing ancillary roles	• **Significant increase** in number of persons who are directly accountable to the regulators for compliance with Individual Conduct Rules.

Extending the SMCR to insurers

1. Senior Managers Regime

SENIOR MANAGEMENT FUNCTIONS

- PRA will keep its current list of Senior Insurance Management Functions **(S(I)MFs)**
- **FCA-designated SMFs** replace Controlled Functions **(CFs)** currently applying under the APR
- In general, firms will have **fewer FCA-designated SMFs** than CFs – current approved persons who fall outside the new categories of SMF are likely to fall into the Certification Regime
- The "Other Overall Responsibility" SMF introduced by the FCA applies on a "**no gaps**" basis. Firms need to identify every activity, business area and management function (including those carried out from a branch overseas) and allocate responsibility for them either to an existing SMF or to an "Other Overall Responsibility" SMF (of whom there may be more than one)
- The scope of the **Compliance Oversight function** has been widened to cover all FCA regulatory requirements

PRA S(I)MFs

Board Non-executive
- S(I) MF 9 – Chairman
- S(I)MF 10 – Risk Committee Chairman
- S(I)MF 11 – Audit Committee Chairman
- S(I)MF 12 – Rem Committee Chairman
- S(I)MF 14 – Senior Independent Director

Board Executive
- S(I) MF 1 – Chief Executive Function
- S(I)MF 4 – Chief Risk Function
- S(I)MF 5 – Head of Internal Audit
- S(I)MF 2 – Chief Finance Function
- S(I)MF 24 – Chief Operations

Other Insurance Senior Executive
- S(I)MF 22 – Chief Underwritting Officer
- S(I)MF 23 – Underwritting Risk Oversight
- S(I)MF 20 – Chief Actuary
- S(I)MF 21 – With Profit Actuary

Group/Overseas
- S(I)MF 7 – Group Entity Senior Manager
- S(I)MF 19 – Head of Third Country Branch

Business areas with total assets > £10billion or 20% of gross revenue
- S(I)MF 6 – Head of Key Business Area

FCA SMFs

Non-exec
- SMF 13 – Nominations Committee Chairman
- SMF 15 – With Profits Committee Chairman

Executive
- SMF 3 – Executive Director

Compliance
- S(I)MF 16 – Compliance Oversight
- SMF 17 – MLRO
- SMF 23b – Lloyds Conduct Risk

Other business areas
- SMF 18 – Other Overall Responsibility

New function or scope widened

PRESCRIBED RESPONSIBILITIES

- Prescribed Responsibilities must be assigned to Senior Managers
- Three **new Prescribed Responsibilities** (which are to be "shared" by the PRA and the FCA) cover:
  - the firm's performance of its obligations under the Senior Managers Regime
  - the firm's performance of its obligations under the Certification Regime
  - compliance with the firm's obligations in relation to its Responsibilities Map
- The FCA proposes to introduce three new Prescribed Responsibilities (which are not "shared") covering:
  - the firm's performance of its obligations under the FCA Code of Conduct (COCON)
  - compliance with CASS
  - prevention of financial crime
- SoRs are required for all Senior Managers and other KFHs (as under the current regime)

DUTY OF RESPONSIBILITY

- In the event of a **regulatory breach**, the Senior Manager responsible for the area in which the breach occurred could be **held accountable** if they did not take reasonable steps to prevent or stop it.
- **Burden of proof** lies with the PRA or FCA to show that the Senior Manager did not take the steps that a person in their position could reasonably be expected to take to avoid the breach.
- In bringing enforcement action, the PRA and FCA will consider the individual's **Statement of Responsibilities** and the firm's **Responsibilities Map**.
- PRA guidance on enforcement of the duty reproduces the equivalent guidance for banks; the FCA "expects" that the guidance that it has given to banks will also apply to insurers, but that it will consult on this later in the year.
- In practice, it is not clear what additional obligations Senior Managers incur under the duty of responsibility that they have not already held under the SIMR.

2. Certification regime

- Regulatory pre-approval is not needed, but firms will need to certify, on an annual basis, that staff falling within the **Certification Regime** are "fit and proper"
- All **KFHs**, as defined by the PRA under the SIMR, will be within scope unless they are Senior Managers
- **MRTs** i.e. individuals whose professional activities have a material impact on the firm's risk profile will also be covered (again, to the extent that they are not already SMFs or KFHs)
- Other FCA-designated certification functions include (in addition to MRTs):
- **significant management** – roles that can seriously impact the way in which the firm conducts its business (current CF29)
- functions that are subject to **qualification requirements**
- anyone who **supervises a certified person** – this is designed to put in place a clear chain of responsibility between more junior certified employees and the Senior Manager ultimately responsible for the relevant area, and every person in that chain will need to be certified
- persons **performing a client dealing function** – any person dealing with clients, including retail and professional clients and eligible counterparties.
- Whilst the PRA and FCA note that their regimes are co-extensive, there does seems to be some degree of overlap in the functions designated by them, in particular, with regard to the interaction between KFHs, MRTs and "significant management" functions

3. Conduct rules

- Currently, only individuals who carry on a SIMF or CF can be made **directly responsible** to the regulators for compliance with Conduct Rules
- Under the SMCR, the PRA will apply "**Individual Conduct Standards**" and "**Senior Manager Conduct Standards**" to Senior Managers, Notified NEDs (i.e. NEDs who are not performing a S(I)MF) and KFHs
- The FCA intends to apply the Individual Conduct Rules to all non-ancillary staff working at a firm, including all **Certified Employees**

	RULE/STANDARD	REGULATOR	SMFs	NOTIFIED NEDs	KFHs	CERTIFICIED EMPLOYEES AND OTHER EMPLOYEEES, EXCEPT ANCILLARY STAFF
INDIVIDUAL CONDUCT RULES	1. Act with integrity	PRA & FCA	✓	✓	✓	✓
	2. Act with due care, skill and diligence	PRA & FCA	✓	✓	✓	✓
	3. Be open and cooperative with the FCA, PRA and other regulators	PRA & FCA	✓	✓	✓	✓
	4. Pay due regard to the interests of customers and treat them fairly	FCA only	✓	✓	✓	✓
	5. Observe proper standards of market conduct	FCA only	✓	✓	✓	✓
SENIOR MANAGER CONDUCT RULES	6. Take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively	PRA & FCA	✓		✓	
	7. Take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system	PRA & FCA	✓		✓	
	8. Take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively	PRA & FCA	✓		✓	

Extending the SMCR to insurers

RULE/STANDARD	REGULATOR	SMFs	NOTIFIED NEDs	KFHs	CERTIFICIED EMPLOYEES AND OTHER EMPLOYEEES, EXCEPT ANCILLARY STAFF
9. Disclose appropriately any information of which the FCA or PRA would reasonably expect notice	PRA & FCA	✓	✓	✓	
10. Pay due regard to the interests of current and potential future policyholders in ensuring the provision by the firm of an appropriate degree of protection for their insured benefits	PRA ONLY	✓	✓	✓	

NB: The PRA uses the term "Conduct Standards"; the FCA uses "Conduct Rules".

SUMMARY APPLICATION OF THE NEW REGIME

CATEGORY OF PERSON	SENIOR MANAGERS REGIME	CERTIFICATION REGIME	REGULATORY REFERENCES	FITNESS AND PROPRIETY	CONDUCT RULES
Senior Managers, including NEDs performing an SMF	✓		✓	✓	✓
Notified NEDs			✓	✓	✓
Certified Employee* (incl a KFH who is not also a Senior Manager)		✓	✓	✓	✓
Other, non-Certified Employees performing a key function (PRA only)				✓	✓
All other employees (except ancillary staff**)					✓

* **Certified Employee** – Employees who are not Senior Managers or Notified NEDs but whose role may nonetheless have an impact on the firm's business. Includes KFHs and MRTs

** **Ancillary staff** – Employees not covered by any aspect of the regime, such as cleaners and receptionists

Sources of information

PRA CP14/17 "Strengthening individual accountability in insurance: extension of Senior Managers & Certification Regime to insurers"

FCA CP17/26 "Individual accountability: Extending the Senior Managers & Certification Regime to insurers"

What next for the regulators?

- The consultation period for both CP14/17 and CP17/26 closes on Friday, 3 November 2017
- The PRA and FCA intend to publish final policy during 2018
- The extended regime is expected to come into effect some time in 2018

What next for firms?

Our experience of working with our clients on the SMCR and the SIMR suggests that **projects to implement the SMCR should begin now** rather than waiting for the outcome of the PRA and FCA's consultation

Early steps that can be taken include:

- Identify **expertise** needed to facilitate delivery, including legal, compliance, risk, audit, training and development, and human resources
- **Brief** the board, board committees, and executive management
- Plan approach to **internal communications** during implementation phase
- Plan **training programmes** for Senior Managers and Certified cohorts and on Conduct Rules compliance for all relevant staff

Please contact a member of our team if you would like to discuss any of the issues raised by the PRA/FCA proposals further

PRA proposes reforms to Solvency II regime

This article was first published on Thomson Reuters Regulatory Intelligence on 8 November 2017.

The PRA has published the first of three consultation papers (**CP21/17**) on reforming the Solvency II regime. It reflects PRA experience of working with Solvency II since its introduction in January 2016, while covering some of the improvements proposed by the ABI and discussed earlier this year with the House of Commons Treasury Committee (**TC**).

This first consultation paper contains some new guidance from the PRA on firms' use of the Matching Adjustment (**MA**). It also consolidates earlier guidance, allowing firms to comment on the PRA's approach for the first time. The PRA's aim is not to change its existing guidance but to improve a firm's chance of making a successful MA application.

Two further consultation papers in this series will cover:

- Model change process – December 2017
- Reporting – January 2018

The deadline for comments on CP21/17 is Wednesday, 31 January 2018. Firms should consider the draft guidance carefully and, in addition to raising any concerns, should adjust their internal processes as necessary to meet the standards set by the PRA.

Wider context to the proposals

In September 2016, the TC launched an inquiry (the **SII inquiry**) to look at the case for changing, or even replacing, Solvency II in a post-Brexit world. The inquiry was subsequently closed on 3 May 2017, when Parliament was dissolved for the general election.

Nonetheless, evidence provided to the SII inquiry highlighted firms' dissatisfaction with how aspects of the Solvency II regime have been implemented in the UK. The ABI argued that the PRA's approach "goes beyond the requirements of Solvency II in a number of important areas" and *"goes beyond what is necessary for financial stability"*.

Specifically on the MA, the ABI and others have argued that UK implementation of the Directive has been unnecessarily restrictive and that the PRA's approach discourages firms from investing in certain types of asset that are particularly suited to a book of long term liabilities. The PRA argues, on the other hand, that it has taken a flexible approach to implementation of the regime but that its hands are tied by the level of prescription in the Directive.

Proposed changes

The first objective of CP21/17 is to consolidate guidance contained in various publications (mostly in the form of Directors' letters and Executive Director's letters) issued between 1 April 2013 and 15 February 2016 into a single Supervisory Statement. This is helpful. It also means that firms will have an opportunity to comment on that guidance for the first time (it was originally issued without consultation) and with experience of operating within the boundaries of the current guidelines. This may provoke feedback that could not have been anticipated without that practical experience.

The PRA also proposes to include additional guidance on the following issues.

Asset eligibility – demonstrating fixed cash flows

Assets held within a MA portfolio must have cash flows that are fixed in both timing and amount and which cannot be changed by the issuer or any third party (Article 77(1)(b) of the Directive). The PRA proposes to confirm that assets which contain cash flows the timing of which is uncertain, but bounded, can be brought into the MA portfolio, provided that those cash flows are recognised at the latest contractual date and that any additional amount contingent on the timing of cash flows (e.g. additional interest charges) is excluded.

This would cover, for example, bonds which provide for repayments to begin at an undetermined date but which have a fixed latest date for starting. This type of bond may be used on infrastructure projects where loans can have an initial "construction phase". The insurance industry has argued for some time that an insurer with long-term predictable liabilities should be able to invest in well-matched long term assets, such as infrastructure projects.

Criteria for assessing "sufficient compensation"

Where an asset's cash flows are fixed, but can be changed by the issuer or a third party, that asset can still be included in the MA portfolio if the insurer can demonstrate that it will receive "sufficient compensation" to cover the reinvestment risk of replacing those cash flows.

Proposed new guidance from the PRA is designed to allow firms to devise their own criteria for assessing "sufficient compensation" on the basis of the relevant MA liabilities being matched together with the ability to obtain an asset of at least as good quality as the original to replace these cash flows if they are changed by the issuer. The intention is that firms should be able to consider a wider range of assets than under existing guidance.

Changes to MA portfolio

The relevant EU legislation provides that a firm's ability to bring new assets (or liabilities) into its MA portfolio depends on whether they have the same features as assets (or liabilities) already within the portfolio and, therefore, within the scope of the firm's existing MA approval. Updated guidance is intended to help firms carry out this assessment. For example, the PRA expects that a new application would be needed for:

- assets involving restructuring, pairing or grouping;
- infrastructure investments funding a materially different underlying project; and
- assets with a different form of compensation clause from those already included in the MA portfolio.

The PRA also expects new reinsurance agreements, which tend to be bespoke, to need supervisory approval before they can be included in a MA portfolio.

Firms should consider whether the PRA's expectations in this respect given them sufficient latitude. Whilst the relevant EU-level rule must be complied with, it must surely mean *"the same relevant (i.e. relevant to the MA) features"* rather than all the same features.

Consequences of breaching MA requirements

Where a firm's MA portfolio breaches the eligibility criteria set by the Directive, compliance must be restored within two months. The PRA has previously issued guidance that firms should engage with the PRA as early as possible where there is a possibility that the criteria have been breached.

It now proposes that firms should establish appropriate processes to ensure that breaches will be detected on a timely basis. In addition, where a breach is "reasonably" only determined after the date it has occurred (i.e. identified by the firm or notified to the firm by the PRA), the PRA may consider the two month remediation period to have started from the point that a breach is detected or confirmed.

Restructuring asset cash flows using special purpose vehicles (SPVs)

In the lead-up to implementation of Solvency II, many firms were considering how they might restructure assets to fit the MA criteria prescribed by the Directive. The PRA's guidance is intended to help firms decide, on a more informed basis than to date, whether restructuring proposals are likely to be acceptable.

In summary, while the PRA does not rule out the possibility that an intra-group restructuring could satisfy MA criteria (and more general prudential requirements relating to the group), the expectation is that intra-group structures will only be used in exceptional cases. The paper indicates a general preference for structures which resemble as closely as possible an arm's-length transaction. In particular, the PRA expects consideration to be given to counterparty credit risk, in relation to elements of the transaction providing support to the fixed cashflow requirements of the MA portfolio (like liquidity facilities and TRS).

Trading in the MA portfolio

Although the principle underlying the construction of a MA portfolio is that assets will be held to maturity, the Directive acknowledges that some trading of assets may be needed to maintain the required degree of matching to liabilities. Proposed guidance to firms emphasises the limited amount of trading that is permitted within the MA portfolio. Firms must be able to demonstrate that governance and controls are in place to ensure that any rebalancing of assets within the MA portfolio is strictly for the purposes of good risk management.

Future changes

Despite the early termination of the SII inquiry, the TC's report (which was published on 27 October 2017) recommends (amongst other things) that the PRA and industry continue to work together on further amendments of the Solvency II regime and on introducing increased proportionality into the regime.

In CP21/17, the PRA has already confirmed that it is looking at other possible improvements to the Solvency II regime, including in the following areas:

- recalculation of the Transitional Measure on Technical Provisions
- external audit of Solvency and Financial Condition Report.

In the lead-up to Brexit, the PRA will undoubtedly continue to argue that some of the changes to Solvency II being asked for by industry are design faults and not errors in implementation. Once the UK leaves the EU, the design vs implementation debate arguably becomes redundant as the UK will no longer be constrained by Solvency II. In practice, the position is more complex, at least to the extent that the UK wishes to obtain an "equivalence" finding for Solvency II purposes.

Nonetheless, the ABI recognises that the PRA's proposals "are an important step forward" and it looks forward to other areas of concern being addressed.

Brexit – EIOPA publishes opinion on cross-border legacy business

An opinion published by EIOPA on 21 December 2017 raises concerns for UK insurers who have policyholders in EEA states other than the UK. This will include, for example, every life company with annuitants living in an EEA state*, perhaps because they moved from the UK on retirement.

Insurers have been aware of issues raised by Brexit for legacy contracts written (or performed) cross-border since the UK referendum on EU membership. However, it has been widely hoped, to now at least, that a sensible compromise would be reached by the UK government and EU authorities to ensure that firms do not need to embark on expensive and time-consuming processes to avoid detriment to policyholders once the UK finally leaves the EU. Such a compromise currently appears less likely.

EIOPA view – a need to mitigate

In summary, EIOPA warns that UK insurers are unlikely to be able to meet their obligations to EEA policyholder's post-Brexit unless they mitigate the anticipated loss of passporting rights that will come with leaving the single market. It argues that, once UK firms can no longer rely on the passport, they lose their authorisation to carry out insurance activities in other Member States with regard to cross-border contracts. "This includes insurance portfolios in run-off."

It follows that UK insurers will "usually" not be able to pay claims or to fulfil other contractual obligations under pre-existing cross-border policies, despite the fact that those policies will continue to be valid as a matter of contract. The term "usually" has presumably been introduced here because it is a matter of local law whether authorisation is needed to pay claims into a particular jurisdiction. The UK, for example, recognises the ability of non-EEA firms to operate in the UK market on a "non-admitted" basis provided that their activities fall below the threshold set by FSMA for carrying on insurance business in the UK.

EIOPA suggests that mitigating actions available to firms include establishing an EEA subsidiary to act as a "hub" for their EEA business. Capital inefficiencies may, however, make this an unattractive proposition, particularly for insurers who are not writing new business outside the UK and have no intention of doing so post-Brexit.

An alternative solution would be for the UK insurer to obtain authorisation for a third country branch in the relevant EEA jurisdiction(s). This approach carries with it the significant disadvantage, however, that a third country branch (including an EEA branch of a UK insurer post-Brexit) has no passporting rights. Separately authorised branches would be needed, therefore, in every jurisdiction where there are policyholders.

A third solution offered by EIOPA is for the UK insurer to transfer its affected policies to an EEA insurer, which would require a Part VII FSMA transfer. This is, however, a long and expensive process which requires a suitable transferee company to be found or, in some cases, established. A recent warning issued by the PRA to the UK courts also suggests that there are concerns about capacity in the UK to deal with all of the Part VII transfers that would be needed to resolve issues with legacy business.

Will a Part VII transfer work?

In any case, a Part VII transfer does not necessarily provide a perfect solution. For example, what happens when a policyholder who is receiving payments from a UK insurer moves out of the UK after the Part VII transfer has taken place? On the one hand, the UK insurer will usually not be authorised under the relevant EEA state's law to carry on paying claims to that policyholder; on the other hand, it remains contractually obliged to do so. EIOPA has not addressed this issue.

PRA and FCA guidance on Part VII transfers also lacks clarity in this area and could be revisited in support of UK firms. For example, a more flexible approach could be taken to novation's of small numbers of policies in circumstances where a UK insurer has very few policyholders in other EEA states and is able to agree with them to move their policies otherwise than under a Part VII process (at the moment, the guidance suggests that a Part VII transfer might still be needed). The UK regulators' approach to the loss of FSCS protection on transfers might also be reviewed in the context of transfers of policies by UK insurers in response to Brexit concerns.

Creative solutions may also need to be considered. For example, a UK insurance group with an existing, or already planned, EEA subsidiary could decide to offer to receive transfers of all of the affected contracts from all affected UK insurers. The liability (or almost all of the liability) could then be reinsured back to the relevant carrier. We have not considered competition issues at this stage, but such a "multiple transferor, single transferee" Part VII scheme could in theory be accomplished under a single court process with the costs shared appropriately.

Incoming EEA firms

Equally, EEA insurers who currently passport on a branch or services basis into the UK need to consider how they are going to continue servicing their UK policyholder's post-Brexit. They are also caught by EIOPA's announcement. The UK government has confirmed that it will do what is needed to ensure that contractual obligations can be met post-Brexit. However, the PRA has stated that it expects EEA insurers who currently passport into the UK to apply for authorisation to the extent necessary to carry on those activities. This will include EEA insurers who have ongoing payment obligations to policyholders in the UK, at least to the extent that their activities constitute "carrying out contracts of insurance in the UK" for the purposes of the FSMA regime. The approach taken by the UK to "non-admitted" business differs from that in most, if not all, other EEA states. This means that some EEA insurers who currently only do services business in the UK may be able to satisfy themselves that their activities fall outside the UK regime post-Brexit and can therefore avoid the need for authorisation here.

Next steps for firms

EIOPA's comments confirm that UK insurers can no longer assume that a sensible outcome, which is in the interests of policyholders and insurers throughout the EEA, will be reached in Brexit negotiations on legacy contracts. This is despite the fact that the continued enforceability of in-force contracts is arguably just as much a matter of protecting citizens' interests as other issues discussed in the first stage of the Brexit negotiations. Considerable resource will, therefore, need to be devoted to resolving this issue, even by those insurers who only have a handful of policyholders outside the UK. These projects need to begin now to the extent that they have not already been started. EIOPA has advised supervisory authorities that they need to be monitoring insurers' contingency plans carefully, including whether implementation of those plans is "realistic".

*The legal test of whether an insurer is carrying on services business is determined, for life, by the Member State of the commitment (usually, where a policyholder is habitually resident) and, for non-life, by where the risk is situated. This will usually mean that cross-border services are provided where a life company makes payments to annuitants living in another EEA state, although the legal test is one of habitual residence, as opposed to current residence.

UK government proposes regulatory framework for autonomous vehicles

The UK government's plans to establish a regulatory framework for autonomous vehicles were restarted with the introduction of the Automated and Electric Vehicles Bill (the **Bill**). The Bill is the successor to the earlier Vehicle Technology and Aviation Bill, which was scrapped when Parliament was dissolved due to the general election in June 2017.

The Bill proposes to extend compulsory car insurance to include autonomous vehicles. Under the draft legislation:

- primary liability for an accident caused by an autonomous vehicle when in autonomous mode will sit with the insurer of the vehicle where the vehicle is insured (or the vehicle owner where the vehicle is uninsured);
- an injured party (which includes the human driver of the vehicle) will be able to claim compensation from the insurer (or vehicle owner) in line with existing practices; and
- the insurer (or vehicle owner) has a statutory right to claim against any other person who was liable for the accident under existing common law and product liability laws.

By placing primary liability on insurers, the Bill aims to ensure that victims of an accident involving an autonomous vehicle are not left without compensation or forced to pursue complex product liability claims against vehicle and/or software manufacturers. The burden of pursuing such claims will instead fall upon insurers.

The Bill provides two exceptions to this single insurer model:

1. Insurers (and vehicle owners) of automated vehicles will not be held liable where an accident is wholly due to the negligence of the party in control of the vehicle in allowing the vehicle to drive itself when it was inappropriate to do so.
2. An insurance policy may exclude or limit an insurer's liability for damage suffered by an insured person caused as a direct result of software alterations made by the insured person that are prohibited under the policy or failure to install safety-critical software updates.

Comment

The Bill largely replicates the provisions of the earlier Vehicle Technology and Aviation Bill; the requirement that software updates must be *"safety critical"* represents a tightening of the grounds on which insurers may limit their liability to an insured person.

Another notable change is how autonomous vehicles are defined. As was the case in the previous Bill, the Secretary of State will maintain a list of all motor vehicles that are *"designed or adapted to be capable, in at least some circumstances or situations, of safely driving themselves"*. However, the definition of a vehicle *"driving itself"* is now "operating in a mode in which it is not being controlled, and does not need to be monitored, by an individual" – the emphasised wording was not included in the previous definition.

The changes go some way to addressing concerns that were raised regarding the scope of the previous Bill. It now seems clear that vehicles which allow the driver to hand over the entire task of driving, either in all scenarios or where certain road or environmental conditions are met, will be covered. Vehicles which have some level of automation but require the driver to monitor the vehicle and traffic continuously during the journey will continue to operate under the existing regime.

Despite this clarification, areas of uncertainty remain. It is unclear whether the proposed legislation covers vehicles which do not require the driver to monitor the vehicle's progress continuously but will signal to the driver when conditions require the driver to retake control. It is debatable whether the requirement for a human driver to intervene if required amounts to the vehicle being 'controlled' or 'monitored'.

The Automated and Electric Vehicles Bill is still at an early stage and we could see significant changes before it is ultimately enacted into law. Nonetheless, the Bill marks a significant step towards the UK Government's aim of establishing a regulatory framework for autonomous vehicles in the UK.

The development of automated vehicles will have a number of implications for the insurance industry:

- It is expected that levels of safety will improve leading to a fall in road traffic accidents and the number of claims. As a large majority of road traffic accidents are caused by human error, advances in technology towards autonomous vehicles could well have significant implications for road safety.
- While the focus currently is on the *"driverless"* element of such vehicles, the expected *"connectivity"* will lead to cars being able to communicate with road infrastructure and other vehicles which it is expected will lead to a reduction in congestion and accidents. It is expected that the increased safety levels will read to a reduction in insurance premiums. There will be a shift from covering what is understood as traditional motor liability to covering product liability. This will result in a corresponding change in underwriting with an enhanced focus on the technical qualities of the vehicle being insured as opposed to factors related to the driver such as age and driving history which are currently more determinative of the premium.
- It is predicted that there will be a decline in car ownership with increased shared ownership, car share schemes and *"Mobility-as- a-Service"* (**MaaS**) operators. Mobile app based taxi companies may be well placed to take advantage of this trend, replacing their current models with one where users summon a driverless car.

Criminal liability for defective products

When a business discovers that one of its products may be unsafe, its first concerns will often be the negative publicity that will follow a recall and the potential civil claims from end-users and/or other companies in the supply chain. However, the possibility of criminal prosecution should also be given close attention from the outset. The reputational damage from having been prosecuted for a criminal offence can be a significant concern in itself and for the most serious offences (i.e. corporate manslaughter and breaches of health and safety law) companies can face very significant fines under new sentencing guidelines that have been in force since February 2016. In addition, individual directors/employees can in some cases face fines and/or imprisonment. This article discusses the various criminal offences which arise in the context of defective products. We consider in turn offences under the General Product Safety Regulations 2005, the Consumer Protection Act 1987, the Health and Safety at Work etc. Act 1974 and the Corporate Manslaughter and Corporate Homicide Act 2007.

The General Product Safety Regulations 2005

The main regulatory regime that imposes criminal liability on producers and distributors of unsafe products in the UK is set out in the General Product Safety Regulations 2005 (**GPSR**). The GPSR give effect to the European General Product Safety Directive (2001/95/EC) and apply to all products except to the extent that they are subject to sector-specific regulations (e.g. food and drink, toys and cosmetics). The Regulations impose broad safety requirements backed up by criminal sanctions.

Changes to EU law/impact of Brexit

The GPSR is part of UK law albeit its purpose is to implement EU law. It should therefore be covered by the Government's proposed Great Repeal Act (i.e. the saving legislation under which all current UK laws that are derived from EU law will remain in force after the UK leaves the EU unless and until they are specifically repealed and replaced with new national law).

In 2013, the European Commission published a new draft Regulation on Consumer Safety which, when enacted, will repeal the General Product Safety Directive 2001 (i.e. the EU law which is implemented in the UK by the GPSR). If enacted in its current form, the new Regulation will maintain the most important features of the existing regime but there will be some additional requirements including clearer rules for marking products to assist in any recall. Unlike the General Product Safety Directive 2001, the new Regulation on Consumer Safety will have direct effect in all Member States. If the new Regulation is passed by the European Parliament before the UK formally leaves the EU, it will take effect in the UK and will, presumably, then be preserved via the Great Repeal Act. If, on the other hand, it is not passed by the European Parliament before Brexit it will not become law in the UK.

General Safety Requirement

Producers

The core requirement under the GPSR is that producers must not place any product on the market unless it is a safe product (Regulation 5). A safe product is defined broadly in Regulation 2 as one which, under normal or reasonably foreseeable conditions of use, does not present any risk or only the minimum risk compatible with the product's use.

There is a presumption that the general safety requirement is met where the product conforms to either: (i) any applicable specific health and safety requirements laid down by UK law; or (ii) a voluntary national standard which gives effect to a European standard (reference to which has been published in the Official Journal of the European Union). For certain types of products (e.g. refrigerators, freezers, hot water boilers etc.), the producer is required to certify conformance with the relevant EU level safety standards by displaying the 'CE mark' on the product (or, if that is not practical, on its packaging). We are not aware of any discussion as to whether or not these provisions of the GPSR (which incorporate EU safety standards) will be amended when the UK leaves the EU.

Under the GPSR, the very fact of placing an unsafe product on the market is itself a criminal offence. It is an offence of strict liability subject only to the defence of due diligence, which is discussed below. The maximum penalty is a fine not exceeding £20,000 or imprisonment for a term not exceeding 12 months or both.

In many cases it will be clear that a product is unsafe but, in others, the complicated definition provided by Regulation 2 might allow room for uncertainty. Difficult questions could arise from the range of factors to be considered in determining whether a product is unsafe, including:

- the characteristics of the product including its composition, packaging and instructions;
- the presentation of the product, its labelling, any warnings and instructions for use;

- the effect of the product on other products; and
- whether vulnerable consumers, such as children and the elderly, are at risk.

In addition, Regulation 6(3) provides that one factor in assessing whether or not a product is safe is "*reasonable consumer expectations concerning safety*". This underlines the point that different levels of risk will be acceptable in respect of different types of product.

There is a distinction in the GPSR between unsafe products that pose a "serious risk...requiring rapid intervention" and those that do not. Severity of risk is determined through a structured risk assessment (discussed in more detail below). This distinction is primarily relevant to the Government rather than the producer since the Government is required to share information on products posing serious risks via the European RAPEX system but the distinction is also relevant to producers (and distributors) because it affects the speed with which they are expected to notify the authorities. RAPEX is a system which facilitates rapid exchange of information concerning dangerous products between governments of Member States and the European Commission. It remains to be seen whether the UK will continue to participate in RAPEX under the post Brexit settlement.

The relevant prosecuting authority will always have a discretion whether or not to prosecute. Our experience is that the authority will normally choose not to prosecute where the producer is a reputable business and is seen to be taking responsible measures to address the risk created by the product. However, the fact that an offence will often already have been committed by the time the defect is discovered provides the authority with a helpful enforcement tool should the producer not take what the authority considers to be the required remedial action, or fail to do so in the way the authority wishes it to, or within its desired timetable.

Distributors

The equivalent obligation placed upon a distributor is not to supply (or possess for supply or offer or agree to supply) a product that he knows (or should have presumed on the basis of the information in his possession and as a professional) is a dangerous product.

In practice, it is more difficult for a prosecutor to establish that a distributor has committed an offence than it would be in respect of a producer. This is because it is necessary to prove knowledge or implied knowledge on the part of the distributor that the product was unsafe (whereas, for a producer, there is no such requirement). The maximum penalty is the same as for a producer: a fine not exceeding £20,000 or imprisonment for a term not exceeding 12 months or both.

Duty to notify

One of the most difficult judgments to make in practice is when to notify the enforcement authority that a product is (or may be) unsafe. After a producer (or distributor) first becomes aware of a potential issue it will want to carry out tests, which can be time-consuming, to understand the nature and extent of the problem before deciding on a course of action. There may be some uncertainty as to whether or not the product is unsafe and, even if it clearly is, a producer will usually want to establish the risk it poses and, crucially, how many units of the product have been supplied, where and to whom. The most effective recalls in our experience are those in which the producer is able to supply the enforcement authorities with this relevant information and explain what steps it is taking.

Regulation 9, however, requires that once the producer or distributor knows that the product is unsafe (i.e. that it poses risks to the consumer that are incompatible with the general safety requirement) they must notify the enforcement authority "forthwith". European Commission Guidelines to producers and distributors interpret this to mean that notification should be made as soon as relevant information has become available and, in any event, (i) within 10 days,; or (ii) immediately and not later than 3three calendar days where a serious risk is identified. The Guidelines are not strictly binding but are likely to receive judicial notice (this may well be the case even after the UK leaves the EU given that: (i) the wording of the GPSR will remain unchanged and the guidance is therefore still likely to be seen as relevant; and (ii) producing new guidance is unlikely to be a priority for the UK Government).

Failure to notify in accordance with Regulation 9 is a criminal offence and it is committed by a producer or distributor where it is proved that he ought to have known that the product posed risks to consumers that are incompatible with the general safety requirement and failed to notify "forthwith". In our experience, some latitude is given and the enforcement authorities tend to focus on ensuring proper steps are taken to counter the risk rather than on prosecuting companies for technical breaches. However, the position might be different if a consumer has been injured before the authorities are notified. In such circumstances the risk is that the matter will be viewed with the benefit of hindsight and it will be more difficult for the producer/distributor to show that they ought not to have known the product posed a risk. There is, therefore, always some risk in delaying notification.

As noted above, because of the different expectations regarding speed of notification, a company that has determined that a product is unsafe will need to undertake a further assessment to determine whether or not the risk is "serious". The European Commission Guidelines for producers and distributors (referred to above) set out a risk assessment methodology. This requires producers to determine:

- The severity of injury that could be caused by the product (slight, serious or very serious).
- The probability of an injury occurring. This will depend on (i) the proportion of products likely to exhibit the defect,; and (ii) the likelihood of the defect leading to harm. For example, if the defect affects at least 10% of the products and the consequential hazard is likely to occur during normal use, the overall probability of injury is high. If, alternatively, 1% or less of the products are affected and the hazard is less likely to occur, the overall probability of injury is low.
- Whether or not the hazard is likely to affect particularly vulnerable people.
- Whether the danger is obvious or addressed by adequate warnings/safeguards.

Combining the outcomes of these different elements will lead to a classification of low, moderate or serious risk.

Separate Commission Guidelines aimed at member state governments (which are required to determine whether or not a risk is serious for the purposes of RAPEX notification) provide a more sophisticated risk assessment methodology. For example: (i) they provide far greater detail on the classification of different types of injury; and (ii) they require the user to consider the factual scenario that could lead to an injury and to assess separately the probability of each step in that story in order to come to an overall probability of injury. Although 'Member State Guidelines' are not directly applicable to them, producers would be well advised to consider these since they are used by the enforcement authorities. Again, it remains to be seen whether or not the UK will continue to participate in the RAPEX system after it leaves the EU and, if it is does not, what relevance, if any, these Guidelines will have.

Other obligations of producers

Criminal sanctions can also follow non-compliance with the following obligations placed upon producers under Regulation 7:

- The obligation to provide consumers with the relevant information to enable them to assess the risks inherent in a product and to take precautions against those risks where such risks are not immediately obvious; and
- The requirement to adopt measures to enable a producer to be informed of the risks which a product might pose. For example by (i) marking the product or its packaging with the name and address of the producer and the product reference;, and (ii) investigating and, if necessary, keeping a register of complaints concerning the safety of the product.

Other obligations of distributors

Distributors are required under Regulation 8, within the limits of their activities, to participate in the monitoring of product safety by:

- passing on information on the risks posed by a product;
- keeping documentation necessary for tracing the origin of a product and producing it when required; and/or
- co-operating with the enforcement authority and/or the producer to avoid the risk posed by an unsafe product.

Again, these obligations are reinforced by criminal sanctions.

A successful prosecution under Regulations 7 or 8 will result in a fine or imprisonment for a term not exceeding three months or both.

Safety notices

An enforcement authority has the power under the GPSR to serve upon a producer or distributor a variety of safety notices including:

- Suspension notices (Regulation 11) which prevent the producer/distributor, for the period of the notice, from placing the product on the market or supplying it. This type of notice is appropriate where the authority needs time to organise its own safety evaluation of the product.
- Requirements to mark or warn (Regulations 12 and 13). These notices are appropriate where the authority considers the product could pose risks in certain circumstances. The notices ensure the producer/distributor either marks on the product or provides warnings with the product.
- Withdrawal notice (Regulation 14) – which prohibits the producer/distributor from placing the product on the market or supplying it. This is an extreme step and will be taken only if an enforcement authority considers (i) that the product poses a serious risk (requiring urgent action), or (ii) that the action being taken by the producer/distributor to remedy the problem is insufficient.
- Recall notices (Regulation 15) enable the enforcement authority to require a producer/distributor to recall a product. It is a power of last resort and may only be used where other action provided for under the Regulations would be insufficient. Unless the product poses a serious risk (requiring urgent action) a recall notice can only be issued if the action taken by the producer/distributor is unsatisfactory or insufficient and the authority has given not less than ten days' notice of the recall. It is very rare indeed for a recall notice to be imposed on a reputable business since they almost invariably recall dangerous products voluntarily at an early stage.

Contravention of any of these notices is a criminal offence with maximum penalties of a fine not exceeding £20,000 or imprisonment for a term not exceeding 12 months or both.

Defence of due diligence

In relation to each of the offences referred to above, it is a defence for the producer/distributor to show (on the balance of probabilities) that it took all reasonable steps and exercised all due diligence to avoid committing the offence.

Although the burden of proof is only to the civil standard of the balance of probabilities, in practice it is a difficult defence to establish because it requires the corporate entity not only to prove the existence of suitable systems and procedures but, in addition, that the corporate entity sought to ensure that the system was in practice followed correctly. Thus, though the existence of a rigorous regime of safety testing, quality control and inspection might indicate a company has taken reasonable steps – at a structural level – to avoid marketing an unsafe product, demonstration that these rules have been consistently complied with - at a practical level – is also required.

The prosecution of individuals

Regulation 31(2) provides that where a corporate entity is guilty of an offence under the Regulations then, in respect of any act or default which is shown to have been committed with the consent or connivance of, or to be attributable to any neglect on the part of any director, manager, secretary or other similar officer then that individual, as well as the corporate entity, shall be guilty of that offence and shall be liable to prosecution.

Although the wording of the section would appear to potentially include any number of people within a corporate entity holding different positions of seniority, case law has clarified that in most instances the prosecution against individuals will be limited to directors. In the case of R v Boal the Court of Appeal held, in relation to a similar provision in the Health and Safety at Work etc. Act 1974, that the section was only aimed at those who are in "*a position of real authority, the decision makers within the company who have both power and responsibility to decide corporate policy and strategy*".

Consent will be established where a director, knowing of the material facts by which the corporate entity committed the

offence, agrees to conduct the business on the basis of those facts. The prosecution must therefore prove both that the director was aware of the state of affairs and that he agreed to it.

Connivance arises where a director is equally well aware of what is going on but his agreement is tacit. He does not actively encourage what happens, but lets the state of affairs continue. Connivance, therefore, requires the prosecution to prove awareness on the part of the individual, although this can be established by inference.

In contrast, neglect will be established where the director ought to have known about a particular practice given his specific role and position within the company. Neglect, therefore, presupposes the existence of a particular duty on the part of the person charged with the offence. The question will be whether, in any given factual scenario, the director had failed to take some step and whether the taking of that step either expressly fell within the scope of his particular responsibilities or should have done so.

Powers of enforcement authority

The enforcement authority is usually the trading standards office of the local authority in the area where the defective product is first discovered. Trading Standards Officers are given wide powers under the GPSR to conduct investigations, including the power to enter premises and inspect any record or product or any procedure connected with the production of a product, provided it is not covered by legal privilege. In addition, they have the power to seize or detain samples of the product.

It is an offence to intentionally obstruct an officer in carrying out his duties punishable with a fine.

The Consumer Protection Act 1987

The Consumer Protection Act 1987 (**CPA**) gives effect to the European Product Liability Directive (1983/374/EEC) and acts as an umbrella under which detailed regulations applying to some specific types of products (e.g. toys and cosmetics) are promulgated. Other products, such as food and drink, have their own sector-specific regimes out with the CPA. As explained above, where a class of products is subject to a sector-specific regime, the provisions of the GPSR will still apply to the extent that the specific regime does not include an equivalent provision (i.e. the GPSR fills any gaps in the specific regimes).

Part II of the CPA applies to all consumer goods which are ordinarily intended for private use and consumption, save for certain specified exceptions which include food, controlled drugs and licensed medicinal products which (as noted above) are subject to their own sector-specific regimes. Generally, the CPA is narrower in application than the GPSR, since it applies only to (i) the producer of the product, (ii) someone who holds himself out as a producer of the product (for example by applying his own brand mark on a product manufactured by someone else), or (iii) the importer of the product into the EU.

The CPA provides the Secretary of State with the power to make safety regulations and it is under this umbrella that numerous regulations have been made which seek to ensure the safety of goods. Regulations made under the CPA include such diverse matters as the composition, design, construction, finishing or packaging of goods as well as regulations which specify the required approval and testing regimes for specific goods and identify what markings, warnings and instructions should be provided.

The CPA grants the enforcement authority the power to impose suspension notices which are similar to the provision under the GPSR but which may be used where the enforcement authority has reasonable grounds for suspecting that any safety provision has been contravened. The CPA also provides the enforcement authority with similar powers of entry and search to those provided under the GPSR.

The sector-specific regulations made under the CPA are similar in structure to the general regime set out under the GPSR in that they provide a specific safety standard and a means of demonstrating compliance. The specific regulations then refer back to the CPA which contains provisions relating to the defence of due diligence and the liability of individuals, identical to those in the GPSR.

Breaches of Regulations made under the CPA are punishable by an unlimited fine or imprisonment for a term not exceeding six months or both.

The Health And Safety At Work ETC Act

Under the Health and Safety at Work etc. Act 1974, specific duties are placed upon manufacturers and others in relation to articles and substances for use at work.

Under section 6 of the Act it is the duty of any person who designs, manufactures, imports or supplies any article for use at work, so far as is reasonably practicable:

- to ensure that the article is so designed and constructed that it will be safe and without risks to health at all times it is being set up, used, cleaned or maintained by a person at work;
- to carry out or arrange suitable testing to ensure the safety of persons whilst the article is being used at work;
- to take necessary steps to ensure the persons who are supplied with the article are provided with adequate information about its use to ensure that it will be safe and without risks to health at all times when it is being set up, used, cleaned or maintained by someone at work; and
- to ensure that revisions of information are provided.

The duty owed in each case is a qualified one namely to take steps so far as is reasonably practicable. The Act makes it clear that the duty is imposed only so far as the matter is within the control of the employer. The maximum penalty for breach of duties under the Health and Safety at Work etc. Act 1974 is an unlimited fine or imprisonment for up to two years or both.

Corporate manslaughter

Where a defect in a product causes death the Corporate Manslaughter and Corporate Homicide Act 2007 may be engaged. This statutory offence applies only to organisations (individuals can be prosecuted for the common law offence of gross negligence manslaughter) and is designed to punish failures in the way in which an organisation manages or organises its activities which are considered by a jury to be sufficiently serious to amount to gross breach of the duty of care owed to the deceased.

Although the Act has now been in force for almost nine years, we are not aware of a prosecution involving a defective product having been brought. However, the wording of the Act makes clear that it does apply in respect of duties of care owed by organisations involved in "*the supply ... of goods or services (whether for consideration or not)*".

The offence is only committed where there is a gross breach of a relevant duty of care owed by the corporate entity under the law of negligence. The Act sets out relevant duty of care situations which, as noted above, expressly include duties owed by an organisation supplying products.

Importantly the offence is only made out where it can be established that a senior manager, or managers, played a substantial role in the organisation's failure. This means that an organisation will not be guilty of manslaughter where the failure of junior employees causes death and that failure cannot be attributed to a failure by a senior manager or managers.

Management or organisational failure

The central question will be whether the death was attributable to a management or organisational failure. In this context evidence of a failure by a senior manager or managers to follow expected systems and practices to properly identify or rectify a defect in a product which subsequently causes death will be relevant.

During the consultation process, the Government explained that its intention was that:

"The prosecution shall be based not only on the immediate events that led to the death but on the wider context in which those events were able to take place. The wider context could include concepts of corporate culture if appropriate. It could also include a failure to have systems in place or to control risks for the carrying out of particular activities or failure to enforce systems; inappropriate delegation of health and safety responsibilities or inadequate supervision of delegated responsibilities".

The Act itself ensures that broad concepts of corporate culture will be considered by specifically providing that the jury may consider the extent to which the evidence shows there were attitudes, policies, systems or accepted practices within the organisation that were likely to have encouraged any failure. It is likely that the judge in his summing up will specifically direct the jury to have regard to these matters.

The Act itself ensures that broad concepts of corporate culture will be considered by specifically providing that the jury may consider the extent to which the evidence shows there were attitudes, policies, systems or accepted practices within the organisation that were likely to have encouraged any failure. It is likely that the judge in his summing up will specifically direct the jury to have regard to these matters.

A gross breach of a duty of care

A gross breach is defined in the Act as "*conduct falling far below what can reasonably be expected of the organisation in the circumstances*". It is a matter for the jury to decide what standard the organisation should have met and whether the organisation fell far below that standard.

Senior managers

A senior manager is defined as someone who plays a significant role in the making of decisions about how the whole, or a substantial part, of the organisation's activities are to be managed or organised or is someone who is actually managing or organising the whole or a substantial part of the activities.

Whether or not an individual is a senior manager is a question of fact which will be decided by considering all the circumstances. In any prosecution there is likely to be a substantial amount of argument over the identity of the senior managers.

Sentencing

New sentencing guidelines have been in force since February 2016 covering corporate manslaughter and offences under the Health and Safety at Work etc. Act. The guidelines do not apply to offences under the GPSR or CPA (although they do apply to offences relating to the safety of food products which, as noted above, are subject to a separate regime which is outside the scope of this article).

The guidelines, therefore, apply to unsafe products only where there is a prosecution for corporate manslaughter (where a dangerous product has caused death) or under the Health and Safety at Work etc. Act (in the context of a workplace accident involving an unsafe product). We are not aware of any plan to introduce similar guidelines in relation to product safety offences under the GPSR and CPA. However, it may well be that the imposition of higher (and more carefully assessed) fines for corporate manslaughter, health and safety and food safety offences indicates a direction of travel.

The guidelines represent a much more mathematical and structured approach to sentencing corporate manslaughter and health and safety offences than existed previously. The guidelines are based upon the following public policy objectives:

- Sentences (for all offences and all categories of offender) should be proportionate to the offence. A fine must therefore reflect the seriousness of the offence and take into account the financial circumstances of the offender.
- Sentences should punish and deter wrongdoing. Fines must therefore "*be sufficiently substantial to have a real economic impact which will bring home to both management and shareholders the need to comply with legislation*".

The guidelines aim to meet these objectives via a multi-stage approach to sentencing:

- First, a judge must categorise the offence by reference to the level of the company's culpability and the risk of harm it created. In the case of corporate manslaughter there may be relatively little to distinguish between different offenders (since the harm will always be of the most serious kind and the level of culpability must be high for the offence to have been committed). However, the guidance does recognise that some cases will be worse than others (e.g. where there are multiple fatalities and/or other injuries the offence will be seen as more serious than if there was only one fatality and where there may have been additional causes other than the offender's conduct).

- The judge must then consider the size and financial means of the company. The guidelines classify corporate entities by reference to turnover: "*micro*" up to £2 million turnover, "*small*" £2 million – £10 million, "*medium*" £10 million – £50 million and "*large*" more than £50 million. The guidelines also envisage that higher fines may be appropriate for "very large organisations" being "*those whose turnover very greatly exceeds [£50 million]*". Although there is no clarity on what is meant by "*very greatly exceeds*", examples given in the guidance suggest that a turnover of £300 million would not necessarily make a business "*very large*" but a turnover of £900 million might well.
- For a large company (i.e. more than £50 million turnover) the range of fines available on conviction for corporate manslaughter is £3 million to £20 million. What fine might be imposed within this range would depend primarily on the category of offence (i.e. the level of culpability and the severity of harm). For a 'very large company' an even higher fine might be possible.
- This contrasts strongly with the current position. Existing guidance states that an appropriate fine will seldom be less than £500,000 and may be measured in millions of pounds but, in reality, most fines following successful prosecutions have been less than £500,000.
- Finally, the court will, if necessary, adjust the fine to take account of any aggravating or mitigating factors and to ensure that it meets the public policy objectives set out above.

The new sentencing guidelines have led to a number of very significant fines since February 2016 although to date none of these has arisen from prosecution for breach of section 6 of the Health and Safety at Work etc. Act or for statutory corporate manslaughter relating to a dangerous product.

Finally, the Corporate Manslaughter and Corporate Homicide Act empowers the Courts to make Publicity Orders. These require companies to publicise the fact of their conviction, details of the offence and the amount of the fine. The Guidelines indicate that these should normally be imposed as part of the sentence. The Order will specify the place where the public announcement should be made and this should ensure the conviction becomes known to shareholders.

Additional references

R v Boal [1992] 2 WLR 890

European Commission finds that consumer protection legislation is fit for purpose but needs to be applied consistently across EU member states to maximise its effectiveness

The "Fitness Check"

This year the European Commission has conducted a "Fitness Check" of six key consumer protection and advertising protection directives:

- *The Misleading and Comparative Advertising Directive* (2006/114/EC) – which prohibits advertising that misleads traders and regulates comparative advertising.
- The Unfair Commercial Practices Directive (2005/29/EC) – which prohibits misleading and aggressive commercial practices.
- *The Price Indication Directive* (98/6/EC) – which deals with the indication of the selling price and the price per unit of measurement of products offered to consumers.
- *The Unfair Contract Terms Directive* (93/13/EEC) – which protects against the use by traders of standard contract terms which create a significant imbalance in the parties' rights and obligations to the detriment of the consumer.
- *The Sales and Guarantees Directive* (1999/44/EC) – which sets the rules (and remedies) for when products are in conformity with the contract and deals with commercial guarantees.
- *The Injunctions Directive* (2009/22/EC) – which enables injunctions to be obtained if a trader's practice breaches EU consumer law.

The Fitness Check was carried out as part of the Commission's REFIT programme which aims to reduce regulatory costs and make EU law simpler. The objectives of the Fitness Check were:

- to analyse the effectiveness, efficiency, coherence and relevance of the policy pursued by the Directives and whether EU intervention adds value; and
- to look at the extent to which the Directives enhanced consumers' trust and confidence and removed unjustified regulatory obstacles hindering cross-border trade in goods and services.

The Commission separately carried out and published results of a review of the *Consumer Rights Directive* (2011/83/EU). There will be a single follow-up strategy for both of the reviews.

Findings

The Commission found that the Directives are capable of addressing issues facing consumers today so long as they are effectively applied by member states.

The Commission identified issues impacting the effectiveness of the Directives, including that:

- many consumers are not aware of their rights;
- there are shortcomings in available remedies;
- there is insufficient enforcement across member states (with penalties set at varying levels); and
- consumers are often reluctant to initiate lawsuits, particularly where their loss is small compared to costs of litigation.

Recommendations

The European Commission recommended a number of actions to improve the effectiveness, efficiency and coherence of the Directives. These include:

- raising awareness through the creation of a Consumer Law Database, targeted awareness activities and publishing guidance on the Unfair Contract Terms Directive;
- improving enforcement through assessing need for increased penalties, introducing a direct right for consumers to an individual remedy under the Unfair Contract Terms Directive and expanding the scope of the Injunctions Directive to cover more pieces of consumer legislation; and
- improving coherence with other EU consumer and marketing laws including through working with the European Parliament to consider expanding the scope of the proposed Directive for Online Sales of Goods to cover offline sales channels.

The recommendations give an indication of the likely scope of changes that may be proposed although the detail and timeframe of any legislative changes are not yet known. Depending on the timing, the changes may need to be implemented into UK law.

One of the issues investigated was whether the Unfair Contract Terms Directive should be extended to cover business-to-business contracts, specifically to protect SMEs. The Fitness Check found that views were divided on this and no follow-up or conclusions were drawn at this stage.

Additional references

Misleading and Comparative Advertising Directive (2006/114/EC)

Unfair Commercial Practices Directive (2005/29/EC)

Price Indication Directive (98/6/EC)

Unfair Contract Terms Directive (93/13/EEC)

Sales and Guarantees Directive (1999/44/EC)

Injunctions Directive (2009/22/EC)

Consumer Rights Directive (2011/83/EU)

Costs judge finds information from mediation is admissible when considering costs consequences of settlement

(1) Savings Advice Ltd and (2) Zinc Consumer Ltd v EDF Energy Customers Plc [2017] EWHC B1 (Costs)

17 January 2017

A costs judge has held that information about a party's costs provided for the purposes of a mediation could be used as evidence when considering the cost consequences of a subsequent settlement.

Documents produced for the purposes of mediation are generally covered by without prejudice privilege and, subject to limited exceptions, cannot subsequently be used as evidence. In the present case the costs information was provided in emails headed "*without prejudice save as to costs*", so it is perhaps not surprising that the costs judge concluded it could be used as evidence. However, other aspects of the reasoning for the decision are more surprising and arguably not supported by existing authorities regarding the without prejudice rule.

Background

The Claimants brought a claim for damages against EDF Energy Customers Plc (**EDF**). In the run up to a mediation in May 2015, and at the Claimants' request, EDF provided the claimants with a figure for the amount of costs incurred by EDF up to that date. The mediation was unsuccessful but the claim subsequently settled in December 2015 when the Claimants accepted a Part 36 offer made by EDF.

Having accepted the Part 36 offer, the Claimants were entitled to recover their costs from EDF. They had taken out After the Event (**ATE**) insurance and sought to include the premium in their recoverable costs. (It was recoverable in principle, as the policy had been taken out before 1 April 2013; ATE premiums are not recoverable for policies taken out after that date as a result of the Jackson reforms.) The premium was calculated, in part, by reference to the amount of costs that EDF would have been able to recover from the Claimants if it had successfully defended the claim.

The parties disagreed as to the relevant figure for EDF's costs. The Claimants sought to rely on the information that EDF had provided about its costs for the purposes of the mediation and EDF objected on the grounds that the information was confidential and subject to without prejudice privilege.

Decision

The costs judge, Master Haworth, accepted that the costs information had been provided by EDF for the purposes of the mediation but nevertheless held that it was admissible. Although the reasoning in this regard is relatively brief, he appears to rely on three reasons to support this conclusion:

- the statement as to EDF's costs was a statement of pure fact, rather than an admission or concession, and therefore not covered by without prejudice privilege;
- it was provided under cover of emails headed "without prejudice save as to costs" rather than simply "without prejudice"; and
- the whole purpose of the mediation was to achieve a settlement and any costs information given in a mediation must be admissible in order to work out the consequences of any subsequent settlement.

The mediation agreement between the parties also included comprehensive confidentiality provisions (in relatively standard form) agreeing not to disclose or use for any other purpose any material produced for the purposes of the mediation. However the costs judge appears to have concluded that this did not prevent the Claimants from relying on the documents: "*..it cannot be used to suppress relevant information in an assessment relating to the costs of the substantive claim.*"

Admissions and concessions or statements of pure fact

The costs judge held that the costs information was not covered by without prejudice privilege because it was a statement of pure fact rather than an admission or concession. Such distinction has been rejected in previous cases on the basis that requiring parties to a negotiation to constantly analyse whether they are making admissions or factual statements would undermine the privilege's purpose of enabling parties to speak freely in settlement negotiations (see for example the decision of the House of Lords in *Ofulue v Bossert*).

While the protection of admissions and concessions from disclosure is a key aspect of without prejudice privilege, the underlying objective of the privilege is to encourage settlement of disputes by enabling negotiating parties to speak freely. This objective would be undermined if parties discussing settlement had to pre-vet every statement to determine whether or not it constituted a concession. The authorities have therefore confirmed that it is not necessary or appropriate for a court to

try to dissect out admissions and concessions and withhold the privilege from the remainder of negotiations.

The costs judge does not appear to have been referred to the previous authorities on this point and this part of his reasoning is unlikely to be followed in other cases.

Without prejudice save as to costs

The trade-off for the broad remit of without prejudice privilege is that there are certain recognised exceptions to the rule. One such exception is where the parties have agreed to alter the scope of the privilege, such as by marking documents "without prejudice save as to costs" to indicate that the material will be admissible in the context of a dispute as to the costs of the proceedings

In the present case, the fact that the costs information was included in emails headed "*without prejudice save as to costs*" could provide a principled rationale for the costs judge's finding (without needing to rely on an unclear distinction between admissions and statements of fact). However, it appears that the judge proceeded on an unstated assumption that the 'save as to costs' carve out on the emails in question necessarily trumped the fact that the emails were sent for the purpose of a mediation and would therefore normally otherwise attract the full scope of the privilege (under both the normal application of the privilege to mediations and the parties' express confirmation in the mediation agreement that the privilege applied). In doing so, he appears to have been influenced by the fact that the information in question was itself costs-related information, which he had considered 'must' always be admissible in a subsequent costs dispute (see below). It is not clear whether he would draw the same conclusion in relation to more substantive admissions contained in a 'without prejudice save as to costs' communication. Such a conclusion that the marking on a specific document trumped the otherwise existing wider privilege may well be justifiable in many cases. However, the fact that the question turns on the presumed intention of the parties means that whether it would do so in any particular case may depend on the particular circumstances of the case.

Working out the consequences of any subsequent settlement

Another exception to without prejudice privilege is that facts communicated between the parties during negotiations may be admissible as an aid to interpreting any resulting settlement agreement if they are part of the relevant "factual matrix" (*Oceanbulk Trading & Shipping SA v TMT Asia*). It is not clear whether the costs judge had this exception in mind in concluding that the costs figures were admissible because they were necessary 'to work out the consequences' of the subsequent settlement.

It is possible that this exception could provide a basis for allowing costs information provided during a mediation to be used when interpreting the costs provisions contained in a resulting settlement agreement. Whether it would so in any particular case would depend on whether the information was necessary to clarify what the parties had agreed as to costs. However, it is unclear how this would apply to the present case where (i) the settlement agreement in question did not result from the mediation but seven months later by the acceptance of a Part 36 offer and (ii) assessing the amount of costs automatically payable following a Part 36 acceptance does not involve any interpretation or construction of the agreement to settle.

In any event, the costs judge's blanket statement that "*any costs information given in mediation is and must be admissible in order to work out the consequence of any subsequent settlement*" (emphasis added) appears to go well beyond the bounds of the exception as generally understood to date.

Comment

While the costs judge in this case was clearly of the view that costs information given in mediation should be admissible to work out the consequences of a later settlement, that conclusion will not necessarily be followed in other cases, at least where the material is not expressly marked "without prejudice save as to costs". Nevertheless, it may be advisable for parties exchanging costs information in mediation who do not wish the information to be subsequently admissible in relation to costs at a later stage to ensure that this is made clear, including by marking the material as 'without prejudice' without any carve-out for costs.

Additional references

Ofulue v Bossert [2009] UKHL 16

Oceanbulk Trading & Shipping SA v TMT Asia [2010] UKSC 44

Court of Appeal sends further message on mediation: don't drag your heels

Thakkar & Anor v Patel [2017] EWCA Civ 117

25 January 2017

A Court of Appeal decision is the latest instance of the court expressly sending a message to litigants confirming what it expects of them regarding mediation within the court process.

Upholding a first instance decision which it described as "*severe, but not so severe that this court should intervene*", the Court refused to overturn a costs sanction on a party who had agreed to mediate but then "*dragged its heels*" in the discussions over the arrangement of the mediation, to the point where the other party ultimately abandoned the process.

Background

The Claimants were landlords claiming for dilapidations of commercial premises. The tenants had counterclaimed for reimbursement of rent paid when the premises could not be occupied due to flooding. The trial judge awarded damages on both the claim and the counterclaim, with a balance of £28,183.52 (before interest) payable to the Claimant.

In assessing the appropriate costs order, the Court considered (i) a settlement offer made by the Defendants which the Claimants would have failed to beat if not for the addition of interest; and (ii) the parties' conduct regarding aborted attempts to arrange a mediation during a lengthy period when the matter was stayed to allow for ADR.

The trial judge considered that there were real prospects that a mediation would have resulted in a settlement. He noted that both parties had initially expressed willingness to mediate, so it was not a case of simple refusal or rejection or silence. But having reviewed the chronology of events (including contemporaneous correspondence that was apparently not without prejudice, at least as to costs), the Court concluded that "*the claimants were more proactive*" and the Defendant "*was to say the least apparently relatively unenthusiastic or lacking in preparedness to be flexible*". The Claimants had made all reasonable efforts over a period of approximately four months to arrange a mediation but had been thwarted by the defendant being slow to respond to proposals of mediators and suitable dates and, when a clear window was finally agreed, later providing a variety of excuses as to why the dates were no longer suitable.

It was not in dispute that it was in fact the Claimants who had ultimately closed down the attempts to schedule the mediation and decided to have the stay lifted and move forward with the proceedings. The trial judge observed that "*to some extent they can be criticised (for not) continuing to press for mediation and going the extra mile*". However, that was tempered by the finding that "*the reality is that it was the defendants who were the less keen to participate*".

After taking into account the Defendant's conduct regarding the mediation, the judge ordered them to pay 75 per cent of the Claimants' costs of the claim notwithstanding their "well-judged" settlement offer (the Court did not indicate what the costs award would have been in the absence of the adverse findings regarding mediation). The Defendants appealed.

Decision

The appeal was dismissed. Lord Justice Jackson, giving the lead judgment, agreed with the trial judge's characterisation of the parties' respective conduct regarding the attempts to schedule a mediation. He accepted that the Defendants, whilst not refusing outright to mediate, delayed for so long and raised such difficulties that the Claimants lost confidence in the whole ADR process and closed it down.

The Court also agreed that the case was plainly suitable for mediation, highlighting that:

- the dispute was a commercial one, purely about money
- the settlement offers made by the parties were only a small distance apart
- the costs of the litigation were vastly greater than the sum in issue
- bilateral negotiations between the parties had been unsuccessful.

Jackson LJ observed "*In those circumstances I would be astonished if a skilled mediator failed to bring the parties to a sensible settlement.*"

In light of the trial judge's finding that most (albeit not all) of the blame for the aborted mediation lay with the Defendants, the costs sanction was "*a tough order, but it was within the proper ambit of the judge's discretion*". Jackson LJ concluded his judgment with the following message to litigants:

"*The message which this court sent out in PGF II was that to remain silent in the face of an offer to mediate is, absent exceptional circumstances, unreasonable conduct meriting a costs sanction, even in cases where mediation is unlikely to succeed. The message which the court sends out in this case is that in a case where bilateral negotiations fail but mediation is obviously appropriate, it behoves both parties to get on with it. If one party frustrates the process by*

delaying and dragging its feet for no good reason, that will merit a costs sanction."

Comment

The Court of Appeal has in recent years made clear to litigants that it now expects them to be proactive and engage constructively with each other during proceedings to fully explore the potential for the dispute to be mediated – to the point where ignoring a mediation proposal will usually warrant a costs sanction even if the circumstances were such that an outright refusal to mediate would have been justified (*PGF II SA v OMFS*).

The present case confirms that, where mediation is appropriate, the constructive engagement expected by the Court also requires that the parties cooperate and act proactively in the arrangement of the mediation: "*It behoves both parties to get on with it. If one party frustrates the process by delaying and dragging its feet for no good reason that will merit a costs sanction*".

The decision can be seen as the latest in the English courts' continually increasing exhortations for litigants to fully explore any potential for proceedings to be resolved through mediation and to actively engage with each other in this regard.

While there are relatively frequent examples of first instance decisions considering the reasonableness or otherwise of parties' conduct regarding mediation, such decisions do not necessarily present a consistent picture as to where the relevant line will be crossed and they depend to some extent on the particular trial judge's attitude to the merits of ADR generally. However, when such cases reach the Court of Appeal they can, as in this case, provide more reliable guidance on what will and will not be regarded as unreasonable conduct.

This clearly is a warning to parties who might be tempted to formally "*agree*" to a mediation but then rely on logistical "*difficulties*" to prevent it actually proceeding. It should also provide some comfort to parties who are faced with such conduct by their opponents and are deliberating whether they can say "*enough is enough*" and give up on the process. However, such "*innocent*" parties should bear in mind the trial judge's comment in this case that the Claimants' abandonment of the process could also be criticised to some extent (a conclusion which the Court of Appeal mentioned without apparent disapproval) and would be well advised to err of the side of "*going the extra mile*" to exhaust all reasonable efforts to have the mediation proceed.

Additional references

PGF II SA v OMFS [2013] EWCA (Civ) 1288

Contributors

If you would like any more information about Herbert Smith Freehills LLP's insurance and reinsurance disputes group, please visit our website at www.herbertsmithfreehills.com.

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Greig Anderson
Tamsin Baird
Charlotte Benton
Damien Byrne Hill
Nick Case
Susannah Cogman
John Corrie
Anthony Dempster
Dan Eziefula
James Farrell
Rod Fletcher
Ben Goodman
Lachlan Harrison-Smith
Jonathan Heath
Barnaby Hinnigan
Gary Horlock
Tom Hutchinson
Sarah Irons
David Jones
Elizabeth Kantor
Tom Leech
Paul Lewis
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Maura McIntosh
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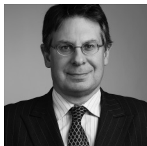
Kate Meakin
Andrew Moir
Clare Montgomery
Ceri Morgan
Grant Murtagh
David Nitek
James Norris-Jones
Alexander Oddy
Jan O'Neill
Chris Parker
Anish Patel
Anna Pertoldi
David Reston
James Rickards
Alison Stonebanks
Donny Surtani
Fiona Treanor
Howard Watson
Simon Watson
Rachelle Waxman
Emma Whitcomb
Daniel Woods

Contacts

Greig Anderson
Partner
Dispute resolution, London
T +44 20 7466 2229
greig.anderson@hsf.com

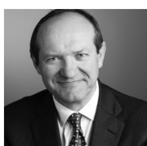


Tony Dempster
Partner
Dispute resolution, London
T +44 207 466 2340
anthony.dempster@hsf.com

Barnaby Hinnigan
Partner
Corporate, London
T +44 20 7466 2816
barnaby.hinnigan@hsf.com

Sarah Irons
Professional Support Lawyer
Dispute resolution, London
T +44 20 7466 2060
sarah.irons@hsf.com

Paul Lewis
Partner
Dispute resolution, London
T +44 207 466 2138
paul.lewis@hsf.com



Geoffrey Maddock
Partner
Corporate, London
T +44 20 7466 2067
geoffrey.maddock@hsf.com

Alison Matthews
Consultant
Corporate, London
T +44 20 7466 2765
alison.matthews@hsf.com

Sarah McNally
Partner
Dispute resolution, London
T +44 20 7466 2872
sarah.mcnally@hsf.com

Alexander Oddy
Partner
Dispute resolution, London
T +44 207 466 2407
alexander.oddy@hsf.com

David Reston
Partner
Dispute resolution, London
T +44 207 466 2244
david.reston@hsf.com

Howard Watson
Partner
Dispute resolution, London
T +44 207 466 2088
howard.watson@hsf.com

Notes

Notes

HERBERTSMITHFREEHILLS.COM

BANGKOK
Herbert Smith Freehills (Thailand) Ltd

BEIJING
Herbert Smith Freehills LLP
Beijing Representative Office (UK)

BELFAST
Herbert Smith Freehills LLP

BERLIN
Herbert Smith Freehills Germany LLP

BRISBANE
Herbert Smith Freehills

BRUSSELS
Herbert Smith Freehills LLP

DUBAI
Herbert Smith Freehills LLP

DÜSSELDORF
Herbert Smith Freehills Germany LLP

FRANKFURT
Herbert Smith Freehills Germany LLP

HONG KONG
Herbert Smith Freehills

JAKARTA
Hiswara Bunjamin and Tandjung
Herbert Smith Freehills LLP associated firm

JOHANNESBURG
Herbert Smith Freehills South Africa LLP

KUALA LUMPUR
Herbert Smith Freehills LLP
LLP0010119-FGN

LONDON
Herbert Smith Freehills LLP

MADRID
Herbert Smith Freehills Spain LLP

MELBOURNE
Herbert Smith Freehills

MOSCOW
Herbert Smith Freehills CIS LLP

NEW YORK
Herbert Smith Freehills New York LLP

PARIS
Herbert Smith Freehills Paris LLP

PERTH
Herbert Smith Freehills

RIYADH
The Law Office of Nasser Al-Hamdan
Herbert Smith Freehills LLP associated firm

SEOUL
Herbert Smith Freehills LLP
Foreign Legal Consultant Office

SHANGHAI
Herbert Smith Freehills LLP
Shanghai Representative Office (UK)

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