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Litigation and Dispute Resolution

Review

EDITORIAL

A number of interesting developments are covered in this month's Review. We report on a Commercial Court ruling on the netting provisions of the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and their relationship to a contractual set-off provision used by the parties (see **Contract**). There are some key messages for finance litigators in the Financial Conduct Authority's 2015/2016 Business Plan (see **Regulatory**). We also cover Burton J's ruling in *Decura IM Investments LLP & ors v UBS AG* which discusses the meaning of "Material Adverse Effect" wording in the termination provision of an exclusivity agreement (see **Contract**).

We report on the Court of Appeal's decision in *Deutsche Bank v Petromena* (a case in which Allen & Overy LLP acted for the successful respondent) where there was found to be a submission to the jurisdiction of the English court by Petromena when it filed a second acknowledgment of service (see **Conflict of laws**). We consider *Alfa Finance Holding AD v Quarzwerke GmbH* a case which illustrates the importance of drafting post-sale "access to documents" clauses carefully to include limitations concerning the purpose for which such a request is made (in the context of a seller requiring post-sale access to a target's documents) (see **Contract**). Finally, we discuss a ruling of the Court of Justice of the European Union which highlights the risk faced by commercial parties receiving financial assistance (eg tax relief) from an EU Member State, that the aid may be incompatible with EU rules on state aid (see **State aid**).

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Contents

Arbitration

GBP 200 MILLION E-BORDERS ARBITRATION AWARD SET ASIDE

Home Department v Raytheon Systems Limited [2014] EWHC 4375 (TCC) (***Raytheon I***), 19 December 2014; *Home Department v Raytheon Systems Limited* [2015] EWHC 311 (TCC) (***Raytheon II***), 17 February 2015

Successful challenges to arbitral awards under s68 Arbitration Act 1996 (the **Act**) are relatively rare. Challenges resulting in the setting aside of an award, removal of the tribunal and referral of the dispute to a new tribunal are even rarer. This decision of Akenhead J to do just that in relation to an arbitral award ordering the Secretary of State for the Home Department (**Home Office**) to pay nearly GBP 200 million in damages is therefore of particular interest. Moreover, such is the importance of the issues raised that Akenhead J has granted permission to appeal both of his decisions.

The dispute involved the termination by the Home Office of a GBP 750 million agreement with Raytheon Systems Limited (**Raytheon**) to design, develop and deliver the e-Borders technology system to the UK Government (the **Agreement**) – a system intended to reform UK border controls.

In July 2010, the Home Office terminated the Agreement on the basis of alleged failure by Raytheon to meet critical milestones for delivery of the system. Raytheon contended that the termination was (a) unlawful, because the Home Office had failed to act "reasonably and proportionately" (as provided for in the Agreement) in exercising its right to terminate, and (b) a repudiation of the Agreement, which Raytheon accepted. An arbitral tribunal (**Tribunal**) agreed with Raytheon and issued a Partial Final Award (**Award**), awarding damages in the sum of around GBP 126 million for what was known as the Transfer of Assets claim, together with further sums and interest, reportedly bringing the total sums awarded to around GBP 200 million.

The Home Office sought to have the Award set aside under s68(2)(d) of the Act on the basis that the Tribunal had failed to deal with all the issues that were put to it, in particular in relation to the grounds for termination (the **Liability Challenges**) and the value of assets transferred after termination (the **Quantum Challenges**).

In respect of the Liability Challenges, the Home Office contended, *inter alia*, that the Tribunal had failed to take into account (a) the legal consequence of the fact that Raytheon had failed to comply with certain notice provisions (which, it was argued, precluded Raytheon from arguing that it was not responsible for any delay) (**Liability Ground 1**); and, in determining whether the decision to terminate by the Home Office was reasonable and proportionate, (b) that all or substantially all of the delay was the fault of Raytheon – as evidenced by the absences of notices required under the Agreement if Raytheon was to contend otherwise (**Liability Ground 2**).

In respect of damages, the Home Office argued, *inter alia*, that, in awarding Raytheon GBP 126 million in damages for assets transferred to the Home Office, the Tribunal had failed to take into account whether increased costs had been incurred as a result of Raytheon's defaults and, if so, whether those amounts should have been accounted for in any damages awarded (**Quantum Ground 3**).

It was Raytheon's position in respect of Liability Grounds 1 and 2 that the reason for the delay was irrelevant – the issue was whether the Home Office complied with the pre-conditions for termination (acting reasonably and proportionately). In respect of Quantum Ground 3, Raytheon argued that it was not an

issue raised by the Home Office in the arbitration (but in any event, that it was dealt with in the Award).

The judgment in *Raytheon I* dealt with the threshold question of whether there had been a "serious irregularity" in the Tribunal's Award for the purpose of s68(2)(d) of the Act and in respect of the Liability and Quantum Challenges. Having determined this issue in the affirmative, Akenhead J then went on (in *Raytheon II*) to determine the appropriate remedy (remittance, set aside or declaring the award to be ineffective).

What is the scope of s68 and when will it be applied?

In Raytheon I, Akenhead J provided a comprehensive summary of the case law establishing the scope, and threshold test for the application of s68 (including in particular s68(2)(d)) – principles of law on which the parties were agreed:

(a) application of s68 is only appropriate where the tribunal has gone "so wrong in the conduct of the arbitration that 'justice calls out for it to be corrected'". The focus of the enquiry is due process, not the correctness of the decision;

(b) the threshold for application of s68 is "high" and the requirement for showing substantial injustice is "designed to eliminate technical and unmeritorious challenges". To meet the "substantial injustice" threshold, the applicant does not need to show that he would have succeeded on the issue; he need only show that his position was "reasonably arguable" and that, had the tribunal found in his favour, "the tribunal might well have reached a different conclusion in its award";

(c) the overriding approach of the courts should be to uphold awards – they should therefore avoid "pick[ing] holes"; and

(d) as for s68(2)(d) specifically:

  (i) a matter will constitute an "issue" under s 68(2)(d) where the "whole of the applicant's claim could have depended upon how it was resolved, such that 'fairness demanded' that the question be deal with". In this regard, there is a failure to deal with an issue where the determination of that issue is essential to the decision reached in the award;

  (ii) the issue must have been put to the tribunal in the same terms as complained of in the s68 application;

  (iii) s68 does not apply if the tribunal has dealt with it "in any way", whether "well, badly or indifferently";

  (iv) a failure to provide reasons is not a failure to deal with an issue;

  (v) there is no failure to deal with an issue if the tribunal has misdirected itself on the facts or drawn unjustified inferences;

  (vi) a tribunal can "deal" with an issue by deciding a "logically anterior point such that the other issue does not arise"; and

  (vii) whether there has been a failure to deal with an issue must be assessed by a fair, commercial and common-sense reading of the award.

Was there a serious irregularity under s68(2)(d)?

Yes. As a matter of fact, Akenhead J found that the Tribunal had failed to grapple with Liability Ground 1. Akenhead J held that had the Tribunal considered this issue, "there is a real chance that it would have to reconsider some of its key findings". Akenhead J also found that Quantum Ground 3 was made out. The fact that this failing had caused "substantial injustice" was evident in the award of GBP 126 million to Raytheon – a sum which might well have been reduced had the Tribunal taken into account costs incurred as a result of any delay by Raytheon.

What was the appropriate remedy (and what is the test for replacing the tribunal)?

In *Raytheon II* and following his findings in *Raytheon I*, Akenhead J had to consider whether simply to remit the Award to the Tribunal for reconsideration (the default position under s68(3)) or to set aside (or declare ineffective) the whole or any part of the Award, a power only to be exercised if the court is satisfied that remittance would be "inappropriate". A separate issue was also addressed by the court, which is whether, on a set aside, the Tribunal should be replaced such that the dispute is heard by a new tribunal altogether.

Akenhead J cited as the test apparently relevant for considering whether to replace the Tribunal the question of "whether a reasonable person would no longer have confidence in the present arbitrator's ability to come to a fair and balanced conclusion on the issues if remitted" drawing from authority under the 1950 Arbitration Act and case law addressing arbitrator misconduct. This test would be satisfied where, for example, the tribunal's original decision "would … make it invidious and embarrassing for him to be required to try to free himself of all previous ideas and to redetermine the same issues.. ".

In deciding to set aside the Award as a whole and direct that the matter be resolved by a new tribunal (noting the paucity of reported cases on s68(2)(d) and drawing some guidance from misconduct and employment law cases), Akenhead J considered of particular relevance the following factors: (a) the more serious the irregularity the more likely it is that setting aside may be the appropriate remedy – the irregularities in this case lay at the more serious end of the spectrum; (b) if, on remittance, the Tribunal nevertheless reached the same conclusions, this might lead to the conclusion that justice had not been done, or had not been seen to be done (a major criterion in determining which remedy was appropriate under s68(3)); (c) there was unlikely to be any serious re-casting of the issues (noting that, if either party sought to raise issues on which it had previously lost and on which it lost again before the new tribunal, an indemnity costs order might follow); and (d) much of the factual and expert evidence already submitted could be re-deployed before the new tribunal (indeed, some of it could be rationalised, given concessions that had been made in the earlier proceedings).

COMMENT

The finding of a serious irregularity in any case is always fact and context specific. However, both *Raytheon I* and *II* are of particular interest, given the relatively few cases that arise for consideration under s68 at all, let alone cases in which a serious irregularity is made out and where the award is then set aside, the tribunal removed and the dispute referred back for resolution by a new tribunal.

Indeed, to the best of the author's knowledge, this is the first time that the English court has taken this course under s68(2)(d) of the Act (the court set aside the award in *Norbrook Laboratories Ltd v A Tank* [2006] EWHC 1055 but on separate grounds, holding that the matters complained of in respect of s68(2)(d) were not made out). The court also set aside the award under s68(2)(d) in *Ascot Commodities NV v Olam International Ltd* [2002] CLC 277, 286(B), but apparently referred it back to the same tribunal for a fresh start ("*I see no reason at all why the people who heard this appeal should not continue to deal with the matter*").)

These two decisions are of interest for the following reasons:

(a) While the principles are well established, *Raytheon I* provides a useful summary of the scope for application of s68 – in general and in particular in relation to s68(2)(d).

(b) *Raytheon II* provides a comprehensive list of some of the factors that may be relevant in determining whether or not it is appropriate in any given case to set aside the award, rather than remit it to the original tribunal (which is the default position) – including the severity of the irregularity, the importance of justice being done (or being seen to be done) and the avoidance of unnecessary duplication and delay. It also contains an indication of the potentially adverse costs consequences of a party seeking to revisit, following a setting aside, an issue on which it was previously unsuccessful.

(c) *Raytheon II* is also of interest because Akenhead J directed that the Tribunal be removed and the matter be resolved anew by a fresh tribunal in circumstances where it is not entirely clear either (a) that this formed part of the application by the Home Office (see para. 3 of *Raytheon I*), or (b) that the court gave any consideration to the power to remove a tribunal under s24 of the Act. That power clearly applies in circumstances where s68 is invoked. Indeed, where the irregularity is serious enough to warrant a set aside, in most cases that will also justify the exercise by the court of its power to remove the original tribunal. However, it is a power that arises only on application by one of the parties.

Given the importance of the issues raised, permission to appeal these decisions was granted by the trial judge. Since then, however, the parties have settled the dispute for a payment by the Home Office to Raytheon of GBP 150 million, as reported by the UK Home Secretary in a letter to a parliamentary committee.

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Conflict of laws

JURISDICTION BATTLE LOST AND *FIONA TRUST* CONSIDERED

Deutsche Bank AG London Branch v Petromena ASA [2015] EWCA Civ 226, 18 March 2015

Following an unsuccessful jurisdiction challenge, a defendant submitted to the jurisdiction of the English Court by filing a second acknowledgment of service. The Court of Appeal also considered the scope of Articles 23 (Jurisdiction agreements) and 5(1) (Matters relating to contract) of the Lugano Convention.[1] In doing so, it placed an important restriction on the principle in *Fiona Trust v Privalov*[2] that jurisdiction clauses and arbitration clauses should be widely and generously construed, noting that this did not extend to all relationships between the parties to the clause. It also confirmed that, where a contractual claim is said to involve a duty to advise, the courts of the place where the party giving the advice collates information and formulates advice will have jurisdiction, rather than the courts of the place where the advice is received.

Background

In 2006 the Norwegian appellant/defendant (**Petromena**) issued bonds under a loan agreement (**Agreement**) in order to finance the construction of oil rigs. The respondent/claimant bank (**DB**) acquired a substantial holding in these bonds thereby acceding to the Agreement which contained an exclusive jurisdiction agreement in favour of the Norwegian courts.

Petromena ran into financial difficulties in 2008 and required additional funding to complete the construction of the oil rigs. DB's analysis concluded that its recovery on its bonds would be optimised if Petromena could secure this further funding. Various discussions took place between DB, Petromena and Petromena's advisers but no further funding was ever provided. The bonds were later accelerated and Petromena went into bankruptcy.

In 2012 DB commenced proceedings in the English Court seeking a declaration of non-liability in respect of complaints made by Petromena in Norway. The Norwegian complaints included allegations *inter alia* that DB had acted as a financial advisor to Petromena and breached various fiduciary type duties.

Petromena filed a first acknowledgment of service challenging the jurisdiction of the English Court and subsequently applied to the English Court for an order declaring that it did not have jurisdiction and that the dispute should instead be heard in Norway. At first instance, Gloster LJ found that the English Court did have jurisdiction on the basis of article 5(3) of the Lugano Convention (to which Norway is a signatory) which provides that, in a matter "relating to tort", a defendant may be sued in the place where the harmful event occurred. Gloster LJ found that: (i) the dispute was a matter relating to tort; and (ii) the place where the

harmful event occurred was England as that was where DB's alleged advice had originated from. Gloster LJ refused Petromena's request for permission to appeal this judgment.

Following Gloster LJ's judgment Petromena filed a second acknowledgment of service before, the next day, writing to DB to say that it intended to apply for permission to appeal from the Court of Appeal. This application for permission to appeal was subsequently granted and the appeal was heard in February 2015.

Second acknowledgment of service constituted submission

DB argued that, regardless of the merits of its appeal, Petromena had submitted to the jurisdiction of the English Court pursuant to CPR 11(8) when it filed its second acknowledgment of service. CPR 11(8) provides that "If the defendant files a further acknowledgment of service…he shall be treated as having accepted that the court has jurisdiction to try the claim". In support of this argument DB relied on *Hoddinot v Persimmon Homes* [2008] 1 WLR 806 where a strict approach to compliance with the materially identical language in CPR 11(5) was adopted.

Petromena argued that the filing of a second acknowledgment of service did not constitute the entering of an appearance for the purposes of Article 24 of the Lugano Convention, which provides that "…*a court of a Member State before which a defendant enters an appearance shall have jurisdiction*…". In addition, Petromena contended that CPR 11(8) ought to be qualified by importing a "reasonable bystander" test whereby Petromena would not be taken to have submitted, when it filed its second acknowledgment of service, if a reasonable bystander would have understood that they were still contesting the jurisdiction of the court. Petromena relied on *Sage v Double A Hydraulics* (unreported, Court of Appeal, 1992), a case under the former RSC Order 12 rule 8.

The court found that Petromena submitted to the jurisdiction of the English court when it filed its second acknowledgment of service, as this constituted the entering of an appearance for the purposes of Article 24 of the Lugano Convention. The Court held that the language of CPR 11(8) was clear and unambiguous and, in preferring *Hoddinot* over *Sage*, found that a reasonable bystander test had no application to CPR 11(8). Whilst such a test may have applied under the RSC, the CPR was a new code which represented a change of culture by the courts.

The correct approach for a defendant who wished to appeal an unsuccessful jurisdiction challenge was to seek an extension of time for the filing of a second acknowledgment of service pending the outcome of its application for permission to appeal and, if permission was granted, the determination of the appeal.

Appeal of Gloster LJ's first instance decision

The Court of Appeal's finding that Petromena had submitted to the jurisdiction of the English court meant that it did not need to consider whether Gloster LJ had been right to find that the English Court had jurisdiction under Article 5(3) Lugano Convention. However, possibly because the appeal raised a number of important questions of law, the Court of Appeal went on to consider this question which focused on Articles 23 and 5(1) of Lugano.

***Fiona Trust* – what is the relevant relationship?**

Petromena contended that the Norwegian courts had jurisdiction under Article 23 Lugano Convention, as the allegations made by Petromena in Norway (as mirrored in DB's claim for negative declaratory relief) arose out of or in connection with the bonds, the terms of which were governed by the Agreement containing the exclusive Norwegian jurisdiction agreement.

Article 23 provides that "*if the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction*". An established line of case law, including the English law case of *Fiona Trust*, has established that jurisdiction clauses should in general be read widely. The reasoning behind this line of authority is that commercial parties are considered likely to have intended that any dispute arising out of the relationship into which they have entered be decided by the same tribunal.

Whilst the Court of Appeal agreed that jurisdiction agreements should in general be read widely in accordance with *Fiona Trust*, there must be a limitation to the scope of the commonly used words "*arising out of or in connection with*". In addition, it was noted that English law was not decisive on this point given its European context.

Longmore LJ focused on the words "*in connection with a particular legal relationship*" in Article 23 and referred to the case of *Powell Duffryn Plc v M Petereit* C-214/89, 1992 which found that the purpose of these words was "*to avoid a party being taken by surprise by the assignment of jurisdiction to a given forum as regards all disputes which may arise out of its relationship with the other party to the contract and stem from a relationship other than that in connection with which the agreement conferring jurisdiction was made*". Longmore LJ stated that if parties make a loan agreement in a "traditional form" and then some years later enter into an entirely different agreement or commitment which will impose fiduciary (or similar) duties of loyalty and avoidance of conflict on the party who originally made the loan, it is not at all obvious that the parties will intend or expect the jurisdiction provision of the loan agreement to apply to the entirely new relationship between them. The first relationship is an ordinary arms-length commercial one of lender and borrower; the second relationship of adviser and advisee is much more than an arms-length commercial relationship and effectively entirely different from it because of the requirement to put the advisee's interests first in preference to the adviser's own. A dispute arising from a breach of this second relationship does not arise out of the original loan relationship. Nor does such a dispute arise in connection with that relationship; the relationship of adviser/advisee is so different from the arms-length relationship of commercial lender that the connection with the original relationship has "virtually vanished".

Quoting Lord Hoffmann in *Fiona Trust* that: "*In my opinion the construction of an arbitration clause should start from the assumption that the parties, as rational businessmen, are likely to have intended any dispute arising out of the relationship into which they have entered or purported to enter to be decided by the same tribunal.*", Longmore LJ took this to mean that the width of the clause is thus to apply to disputes arising out of the relevant "relationship". The dispute in the present case did not arise out of the relationship entered into by Petromena and DB which contained the jurisdiction clause but out of an altogether different (and much closer) alleged relationship. This adviser/advisee relationship was not sufficiently closely connected with the Agreement as to fall within the scope of the Norwegian jurisdiction agreement.

Article 5(1) – Matters relating to contract

Petromena argued that Gloster LJ had also been wrong to find that the present dispute was a matter "*relating to tort*" for the purposes of Article 5(3) of the Lugano Convention. Petromena argued that the dispute ought properly to be characterised as a matter "relating to contract" for the purposes of Article 5(1) and that the place of performance of that contract was Norway not England.

The Court of Appeal did not feel the need to rule on this issue as it concluded that, even if it was a matter "relating to contract", the place of performance of that contract would be England as, applying *Wood Floor Solutions* [2010] 1 WLR 1900, that was where the bulk of DB's alleged advisory services were performed.

The court held that an advisor performs its services in the place where information is collated and the advice formulated, rather than the place where that advice is received. In this case, the relevant individuals at DB had been based in London and had carried out the bulk of their work from London. The English Court therefore had jurisdiction regardless of whether the claim was characterised as contractual or tortious.

Allen & Overy LLP acted for the successful claimant/respondent, both at first instance and in the Court of Appeal.

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[1] Whilst this judgment refers to the Lugano Convention, its findings are equally applicable to the Brussels Regulation.

[2] [2008] 1 Lloyds Rep 254.

APPLICABLE LAW FOR WHETHER A CONTRACT HAS BEEN VALIDLY EXECUTED BY A FOREIGN COMPANY

Integral Petroleum SA v SCU-Finanz AG [2015] EWCA Civ 144, 26 February 2015

Whether a company had validly executed a contract was to be determined according to the laws of that company's place of incorporation and not the contract's governing law clause.

In the context of an application to set aside a default judgment, Popplewell J had to decide which law applied to an issue concerning whether a contract was binding on a Swiss company.

Integral and SCU, both Swiss companies, had entered into an oil supply contract subject to English law and jurisdiction. Integral alleged a breach of this contract. In the present application, to set aside default judgment, SCU argued (among other things) that the contract was not binding on the basis it had not been executed properly.

Swiss law states that where a power of signature has been given jointly to more than one "prokurist" (a representative of a Swiss company), as was the case for SCU, signatures of all prokurists are required for a document to be executed validly. The contract between Integral and SCU had only been signed by one prokurist on behalf of SCU. As such, SCU argued that the agreement was not binding on SCU because it was not signed by "all" of SCU's prokurists (namely, two of them). At first instance, Popplewell J agreed. Integral appealed.

Characterisation of the dispute – validity or capacity?

It was not in dispute that the approach to resolving conflict of laws issues is as summarised by Mance LJ (as he then was) in *Raiffeisen Zentralbank Österreich AG v Five Star Trading LLC* [2001] EWCA Civ 68. The first step is to characterise the issue which divides the parties.

Integral argued that the issue should be characterised as whether the contract was valid for want of a second signature. The validity of the contract was a matter to be determined in accordance with Article 11 of Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (the **Rome I Regulation**). Under the Rome I Regulation, a contract is valid where it satisfies the requirements of its governing law, which in this case was English law. Integral also argued that, in a contract governed by English law according to the choice of the parties, it would be anomalous and uncommercial that the parties should be pointed to a foreign system of law to determine whether the contract has been executed validly.

Integral argued in the alternative that The Overseas Companies (Execution of Documents and Registration of Charge) Regulations 2009 (the **2009 Regulations**) applied. The 2009 Regulations modify the Companies Act 2006, and set out the formalities for an overseas company validly to execute a document. The Companies Act 2006, as modified by the 2009 Regulations, states that a contract is deemed to have been duly executed when it *purports* to be signed in accordance with s44(2) Companies Act 2006, in that it was signed by a person acting under the authority of the company in question.

In contrast, SCU argued that the issue to be decided was whether SCU could contract by means of the signature of a single prokurist. This was a question of whether the act of entering into the contract could have been attributed to the company. SCU relied on English common law rules concerning the capacity of corporations to enter transactions (the law governing questions of corporate capacity is not determined pursuant to the Rome I Regulation as questions of corporate capacity are excluded from the scope of the Regulation). In summary, the common law rules state that all matters concerning the constitution of a corporation are governed by the law of the place of that company's incorporation. SCU argued that the issue was whether the company had *capacity* to enter the contract, by reference to the company's constitution and Swiss law.

Decision

Floyd LJ delivered the main judgment, and dismissed the appeal. Floyd LJ held that SCU was correct, as was Popplewell J at first instance, that the issue between the parties should be characterised as whether the single prokurist had authority to bind SCU. The point was governed by the common law rules concerning the capacity of corporations to enter transactions. This was a matter for SCU's constitution as governed by Swiss law, the place of SCU's incorporation. Under Swiss law, the signature of a single prokurist could not bind SCU. This was not a matter for the Rome I Regulation, as the Rome I Regulation states it does not apply to the legal capacity of companies.

The Companies Act as modified by the 2009 Regulations did not assist Integral because the contract did not purport to be signed by a person acting under the authority of SCU. To determine the authority of SCU, it was necessary to consider the requirements under Swiss law, in this case for the signature of two prokurists, and the contract did not purport to be signed in this way.

COMMENT

This case highlights the importance of ensuring when entering into a transaction that the transaction documents are properly executed in accordance with the law of the place of incorporation of the contracting parties and not simply as a matter of the law chosen by the parties to govern their substantive obligations. As such, it emphasises the need to obtain a legal opinion from local lawyers confirming that signatories have authority to bind the relevant party. It also demonstrates the importance at the disputes stage of the first stage of the approach to resolving conflicts of laws. Characterising the issue in dispute in this case as a matter of the authority of the signatory meant that Rome I Regulation did not apply, and that the applicable laws were those of the company's country of incorporation.

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Contract

MEANING OF "MATERIAL" AND "MATERIAL ADVERSE EFFECT" IN TERMINATION PROVISION

Decura IM Investments LLP & ors v UBS AG, London Branch [2015] EWHC 171 (Comm), 30 January 2015

Material adverse effect and material adverse change (**MAC**) clauses frequently appear in finance and M&A contracts, but they are not often interpreted by the courts. In this case Burton J considered the meaning of "material" and "material adverse effect" in deciding whether a termination event had occurred under an exclusivity arrangement.

Decura sought a declaration that it was entitled to terminate an introduction and outsourcing agreement (the **Agreement**) between the parties on the grounds that UBS had triggered a termination event under the Agreement.

Under the Agreement, UBS agreed that it would cease to develop or obtain from third parties' financial products and services defined in the Agreement as 'Exclusive Business Services' (**EBS**) and to acquire any

EBS products required by UBS investment bank (**IB**) or its clients from Decura. In general terms: (i) UBS agreed to market EBS to its clients; (ii) Decura agreed not to enter into any agreement to provide EBS to a third party; and (iii) both parties agreed to share the revenues from EBS products sold to UBS's clients.

The Agreement was of unlimited duration, but provided for certain termination events. In particular, Decura could terminate the Agreement if UBS "ceases to carry on a material part of its UBS IB business at any time" and "…such cessation… has a material adverse effect on UBS IB's ability to market the Exclusive Business Services".

Effect of restructuring of UBS's investment banking business

After the Agreement was signed, UBS announced a strategy called "Project Accelerate". Project Accelerate sped up the restructuring of UBS's investment banking business, which was already underway as part of a previously announced "Simplification strategy". The issue before the court was whether the changes made to UBS's investment banking business as a result of Project Accelerate would constitute a termination event, entitling Decura to terminate the Agreement.

Burton J summarised the issues for determination as follows:

- Issue 1 – What was the effect and meaning of the word "material" in the provision?
- Issue 2 – Did Project Accelerate have the effect that UBS ceased to "*carry on a material part*" of its business?
- Issue 3 – If there was such a cessation of a material part of the business, did that have a "material adverse effect" on UBS's ability to market the EBS?

Issue 1 – What was the effect and meaning of the word "material"?

Burton J made a number of observations that were common to both usages of "*material*" in the clause:

- The parties had not adduced expert evidence as to what was material to a banking business.
- It was common ground that the answer was objective and, in particular, did not depend on what Decura believed was material when it served notice of its entitlement to terminate.
- Materiality must be assessed at the relevant time, which Burton J found to be when Decura served its notice.
- There are degrees of materiality (*Grupo Hotelero Urvasco SA v Carey Value Added* [2013] EWHC 1039 applied), and the consequences for this case were that if both tests of materiality were satisfied an important commercial contract could be terminated.

As to the spectrum of materiality, Burton J found that both parties were correct that, based on Blair J's analysis of similar words in *Grupo Hotelero*, "material" could be equated to "substantial" or "significant" in the context of the factual matrix of the contract. UBS submitted that, on the facts, "material" must be construed by reference to a "very high threshold" (ie very significant or substantial). Burton J concluded, however, that he did not need further assistance by the insertion of the word "very" but would, where necessary, assess materiality within the relevant factual matrix without determining it as a separate issue.

Issue 2 – Did UBS cease to "carry on a material part" of its business?

Burton J acknowledged that Project Accelerate was a "much more dramatic" move than the "Simplification strategy". It was, however, clear from the evidence and the name of the project, that Project Accelerate was an acceleration of an existing strategy. Project Accelerate involved "significant changes" and a "shrinking" of UBS IB. There had been a reduction in the business by the fixed income department and a "substantial cutting back" of the number of structured products on offer, which led to a reduction in the sales of structured products.

However, Burton J held that "there was no cessation of a part of the business of UBS IB". No specific part of the business had ceased as not all structured products were exited. Ceasing to trade in "very complex, punitively high-risk weighted asset structured finance products" whilst continuing to provide clients with "various fixed income services" did not amount to cessation of a part of the business and some of the

changes had occurred as part of the "Simplification strategy", to Decura's knowledge, before the Agreement.

As there were many different aspects to UBS's IB business, Burton J found that "the clause must be construed by reference to the identification of a specific part of the business, and none such is identified".

Burton J therefore found in favour of UBS without needing to address the question of "materiality". Burton J noted that the percentage reductions in the sale of structured products and of the size of the sales force and the client base of the fixed income department, for example, were significant. In light of the factual witness and documentary evidence, and the absence of an expert witness, however, Burton J considered there would be "real doubt" whether of themselves they would constitute a "material" cessation of a part of UBS's IB business.

Issue 3 – Was there a "material adverse effect" on UBS's ability to market the EBS?

As Burton J found in favour of UBS on Issue 2, he considered Issue 3 on a hypothetical basis only.

The parties agreed Issue 3 was an objective test. The onus was on Decura to establish that there had been an actual (not likely) material impairment of UBS's ability to market the EBS. It was not a question of material adverse effect on sales.

Burton J noted that the "material" impairment of UBS's ability to market the EBS must result from Project Accelerate and not from changes prior to Project Accelerate. This was because the exit from complex structured products was in place prior to the Agreement as part of the "Simplification strategy" and Decura was aware of this.

Burton J found that UBS's witnesses gave "detailed and persuasive" evidence about the extent and ability of UBS IB's sales force and Decura did not adduce any expert evidence to counter UBS's evidence. On the evidence, Decura failed to establish that Project Accelerate had a "material adverse effect" on UBS's ability to market the EBS.

COMMENT

Material adverse effect and MAC clauses commonly appear in finance and M&A agreements. Such clauses are, however, rarely interpreted by the courts and there has been little certainty as to their operation and effectiveness. The High Court decision of *Grupo Hotelero*, which we covered in our May/June 2013 Litigation Review, offered greater clarity as to the operation of MAC clauses in loan agreements.
The present case applies the principles set out in *Grupo Hotelero* and provides further useful guidance on the courts' approach to the meaning of "material" and "material adverse effect" in the context of a different type of commercial contract.

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ENGLISH CASE ON NETTING AND SET-OFF UNDER THE 1992 ISDA MASTER AGREEMENT

MHB-Bank AG v Shanpark Ltd [2015] EWHC 408 (Comm), 25 February 2015

In a summary judgment that turned on the proper construction of the 1992 ISDA Master Agreement, Mr Justice Cooke in the Commercial Court has affirmed that the payment netting and close-out netting provisions of the Master Agreement are limited to amounts due under the terms of the Master Agreement. Amounts payable under any other agreement can only reduce the Early Termination Amount to the extent they can be set off. The judgment also considers *obiter* whether the contractual set-off provision added to the Master Agreement in this case was wide enough to permit a claim for unliquidated damages to reduce the Early Termination Amount.

This ruling focuses on the netting provisions of the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and their relationship to the contractual set-off provision used by the parties in this case.

Each of the three defendants had entered into a Sterling Term Facilities Agreement (a **Loan Agreement**) with Anglo-Irish Bank plc, which on 1 July 2011 became the Irish Bank Resolution Corporation (the **Bank**) and each, to hedge its interest rate risk on loans drawn down under the Loan Agreement, had entered into related swaps with the Bank under a 1992 ISDA Master Agreement (Multicurrency – Cross Border) (the **Master Agreement**). Each Master Agreement was materially the same and had been amended, by a provision in the Schedule, to insert a contractual set-off provision in Section 6, as a new provision Section 6(f). This provision tracked the basic set-off provision contained in ISDA's User's Guide to the 1992 ISDA Master Agreements (at p56).

As the facts were essentially the same in relation to each defendant, Cooke J focused in his judgment on the defendant, Shanpark. One important fact was that Shanpark entered into the Loan Agreement with the Bank in December 2012, replacing all previous loan agreements. The swaps had been entered into under a Master Agreement concluded on 10 October 2007. So, the Loan Agreement post-dated the Master Agreement. Although it is not expressly stated in the judgment, presumably the same was true in relation to the other two defendants.

On 7 February 2013 the Bank was put into liquidation in Ireland, which constituted an Event of Default in relation to it. Shanpark did not exercise its early termination rights under the Master Agreement, but instead relied on Section 2(a)(iii), which provides that the payment and delivery obligations of a party under each Transaction under the Master Agreement are subject to the condition precedent that no Event of Default or Potential Event of Default has occurred in respect of the other party and that no Early Termination Date has occurred or been effectively designated.

On 20 December 2013 Shanpark repaid its loans in full. This constituted an Additional Termination Event under the Master Agreement, and the Bank as the Non-affected Party designated an Early Termination Date under Section 6(b)(i) of the Master Agreement, resulting in an Early Termination Amount, the amount of which was not disputed. The Bank notified Shanpark of this amount by letter on 6 January 2014, and it became payable to the Bank under Section 6(d)(ii) two business days later on 8 January 2014.

On 14 May 2015, the Bank, as part of its winding up, assigned to MHB-Bank AG (**MHB-Bank**) its claim for the Early Termination Amount due by Shanpark. MHB-Bank sought payment of the Early Termination Amount by these proceedings which it commenced on 24 June 2014.

Previously, Shanpark had separately sued the Bank alleging mis-selling of the swaps, in proceedings commenced on 26 November 2013 (the **Parallel Proceedings**).

When MHB-Bank sued for payment of the Early Termination Amount, Shanpark sought to net or set off (under Section 2(c) (Netting) and/or the inserted Section 6(f) (Set-off) of the Master Agreement) its unliquidated damages claim for mis-selling in the Parallel Proceedings against the Early Termination Amounts sought by MHB-Bank. Shanpark also alleged that, in its defence and counterclaim in the Parallel Proceedings, the Bank had exercised its contractual rights of set-off under the Loan Agreement and/or under Section s6(f) of the Master Agreement and the rights of MHB-Bank, as the Bank's assignee, were limited by and subject to that set-off.

The key issues considered by Cooke J, were the proper construction of Section 2(c) (Netting) and Section 6(e) (Payments on Early Termination) of the Master Agreement, the proper construction of the inserted Section 6(f) (Set-off) of the Master Agreement and the interrelationship between these provisions and certain provisions of the Loan Agreement. Cooke J also considered the effect of the Bank's statement of case in the Parallel Proceedings. There are some other interesting observations that are summarised in our "Comment" below.

One point to note when reading the judgment is that Cooke J makes the relatively common error of referring to the early termination of the Master Agreement, rather than the early termination of the Transactions. As a matter of construction, the Master Agreement is not terminated by notice designating an Early Termination Date under Section 6(a) or 6(b), and there is nothing in the judgment to suggest that the parties had amended the Master Agreement in this regard to provide otherwise. Cooke J set out the relevant provisions of the Master Agreement in his judgment in some detail. Fortunately, his analysis does not turn on this distinction. It is respectfully suggested that such references in his judgment can be read as shorthand for early termination of the Transactions, and the remainder of this note, for the sake of precision, will refer to early termination of the Transactions.

The difference between netting and set-off

Cooke J recognised that for the purposes of the Master Agreement "netting and set-off are two distinct concepts". Netting relates to amounts due under the Master Agreement (whether before or after early termination of the Transactions), while set-off permits (in certain circumstances) amounts payable under any other agreement to reduce the Early Termination Amount, which is in itself the result of close-out netting following early termination.

Netting under Sections 2(c) (Netting) and 6(e) (Payments on Early Termination)

Cooke J recognised that there are two separate netting regimes in the Master Agreement, payment netting under Section 2(c) and close-out netting under Section 6(e).

In relation to the first regime, payment netting, Cooke J noted that Section 2(c) ceases to apply once all of the Transactions have been terminated by the giving of a notice designating an Early Termination Date under Section 6. Furthermore, Section 2(c) only relates to amounts payable "on any date", "in the same currency" and "in respect of the same Transaction" (or more than one Transaction if the parties have so elected, which they did not in this case).

Cooke J made clear that there is no room for the setting off of unliquidated damages under Section 2(c) of the Master Agreement. He dismissed Shanpark's submission that the wording of Section 2(c) is very wide and could encompass a claim for mis-selling which arises "in respect of the same Transaction." Cooke J gave a number of reasons why Section 2(c) was inapplicable in the circumstances, including the following:

- Once the Master Agreement has been terminated there is no outstanding Section 2(a) payment obligation in respect of which netting or set-off could occur.
- Section 2(c) is concerned with "netting" of sums "specified in each Confirmation", namely those

which are payable under Sections 2(a)(i) or 2(e) on the same date, in the same currency and in respect of the same Transaction. It has nothing to do with the Early Termination Amount payable under Section 6(e) or any set-off against it in respect of any amount payable under another agreement under the inserted Section 6(f).

- Unliquidated damages are not payable in respect of the same Transaction and arise outside of the Master Agreement altogether.
- Section 2(c) relates to obligations to pay arising on the same date. Any mis-selling cause of action arose long before the Early Termination Amount became payable.
- Unliquidated damages are not "payable" as they only become "payable" at the point at which they are ascertained by a court or agreed by the parties, which had not yet happened at the time of this judgment. The claims for damages could not be said to be payable on the same date as the Early Termination Amount became payable.

The second regime, close-out netting, applies following designation of an Early Termination Date by reason of the occurrence of an Event of Default or Termination Event. Once an Event of Default or Termination Event has occurred, Section 6 (Early Termination) comes into play. If a party exercises its right to designate an Early Termination Date, then Section 2 (Obligations) no longer applies.

In the calculations applicable on early termination, Section 6(e) takes into account the outstanding Section 2(a)(i) sums due in the context of early termination, and there is no room for the operation of Section 2(a)(iii) since Section 6(e) makes full provision for the way in which outstanding sums on the Transactions are to be taken into account.

Having held that there is no room for the setting off of unliquidated damages under Section 2(c) or Section 6(e), Cooke J then turned to consider whether unliquidated damages could be set off against the Early Termination Amount under the contractual set-off provision in Section 6(f) of the Master Agreement.

Set-off under the contractual set-off provision inserted by the parties

Section 6(e) of the Master Agreement (as per the standard form 1992 ISDA Master Agreement) is expressly stated to be "subject to any Set-off". As mentioned, the inserted Section 6(f) of the Master Agreement tracked the basic set-off provision contained in ISDA's User's Guide to the 1992 ISDA Master Agreements. At first blush, set-off under Section 6(f), rather than netting under Section 2(c), was a more appropriate route for Shanpark to use as it expressly envisaged the set-off of obligations arising outside of the Master Agreement.

However, Section 6(e) which specifically allows for "*any Set-off*" conflicted with the Loan Agreement, which included a provision excluding Shanpark's ability to make any deduction or exercise any set-off in relation to amounts due under the Loan Agreement or the Master Agreement but without prejudice to netting under Section 2(c) and Section 6(e) of the Master Agreement. Cooke J held that the Loan Agreement exclusion of set-off prevailed over Section 6(f) of the Master Agreement because the former post-dated the latter. The Loan Agreement provision should be read as recording the final agreement between the parties on the availability of set-off to Shanpark. This means that, even if Section 6(f) were otherwise available to Shanpark, it would not be entitled to exercise a right of set-off under Section 6(f) in any event.

But, in fact, it was clear that, regardless of the Loan Agreement, Shanpark was not entitled to exercise any right of set-off under the inserted Section 6(f). That provision was engaged only when there was a Defaulting Party or an Affected Party arising as a result of a Termination Event under Section 5(b)(iv) (Credit Event upon Merger) and was exercisable, in either case, only by the party that was not the Defaulting Party or the Affected Party.

Shanpark argued that the Bank's entry into liquidation in February 2013 made it a Defaulting Party, entitling Shanpark, as the Non-defaulting Party, to exercise a right of set-off under Section 6(f). Shanpark had not, however, served a notice pursuant to Section 6(a) (Right to Terminate Following Event of Default) of the Master Agreement designating an Early Termination Date, but had chosen instead to exercise its right to rely on Section 2(a)(iii) of the Master Agreement.

The Bank subsequently terminated the swaps under Section 6(b) by reason of the repayment by Shanpark of

the loans, which constituted an Additional Termination Event in respect of which Shanpark was the Affected Party. Cooke J held that while the Bank may, in a sense, have been a Defaulting Party from the time of its entry into liquidation, it ceased to be so upon the designation of an Early Termination Date under Section 6(b). Accordingly, there was no Defaulting Party for the purpose of Section 6(f) and no Affected Party in respect of Section 5(b)(iv). Accordingly, Section 6(f) was not engaged.

The effect of the Bank's statement of case in the Parallel Proceedings

In the Bank's statement of case (that is, its defence and counterclaim) in the Parallel Proceedings, it initially set out its position in the following words:

> "*If, which it is denied, the claimants have any claims against the Bank, the Bank will by way of defence set off against those claims amounts claimed by way of Counterclaim herein*."

The statement of case then set out the Bank's entitlement to the Early Termination Amount plus accrued interest.

In its original defence in these proceedings Shanpark claimed that the statement quoted above in the Bank's statement of case in the Paralell Proceedings meant that the Bank had exercised its right of set-off under the Master Agreement and/or the Loan Agreement. In its amended defence served in December 2014, Shanpark also attempted to argue that either (i) it had exercised its right of set-off under Section 6(f) when responding on 7 January 2014 to the Bank's letter of 6 January 2014 setting out the Early Termination Amount, or (ii) if the defendants did not have any right to set off or net against that amount, then Shanpark became a Defaulting Party by failing to pay the Early Termination Amount, and the Bank had exercised its right of set-off against Shanpark. This is significant because if either party effectively exercised its right of set-off as argued by Shanpark, then no Early Termination Amount was due from Shanpark to MHB-Bank (as assignee of the Bank's claim for the Early Termination Amount), because the amount claimed under the mis-selling action in the Parallel Proceedings substantially exceeded the Early Termination Amount.

Cooke J gave short shrift to these submissions on the basis that (a) Section 6(f) of the Master Agreement was not available to either party (as there was no Defaulting Party or Affected Party further to a Credit Event upon Merger) and (b) the set-off clause contained in the Loan Agreement was also not available to either party. Regarding the latter point, Clause 31 (Set-off) of the Loan Agreement only permitted the Bank to exercise a contractual right of set-off and only in relation to "matured obligations". Therefore, the Bank could not have effectively exercised a right of set-off under that clause in relation to Shanpark's claim for unliquidated damages.

There was some discussion as to how set-off under the inserted Section 6(f) can be effected. Cooke J made clear that the Bank's reference to set-off in its statement of case in the Parallel Proceedings, which the Bank subsequently withdrew, did not amount to the exercise of set-off. Instead, it was merely an expression of its intention to exercise a set-off, contingent on Shanpark establishing liability against it either by agreement or the obtaining of a relevant judgment (which as at the date of the trial in these proceedings, Shanpark had not).

Interestingly, Cooke J stated that if Shanpark had had a right of set-off under Section 6(f), it would not have mattered that it purported in its letter to the Bank of 7 January 2014 to exercise such right under Section 2(c) of the Master Agreement or under a provision of law which did not justify it. In Cooke J's view, its assertion of its intent to set off its damages claim against the Early Termination Amount (which, as noted above, became payable on 8 January 2014) would have been good enough despite the lack of an explicit reference to Section 6(f).

Can a claim for unliquidated damages be set off under the inserted Section 6(f) of the Master Agreement?

Notwithstanding Cooke J's conclusion that the set-off provisions in the inserted Section 6(f) of the Master Agreement did not apply on the facts, Cooke J went on to consider in *obiter dicta* whether, if Shanpark had in fact had a right of set-off under that provision, a claim for unliquidated damages could fall within it. Although Cooke J accepted that Section 6(f) had been drafted with contractual debts in mind, he held that the terms of

the provision were wide enough also to allow unliquidated damages to be set off against the Early Termination Amount:

> "*Section 6(f) specifically allows for the set off of amounts which are not yet due and which are only contingently due. Claims for unliquidated damages will only become a debt upon judgment being given by a court or upon agreement between the parties but Section 6(f) allows for a good faith estimate to be made, which in itself involves a good faith estimate of the existence of duty and breach, as well as damages*". (para 73)

Cooke J thought that this was the effect, in particular, of two specific parts of the inserted Section 6(f), namely:

- the definition of "Other Agreement Amounts", which refers to the amounts due to the party exercising the set-off to be used to discharge an Early Termination Amount owed by that party, and which is defined as follows "*any amount(s) … payable (whether at such time or in the future or upon the occurrence of a contingency) by the Payee [the party entitled to payment of the Early Termination Amount] to the Payer (irrespective of the currency, place of payment or booking office of the obligation) … under any other agreement(s) between the Payee and the Payer or instrument(s) or undertaking(s) issued or executed by one party to, or in favour of, the other party)*"; and
- the provision permitting that party, in the case of an obligation that is unascertained, to estimate it in good faith and set off in respect of the estimate, subject to the relevant party accounting to the other when the obligation is ascertained.

Cooke J was not deterred from this conclusion by the argument of MHB-Bank that unliquidated damages are not "payable" under an agreement, instrument or undertaking between the parties. It does, however, appear to have been part of his reasoning that the claim for unliquidated damages must arise from a breach of a contract between the parties and not on some other basis. Query whether a claim for damages for mis-selling arose in this case from a breach of contract or as a breach of a fiduciary duty owed to Shanpark (and each other defendant) by the Bank.

COMMENT

While Cooke J affirms the distinction between netting and set-off, he makes it clear that he is doing so in the context of the Master Agreements at issue in this case, including the inserted Section 6(f) setting out a contractual set-off provision. He limits his delineation of the distinction to pointing out that payment netting is the mechanism in Section 2(c), close-out netting is the mechanism in s6 and set-off, in this case, is the mechanism set out in the inserted Section 6(f). He does not attempt a deeper analysis of the distinction (of the type, for example, set out in our opinion addressed to ISDA on the enforceability under English law of close-out netting under the ISDA Master Agreements). In fact, in para 55 of his judgment, he also says that "the netting specifically provided for in Sections 2(c) and 6(e), which are the netting provisions, … could be seen as a form of set off". So, this judgment is of limited utility on the question of the distinction between netting and set-off.

Another point that limits the potential utility of this judgment is the fact that it turns on the construction of a form of contractual set-off provision that is not part of the standard form of the 1992 ISDA Master Agreement but was instead added by the parties. While the added provision tracks the basic set-off provision in the 1992 User's Guide, that provision is not in universal use in the market. Some parties do not include a contractual set-off provision in the 1992 version of the ISDA Master Agreement, and many that do include one, either substantially amend the User's Guide version or simply use a different form of contractual set off provision. It is perhaps worthy of note that the contractual set-off provision in Section 6(f) of the 2002 version of the ISDA Master Agreement varies in some important ways from the basic set-off provision in the 1992 User's Guide, and so this judgment will be of limited relevance to the construction of Section 6(f) of the 2002 version.

Accordingly, while this is a sound and sensible decision that is largely in accord with what we believe to be the

general market understanding of the relevant provisions of the 1992 ISDA Master Agreement, it is principally a careful and sensible application of well known principles to a particular set of facts. It does not break new ground (and it is doubtful that Cooke J would consider that it did), and therefore the judgment may not be of particular importance as a precedent. It may, however, be helpful in dissuading future litigants from running some of the hopeless arguments raised by Shanpark in this case.

Having said that, some interesting points are raised by this case:

- The case illustrates the importance of Shanpark's decision to rely on Section 2(a)(iii) after the Bank went into liquidation rather than having taken the initiative by designating an Early Termination Date under Section 6(a). Had it done so, then it would have been able to rely on the inserted Section 6(f) and avoided having to pay the Early Termination Amount to MHB-Bank while holding an irrecoverable mis-selling claim against an insolvent bank. While it is comparatively rare for a Non-defaulting Party to rely on Section 2(a)(iii) indefinitely (as was indirectly confirmed by the *Lomas v Firth Rixson* case, where the respondents were, in fact, the only counterparties out of hundreds of Non-defaulting Parties relative to Lehman Brothers (International) Europe as the Defaulting Party, to do so), this case provides a further cautionary tale pointing to the wisdom of a Non-defaulting Party closing out following an Event of Default within a reasonable period of time.
- In one part of the judgment, Cooke J considers First Method in order to contrast it, for purposes of his analysis, with Second Method, which actually applied in this case. While he only does so in passing, it is interesting that he does not raise a hint of a suggestion that First Method would not be enforceable under English law. While this is hardly a ringing judicial endorsement of First Method, it may provide some comfort to any parties who have elected First Method in their 1992 ISDA Master Agreement (which would these days be a relatively rare case), given the relative scarcity of other judicial consideration of the issue.
- Cooke J dealt robustly with Shanpark's argument (in order to be able to exercise the right of set-off under Section 6(f)) that the Bank was the Defaulting Party under the Master Agreement, by virtue of its entry into liquidation, notwithstanding that Shanpark had never designated an Early Termination Date in respect of that Event of Default). Cooke J made it clear that the term "Defaulting Party" is defined in Section 6(a) and simply refers to the party in respect of whom an Early Termination Date is designated by the other party, defined as the "Non-defaulting Party". He notes that the Non-defaulting Party:

  "*is the one who sends the notice specifying the relevant Event of Default and designating the Early Termination Date, whether or not that party is itself in default in any material respect and whether or not the other party could have served a notice under Section 6(a) (but did not do so)*".

  In our view, this is obvious and clearly the correct construction of Section 6(a), but it is helpful to have judicial endorsement of the point.
- One aspect of the judgment that might seem surprising to some was Cooke J's conclusion, albeit *obiter*, that the form of contractual set-off in this case (the inserted Section 6(f)) was broad enough to permit the party exercising the right of set-off to include claims for unliquidated damages in order to reduce its liability to pay an Early Termination Amount to the Defaulting Party or Affected Party in relation to a Credit Event Upon Merger. While Cooke J's conclusion appears to be limited to claims for unliquidated damages arising from a breach of agreement, it may be that parties wish to amend their contractual set-off provision, whether it is one added to a 1992 ISDA Master Agreement or it is Section 6(f) of the 2002 ISDA Master Agreement, to exclude claims for unliquidated damages. Having said that, a Non-defaulting Party will generally want the broadest possible right of set-off against a Defaulting Party and will generally have an interest in submitting a claim in administration or winding up proceedings in respect of the Defaulting Party that is less, rather than more, likely to be challenged. In practice, therefore, there may be a danger of overstating the risk that a Non-defaulting Party will abuse the possibility of including claims for unliquidated damages within the scope of a contractual set-off under the ISDA Master Agreement.

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ACCESS TO TARGET'S DOCUMENTS POST-SALE

Alfa Finance Holding AD v Quarzwerke GmbH [2015] EWHC 243 (Ch), 26 January 2015

A claimant's contractual entitlement under a share purchase agreement for "reasonable access" to documents post-sale only required the method and timing of access to be reasonable, not the purpose. The consequence was that the claimant could request documents which may have affected ongoing arbitration between the parties. The case is subject to an appeal by the defendant.

The defendant agreed to purchase, from the claimant, shares in a Bulgarian company and its subsidiaries. Under the share and purchase agreement, the claimant had the right to reasonable access to those companies' documents after completion of the share sale:

> "*…the relevant Group Companies shall allow the Seller [the claimant] and its professional advisers reasonable access to such books, records and documents, including the right to take copies at the Seller's expense*."

Two years after completion, the claimant requested access to documents under the contract. The defendant did not comply. The claimant requested specific performance of its contractual rights to reasonable access of documents.

The defendant argued that it should not have to provide access to the documents because the terms of the request were onerous and that the claimant had not set out the reasons for seeking access.

Further, at the time of the request there was an ongoing arbitration between the claimant and defendant. The defendant raised concerns that the claimant was seeking, in some way, to circumvent the disclosure process in the arbitral process.

Meaning of "reasonable access"

The judge, HH Purle QC, held that the meaning of "reasonable access" extends only to the method and timing of access. The judge held that, in this case, the practical difficulties the defendant raised for providing access "may have been over-exaggerated". The reasons for the claimant seeking to exercise its contractual rights in the present case are, in the words of the judge, "neither here nor there".

This meant that the claimant had the right to see the documents it requested, even if that was for, what was described by the defendant, as a "fishing expedition" in respect of the arbitration. The judge agreed with the

claimant that the access to documents would not hinder the arbitration or circumvent it, because, if there were further material documents which ought to have been disclosed in the arbitration, the arbitral process would have been enhanced, and if not, the arbitral process would have been unaffected.

In a post-judgment note in response to questions from the defendant, the judge sought to clarify some of his reasoning. The judge noted that a construction of the above clause requiring the claimant to explain or justify its wish for access would be wholly uncommercial, a recipe for potentially endless disputes, and would not fit naturally with the wording of the clause.

Specific Performance

The defendant also argued that the contractual clause was not suitable for specific performance. The judge recognised that specific performance may not be available if an order left the performing party uncertain as to their obligations to perform. It was also acknowledged that the obligation under the clause could be performed in a number of different ways.

It was held, however, that specific performance was suitable. The judge considered the nature and location of documents that the claimant requested access to in its draft order, and determined that, subject to a few amendments, specific performance could be ordered that made it clear what the defendant's obligations were.

COMMENT

There are a variety of reasons why a right to access documents post-completion is provided for in a share purchase or business transfer agreement. For example, often in a business transfer, where only some of the group companies have been transferred, the seller will continue to hold documents relevant to and required by the transferred part of the business, so the buyer will need access.

This case means that simply stating that access must be reasonable may not limit access in the way that the person providing the documents may have envisaged. The disclosing party may therefore want to specify in the contract for what purposes a request for documents can be made.

The disclosing party will also want to ensure minimal disruption. This is why agreements generally specify that access must be on reasonable notice, take place during usual business hours, and must be at the requesting party's expense.

The potential for an open-ended "fishing expedition" should, in theory, be limited by the fact that specific performance will only be ordered where the obligation is sufficiently clear.

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Criminal

MONEY LAUNDERING OFFENCES APPLY TO CONDUCT OCCURRING ENTIRELY OUTSIDE THE UK

R v Rogers & ors [2014] EWCA Crim 1680, 1 August 2014

An individual can be prosecuted for committing a money laundering offence under the Proceeds of Crime Act 2002 even if their conduct took place entirely outside the UK, so long as a significant part of the underlying criminal scheme took place in the UK and it had harmful consequences in the UK.

The defendants were participants in a fraudulent scheme which involved persuading people in the UK to pay advance fees for certain services which were never performed. The money was paid into UK bank accounts and was used to pay expenses, with profits being transferred to accounts in Spain. Approximately GBP 5.7 million was obtained from the scheme. One of the fraudsters, Rogers, was a UK citizen resident in Spain who permitted GBP 715,000 to be paid into a Spanish bank account controlled by him. Rogers allowed the scheme's principal to withdraw money from that account.

At trial in England, the defendants (apart from Rogers) were convicted of conspiracy to defraud and received prison sentences. Following extradition from Spain, Rogers was convicted of converting criminal property contrary to s327(1)(c) Proceeds of Crime Act 2002 (**POCA**) and sentenced to two years and ten months imprisonment. This article covers Rogers' appeal against his conviction on the grounds that the Crown Court had no jurisdiction to deal with the allegations against him because he lived and worked in Spain and he had not committed any part of the offence within the UK.

The Court of Appeal (Treacy LJ, Lang J and HHJ Bevan QC) held that there was jurisdiction to try Rogers in England and dismissed his appeal. There were two bases for the court's decision: (1) the provisions of POCA; and (2) modern principles of jurisdiction in criminal law derived from previous cases.

Extra-territorial reach of POCA

POCA s327(1) creates the offences of concealing, disguising, converting, transferring and removing criminal property. The court recognised the established presumption in construing a statute that creates an offence that, in the absence of clear words to the contrary, it is not intended to make extra-territorial conduct triable in an English court. However, the Court found that the following provisions of POCA indicate that Parliament intended s327 to have extra-territorial effect:

- Section (2A) provides a defence to a person who knows or believes that the criminal conduct occurred outside the UK if the conduct was lawful in that country at the time it occurred.
- Section 340(2)(b) defines criminal conduct as including conduct which would be an offence in the UK if it had occurred in the UK.
- Section 340(9) defines property as "all property wherever situated".
- Section (11)(d) defines money laundering as an act which would constitute an offence under ss327-329 if it had taken place in the UK.

The money obtained by fraud in the UK became criminal property for the purposes of POCA once it reached the UK bank accounts, and it did not cease to be criminal property when it reached Rogers' bank account in Spain. Rogers had therefore converted criminal property by allowing his bank account to be used for receiving and

withdrawing the money. The court described money laundering as "par excellence an offence which is no respecter of national boundaries. It would be surprising indeed if Parliament had not intended the Act to have extra-territorial effect".

Extra-territorial criminal jurisdiction

The court considered the Court of Appeal's decision in *R v Smith (Wallace Duncan) (No 4)* [2004] Cr App R 17 and earlier cases, and concluded that if there is no geographical limitation in the definition of a statutory offence, where a substantial measure of the criminal activity takes place within the UK, the courts have jurisdiction to try the crime unless it should be dealt with by another country on the basis of international comity. It is not necessary that the essence of the offence took place within the UK. However, each state should refrain from punishing people for their conduct within the territory of another state unless that conduct had harmful consequences within the territory of the state seeking to impose the punishment.

Here, the court held that a "significant part of the criminality underlying the case" took place in the UK and impacted upon victims in the UK. Rogers' conduct in Spain was directly linked to the criminal conduct in the UK through his conversion of the criminal property. The court decided that there was no reasonable basis for withholding jurisdiction, as this was unlikely to be an offence in which the Spanish authorities would have been interested.

COMMENT

This decision is important in clarifying that the money laundering offences created by POCA ss327, 328 (involvement in arrangements regarding criminal property) and 329 (acquisition, use or possession of criminal property) have substantial extra-territorial effect, allowing an individual to be prosecuted even if their conduct occurred entirely outside the UK. This is subject to the restrictions that a significant part of the underlying criminality must have taken place in the UK and it had harmful consequences in the UK. The Court's approach in this case demonstrates its willingness to develop statutory interpretation and case law in a way that responds to the international nature of modern criminal activity.

Lawyers, those working in financial services firms, and others in the "regulated sector" for the purposes of POCA also need to consider this judgment when deciding whether to make a report to their Money Laundering Reporting Officer or the National Crime Agency under POCA s330. A disclosure may need to be made in circumstances where, for example, a crime is committed in the UK and the proceeds are then received and laundered abroad.

Previously, it could have been considered that ss327-329 of POCA were more narrowly intended to apply only where the relevant conduct had taken place in the UK, with s340 allowing the prosecution of an individual in the UK who had been involved in laundering within the UK the proceeds of a crime committed overseas, or an individual who had acted within the UK to launder the proceeds of crime situated overseas.

The court also extended the restriction in *Smith* (that a substantial measure of the activities constituting the crime must take place in the UK) to cover the situation in this case, where none of Rogers' activities took place in the UK. Instead, the court found that it was sufficient if a significant part of the underlying criminality, in the sense of the defendants' entire scheme, took place in the UK.

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Employment

GENDER PAY GAP REPORTING

The controversial gender pay gap reporting provisions in the Equality Act have lain dormant for almost five years. These are the provisions that permit the Government to make regulations requiring employers with more than 250 employees to publish gender pay information, and in particular to declare whether there are any gender pay differentials. Just prior to Parliament being dissolved in preparation for the election, the Liberal Democrats successfully managed to insert an unusual amendment into the Small Business, Enterprise and Employment Bill, which will bring these gender pay reporting provisions to life.

The amendment requires the Government, as soon as possible, and no later than 26 March 2016, to make the gender pay reporting regulations, and to consult as part of the process. This means that whatever the colour of the Government after the election, there is an obligation to make gender pay gap reporting a reality. Realistically, this means that within two years all medium to large employers will need to have carried out an equal pay audit of some description, and will be required to publish the results on a regular basis (probably in the region of every three to five years).

This is particularly a high-risk area for those in the financial sector. Since 2009, the Equality and Human Rights Commission has been investigating the financial sector, and found that women working full-time earn 55% less per year than their male counterparts. This gap is twice as large as the average gap across the economy as a whole. According to the Commission, the impact of bonuses on earnings is particularly striking, with women on average receiving only a fifth of the annual bonus of men.

Until the new Government consults, and the draft regulations are published, it is a guessing game as to the level of detail required, and as to what exactly "publication" means. This does not mean employers should do nothing until then, however. Work needs to begin on determining how employees should be categorised and graded if a formal system is not already in place. If there is a suspected pay gap, there is an opportunity now to fix it before such disparity becomes a public issue. Work also needs to begin on how information should be presented in due course and what explanations exist behind any discrepancies in pay – for example, it may be that some employees' pay has been ring-fenced as a result of them being acquired from another business, or particular employees may have had to be paid more when there has been a skill gap in the market or to encourage them to join from a competitor. This won't be gender-related but it could result in your data appearing to lack parity without appropriate explanations being included.

We are currently looking at these issues with a number of our clients. Please contact Sarah Henchoz or your usual A&O contact to discuss the potential impact for your business. We will also conduct an "Ask" survey in due course to find out what employers are doing in preparation. When we did this in December last year, in relation to the new employment tribunal regime whereby an equal pay audit can be ordered if an employer loses an equal pay case, only 30% of employers said that they had taken the pre-emptive step of conducting an equal pay audit. A further 10% said that they would do so within the next 12 months. We could expect those figures to increase significantly this year.

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Regulatory

FCA BUSINESS PLAN 2015/16: KEY MESSAGES FOR LITIGATORS

On 24 March 2015, the FCA published its Business Plan for 2015/16. The purpose of the Business Plan is to set out the key areas of focus for the FCA during the forthcoming financial year. Here we set out an overview of key points made by the FCA in its Business Plan that may be of most interest to litigators working in financial institutions, as well as an indication of the possible litigation and regulatory enforcement risks they pose.

Culture

The FCA has previously emphasised the importance of firms embedding positive cultural changes and 'setting the right tone from the top'. This topic featured prominently throughout the FCA's Business Plan for 2015/16, which noted the various ways in which the FCA expects firms to reinforce standards of culture to their employees, including, for example:

- remuneration;
- hiring processes;
- performance management;
- promotions;
- internal reporting of concerns (including whistleblowing);
- responsibilities of the first line of defence; and
- the autonomy and empowerment of key control functions.

On a positive note the FCA has acknowledged that firms have made improvements in relation to their cultures and embedding good cultural changes within their organisations. Nonetheless, the FCA has indicated in its Business Plan that there is still more work to be done in this area, perhaps in part due to the number of enforcement cases published over the past year which have featured comments about firms' cultures and values.

Importantly, in 2015/16 the FCA is proposing to undertake a new thematic review on whether culture change programmes in retail and wholesale banks are driving the right behaviour, with a particular focus on remuneration, appraisal and promotion decisions of middle management, as well as how concerns are reported and acted on. If the FCA identifies deficiencies in a firm's culture during this thematic review then it may use this as a basis for launching an enforcement investigation.

Individual accountability

The new Senior Managers and Certification Regime

High on the FCA's agenda for the next financial year is the introduction of the new Senior Managers and Certification Regime, as well as the new Code of Conduct. This is due to come into force from 6 March 2016.

Earlier in March 2015, the FCA and the PRA published their 'near final' rules for the Senior Managers and

Certification Regime, as well as the new Code of Conduct. As a result, there is much that affected firms need to be doing in order to implement the new regime, including various issues and risks that may need to be considered from a litigation perspective.

Allen & Overy has published a variety of client materials on the new Senior Managers and Certification Regime. If you would like to receive copies of these materials, please contact magdalena.flynn@allenovery.com.

Whistleblowing

In the Business Plan for 2015/16, the FCA notes the 45% increase in the number of whistleblowing disclosures that have been made to it over the past year, as well as the quality of the information it has received from whistleblowers. In particular, the FCA has announced that 124 reports made by whistleblowers have either directly contributed to the FCA's enforcement activities or were otherwise of "significant value" to the FCA.

Earlier in 2015, the FCA published a consultation paper relating to various arrangements that it intends to require firms to put in place relating to whistleblowing. These proposals appear to almost encourage employees to make disclosures directly to the FCA, as opposed to going through their employers' whistleblowing processes. For a copy of our briefing on this consultation paper, please contact magdalena.flynn@allenovery.com.

Unsurprisingly, the FCA is keen to maximise whistleblowers as a potential source of information which may assist with its enforcement and market surveillance activities.

Remuneration

The way in which firms remunerate and incentivise their employees is also set to remain another key focus for the FCA for the next financial year and is closely linked to the FCA's continued focus on culture. We have observed the FCA (and the PRA) becoming increasingly interested and involved in firms' remuneration decisions, especially where individuals may be the subject of or witnesses in on-going enforcement investigations.

In an enforcement context, it is becoming increasingly common for the FCA to request details of firms' remuneration structures and policies, as well as the rationales for them, as 'standard' items during enforcement investigations. The FCA also continues to expect firms to take appropriate action in relation to employees, including their remuneration, if they are found to have engaged in misconduct, and report steps that have been taken in this respect to the FCA.

Conflicts of interest

The FCA has described conflicts of interest in its Business Plan for 2015/16 as being "at the root of many conduct risks across markets". Conflicts of interest have also been a focus in a number of FCA enforcement cases that have been concluded over the past year.

The FCA also mentions that it is intending to undertake a number of thematic reviews which either focus on or may touch upon conflicts of interest. These include:

- inducements and conflicts of interest in retail investments (from Q2 2015);
- controls over flows of information in investment banks (in progress);
- trader controls around benchmarks (in progress); and
- conflicts of interest in dark pools (from Q2 2015).

The FCA may use its findings from these thematic reviews to refer firms to enforcement, if appropriate.

Financial crime

The importance of firms having systems and controls in place to prevent financial crime was listed in the FCA's Business Plan for 2015/16 as a "new" forward-looking area of focus for the coming year. The FCA is proposing to focus on controls designed to prevent money laundering, bribery and corruption, as well as "cyber-crime".

The FCA has noted that some firms' approach to reducing the risk of financial crime in their organisations has been to move away from providing services to certain groups of customers or business sectors. In recognition of its new competition powers that took effect on 1 April 2015, the FCA described this approach in the Business Plan as being potentially anti-competitive and a way in which legitimate customers may be impeded from accessing financial

services. The FCA has indicated that it is concerned by this approach and that it intends to work with the PRA and the Financial Stability Board, as well as regulators in other countries, to take action to address its concerns.

As a result, firms will need to ensure that they have robust systems and controls to prevent financial crime that strike an appropriate balance between preventing financial crime, while still satisfying the FCA's expectations that firms do not simply move away from providing services to certain higher-risk categories of customers or businesses. This may be a challenging balance to achieve in practice.

Increased focus on certain markets

In the 2015/15 Business Plan, the FCA states its intention to focus on specific markets, such as **wholesale banking, investment and wealth management and retail banking and investments**, and undertake more in-depth pieces of work in relation to them. Allen & Overy has published a client bulletin providing more detail on the FCA's planned work in these markets. Please click here to view a copy of the client bulletin.

Potential changes to the FCA's enforcement processes

At the end of 2014, HM Treasury published its final report and recommendations relating to the FCA and PRA enforcement decision-making processes. The FCA acknowledges HM Treasury's recommendations in its Business Plan for 2015/16. However, the FCA does not comment when and how it intends to implement the recommendations made by HM Treasury. Only when the FCA and the PRA indicate how they will go about implementing HM Treasury's recommendations will we get a better sense as to how helpful they are likely to be in practice.

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FCA DECISION ON MARKET ABUSE OVERTURNED

Tariq Carrimjee v The Financial Conduct Authority [2015] UKUT 0079 (TCC), 4 March 2015

The Upper Tribunal has overturned an FCA decision that a fund manager acted without integrity by recklessly assisting a client to commit market abuse. Instead, the Upper Tribunal concluded that the fund manager acted without due skill, care and diligence.

Mr Carrimjee, an investment adviser, introduced one of his clients, Mr Goenka, to a broker, so that Mr Goenka could trade in the closing auction operated by the London Stock Exchange for certain Global Despositary Receipts (**GDRs**). Mr Carrimjee made that introduction, participated in discussions about trading and assisted with arrangements for trading, despite suspecting and speculating to others that Mr Goenka may be intending to manipulate the closing prices of certain GDRs.

Mr Goenka abandoned his proposed trading strategy. However, on a later date he did effect orders to trade (through the broker Mr Carrimjee had introduced him to) which artificially inflated the closing price of certain GDRs on that day. The FSA (as it then was) found that Mr Goenka's trading amounted to market abuse and that it had allowed him to avoid a trading loss of just over USD 3 million under the terms of a separate structured product he held.

FSA findings

The FSA found that, as a result of his conduct in relation to Mr Goenka, Mr Carrimjee had failed to act with integrity in breach of Principle 1 of the Statements of Principle and Code of Practice for Approved Persons (**APER**). The FSA also proposed to withdraw Mr Carrimjee's approved person status, impose a prohibition order on him and fine him GBP 89,004.

Reference to the Upper Tribunal

Mr Carrimjee disputed the FSA's findings and referred his case to the Upper Tribunal (Tax and Chancery Chamber). In considering this case, the Upper Tribunal decided that it needed to determine the following four issues.

Issue 1: Did Mr Carrimjee's conduct demonstrate a lack of integrity?

The conduct and evidence that led to the FSA alleging that Mr Carrimjee had acted without integrity in breach of APER Principle 1 was broadly the same as the conduct that formed the basis of the FSA's case against the broker who, in a separate investigation, the FSA found had acted without due skill, care and diligence in breach of APER Principle 2.

Mr Carrimjee argued before the Upper Tribunal that the FCA (as it had become) has a public law duty to act rationally. He submitted that the FCA should treat like cases alike, meaning that it should apply the same disciplinary approach consistently to all whom it regulates and it could not advance inconsistent factual positions in different proceedings. As such, Mr Carrimjee submitted that the FCA's case against him directly conflicted with the findings it had made in relation to the broker and that this was untenable as a matter of evidence.

The Upper Tribunal emphasised that it had to assess Mr Carrimjee's conduct and state of mind according to the evidence presented to it in this case. On the facts, the Upper Tribunal found that Mr Carrimjee was not aware of, and did not suspect, an intention on the part of Mr Goenka to manipulate the price of certain GDRs. As a result, the Upper Tribunal found that Mr Carrimjee had not failed to act without integrity in breach of APER Principle 1.

Issue 2: Did Mr Carrimjee's conduct demonstrate a failure to act with due skill, care and diligence?

The Upper Tribunal then turned to consider whether Mr Carrimjee's conduct had demonstrated a failure to act with due skill, care and diligence in breach of APER Principle 2.

The Upper Tribunal found that Mr Carrimjee had breached APER Principle 2 on the basis that he did not react appropriately to various factors and warning signs that were apparent to him during his dealings with Mr Goenka, specifically the risk that was apparent from his dealings with Mr Goenka that he might have been intending to engage in market manipulation.

Issue 3: What financial penalty should be imposed on Mr Carrimjee?

The Upper Tribunal emphasised that a significant financial penalty should be imposed on Mr Carrimjee so as to act as a deterrent to both Mr Carimjee from committing further breaches in the future, as well as a deterrent to others. Mr Carrimjee did not dispute this principle, but argued that the penalty proposed by the FCA on the basis that he had acted without integrity and breached APER Principle 1 was excessive.

The Upper Tribunal was critical of the way in which the FCA had calculated Mr Carrimjee's financial penalty (particularly, the way in which the FCA had tried to increase the final figure). However, notwithstanding these comments the Upper Tribunal ruled that the financial penalty calculated by the FCA was appropriate.

Issue 4: Further directions in relation to the FCA's proposal to remove Mr Carrimjee's approval and impose a prohibition order on him.

As the Upper Tribunal found that the FCA had not made out its case that Mr Carrimjee acted without integrity, the Upper Tribunal remitted this matter to the FCA with a direction to reconsider its proposal to remove Mr Carrimjee's authorisation and impose a prohibition order on him. In doing so, the Upper Tribunal noted that it is relatively rare for the FCA to withdraw a person's approved person status and impose a prohibition order in cases where individuals have failed to act with due skill, care and diligence on one occasion. The Upper Tribunal stated that this factor, as well as the treatment of the broker (who did not have her approved persons status removed or a prohibition order imposed on her) in relation to this matter, suggests that it would be irrational and disproportionate if the FCA withdrew Mr Carrimjee's approval and imposed a prohibition order on him.

COMMENT

The decision of the Upper Tribunal reinforces the importance of approved persons remaining alive to the risk of market abuse and escalating any concerns that they have in an appropriate and timely manner.

Although previous FCA and FSA decisions have no official precedent value, the Upper Tribunal's decision in this case emphasises the importance of the FCA being seen to take a consistent approach towards similar cases which rely on broadly the same evidence.

However, these comments are likely only to be of limited use to subjects of FCA enforcement investigations who want to argue that they should be treated the same as others who are being investigated for similar conduct in relation to the same matter. This is because subjects very rarely know what, if any, action the FCA is proposing to take against others before the FCA's findings are published and it is too late to challenge them. As a result, although subjects of enforcement investigations may remind the FCA of its public duty to act rationally and be consistent in its approach to taking enforcement action, only if subjects of enforcement investigations refer their matters to the Upper Tribunal and the FCA's proposed findings are laid out in public may such arguments be made to their full effect.

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FCA TAKES ENFORCEMENT ACTION AGAINST COMPLIANCE OFFICER FOR BEING KNOWINGLY CONCERNED IN A BREACH OF REGULATORY REQUIREMENTS COMMITTED BY THE FIRMS HE WORKED FOR

Final Notice issued against Stephen Edward Bell, 13 March 2015

The FCA has taken enforcement action against an individual in relation to regulatory breaches committed by the firms he worked for relating to compliance systems and controls. This case is unusual in that the FCA did not take action against the individual for breaching its Statements of Principles for Approved Persons (**APER**) – instead the FCA took action against the individual for being knowingly concerned in a breach of regulatory requirements committed by the firms he worked for.

Breach of Principle 3 of the FCA's Principles for Businesses

Financial Limited and Investment Limited (together, the **Firms**) form an adviser network, which advises approximately 60,000 customers on pensions, investments, mortgages and general insurance/protection products. Between them, the Firms are also responsible for over 300 Registered Individuals (**RIs**) and 250 Appointed Representatives (**ARs**).

In 2012 the FSA (as it then was) required the Firms to commission a Skilled Persons Report in order to review the effectiveness of the Firms' systems and controls and risk management (the **Skilled Persons Report**). The Skilled Persons Report, which was issued in September 2013, identified material deficiencies in the Firms' systems and controls, and found that the Firms had failed to implement a robust risk management

framework that enabled the Firms' senior management to identify and manage risk proactively.

Following the Skilled Persons Report, the FCA (as it had become) launched a further investigation into the Firms and found that between August 2008 and April 2013 the Firms had breached Principle 3 of the FCA's Principles for Businesses. Principle 3 is a broad obligation which requires a firm to "take reasonable care to organise and control its affairs responsibly and effectively" and to implement "adequate risk management systems".

Being "knowingly concerned" in a breach of regulatory requirements

Under s66A of the Financial Services and Markets Act 2000, the FCA may take enforcement action against an individual if that individual is found to have been knowingly concerned in breach of a regulatory requirement (including the FCA's Principles for Businesses). In order to do so, the FCA must establish that the individual in question had knowledge of the facts that caused the breach, but not that he or she had knowledge that a breach had actually occurred. In addition, it is not necessary for the FCA to prove that an individual has acted dishonestly in order to find that they have been knowingly concerned in a breach of a regulatory requirement.

Findings against Stephen Bell

Mr Bell was responsible for the compliance systems and controls within the Firms and at various points during this period he held a combination of the following Significant Influence Function (SIF) positions: CF1 (**Director**), CF10 (**Compliance Oversight**), CF11 (**Money Laundering Reporting**) and CF28 (**Systems and Controls**).

The FCA found that Mr Bell had been responsible for establishing the majority of the Firms' systems that were found by the FCA to be inadequate and led to the Firms being found to have breached Principle 3 of the FCA's Principles for Businesses. These systems included the application and recruitment processes for the ARs and RIs, the training and supervision of the ARs and RIs. and the systems and controls for determining an RI's competence to advise customers.

Using its powers under s66A FSMA, the FCA found that Mr Bell had been knowingly concerned in the Firms' breach of Principle 3 of the FCA's Principles for Businesses insofar as they related to the management of compliance risks. The FCA came to this conclusion on the basis that Mr Bell had knowledge of and was responsible for the compliance systems and controls at the Firms and that these had been found by the FCA to have fallen short of regulatory requirements.

The FCA imposed a financial penalty of GBP 33,800 on Mr Bell. In addition, the FCA imposed a prohibition order on Mr Bell, preventing him from performing the Compliance Oversight function in the future on the basis that he is not a fit and proper person in terms of his competence and capability.

COMMENT

The approach taken by the FCA in this case is different to the one it typically takes in enforcement investigations involving SIFs and approved persons. Instead of focusing on potential breaches of APER (the FCA's rules that apply specifically to the conduct of approved persons), the FCA chose to take action against Mr Bell for being knowingly concerned in a breach of regulatory requirements committed by the Firms.

It is not entirely clear why the FCA took a different approach in this case. However, it is possible that the various SIF positions that Mr Bell held during the relevant period may have made it more difficult for the FCA to establish that he had breached APER throughout this period. Alternatively, the FCA may have considered that its findings against Mr Bell were so closely aligned to the Firms' regulatory breaches that it was more appropriate to conclude that Mr Bell had been knowingly concerned in the Firms' regulatory breaches.

The low legal threshold that the FCA must meet if it wants to find that an individual has been knowingly concerned in a breach of a regulatory requirement presents another risk for senior individuals within financial institutions. Even if the FCA cannot establish that they breached APER or other regulatory requirements, the FCA may be able to satisfy a lower legal threshold and argue that an individual has been

knowingly concerned in a breach of a regulatory requirement by a firm.

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State aid

STATE AID RECOVERY RATES ORDERED AGAINST IRISH AIRLINES

Case T-473/12 Aer Lingus Ltd v Commission, and *Case T-500/12 Ryanair Ltd v Commission*

In an appeal against an European Commission decision that Irish air travel tax constituted incompatible state aid that must be recovered from the beneficiaries of the aid (namely Ryanair, Air Lingus and Aer Arann), the General Court upheld the state aid finding but annulled the decision in so far as it ordered recovery at an amount which had been erroneously set by the Commission. The importance of this decision is not confined to the airline industry. It is relevant for any recipient of relief from any tax or duty which would otherwise be payable, in the event that such relief is determined to be incompatible state aid and is to be recovered from the beneficiary.

State aid

By way of overview of the relevant provisions of EU law, any aid from a Member State to business undertakings which distorts or threatens to distort competition by favouring certain undertakings are incompatible with the common market (Article 107(1) of the Treaty on the Functioning of the European Union) save for certain exceptions set out in the Treaty. If the Commission or its supervisory courts find that there is incompatible state aid, they can impose a range of sanctions, including that the state recovers the aid in question from the beneficiaries (except from beneficiaries who are individuals) with interest. The Commission or the relevant national court can determine the amount of aid to be recovered.

Background

Since 30 March 2009, an "air travel tax" (**ATT**) has been payable by airlines for every passenger departing from an Irish airport with more than 10,000 passengers a year, save for transit and transferring passengers. This excise duty was intended to be passed on to passengers through the ticket price but the airlines operators are accountable for it and liable to pay it.

In the period 30 March 2009 to 28 February 2011, the amount of ATT payable per passenger depended on the

distance between the airport of departure and the airport of arrival – the ATT was EUR 2 for flights of no more than 300km from Dublin airport and EUR 10 in all other cases. Following an investigation by the European Commission (triggered by Ryanair Ltd (**Ryanair**)), in 2011 the Irish government amended the relevant legislation to remove the discriminatory differentiation between the length of flight in the original rules. A uniform ATT of EUR 3 was thereafter applicable to all passengers, again save for transit and transferring passengers.

In July 2009, Ryanair filed a complaint with the European Commission regarding the ATT in force prior to March 2011 on three grounds: (1) not applying the ATT to transit and transferring passengers was illegal state aid to Aer Lingus Ltd (**Aer Lingus**) and Aer Arann because they had a high proportion of such passengers; (2) levying the ATT at a flat rate made the tax proportionality higher for low-cost airlines such as Ryanair; and (3) the lower rate of ATT for shorter flights favoured Aer Arann as 50% of its flights were no more than 300km from Dublin airport.

The present proceedings concern issue (3) above.[1] In its July 2011 preliminary decision, the Commission found that the different ATT rates in place between 2009 and 2011 appeared to constitute incompatible state aid. Following a subsequent formal investigation, on 15 July 2012 the Commission found that the measure did favour short-distance flights and ordered recovery of the aid from the airlines that had benefitted from it ie Ryanair, Aer Lingus and Aer Arann (the **Contested Decision**).[2] The Commission further decided that the amount of state aid recoverable was the difference between the lower rate of ATT (EUR 2) and the standard rate (EUR 10) levied on each passenger ie EUR 8 per passenger.

Aer Lingus and Ryanair separately appealed the Contested Decision to the General Court of the European Union. Ireland intervened in support of the Commission in both cases and Aer Lingus intervened in support of Ryanair in its appeal.

Judgment

The main points raised by the parties in their separate appeals, and the main substantive grounds of the two judgments, are similar. Ryanair and Aer Lingus essentially claimed that the Commission erred in finding that the EUR10 rate of the ATT was the 'normal' rate in order to establish the existence of a selective advantage in favour of the airlines subject to the lower rate of EUR 2 and made various errors of law in the recovery decision. They also claimed that the Commission failed to give sufficient reasons for aspects of its decision and Ryanair claimed that it had been deprived of an opportunity to comment on the order for recovery of the aid.

In both judgments, the General Court annulled the Contested Decision in so far as it ordered the recovery of the aid from the beneficiaries for an amount of EUR 8 per passenger. The court found that the Commission erred in setting the aid to be recovered as the difference between the lower and the higher rates of ATT because the Commission was not entitled to assume that the advantage enjoyed by the beneficiaries of the aid automatically amounted to EUR 8 per passenger in all cases. In particular, the economic advantage received by the beneficiaries of the aid could have been fully or partially passed on the airlines' passengers (from whom the aid was not recoverable). Had the airlines paying ATT at EUR 2 per passenger systemically increased the price of their tickets (and therefore its potential profit) by EUR 8 per passenger, then that rate might be appropriate rate of recovery. However, the Commission had not explained whether this would in fact be the case for all or any of the airlines.

The General Court found that the Commission should have determined the extent to which the airlines had actually passed on the economic benefit of the lower ATT to their passengers. Following such an assessment, it should have ordered the recovery of the advantage actually realised by the airlines. If the assessment proved impossible then the Commission could have conferred that task to the national authorities.

Further, the General Court decided that the Commission should have set a rate of recovery which would ensure the restoration of the competitive situation that would have prevailed in the absence of the state aid. If the airlines automatically had to repay EUR 8 per passenger, this could create additional distortions of competition since it could lead to the recovery of more from the airlines than the advantage they actually enjoyed.

The remainder of the airlines' actions were dismissed and the General Court upheld the finding in the Contested Decision that the application of different ATT rates based on flight distance conferred a selective advantage on the beneficiaries of the lower ATT and so constituted state aid. The court also found that the Commission did not err in using the EUR 10 ATT as the reference rate for these purposes.

COMMENT

This decision is relevant for any commercial recipient of relief from any tax or duty which would otherwise be payable.

The judgments offer high-level guidance in setting rates of recovery where incompatible state aid is found. The clear message from the General Court is that a prescriptive or theoretical approach is inappropriate and that the rates of recovery should reflect the amounts actually required to ensure the restoration of the competitive situation that would have prevailed in the absence of the aid. The determination of such a rate may be complex in practice, but such an approach is consistent with ensuring the level playing field of the common market.

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[1] Issue (1) above was the subject of separate proceedings before the General Court which are not considered in this article. In its July 2011 decision the Commission decided that the exclusion of transit and transferring passengers from ATT did not constitute state aid and no further investigation was to be carried out on this issue. This decision was successfully challenged by Ryanair in Case T-512/11 – *Ryanair Ltd v Commission* and the General Court annulled the Commission's July 2011 decision in so far as it found that the non-application of ATT to transit and transferring passengers does not constitute State aid.

[2] Commission Decision 2013/199/EU of 25 July 2012 on State aid Case SA.29064.

Tort

DISCLAIMER PRECLUDES THIRD-PARTY RELIANCE ON AUDITOR REPORTS

Barclays Bank PLC v Grant Thornton UK LLP [2015] EWHC 320 (Comm), 18 February 2015

A standard disclaimer included in non-statutory audit reports was effective and prevented a tortious duty of care arising in common law to a third party that had relied on them. The judgment emphasised that it would not be fair, just or reasonable to impose a duty on the auditors in these circumstances. The disclaimer satisfied the requirements of the Unfair Contract Terms Act 1977.

The Unfair Contract Terms Act 1977

Under s2 of the Unfair Contract Terms Act 1977 (**UCTA**), liability cannot be excluded or restricted in relation to negligence, except where a notice is produced and it satisfies the requirement for reasonableness. A notice is deemed to be reasonable for the purposes of UCTA where it is fair and reasonable in all the

circumstances for the party to rely on it. Schedule 2 of UCTA provides guidelines for determining whether a disclaimer in a contract is reasonable. The onus is on the party claiming that the notice is reasonable to illustrate it meets the requirement for reasonableness.

Facts

Grant Thornton UK LLP (the **defendant**) provided auditor services to the Von Essen Hotels Limited Group (**VEH**) in connection with a refinancing of an existing facility with two banks. The defendant was appointed to provide a limited scope review of VEH's financial condition and produce audit reports in respect of its financial statements (the **Audit Reports**). The Audit Reports expressly stated that they had been prepared solely for VEH's director and that 'to the fullest extent permitted by law' the defendant did not accept or assume responsibility to anyone other than VEH and its director, for the audit work, the Audit Reports or the opinions given (the **Disclaimer**). This wording followed standard Institute of Chartered Accountants in England and Wales wording for use in statutory audit reports. The Audit Reports each consisted of two pages followed by the audited accounts. The Disclaimer was presented on the first page of each report and appeared directly under the heading. It was followed by a further paragraph on the second page of the report under a similar capitalised heading to the first page. The second disclaimer stated that the opinion provided by Grant Thornton in relation to the Audit Reports gives a true and fair view of the state of the group's affairs.

A subsequent investigation in 2011 found that two VEH employees had fraudulently manipulated the figures provided to the defendant when they were preparing the Audit Reports. One of the banks (the **Bank**) subsequently filed a claim against the defendant, claiming that the defendant owed it a tortious duty of care in relation to the Audit Reports and that the defendant's failure to uncover the dishonesty of the VEH employees was negligent.

The defendant applied to the court for summary judgment and an order that the claim be struck out.

Disclaimer precludes duty of care

The Commercial Court considered whether the Disclaimer prevented a common law tortious duty of care from arising, as well as whether it met the 'reasonableness' requirement in UCTA. The Commercial Court held:

- The Disclaimer was clear and had been brought to the Bank's attention. As a result, it met the 'reasonableness' requirement in the UCTA.
- The defendant had made it clear that it was not prepared to assume responsibility to any third parties, including the Bank, in relation to the Audit Reports. Cooke J commented that this was not unusual between two 'sophisticated commercial parties' such as the defendant and the Bank (per *Omega Trust v Wright, Son and Pepper* [1997] PNLR 424) and the inclusion of such wording in audit reports was standard.
- Points that the Bank sought to advance in order to establish that the defendant owed it a tortious duty of care in common law in relation to the Audit Reports could not be outweighed by the fact that the Disclaimer was clear and the Bank had no letter of engagement with, and had paid no fees to, the defendant in connection with the Audit Reports. Following *McCullagh v Lane Fox & Partners Ltd* [1996] PNLR 205, the Commercial Court held that a person cannot be taken to have assumed responsibility for something when they have expressly limited it.

As a result, the Commercial Court allowed the application for summary judgment and ordered that the Bank's claim be struck out pursuant to CPR 3.4(2)(a).

COMMENT

The ruling emphasises the need for auditors and other professionals to include clear and carefully drafted disclaimers in their reports and engagement letters. In addition, any such disclaimers must comply with the 'reasonableness' requirements of the UCTA or otherwise risk being found to be void. Attention must also be paid to the placement of such disclaimers. For example, it may be preferable for auditors and other professionals to include disclaimers in a prominent position in documents so as to avoid arguments that they were not presented clearly. Using standard disclaimers that are commonly used in a particular industry or recognised by an industry body may help professionals to argue that their

disclaimers are reasonable given the weight that the Commercial Court placed in this case on the defendant's use of a standard form of disclaimer used in the Audit Reports.

In addition, this case highlights the cautious approach that third parties should take to placing reliance on work produced by a professional firm for another client, especially where (like in this case) that work includes a disclaimer restricting third parties from relying on it.

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Registration and buffet lunch will take place from midday; the seminar commences at 12.30 pm.

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In the second of two seminars we look at remedies other than damages for contractual disputes such as specific performance, declaratory relief, injunctions and rectification.

Registration and buffet lunch will take place from midday; the seminar commences at 12.30 pm.

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decisions: *Prince Abdulaziz v Apex Global Management Ltd & an*r (Jan)

Public procurement

Review of authority's decision to cancel tender process: *Croce Amica One Italia Srl v Azienda Regionale Emergenza Urgenza* (Jan)

Regulatory

FCA Business Plan 2015/16: Key messages for litigators (April)

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New Senior Insurance Managers Regime (Jan)

Service

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Settlement

Inter-solicitor email exchange held to amount to a binding settlement of a complex litigation: *Raymond Bieber & ors v Teathers Ltd (in liquidation)* (FebMar)

State Aid

State aid recovery rates ordered against Irish airlines: *Case T-473/12 Aer Lingus Ltd v Commission and Case T-500/12 Ryanair Ltd v Commission* (April)

Tort

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