ALLEN & OVERY

August/September 2016

Litigation and Dispute Resolution

Review

EDITORIAL

This edition covers a number of important decisions handed down before the courts' summer break.

Complex procurement cases that reach full trial are quite rare. We cover *Energy Solutions v Nuclear Decommissioning Authority* in which the High Court ruled that the Nuclear Decommissioning Authority breached the Public Contract Regulations (PCRs) when awarding a GBP 4.6 billion contract. The ruling contains a number of salutary reminders for contracting authorities, suppliers to the public sector, and lawyers and is likely to be a reference point for future procurement exercises (see **Public Procurement**).

The insolvency of an agent (especially one that collects money) is a financial risk for a business. The Supreme Court handed down an important ruling concerning the ability of a principal to revoke an agent's authority and to recover money. For a principal wishing to avoid having to prove as an unsecured creditor in an agent's insolvency our article contains some drafting tips for agency agreements (see **Agency**).

The Court of Appeal's ruling in *Ferster v Ferster* highlights the downside of making, during settlement negotiations, threats should a party not agree to a claimant's settlement demands. Whilst not 'blackmail' the nature of the threats meant that a communication, which would normally have been protected by 'without prejudice' privilege, was not privileged so could be shown to the court (see **Privilege**).

Other articles include a pro-insured ruling by the Supreme Court that a 'collateral lie' by an insured will not necessarily invalidate a claim (which has caused concern to the insurance industry) and a landmark ruling by the Competition Appeals Tribunal in interchange fee litigation.

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Agency

MITIGATING RISK OF AGENT INSOLVENCY

Bailey v Angove's PTY Ltd [2016] UKSC 47, 27 July 2016

The Supreme Court has allowed a principal to recover payments received by its insolvent agent from customers. The insolvency of an agent who holds funds on a principal's behalf is a risk faced by any business using agents as, in the worst-case scenario, the principal is left to prove as an unsecured creditor in the agent's insolvency. The Supreme Court has made it harder for an agent to argue that its authority is irrevocable (although on the facts in this case, the agent's authority was found to be revocable). The Supreme Court has also ruled that the fact that an agent receives money at a time when it knows it will not be able to perform his corresponding obligation (eg to transfer funds to its principal) is not enough to give rise to a constructive trust. The case highlights some useful drafting points for those involved with negotiating agency agreements.

This appeal raised two "important and controversial" questions: (1) in what circumstances will the law treat the authority of an agent as irrevocable? (2) whether a recipient of money at a time when the recipient knows that imminent insolvency will prevent from performing his corresponding obligation, can give rise to liability to account as a constructive trustee.

The claimant winemaker entered into an agreement with the defendant agent and distributor in the UK. Under the agreement, the defendant supplied wine made by the claimant to customers (major UK retailers) in return for a commission on sales. It bought wines from the claimant in its own right and it sold wines on the claimant's behalf to UK customers, mostly retailers. The agreement was terminable by either side on six months' notice or by notice with immediate effect in a number of events, including the appointment of an administrator or liquidator.

The defendant became insolvent while there were still two outstanding customer invoices of nearly AUD 900,000 to be paid. The claimant, presumably concerned about the defendant collecting customer proceeds whilst insolvent, gave notice to the defendant to terminate the agreement including the defendant's authority to collect payment under the two remaining invoices. It stated that it would collect payment from the customers directly and account to the defendant for the commission separately. The liquidators of the defendant argued that the defendant's authority to collect customer payments survived termination of the agreement, and therefore were entitled to deduct their commission and leave the claimant to prove in the winding up for the rest of the price.

The Supreme Court had to determine whether the defendant's authority to collect payments had been validly revoked. In general, an agent's authority is revocable even if the parties have agreed otherwise. By way of exception, an agent's authority will be irrevocable if (i) the parties have agreed that the authority is irrevocable, **and** (ii) the authority is intended to secure an interest of the agent, where the interest is a proprietary interest (for example, a power of attorney to perfect an equitable interest) or a liability (most often a debt) owed to the agent personally. If both (i) and (ii) are satisfied, the agent's authority is irrevocable while the interest subsists.

This exception had previously been thought to apply only to instances where the sole purpose of the agent's authority was to secure his own financial interest, and was in reality no more than the commercial equivalent of an assignment for example, see Bowstead & Reynolds on Agency 20th Ed (2014) 10-007). The Supreme Court

rejected this narrow approach and instead held that the exception also applies to a "true agent employed on his principal's affairs", ie where an agent is acting both for himself and his principal.

The Supreme Court held that an agent's commercial interest in earning his commission is insufficient to render his authority irrevocable. In contrast, an interest in recovering a customer debt owed in respect of commission already earned would be sufficient. There was no reason "to distinguish a debt arising in this way from any other debt", provided that it was clear that the parties intended that the agent's authority should secure such an interest.

The court ruled that, on the facts, neither of the conditions for the exception to apply were made out:

- The contract did not expressly stipulate that the defendant's was irrevocable, nor was it expressed to survive termination of the contract, even though it would have been a simple task to insert such provisions into the agreement.
- The ability of customers to pay the claimant directly made it difficult to view collection from the customer as a right of the defendant, rather than simply a function to be performed by it. As such, the defendant's responsibility to collect payment from the customers was not a form of security.
- The defendant's ability to deduct commission in the event that payment was made to the claimant was also seen as a procedural mechanism rather than a form of security, as the customer was able to pay the claimant directly.
- It was inherently improbably that the parties should have so intended the authority to be irrevocable. An express termination right had been provided for in the event of insolvency and the claimant clearly wanted to avoid the problems associated with an insolvent agent.

The Supreme Court concluded that the claimant's notice was immediately effective to terminate the defendant's authority to collect on outstanding invoices.

No constructive trust

The court went on, *obiter*, to consider a point of "general importance", namely whether, if the defendant had in fact been entitled to continue to collect money on the outstanding invoices, the amounts received would have been held on constructive trust for the benefit of the claimant.

The Supreme Court rejected the notion that an agent who receives money, on behalf of a principal, at a time when the agent knows that its imminent insolvency will prevent it from performing its obligations, holds the money on a constructive trust.[1]

Instead, the court held, a constructive trust would not arise in this situation. If there was a trust over money already paid by the claimant to the defendant then it would not form part of the insolvent estate of the company thus conferring priority on the claimant over other creditors. This would be unfair when many of those creditors would otherwise be in a position no different from their own. The rule is, therefore, that unless the agent is expressly made trustee for the money then it will form part of the agent's insolvent estate and the principal must prove in the liquidation.

COMMENT

Any business that uses an agent which holds the principal's funds (for example, payments from customers or advance payments from the principal which the agent uses to pay third parties) faces a financial risk should the agent become insolvent whilst still holding substantial amounts of the "principal's" funds. Faced with the prospect of proving as an unsecured creditor in an agent's insolvency, a principal will need to consider both mitigating that risk upfront (ie by inserting appropriate provisions in the agency agreement) and, should an agent become insolvent, take swift action.

On drafting, a principal should:

- ensure that the power of the agent to collect receivables directly from customers is expressed to be revocable and does not survive termination of the agreement. Whilst it is not necessarily fatal, if it is described as irrevocable it is certainly less helpful. Also ensure that the power is not coupled with an interest (ie it is the only way for the agent to collect its commission);
- ensure that the agent's power to collect receivables (even in respect of transactions prior to termination) is automatically terminated on termination of the agreement;
- consider including more sensitive insolvency termination provisions in the agreement – earlier than actual insolvency;
- ensure that the principal has a right to collect payments directly from the customers and include an obligation on the principal to pay the agent its commission in these circumstances;
- express the collection of payments by the agent as being an obligation of the agent, rather than a right;
- include a mechanism in the agreement between the principal and the end customer whereby the principal can give the customer notice that it must pay to the principal rather than the agent and that any payment to the agent will not constitute a good discharge by the customer of its obligations to pay the purchase price; and
- provide for regular payments by the agent to the principal of the amounts collected, in order to minimise financial exposure. Consider only 30-day payment terms or alternatively provide for a longer period but specify that where amounts held exceed GBP X, the excess over GBP X should be paid over immediately.

In terms of increasing the chance of a court finding that a constructive trust has arisen over funds held by the agent on the principal's behalf (and depending on the negotiating position of the parties and the amounts involved) the agency agreement should clearly declare that the receivables are to be held on trust and include provisions relating to the mechanics of them being so held (such a separate account). The agent must not be permitted to use the receivables as part of his own funds and the receivables should be segregated from the other assets of the agent and clearly be identifiable.

When a principal becomes aware of an agent's insolvency it needs to act quickly to terminate the agency by notice to the agent. Substantial customers should also be notified, to remind them to pay directly to the principal.

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[1] The Supreme Court doubted the reasoning of Bingham J in *Neste Oy v Lloyd's Bank Plc* [1983] 2 Lloyds Rep 658. Re Japan Leasing Europe Plc [1999] BPIR 911 was "wrongly decided".

Anti-trust

COMPETITION APPEAL TRIBUNAL'S LANDMARK JUDGMENT IN INTERCHANGE FEE LITIGATION

Competition Appeal Tribunal 1241/5/7/15 (T) *Sainsbury's Supermarkets Ltd v MasterCard Incorporated & ors*, Case No. 1241/5/7/15(T), 14 July 2016

MasterCard has been ordered to pay GBP 8,582,245 (plus interest) in damages to Sainsbury's Supermarkets Ltd (**Sainsbury's**) in the first standalone damages action to result in judgment in the UK. The CAT found that the default interchange fee set by MasterCard was a restriction of competition by effect. This judgment is expected to have significant ramifications for the on-going interchange fee cases against both MasterCard and Visa. It may also impact the GBP 14 billion consumer class action threatened against MasterCard.

What are interchange fees?

MasterCard is one of the world's largest retail electronic payment networks. Its licensees are banks or other financial institutions which are either issuers (providing payment cards to cardholders) or acquirers (providing acquiring services – including the ability to accept card payments – to merchants eg shops and businesses).

Under the MasterCard Scheme, interchange fees are fees paid to issuers by acquirers each time a card payment transaction occurs. The issuer forwards the purchase amount to the acquirer minus the interchange fee. This fee is intended to incentivise issuers to issue cards to cardholders, leading to increased numbers of cardholders wishing to use MasterCard branded cards at merchants. MasterCard does not receive any of the interchange fees itself. Its aim is to set these fees at a level which maximises transaction volumes. Interchange fees may be agreed bilaterally between the issuer and acquirer or, if there is no agreement in place, the default fee is established multilaterally by MasterCard pursuant to its Scheme Rules. This is known as a Multilateral Interchange Fee (**MIF**). In practice bilateral fees are very rarely agreed and the MIF applies to virtually all transactions.

Acquiring banks pass the MIF on to merchants (such as Sainsbury's) through the Merchant Service Charge (**MSC**), a charge paid by merchants to their banks for the provision of merchant services. The MIF forms approximately 90% of the MSC.

Sainsbury's alleged that the UK MIF was set at an anticompetitively high level and had as its object and/or effect the appreciable prevention, restriction or distortion of competition between acquiring banks in the UK. It argued that the level of the UK MIF inflates the base on which acquirers set their MSCs resulting in a "floor" price for merchants.

Restriction of competition

The CAT concluded that the UK MIF is a restriction of competition by effect. The "effect" was assessed by reference to what the situation would have been "but for" the competition infringement – this is known as the "counterfactual". The CAT found that bilaterally agreed interchange fees would have been agreed in place of the UK MIF. These bilaterally agreed fees would have been equivalent to 0.50% for credit and 0.27% for debit (rather than the actual rates of 0.9% and 0.36% respectively). This is a level that, according to the CAT, would encourage issuing banks to remain in the MasterCard Scheme, and avoid the fatal erosion of MasterCard's market share.

The CAT concluded that the actual UK MIFs were not capable of exemption under Article 101(3) TFEU. An exemptible MIF must function as a defensible price in

all relevant markets, but particularly in the issuing and acquiring markets. An exemptible MIF must take account of the benefits of the scheme derived by acquirers and, more particularly, merchants and quantify the costs to issuers of those benefits.

It rejected the Merchant Indifference Test (**MIT**) as an appropriate methodology to calculate an exemptible level of MIF. The MIT determines the extent to which a merchant would prefer to receive payment by cash rather than card. The CAT concluded this was unsuitable as this test does not actually take into account advantages gained by merchants through the use of cards and entirely ignores the costs of card schemes in the issuing market.

Calculation of damages

The CAT concluded that Sainsbury's is entitled to damages in an amount equivalent to the "overcharge" ie the difference between the MIFs actually paid by Sainsbury's and the hypothetical bilateral interchange fees.

MasterCard's *ex turpi causa* defence failed. This defence relied on the fact that although Sainsbury's alleged that the MIFs were unlawful, Sainsbury's Bank Plc (a sister company) had issued cards and collected MIFs itself. The CAT dismissed this argument on the grounds that Sainsbury's Bank's autonomy was not compromised and its conduct was insufficiently wrongful to trigger the defence. However, the CAT concluded that Sainsbury's must give credit for 80% of the total UK MIF received by Sainsbury's Bank throughout the period of the claim as this amount is assumed to have been spent for the benefit of Sainsbury's.

Was the overcharge passed on to consumers?

MasterCard argued that Sainsbury's did not in fact suffer any loss because any 'overcharge' was passed on to its customers in the form of higher prices. Despite acknowledging that a pass-on defence is not really a defence at all, but a mechanism to ensure that a claimant is sufficiently compensated, the CAT identified a stringent legal test for MasterCard's pass-on defence to succeed. The CAT ultimately concluded that it must fail because "no identifiable increase in retail price has been established, still less one that is causally connected with the UK MIF. Nor can MasterCard identify any purchaser or class of purchasers of Sainsbury's to whom the overcharge has been passed who would be in a position to claim damages".

However, despite ruling that the pass-on defence must fail, the CAT awarded Sainsbury's compound interest on only 50% of the total damages, concluding that "a substantial amount of the UK MIF – 50% – would have been passed-on (albeit not in a manner which would have amounted to a "defence" of pass-on)".

COMMENT

This judgment provides a complicated precedent for future cases to follow. The most significant of the difficulties it presents relates to the pass-on defence as there is a tension between the CAT's approach to pass-on and its subsequent award of compound interest.

The counterfactual is also surprising as it is not one which was supported by either MasterCard or Sainsbury's. The expert evidence (on both sides) suggested a bilateral interchange fee was unlikely to be a viable counterfactual.

Considerations when instructing experts

The CAT did not place much reliance on the expert evidence as the experts were economists, not experts in payment systems. In competition cases such as this it is however very common to appoint economists as experts.

The CAT suggested that in future cases the parties must ensure that economic experts give their opinions based upon a "common – and, if possible, agreed – factual base". In practice this may be very difficult to achieve.

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Contract

NO IMPLIED DUTY OF GOOD FAITH IN TERMINATION CLAUSE

Monde Petroleum SA v Westernzagros Ltd [2016] EWHC 1472 (Comm), 28 June 2016

The High Court ruled that there was no implied term in a commercial contract that a party would not terminate in bad faith. There was no indication that the contract would lack commercial or practical coherence without an implied term of good faith, and there were no other special circumstances that would justify an implied term to that effect. The judge also found that, provided the contract requirements (if any) for the exercise of an express contractual right to terminate are met, that right may be exercised irrespective of the exercising party's reasons for doing so.

Westernzagros Limited (**WZL**) negotiated with the Kurdistan Regional Government to reach an exploration and production sharing agreement for oil in Kurdistan. WZL engaged Monde under an agreement (the **Consultancy Agreement**) to assist WZL with the negotiations. In return for its services it was agreed that Monde would be paid monthly fees, success fees payable on completion of certain milestones and, ultimately, be granted an option to acquire a 3% working interest in the project.

WZL served a termination notice to terminate the Consultancy Agreement in accordance with its express terms, but it failed to give the 30 days' notice required. Monde sued WZL.

This article focuses on two of Monde's claims:

- that the termination provisions in the Consultancy Agreement were subject to an implied term that they should not be exercised in bad faith or in an unconscionable manner, intending to deprive Monde of its remuneration under the Consultancy Agreement, including the 3% option; and
- the termination notice was invalid and that, by serving it, WZL had committed a repudiatory breach of the Consultancy Agreement entitling Monde to substantial damages.

Was there an implied term not to terminate in bad faith?

Monde relied on the Supreme Court's decision in *British Telecommunications plc v Telefonica O2 UK Ltd* [2014] UKSC 42 in which Lord Sumption said "…it is well established that in the absence of very clear language to the contrary, a contractual discretion must be exercised in good faith and not arbitrarily or capriciously…". Monde argued that this principle extended to the exercise of termination rights in a contract. It could not be right that WZL could bring the Consultancy Agreement to an end after Monde had done most of its work but before it had reaped a substantial part of its reward.

The judge, HHJ Richard Salter QC, rejected this argument.

No general or implied duty of good faith

First, the fact that a contract was long-term or relational is not, of itself, enough to justify an implied duty of good faith. There is no general doctrine of 'good faith' in English contract law. There are certain examples of contracts which may involve expectations of loyalty implicit in the parties' understanding and necessary to give business efficiency to the contract, and in which an

implied duty of good faith may sometimes be justified. In all other categories of contract, however, such a duty will only be implied where the contract would lack commercial or practical coherence without it and where all the other requirements for implication are met (*Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72).[1]

There was nothing in the commercial background or the relationship between the parties, as set out in the Consultancy Agreement, which indicated that the Consultancy Agreement would lack commercial or practical coherence without an implied term of good faith. The Consultancy Agreement was detailed and professionally drafted, and both sides were advised by lawyers. The Consultancy Agreement did not contain the sorts of mutual obligations and commitments that would be expected in the kind of relational contract where there are "expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties' understanding" (*Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB))[2] which may, in the absence of any contrary indications, justify an implied term of good faith.

Reason for termination was irrelevant

Secondly, the judge found that a contractual right to terminate is a right which may be exercised irrespective of an exercising party's reasons for doing so. Provided that the contract conditions (if any) for the exercise of such a right are met, the party exercising that right does not have to justify its actions. In *Lomas v JB Firth Rixson Inc* [2012] EWCA Civ 419 the Court of Appeal characterised as "hopeless" the argument that a Non-Defaulting Party's express right under the ISDA Master Agreement to bring that agreement to an end upon an Event of Default was impliedly subject to the requirement "to exercise its discretion…in a manner which is not arbitrary, capricious or unreasonable".

The judge considered that this principle is one of general application. One reason for this is that a contractual right to terminate is not the exercise of a contractual discretion. Contractual discretions arise where there are a range of options to choose from whereas a contractual right to terminate involves a binary choice.

The judge distinguished Leggatt J's decision in *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2015] EWHC 283[3] in which it was suggested that a party may be bound to exercise a termination right in good faith. The judge did so on the basis that: (i) *MSC Mediterranean* dealt with a different situation, namely the limits placed by law on an innocent party's common law right to affirm the contract and insist on future performance, not an express contractual right to terminate; and (ii) it did not appear from the *MSC Mediterranean* judgment that *Lomas* had been cited to the judge.

COMMENT

Unlike many other jurisdictions, it is a longstanding principle that English law does not recognise a general doctrine of good faith.

The decisions of Leggatt J in *Yam Seng* and *MSC Mediterranean* had suggested a possible move towards the development of a concept of good faith in English contract law. Shortly after the ruling in *Monde Petroleum* the Court of Appeal ruled on *MSC Mediterranean* [2016] EWCA Civ 789, reversing in part the High Court decision mentioned above. Although "good faith" did not play a prominent role in arguments before the Court of Appeal, it was one of a number of additional points raised by the lower court judgment that the Court of Appeal said called for comment. In doing so, Moore-Bick LJ cited with approval the approach put forward by Bingham LJ in *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433 to develop "piecemeal solutions in response to demonstrated problems of unfairness". The ruling in

Monde Petroleum and the Court of Appeal's subsequent decision in *MSC Mediterranean* therefore seem to indicate a return towards a more traditional approach of dealing with matters of good faith on a case-by-case basis.

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[1] http://www.allenovery.com/publications/en-gb/Pages/Test-for-implying-a-term-in-to-a-contract-is-stringent-and-has-not-been-diluted.aspx

[2] http://www.allenovery.com/publications/en-gb/Pages/A-new-era-for-good-faith-in-English-contract-law.aspx

[3] http://www.allenovery.com/publications/en-gb/Pages/Right-to-affirm-a-contract-after-repudiatory-breach-fettered-by-good-faith.aspx

Costs

CURRENCY FLUCTUATIONS AND PART 36 OFFERS TO SETTLE

Novus Aviation Ltd v Alubaf Arab International Bank BSC(c) [2016] EWHC 1937 (Comm), 27 July 2016

This ruling is relevant when unforeseen fluctuations in the currency exchange rate between the time of a Part 36 offer and the time of judgment affect whether the Part 36 offer has been 'beaten or not'. The court ruled that the value comparison between a judgment and a Part 36 offer should be done on the date of the court's order. The only reason that the claimant obtained a judgment (in U.S. dollars) which was more advantageous than its Part 36 offer (in pound sterling) was as a result of the post-Brexit vote fall in pound sterling. In these circumstances, the court found it unjust to order the normal Part 36 costs consequences which apply where an offer has been beaten at trial.

Novus' Part 36 offer

Novus made an offer under the Civil Procedure Rules Part 36 (**CPR Part 36 offer**) to Alubaf in pound sterling but the amount for which judgment was entered in favour of Novus was in USD. If applying the (post-Brexit vote) exchange rate at the time of judgment (GBP 1 = USD 1.31), then Novus no doubt obtained a judgment which was more advantageous than its Part 36 offer. However, if applying the (pre-Brexit vote) exchange rate at the time of Novus' offer (GBP 1 = USD 1.68), the converted amount of the offer in USD was substantially more that the judgment amount.

In determining whether the CPR Part 36 costs consequences should apply, when should the relevant comparison be made? Is it: (i) when the Part 36 offer was made, (ii) at the end of the "relevant period" (as defined in CPR 36x.3(1)(c), now CPR 36.3(g)), which period could extend to the end of the trial, or (iii) at the time of judgment?

The currency in which Novus conducts its business and suffered loss is USD, and this was relied on by Alubaf as a basis for arguing that the relevant comparison to be undertaken is at the time when Novus made its offer. However, Leggatt J ruled that this cannot trump what is set out in the rules. The relevant time at which to make the comparison in money terms between the judgment

and the Part 36 offer is specified as being "upon judgment being entered", which means the date when the order containing the court's judgment is made.

The fall in the pound sterling/dollar exchange rate meant that Alubaf became liable for Part 36 costs consequences in circumstances where it otherwise wouldn't have been had the trial taken place earlier and/or had the judgment been handed down prior to the Brexit vote. Indeed, if judgment had been entered at any time between the start of the trial (on 26 April) and 23 June 2016, Novus would not have beaten its Part 36 offer and orders for interest at an enhanced rate and indemnity costs could not have been made.

Was it unjust to order the costs consequences

CPR 36x.14(3), now CPR 36.17(4), provides the court with discretion not to order the costs consequences if "it considers it unjust to do so" and, by CPR 36x.14(4), now CPR 36.17(5), the court is to "take into account all the circumstances of the case". In the court's view, it is a highly material circumstance that the only reason why Novus has beaten its Part 36 offer is the recent fall of the pound sterling against the dollar. As such, the court considered that: "it would in these circumstances be unjust to make orders under CPR 36x.14(3) for any part of the period between the date on which "the relevant period" expired and today's date. The reality is that if at almost any time between the date when the offer was made and the end of the trial Alubaf had accepted the offer, the sum received by Novus would have been worth more than the judgment which it has ultimately obtained (even ignoring the time value of money). It would in these circumstances be adventitious and inconsistent with the principle of risk allocation which underlies Part 36 to penalise Alubaf for not accepting the offer."

COMMENT

This judgment is particularly relevant in circumstances where a Part 36 offer is made in one currency and the quantum of damages ordered by the judgment is in a different currency, and unforeseen fluctuations in the currency exchange rates have been observed between the time of the offer and the time of judgment. The court decision provides some comfort to parties in Alubaf's position in finding that it is unjust to order the costs consequences for any part of the period between the date on which the relevant period of the offer expired and the judgment date. In order to achieve greater certainty, an offering party should consider making an offer in the same currency in which the claimant's loss is likely to be suffered, so as to mirror the currency in which the quantum of damages would be ordered by the court.

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Crime

PLACE YOUR BETS: CONTRACT, RESTITUTION AND ILLEGALITY

Patel v Mirza [2016] UKSC 42, 20 July 2016

The Supreme Court ruled that the "illegality defence" would not prevent restitution of money which had been paid as part of an attempted crime which was never carried out. The majority identified factors to be considered when deciding whether the illegality defence should apply. These factors are an attempt to clarify what has always been a complicated, and often contradictory, area of law.

The "illegality defence" may prevent a claimant from bringing a claim if he has been involved in illegal activity associated with the claim: "No court will lend its aid to a man who founds his case upon an immoral or an illegal act" (Lord Mansfield *Holman v Johnson* (1775) 1 Cowp 341). However, the exact degree and nature of illegality which is required under English law to defeat such a claim has never been certain.

Money paid for illegal bet

The respondent (**Patel**) had given the appellant (**Mirza**) GBP 620,000 to place a bet on RBS shares on the understanding that Mirza was going to obtain insider information from RBS contacts. This agreement amounted to a crime of conspiracy to commit insider dealing contrary to s52 Criminal Justice Act 1993.

The insider information did not materialise and so the bet did not take place. However, Mirza refused to repay Patel. Patel brought a claim to recover the money on various bases including contract and unjust enrichment.

The Court of Appeal held that Patel's claim for return of the money should succeed, and Mirza appealed against this.

Illegality defence fails

The Supreme Court judges all agreed that the appeal should be dismissed and that Patel was entitled to restitution of the full GBP 620,000. However, they arrived at the decision in different ways.

The majority agreed with Lord Toulson, who gave the leading judgment, that the essence of the illegality doctrine is that it would be contrary to the public interest to enforce a claim if doing so would harm the integrity of the legal system. Lord Toulson set out guidelines for assessing whether allowing a claim would harm the public interest. The majority held that allowing Patel's claim would not undermine the integrity of the justice system. However, although the minority agreed with the outcome, they criticised this approach.

Majority reasoning

The majority held that there were two main policy reasons for allowing illegality to be a defence to civil claims. First, no one should be allowed to profit from their own wrongdoing. Secondly, "the law should be coherent and not self-defeating, condoning illegality by giving with the left hand what it takes with the right hand".

Lord Toulson compared two different approaches to the illegality defence: a "rule-based approach" and a "range of factors approach". The majority favoured the latter: "the public interest is best served by a principled and transparent assessment of the considerations identified, rather than by the application of a formal approach capable of producing results which may appear arbitrary, unjust or disproportionate".

There were three key considerations when assessing whether allowing a claim would be contrary to the public interest and so harm the integrity of the judicial system:

(1) The underlying purpose of the law which has been broken, and whether that purpose would be enhanced by denying the claim.

(2) Whether there were any other relevant public policies which might be made ineffective or less effective by denying the claim.

(3) Whether denying the claim would be a proportionate response to the illegality.

When considering proportionality, there were various different factors to be considered such as the seriousness of the conduct, its centrality to any agreement, whether it was intentional and whether there was a marked disparity in the parties' culpability.

On the facts of the case, Lord Toulson agreed with Gloster LJ in the Court of Appeal that "there was no logical basis why considerations of public policy should require Mr Patel to forfeit the moneys which he paid into Mr Mirza's account, and which were never used for the purpose for which they were paid". "[S]uch a result would not be a just and proportionate response to the illegality." Lord Toulson noted that, in re-claiming the money, Patel was trying to unravel the contract rather than profit from it.

Lord Toulson criticised the reliance rule set out in *Tinsley v Milligan* [1994] 1 AC 340 and held that it should no longer be followed. In essence, this rule was that a claim cannot be brought if a claimant has to rely on his own illegality when asserting his claim. Lord Toulson felt the reliance rule turned on a "procedural technicality which had nothing to do with the underlying policies" and was a "narrow rule-based approach". Application of the illegality defence "is not a matter which can be determined mechanistically" and doing so can lead to arbitrary results.

Minority reasoning

Lords Mance, Clarke and Sumption criticised the approach suggested by the majority on the basis that "it is far too vague and potentially far too wide to serve as the basis on which a person may be denied his legal rights. It converts a legal principle into an exercise of judicial discretion".

Lord Sumption disagreed with the majority's criticisms of the reliance test. He felt that it "accords with principle" and that "every alternative test which has been proposed would widen the application of the defence as well as render its application more uncertain". In particular, the reliance test:

- gives effect to the principle that a person may not derive a legal right from his own illegal act;
- establishes a direct causal link between the illegality and the claim; and
- ensures that the illegality principle applies no more widely than is necessary to give effect to its purpose of preventing legal rights from being derived from illegal acts.

Lord Clarke felt that: "The correct response is not for us to leave the problem to a case by case evaluation by the lower courts by reference to a potentially unlimited range of factors, but to address the problem by supplying a framework of principle which accommodates legitimate concerns about the present law."

COMMENT

The earlier case law on the illegality defence was complex, incoherent and lacking in clear principles. In the recent case of *Bilta (UK) Ltd v Nazir (No 2)* [2016] AC 1, Lord Neuberger had called for the issue to be brought before a Supreme Court bench.

This has now happened, but, as the minority said, it is questionable whether greater clarity and coherence will be the result.

On the facts, the Supreme Court had little difficulty in deciding that Mr Patel should succeed. He was not seeking to enforce an illegal contract. He was merely seeking restitution of the money he had provided to Mr Mirza. Although he had been party to an illegal agreement, the court did not feel this was any reason why the other party to the agreement should be entitled to keep Mr Patel's money. It was no part of the civil justice system to punish Mr Patel and allow Mr Mirza a windfall. Granting restitution, and putting the parties back into their original position, would not prevent the criminal courts applying any appropriate sanction.

However, even on these relatively straightforward facts, the court arguably contradicted, or at least ignored, other legal principles. Thus, restitution is an equitable remedy, but it is a rule of equity that a party seeking a remedy must come to the court with "clean hands". It is hard to see how Mr Patel could claim to have done this. Further, as the minority pointed out, the effect is to replace the stark simplicity and certainty of the "reliance" rule with a more flexible set of rules with – as yet – uncertain application.

Having said that, the illegality defence has been invoked in circumstances ranging from highway men disputing how to allocate the spoils of robbery, to social security fraud, attempts to put assets beyond the reach of creditors and, as here, conspiracy to commit insider dealing. Given this, it may be asking too much of a single rule that it should do justice, and produce proportionate results, in all possible cases. As things stand, until a body of relevant case law has been built up, the scope and effect of an illegality defence may remain highly uncertain.

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Data Protection

PRIVACY SHIELD READY FOR BUSINESS

On 12 July 2016 the EU adopted the EU-U.S. Privacy Shield Framework. This new framework replaces the U.S.-EU Safe Harbor Framework for data flows between the European Union and U.S. after its well-publicised invalidation by the European Court of Justice in October 2015.

The five key stated improvements of the Privacy Shield as set out by the European Commission, are the following:

- the Privacy Shield includes stricter rules on how U.S. companies must handle personal data of European citizens (including tighter rules on the onward transfer of personal data to other companies);
- U.S. authorities have committed to monitor actively and enforce U.S. companies' compliance with the Privacy Shield;
- there are several redress mechanisms for European citizens. These mechanisms include the establishment of a new Ombudsperson who will follow up complaints and enquiries made by European citizens;
- U.S. authorities have given written assurances on how they will handle the collection and use of personal data for national security and police enforcement purposes; and
- the Privacy Shield will be a dynamic system, which will be subject to a yearly joint review by EU and U.S. authorities.

The adoption of the Privacy Shield marks the conclusion of a lengthy and animated discussion, with earlier versions of the Privacy Shield having been subsequently criticised by the Article 29 Working Party, the

European Parliament and the European Data Protection Supervisor.

Following these discussions, the European Commission renegotiated the Privacy Shield with U.S. authorities, resulting in an updated version. This updated version includes some improvements, for instance on the bulk collection of personal data for national security purposes (although, according to many, these assurances do not fully address many of the concerns raised).

Written assurances

Much has been said (and will continue to be said) about the precise legal status of the written assurances provided by U.S. authorities (including the U.S. Department of Justice and the Office of the Director of National Intelligence). These are in the form of written letters by these authorities.

During the debate on 11 July in the European Parliament, several members of the European Parliament questioned the binding nature of these letters, in particular referring to the upcoming U.S. elections as a risk factor.

What next

The Privacy Shield is now in force, and the U.S. Department of Commerce has started accepting applications under the Privacy Shield. Companies will therefore soon be able to rely on the Privacy Shield to justify transfers of personal data to the U.S.

The Privacy Shield will undoubtedly continue to be tested in the coming months and years. Several privacy advocates (including Max Schrems, who was responsible for bringing the legal challenge against the Safe Harbour mechanism) have already announced that they will challenge the Privacy Shield before the Court of Justice of the European Union.

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Employment

SETTLING MORE THAN YOU BARGAINED FOR: RELEASE CLAUSE IN DIRECTOR'S COMPROMISE AGREEMENT DEFEATS SUBSEQUENT IP CLAIMS AGAINST DIRECTOR AND CO-DEFENDANTS

Oran Pre-Cast Ltd v Oranmore Precast Ltd [2016] EWHC 1846 (IPEC), 21 July 2016

A release in a director's settlement agreement was sufficiently wide to cover liability for later claims of trade mark infringement and passing off against the director and two co-defendants. The case reinforces the importance of providing unambiguous parameters to the scope of a release when negotiating any sort of settlement.

Oran is an Irish entity that provides goods and services for the construction industry. Oranmore was incorporated in the UK by Mr Melville and Mr Burke, both of whom previously worked for Oran. It provides identical and similar goods and services to Oran, and has substantially the same commercial sign as Oran. The other directors of Oran were aware of these facts by June 2012. Mr Burke's directorship of Oran was terminated when he was made redundant in December 2011. He was owed EUR 600,000 in back pay in addition to redundancy pay. When Oran failed to discharge this debt, Mr Burke issued proceedings in the Irish High

Court, and was granted summary judgment for the back pay. In lieu of enforcing the judgment, Mr Burke entered into a compromise agreement in May 2013 in which Oran provided a wide release for all claims against him. In November 2015, Oran brought trade mark infringement and passing off claims (IP Claims) against Oranmore, Mr Burke and Mr Melville as joint-tortfeasors. The defendants relied on the release provision in the compromise agreement as their defence to the IP Claims.

Compromise agreement

The compromise agreement was made up of three documents. The first was a release given by Mr Burke to Oran for "all sums due and owing" in exchange for a payment of EUR 26,092. This figure represented his outstanding redundancy pay. The second document was the release from Oran given to Mr Burke, in exchange for him compromising his rights under the back pay summary judgment, and confirming that Oran had no claim against him "…whether arising by contract, common law and/or statute". The final document was labelled as a "Discharge Form" in which Mr Burke compromised any other claims he might have against Oran.

The defendants' position was that the release given by Oran provided a complete answer to the IP Claims: it was "unambiguous and wide-ranging, covering present and future claims of whatever nature".

Oran argued that the compromise agreement did not cover claims beyond Mr Burke's employment and its termination, and as such, the IP Claims were not caught by the release. Oran also contended that the wording of the compromise agreement did not amount to a release of claims against Mr Burke, but was merely a promise not to sue. If this line of argument had been successful, the other defendants would not have been able to rely on the compromise agreement as a defence to the claims.

Decision

In light of the factual, documental and commercial context in which the agreement was made, the widely-drafted wording in the agreement was sufficient to release Mr Burke from any liability. In the absence of an express or implied reservation against his joint tortfeasors, Oranmore and Mr Melville were also held to be released from any liability.

The court found that a "reasonable person with the relevant background knowledge of the parties" would interpret the scope of the release given by Oran to extend beyond claims relating solely to Mr Burke's employment and termination. Taking into account the fact that Mr Burke waived his rights under the judgment for EUR 600,000 in his favour, the judge assessed that it had been Mr Burke's intention to compromise all future claims against him to "enable him to draw a line in the sand…and get on with his working life" at Oranmore. Equally, as Oran would have struggled to have paid the amount owing to Mr Burke, or to have secured commercial credit in light of the summary judgment, it too had a "commercial imperative" to settle.

The judge also held that the wording of the compromise was "unambiguously a release" and not a promise not to sue. This meant that not only was Mr Burke released from liability, but so too were his co-defendants in their capacity as joint tortfeasors. At common law, a settlement that releases one tortfeasor where there are several will also have the effect of releasing the other tortfeasors, save where the drafting includes an express reservation of the right to sue the others. In the absence of such reservation, the other defendants in this case were able to rely on the release given to Mr Burke.

COMMENT

In the absence of clear drafting, the courts will rely on context when examining the effectiveness of a release clause. The judgment found that Mr Burke had purposefully sought to wipe the slate clean, compromising his right to an award of EUR 600,000 in exchange for the release from Oran. It was clear, in light of the factual and commercial context, that the release was intended to catch future IP Claims arising out of the use of the Oranmore name and similar Oran sign. Even if this was not explicit, it could be implied.

However, as shown in *Khanty-Mansiysk Recoveries v Forsters LLP* [2016] EWHC 522 (Comm), unknown claims (that arise outside of the particular circumstances in which a settlement agreement is negotiated) can also

be inadvertently caught by a wide release clause. The parties in that case were settling claims relating to unpaid legal fees. A breach of contract and negligence claim was not in contemplation at the time of signing. However, because it was not inconceivable that such a claim could arise in future, it was held to be caught by the release. This can be distinguished from the case of *Bank of Credit and Commerce International SA v Ali* [2002] 1 AC 251 in which a claim was not caught by a wide release clause, because the nature of the claim was an "unknown unknown". At the time the clause was entered into, the claimant was not aware, and crucially, could not have been aware, that his claim would arise. His claim could not, therefore, be caught by the release he had provided earlier.

In both *Khanty-Mansiysk*[1] and *Oran Pre-Cast Ltd* the lesson remains that great emphasis needs to be placed on making the release clause as clear as possible: carve out specific existing or potential liabilities which are not being settled to avoid inadvertently doing so, and make it as explicit as possible which specific liabilities are being settled, to avoid having to rely on a catch-all clause. Of equal importance is to ensure that when providing a release – rather than a promise not to sue – the drafting must be unambiguous, and that appropriate reservations of the right to sue other parties are included, so as not to unintentionally release joint tortfeasors.

The judgment in this case pointed out that the courts are aided by "assistive or explanatory text" in the wording of a release clause. Clearly, this is a fact specific case, but it serves as salutary reminder of the importance of ensuring that the scope of any release is carefully tailored to the matters at hand, clearly drafted, and with consideration given to the wider commercial context in which it is provided.

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[1] See June 2016 Review: http://www.allenovery.com/publications/en-gb/Pages/Wide-interpretation-of-release-clause-in-settlement-agreement.aspx

Insurance

"COLLATERAL LIES" DO NOT NECESSARILY UNDERMINE AN INSURANCE CLAIM

Versloot Dredging BV & anr v HDI Gerling Industrie Versicherung AG [2016] UKSC 45, 20 July 2016

An insured was not precluded from recovering under an insurance policy even though it had made a false statement during the claims process with a view to strengthening its claim. The Supreme Court considered the extent of the fraudulent claims rule which applies to insurance contracts and prevents an insured recovering under an insurance policy where the claim is fabricated or exaggerated. The Supreme Court held (Lord Mance dissenting) that this rule does not apply to false statements that are immaterial to an insured's right to recovery under the policy. Insurers have expressed their concern at the decision.

The claimant ship owners suffered irreparable damage of a vessel's engine after the engine room was flooded, causing a loss of EUR 3,241 million, which they sought to recover from the defendant insurers. The ship owners had falsely stated, in response to inquiries made by the insurers, that an alarm had sounded but that no action had been taken by the crew as the alarm was attributed to the ship rolling in heavy seas. In actual fact no alarm had sounded. The ship owners had been frustrated by the insurers' delay in recognising the claim and this statement was intended to reassure the insurers that the ship was seaworthy with fully operational alarm systems. They believed that this statement would fortify the claim and accelerate payment.

The alarm statement was later discovered to be false, but was irrelevant to the validity of the claim. Although the alarm had not sounded, it was tested shortly after the incident and found to be working. Even if it had not been working, Popplewell J at first instance held that this would not assist the insurers as the alarm's failure to sound would not have been the proximate cause of the loss. Popplewell J concluded that the loss was caused by a peril of the seas covered by the insurance policy. Nevertheless, Popplewell J held that the insurers were entitled to repudiate the entire claim under the ship owners' insurance policy as a result of this false statement. The ship owners appealed, with the Court of Appeal upholding the decision.

Fraudulent and exaggerated claims

At common law it is well established that if an insured makes a fraudulent or exaggerated claim on its insurer, the insured loses the right to recover the entirety of that claim, including any genuine losses it would have obtained. The law refuses to sever the honest part of the claim from the invented part.[1] This is commonly referred to as the "fraudulent claims rule".

Section 12 of the Insurance Act 2015 (which came into force on 12 August 2016) has preserved this rule. It does not, however, define what constitutes a fraudulent claim and does not refer to a situation where a valid claim is supported by a false statement.

Collateral lies and fraudulent devices

The extension of the common law rule to justified claims supported by false statements is more recent and controversial. Lord Sumption referred to *Agapitos v Agnew (The Aegeon)* [2003] QB 556, where Lord Mance had considered, obiter, whether the fraudulent claims rule could apply to a lie made in the presentation of a claim which does not affect the merits of, or the amount of, the claim. This has been generally termed a "fraudulent device" (or, adopting Lord Sumption's expression, a "collateral lie"). Lord Mance considered

that such collateral lies were also subject to the fraudulent claims rule.

The majority of the Supreme Court, with Lord Sumption giving the lead judgment, disagreed with this approach. Lord Sumption distinguished between a fraudulent exaggerated claim, which is designed to enable the insured to gain something which it is not entitled to, and a justified claim supported by a collateral lie. Where the lie is irrelevant to the existence or the amount the insured is entitled to, the insured gains nothing from the lie which he was not already entitled to by law and the insurer loses nothing from meeting a liability it already had (having crystallised at the moment of loss). The lie is therefore dishonest but the claim is not.

Lord Sumption concluded that it was disproportionately harsh to the insured and would go further than any legitimate commercial interest for the fraudulent claim rule to extend to collateral lies. The policy of deterrence did not justify such an extension of the rule.

COMMENT

The historic justification for the fraudulent claim rule was as a clear deterrent to fraudulent claims, recognising that insurers can be dependant on the insured for information, both at the formation of the contract and in the processing of claims. Honest policyholders would otherwise bear the financial burden of costs incurred by the insurers due to fraudulent or exaggerated claims, through increased premiums. As the judges recognised, fraudulent insurance claims are a serious issue, with insurance fraud widely perceived as victimless (a perception the judges emphasised was quite false).

However, this judgment prevents any extension of this rule and limits an insurer's right to reject a claim. Although the decision has raised concerns within the insurance industry, it is far from being an invitation for an insured to embellish an insurance claim without fear of any consequences. Any attempt to enhance a claim which would result in increasing the amount recoverable will lead to forfeiture of the entirety of the claim if discovered. Even where a false statement is wholly collateral to a justified claim, an insured may be penalised for that statement if exposed. In the context of a contested claim, any settlement agreement induced by the false statement could be set aside. Moreover, there could be cost orders in any proceedings, increased premiums and difficulty in obtaining future insurance policies after the requirement to disclose the insured's claims history in any insurance proposal is met. Insureds will also want to avoid litigation concerning whether a false statement is collateral or not to a justified claim.

Finally, insurers can consider including clauses in insurance contracts precluding the recovery of any claims supported by collateral lies. It is likely that going forward insurers will seek legal advice as to the merits of doing so.

For more information on recent changes to insurance law, including new laws that came into effect in August 2016, please see "New insurance laws – a field day for policy holders?"[2]

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[1] (*Britton v Royal Insurance Co* (1866) 4 F & F 905).

[2] http://www.allenovery.com/publications/en-gb/Pages/New-insurance-laws-a-field-day-for-policyholders.aspx

Precedent

JUDICIAL PRECEDENT: SUPREME COURT CLARIFIES THE STATUS OF PRIVY COUNCIL DECISIONS

Willers v Joyce & anr [2016] UKSC 44, 20 July 2016

The Supreme Court has provided clarity on a previously unsettled point of the doctrine of precedent: the English courts should never follow a decision of the Privy Council if it is inconsistent with a decision that would otherwise be binding on the lower court, unless the Privy Council has expressly directed that domestic courts should treat its decision as representing the law of England and Wales.

The point arose in the context of an appeal against a decision that the tort of malicious prosecution was not available in respect of civil (as opposed to criminal) proceedings. The first instance judge, Amanda Tipples QC, reached that conclusion on the basis that she was bound by a decision of the House of Lords, despite a subsequent conflicting decision by the Judicial Committee of the Privy Council (the **JCPC**). The judge concluded that she could only follow a JCPC decision to the opposite effect "if, for all practical purposes, it is a foregone conclusion that the Supreme Court will follow the decision of the Privy Council" (which, on the facts, it was not). The appellant appealed and was granted a leapfrog certificate to the Supreme Court who granted permission to appeal.

By a 5:4 majority decision, the Supreme Court held that a tort of malicious prosecution is equally applicable to civil as well as criminal cases. Separately, Lord Neuberger delivered a unanimous decision on the status of JCPC decisions in England and Wales.

The JCPC

Although the function of the JCPC has varied somewhat since its creation by the Judicial Committee Act 1833, its primary function today is as the final appellate court for a number of Commonwealth countries, the 14 British Overseas Territories, the Channel Islands and the Isle of Man. The JCPC advises the monarch of the disposal of appeals or, in the case of republics, determines the disposal of appeals. Accordingly, the JCPC is not a court of any part of the United Kingdom. That said, the JCPC almost always applies the common law, and either all or four of the five Privy Counsellors who sit on any appeal will almost always be Justices of the Supreme Court.

As a matter of precedent, given the JCPC is not a UK court, its decisions cannot be binding on any judge of England and Wales. However, a JCPC decision should normally be afforded great weight and persuasive value. Conversely, the JCPC, when applying the law of England and Wales, should consider itself bound by any House of Lords or Supreme Court decision.

The decision of the Supreme Court

Lord Neuberger's decision first sets out the doctrine of precedent applied to the hierarchy of courts in England and Wales. He highlights its "fundamental" nature; a "natural and necessary ingredient" of the common law system, but one that is rather more nuanced when it comes to courts of co-ordinate jurisdiction, such as the JCPC. While there is no doubt that (unless there is a decision of a superior court to the contrary effect) a court in England and Wales can normally be expected to follow a JCPC decision, there is no question of it being bound to do so as a matter of precedent. Likewise, there is also no doubt that a court should not usually follow a JCPC decision if it is inconsistent with a decision of a court which is binding in accordance with the doctrine of precedent.

The question, however, is whether that latter rule is absolute, or whether a JCPC decision can take precedence on the basis that it is a "foregone

conclusion" that the Supreme Court would also follow the JCPC decision. That, as mentioned, was the decision of the High Court in *Willers v Joyce*. Lord Neuberger concluded it more satisfactory to take an absolute position, stating that an English court should never follow a decision of the JCPC if it is inconsistent with a decision that would otherwise be binding on the lower court.

However, Lord Neuberger carved out one exception to this: when an appeal to the JCPC challenges the correctness of an earlier decision on a point of English law (whether of the House of Lords or the Supreme Court, or of the Court of Appeal), and where the JCPC decides that the House of Lords or Supreme Court, or the Court of Appeal, may be wrong. In this instance, Lord Neuberger says, the JCPC should have the power to direct the English courts to henceforth apply the JCPC decision as precedent instead of the earlier English court decision. To support this view, it was pointed out that were this not the case, "[i]t would plainly be unfortunate in practical terms". Moreover, this modified approach is preferable in light of the fact that the President of the JCPC is the same person as the President of the Supreme Court and that panels of the JCPC normally consist of Justices of the Supreme Court.

Accordingly Lord Neuberger directed the modification of JCPC Practice Directions 3.1.3 and 4.2.2 as follows:

- when an appeal to the JCPC involves deciding upon the correctness of an earlier decision of the House of Lords or Supreme Court, or the Court of Appeal, the registrar of the JCPC will draw the attention of the President of the JCPC to this fact; and
- the President can then take that fact into account when deciding on the constitution and size of the panel which is to hear the appeal, and the members of that panel can, if they think it appropriate, not only decide that the earlier decision of the House of Lords or Supreme Court, or of the Court of Appeal, was wrong, but also can expressly direct that domestic courts should treat the decision of the JCPC as representing the law of England and Wales.

COMMENT

This decision provides clarity and coherence to a previously unsettled issue as to whether a lower court could apply a JCPC decision if it were a "foregone conclusion" that the JCPC's view would be accepted by a superior court. The Supreme Court has rejected that approach, confirming that the rule is an absolute one except if the JCPC has expressly directed domestic courts to treat a decision as representing the law of England and Wales. Where there is no inconsistency between the decision of a superior court and the JCPC, JCPC decisions will continue to be regarded as being of "great weight and persuasive value" (para. 12).

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Privilege

WHEN THREATS MADE WITHOUT PREJUDICE ARE NOT WITHOUT PREJUDICE

Jonathan Ferster v Stuart Ferster & ors [2016] EWCA Civ 717, 12 July 2016

The appellants' threats, contained in an email during settlement negotiations "unambiguously exceeded what was permissible in settlement of hard fought commercial litigation". The email therefore was not protected by without prejudice privilege. The Court of Appeal examined the 'unambiguous impropriety' exception to without prejudice privilege. The ruling provides a good reminder of the importance of taking a measured approach even during heated settlement negotiations in order to avoid losing without prejudice privilege.

"Without prejudice" privilege protects statements made (either in writing or orally) in a genuine attempt to settle an existing dispute. Such statements are not admissible evidence against the interest of the party that made them. There are some limited exceptions. In *Unilever plc v The Procter & Gamble Co.* [2000] 1 WLR 2436, the Court of Appeal stated that without prejudice communications may be allowed in evidence "if the exclusion of the evidence would act as a cloak for perjury, blackmail or other 'unambiguous impropriety'" . In subsequent cases, the courts have not permitted mere admissions or acknowledgments by parties to come within this exception.

This dispute concerned an email which was sent in the context of settlement negotiations. Interactive Technology Company Ltd. (**ITC**), the third appellant, is owned jointly by the respondent Jonathan Ferster (**Jonathan**), and the first and second appellants, Stuart Ferster (**Stuart**) and Warren Ferster (**Warren**). At the instigation of Stuart and Warren, ITC sued a number of defendants including Jonathan for, *inter alia*, breach of fiduciary duty in its management. Jonathan was ordered to disclose his assets. In response, Jonathan filed a petition under s994 (the 'unfair prejudice' provision) of the Companies Act 1996 alleging that Stuart and Warren had procured the action against him in order to pressurise him into buying their shares in ITC at an inflated price. Jonathan subsequently sought to refer to the contents of an email that had been sent following mediation (**email**).

At mediation, Stuart and Warren had offered to sell their shares in ITC to Jonathan for a specified sum of money. No agreement was reached. Subsequently, the mediator sent the email to Jonathan's lawyers passing on certain messages from Stuart and Warren. In the email Stuart and Warren withdrew their existing offer to sell their shares in ITC to Jonathan and asked for a higher sum of money. The e-mail expressly stated that they had increased their offer as they had "become aware of further wrongdoings by Jonathan". They stated that they had information that Jonathan held additional offshore accounts which he had not disclosed pursuant to the order to disclose his assets. They further stated that if their offer was not accepted within 48 hours, a further higher sum of money would be required to purchase their shares. It was emphasised that Jonathan could face charges of perjury, perverting the court of justice, contempt of court, and potential imprisonment. Similarly, Jonathan's partner could be investigated and charged. If this were to happen, "Jonathan's credibility and reputation will be destroyed barring him out of the online gaming business in the future".

After the email was sent, Jonathan's lawyers asked the appellants' lawyers for full details of the allegations. The appellants' lawyers responded by stating that their client did not intend that committal proceedings would be issued if the offer was not accepted. According to the

appellants' lawyers, no threats had been made as to what would happen if the parties did not reach a settlement agreement.

Jonathan sought to rely on the email to show that Stuart and Warren sought to extort a ransom price from Jonathan for their ITC shares by making improper and unwarranted threats that ITC would bring committal and criminal proceedings against him unless he agreed to purchase their shares at an inflated price.

Improper threats fall within the exception of "unambiguous impropriety"

Lord Justice Floyd stated that the critical question was whether a privileged occasion had been abused. It may be easier to show that there is unambiguous impropriety where there is an improper threat than where there is simply an unambiguous admission of the truth (eg where a party makes an admission during negotiations that is inconsistent with his pleaded case).

In her first instance judgment, Rose J had stated that the email constituted an attempt at blackmail and was therefore admissible. The impropriety, in her opinion, consisted of the threat to pursue contempt proceedings unless Jonathan paid the appellants a higher price. There was no ambiguity in the purpose of the threat which was to pressure Jonathan to pay more for the shares. The increase in price had nothing to do with any increase in the value of shares or ITC's business but instead it was the price being exacted for Stuart and Warren to not cause ITC to take action to deal with the supposed wrongdoing which they had allegedly uncovered.

The appellants' counsel argued that the discovery of Jonathan's additional accounts would increase the value of ITC's action against him and would therefore have a proportionate impact on the value of the appellants' shares. Through their offer, Jonathan would buy the appellants' shares and be in complete control of ITC and could, therefore, discontinue the action against him. Lord Justice Floyd rejected this submission. In the email, the appellants were making it clear that if the offer was not accepted, they would use their control of ITC to take the steps identified. While those steps might be proper for ITC to take if it had a genuine belief in the basis for the action, it was wrong for them to be used as a lever to enable the appellants to get a greater sum of money for their shares.

Lord Justice Floyd pointed to the thinly-veiled threats in the email and to the attention drawn to the criminal consequences of giving false evidence and perjury. The impropriety in this case was apparent from the email and arose from the fact that the increase in price was tied to the threats affecting Jonathan's liberty, family and reputation. The threats did not have to fall within a formal definition of blackmail to be regarded as unambiguously improper (applying *Boreh v Republic of Djibouti* [2015] EWHC 769 (Comm)). Instead, it needed to be evaluated whether the threats unambiguously exceeded what was permissible in the settlement of hard fought commercial litigation. In *Boreh v Djibouti*, the court concluded that the threat of terrorist charges against Mr Boreh was improper commercial pressure to settle the litigation (and it was unnecessary to decide whether the threat fell within the definition of blackmail in English criminal law) and therefore, fell within the test of unambiguous impropriety.

Lord Justice Floyd agreed that the threats in this case unambiguously exceeded that threshold for the following reasons:

- The threats of criminal action were far beyond what was reasonable in the pursuit of civil proceedings.
- They had serious implications for Jonathan's family because of his wrongdoings.
- The threat to publicise the allegations within the short timescale placed pressure on Jonathan.
- The purpose of the threats was to obtain an immediate financial advantage for Stuart and Warren out of circumstances which (if they were true) benefitted ITC.
- There was no attempt to make any connection between the alleged wrong and the increased demand.

COMMENT

There have been a number of decisions where the unambiguous impropriety exception has been held not to apply where an admission or acknowledgment has been

made by a party during negotiations which could be detrimental to that party in subsequent proceedings.[1] However, it is more likely to apply, as this case shows, where there is a threat made by one of the parties, irrespective of whether such threat falls within the formal definition of blackmail under English law.

During the course of trying to settle or negotiate difficult and contentious matters, it is usual for parties to set out the benefits of their offer to the other side. This case is a reminder of the limits of this approach. Neither the subsequent correspondence by the appellants' solicitors nor the involvement of a mediator was given any weight in assessing the first e-mail. This emphasises the importance of ensuring that correspondence during negotiations is very carefully considered.

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[1] Such as *Ofulue v Bossert* [2009] UKHL 16, *Alan Ramsay v Typhoo Tea* [2016] EWHC 486 (Comm) and *Rochester Resources v Lebedev* [2014] EWHC 2185 (Comm)

Public Procurement

SUCCESSFUL PROCUREMENT CHALLENGE AND WITNESS SUCCESS BONUSES

Energy Solutions EU Ltd v Nuclear Decommissioning Authority [2016] EWHC 1988, 29 July 2016

The High Court has held that the Nuclear Decommissioning Authority breached the Public Contract Regulations (**PCRs**) when awarding a GBP 4.6 billion contract for the decommissioning of 12 Magnox reactors in the United Kingdom. As a result, Energy Solutions is now entitled to what is likely to be a very sizeable damages award. After the trial it emerged that the claimant's witnesses had been offered litigation success bonuses. The judge rejected the application to strike the claim out due to the existence of these agreements, but in doing so heavily criticised the use of such arrangements – which are illegal and contrary to SRA rules – and in particular the lawyers involved in drafting them.

A procurement exercise governed by the PCRs was conducted using the competitive dialogue procedure by the Nuclear Decommissioning Authority (the **NDA**) to select a company to decommission 12 former nuclear power station and nuclear research sites. Energy Solutions was the incumbent site operator for ten of those sites and was unsuccessful in its bid, as part of a consortium, for the contract. Energy Solutions brought a claim on the basis that there had been "manifest errors" in the evaluation of the bids, and as a result that its consortium should have been awarded the contract. Unusually for procurement challenges, Energy Solutions decided not to issue proceedings in the statutory standstill period, and therefore the only remedy available to it was a damages claim rather than an order that the tender exercise should be re-run. The NDA had argued as a preliminary issue that, by failing to issue proceedings within the standstill period, Energy Solutions had caused its own loss. The Court of Appeal rejected that argument and therefore the matter proceeded to a full trial.

The judge identified a series of manifest errors in the scoring exercise carried out by the NDA's experts which meant that the NDA was in breach of its statutory duties under the PCRs. In doing so, he heavily criticised the NDA's approach to the bid evaluation documentation, whereby the NDA had sought to limit any written note taking by the bid evaluation team, contrary to the NDA's duty of transparency. He also heavily criticised the way

in which scores were changed even after the electronic scoring system had been closed down by the bid evaluation team.

The judge, having heard further evidence from the witnesses under cross-examination, held their trial evidence had not been affected by the bonus arrangements (which took the form of a bonus payment if Energy Solutions succeeded in its claim). The fact that such arrangements were contrary to public policy and the SRA rules did not of itself entitle the NDA to succeed in applying to strike the claim out. The existence of the arrangements was, however, relevant to the weight to be given to the respective witnesses' evidence.

Manifest error

Energy Solutions had identified a series of failures in the way the NDA's experts had evaluated the various bids. The NDA argued that a manifest error could not arise in the course of a purely evaluative judgment, and that it was the score ultimately awarded that must be manifestly wrong. The judge rejected this approach. It was not restricted to only considering the scores awarded to the bidders in isolation. It was necessary to consider whether the NDA's reasoning disclosed a manifest error, and to then consider whether these errors were material. There were several examples of where scoring criteria had been applied inconsistently or incorrectly. This included the application of pass/fail criteria where the NDA had sought to exercise discretion not to disqualify non-compliant bids. This discretion was not available to the NDA on a proper construction of the tender documents. The bid evaluation team were not permitted to "lean against disqualification" and to apply the scoring criteria differently to how those criteria were set out in the tender documentation, simply because they feared that to apply them correctly would result in the drastic consequences of a bid being disqualified. A legal review had been carried out by a law firm instructed by the defendant, which resulted in scores being changed, but the NDA refused to waive privilege over those documents. While the refusal to waive privilege was not in itself a breach of the duty of transparency, it left the Court in a position of being unable to ascertain why certain scores had been changed.

Litigation success bonuses

The judge noted that Energy Solutions' legal advisers had correctly brought the existence of these arrangements to the attention of the court as soon as they became aware of them. Although the drafting of these agreements was contrary to proper professional standards and contrary to Rule 5.8 of the Solicitors' Code of Conduct, the judge did not consider that on the facts of this case they could be described as "inherently corrupt". On the facts, neither the existence of the agreements nor the initial failure to disclose them justified striking out the claim.

COMMENT

Complex procurement cases that reach full trial are reasonably rare, as cases tend to settle once proceedings have passed the interim relief stage. This lengthy judgment contains a number of salutary reminders for contracting authorities, suppliers to the public sector, and lawyers alike and looks set to be a reference point for future procurement exercises. For contracting authorities, it shows that limiting the amount of internal documentation produced by the bid evaluation team deliberately to reduce the risk of being successfully challenged can backfire badly. In this case, it was a quick way to lose the court's sympathy. For disappointed bidders involved in bids for major UK projects, it shows that the UK Technology and Construction Court is willing and able, in appropriate circumstances, to scrutinise in considerable detail the scoring of multiple facets of a very complex and technical bid. For lawyers, it highlights the obvious inappropriateness of litigation success bonuses for witnesses and the potentially catastrophic consequences. It also demonstrates that legal reviews of procurement exercises should not be used as a substitute for the bid evaluation team recording their own reasons why certain evaluation decisions were reached.

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Tort

REFINANCING LOANS AND VALUATIONS

Tiuta International Ltd v De Villiers Surveyors Ltd [2016] EWCA Civ 661, 6 July 2016

Liability for a negligent valuation relied upon by a lender in refinancing a pre-existing loan facility would not be limited to any new funds advanced but extend to the entire refinanced facility. Had there not been a negligent valuation, the lender would not have made the refinancing loan. The fact that the purpose of the loan was in part to discharge an earlier (potentially loss-making) loan on the part of the same lender was irrelevant in fact and law to the valuer, who was fully liable in respect of the full amount of the loan.

Secured loan for property development

De Villiers Surveyors Ltd (the **Valuer**) was instructed in February 2011 by the appellant, Tiuta International Ltd (the **Lender**), to value a partly completed residential development (the **Property**) it was considering accepting as security for an advance to the borrower-developer. The Valuer valued the property at GBP 3.25 million in its current state and GBP 4.9 million on completion (the **February Valuation**). In reliance on the February Valuation, the Lender advanced GBP 2.5 million (the **Original Facility**) in exchange for the security of a first legal charge over the Property.

In November 2011, the borrower-developer sought to increase the facility to GBP 3 million on the basis of the same security. The Valuer was instructed to provide a fresh valuation of the Property, which was GBP 3.5 million in the Property's current state and GBP 4.9 million on completion (the **December Valuation**). In reliance on the December Valuation, the Lender agreed to provide the additional funds, but did so by way of a complete refinancing (rather than a variation) of the Original Facility. Consequently as well as providing additional funds, the Lender advanced the GBP 2.5 million necessary to repay the Original Facility, released its first legal charge and registered a new charge over the Property at the Land Registry (the **Second Facility**).

Upon expiry, the Second Facility was not repaid and approximately GBP 2.84 million was owed to the Lenders. The sale of the Property recovered only GBP 2.1 million for the Lender.

The Lender commenced proceedings against the Valuers seeking to recover the entirety of its loss in respect of the Second Facility on the basis that the December Valuation had negligently overstated the value of the Property. The Bank did not allege that the February Valuation had been negligent. In response, the Valuer contended that, at the time of the December Valuation, the Lender had already advanced GBP 2.5 million under the First Facility to the borrower-developer, and even if the December Valuation had been negligent (which was denied) the Lender's loss should be limited to the additional amount advanced from December 2011 only. The Valuer sought summary judgment on this question. For the purpose of the hearing and judgment, all other matters of fact in contention were assumed to be established in the Lender's favour (including the negligence of the December Valuation). The Valuer succeeded at first instance, and the Lender appealed.

Court of Appeal allows full recovery

The Court of Appeal allowed the Lender's appeal. Lord Justice Moore-Bick gave the leading judgment, with Lord Justice McCombe dissenting. The Valuer was, on a correct application of the 'but for' test of causation, liable to the Lender for the full amount of the loss flowing from any negligence in the December Valuation.

In order to determine the loss caused by the negligent valuation, it is necessary to identify the nature of the transaction and the Valuer's part in it. The Lender was willing to enter a new facility agreement with the borrower-developer, the proceeds of which would be used (in part) to repay the original loan. However, the purpose to which a fresh loan would be put is of "no interest or relevance, either in fact or in law, to the person who is asked to value the property on which it is to be secured". A valuer remains liable for the adverse consequence attributable to any negligence in its valuation.

The appropriate measure of damages recoverable from a negligent valuation (applying *Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd* [1997] 1 WLR 1627) remains the difference between the amount of money lent and the value of the rights acquired (being the borrower's covenant and the true value of the property). In this case, the borrower-developer's covenant had no value, so all the Lender acquired was the value of the security (ie the Property). The correct measure of the Lender's loss was therefore the difference between the net amount of the Second Facility and the true value of the secured property.

What about the fact that the Lender would likely have suffered a loss without the refinancing? Moore-Bick LJ recognised that, had the refinancing not occurred, the Lender would have been left with the Original Facility and the security over the Property together with a (potential) claim against the Valuer in relation to the earlier February Valuation. However, he founds this "of no relevance" to the Valuer in the context of preparing the later December Valuation relied upon by the Lender in entering the Second Facility. The Valuer had valued the Property "in the expectation that the [Lender] would advance funds up to its full reported value in reliance on its valuation", and that there was nothing "unfair" in the Valuer being held liable for its own "factually and legally separate" valuation prepared for the purpose of the Lender advancing funds under the Second Facility. The only link between the two valuations was that the Second Facility enabled the borrower to repay the Original Facility.

The trial judge's decision in favour of the Valuer had failed to take into account the fact that the transaction had been structured in order that the Second Facility should be used to repay the Original Facility. This would have been very clear on the facts had the refinancing lender been different to the original lender, but the fact that the lender in both transactions was the same entity was "immaterial". Importantly, the repayment of the Original Facility with the proceeds of the Second Facility released the Valuer from any potential liability in respect of the February Valuation.

Lady Justice King agreed with Moore-Bick LJ, and emphasised that "it is of no interest to the [Valuer] the purpose to which the new loan is to be put", noting that the Valuer could have limited its exposure by way of negotiated terms and conditions when accepting instructions.

COMMENT

In times of increasing market turbulence and oscillating property values, the case clarifies the extent of valuers' liability when re-valuing property for the purpose of refinancing. The result is that a valuer's liability is not reduced simply by virtue of the fact that other valuations (and loans) may have pre-dated the refinancing: they are bound to their own valuation, regardless of what may have passed before between lender and valuer. Valuers (or more accurately, their insurers) cannot seek extra-contractually to limit their liability for any fresh advance merely because a refinancing may discharge an earlier liability, even if to the same lender.

Lenders should consider, when advancing new funds in reliance on an updated valuation, clearly structuring any fresh advance as a refinancing such that the second transaction does result in the redemption of the first loan in the lender's books and ensures the clear transfer of full liability to the later valuation.

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