Dispute Resolution

December 2015

DISPUTE RESOLUTION BULLETIN





Welcome to the December edition of our Dispute Resolution Bulletin.

In our first article this month, Partner, Steven Paull, and Trainee Solicitor, Strachan Gray, review the Supreme Court's judgment in two cases concerned with penalty clauses and liquidated damages.

The second article, from our insolvency practice led by Partners, Noel Campbell and Rick Brown, comments on the judgment in their own case of *Lockston Group Inc v Wood*, where the court considered the *pari passu* principle central to English insolvency legislation in the context of a deceased's insolvent estate.

Our third article, written by Associate, David Chalcraft, looks at the Supreme Court's decision on unjust enrichment and the doctrine of subrogation in the case of *Menelaou v Bank of Cyprus*.

Fourthly, Associate, Eleanor Midwinter, discusses the latest judgment on privilege in the context of regulatory investigations, in the case of *Property Alliance Group Ltd (PAG) v The Royal Bank of Scotland.*

Lastly, Senior Associate, Elizabeth Sloane, from our Hong Kong office looks at the recent developments in third party funding in Hong Kong arbitrations.

Should you require any further information or assistance on any of the issues dealt with here, please do not hesitate to contact any of the contributors to this bulletin, or your usual contact at HFW.

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Supreme Court upholds and clarifies penalty clauses

A specially convened seven judge Supreme Court panel adjudicating on a sophisticated acquisition agreement, and an orange car park sign have re-written the law on penalty clauses. The century old power to strike down such clauses survived the attack on its very existence, but in a form re-scoped and re-fashioned for the 21st Century.

This significant legal development, which gives parties greater latitude to develop contractual provisions capable of robustly protecting their commercial interests, will have an important impact on how commercial contracts are drafted and litigated.

Definitive guidance has been given confirming the expanded application of the power to strike down penalty clauses covering both money and asset transfers, and to both the making of payments and the withholding of payments, but only where the provision concerns the consequences of a breach. The terms setting the primary obligations of an agreement are now declared to be outside the scope of the penalty rule.

Introduction

The law governing penalty clauses has been definitively recast following the Supreme Court's combined judgments in the two cases heard together: *Cavendish Square Holding BV v Talal El Makdessi;* and *ParkingEye Limited v Beavis*[1].

An important consequence of these judgments is that commercial parties now have more freedom to include clauses which would previously have been unenforceable as penalties.

What has happened?

The judgment considered two appeals.

In *Makdessi*, the Supreme Court overturned the Court of Appeal's ruling that one party to a sophisticated acquisition agreement, Cavendish, could not enforce provisions which imposed a disproportionately severe financial detriment on the other party, Mr Makdessi, for breaching certain non-compete restrictions. The Court of Appeal had concluded that the provisions were unenforceable as they were designed to deter Mr Makdessi from breaching the non-compete restrictions and because the detriment they imposed had the potential to far outweigh any loss suffered by Cavendish.

In *ParkingEye*, the Supreme Court upheld the Court of Appeal's decision that ParkingEye, a car park operator, could charge Mr Beavis, a motorist, for overstaying a free parking limit even though the charges primary purpose was to deter overstaying and despite the fact that the charge levied was far greater than any loss caused to ParkingEye by overstaying motorists.

As set out below, the Supreme Court's decisions have both redefined what constitutes a penalty clause and restated the test of whether a clause is unconscionable and extravagant taking into account all legitimate interests of the beneficiary of the clause and is not tied (in non standard cases) to the simple genuine pre-estimate of damages formula.

Background

For the last 100 years the English courts have traditionally followed Lord Dunedin's tests in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*[2] and applied a strict approach to clauses which impose an enhanced financial detriment on a party who has breached a contract.

Traditionally to be enforceable, such a clause had to compensate the innocent party for the loss caused by the other party's breach of contract. This compensation had to be a "genuine pre-estimate" of any likely loss, although the actual loss in any particular case might be much less or even much more. By contrast, clauses which did not reflect a genuine pre-estimate were treated as penal, leading to ever increasing ingenuity being applied by a party facing such a clause in discovering circumstances where it might apply without the beneficiary having suffered any significant loss.

Now, following the Supreme Court's decisions in *Makdessi* and *ParkingEye*, the law on penalties has changed again. This marks an important departure from the traditional approach.

The new approach

In its leading judgment, the Supreme Court described the historical development of the traditional approach as "unfortunate" finding that the absence of a genuine pre-estimate of loss did not necessarily mean that a term was penal and instead there could be other equally legitimate factors which the beneficiary of the clause may have cause to protect.

In reaching this conclusion the Supreme Court dismissed the attack on the power to strike down penalties, noting that this power was replicated in many other common law and civil law jurisdictions dismissing the suggestion that the jurisdiction should be disapplied from commercial matters.

Accordingly, the Supreme Court took the opportunity to restate the test for identifying penalties:

1. Penalties only take effect on terms which make provision for the consequence of a breach, the rule has no application to the primary obligations under any agreement. A clause can only be a penalty if it is

1 [2015] UKSC 67

2 [1915] AC 79



engaged by the breach of another clause in the contract.

2. The rule is not limited to clauses concerning payments of money but also applies to provisions permitting the withholding of money and the transferring of assets such as the share option in the *Makdessi* case.

3. To be a penalty, a clause must impose a detriment, which is out of all proportion to the innocent party's "legitimate interest" in enforcing the primary obligation that has been breached.

The definition of "legitimate interest" is the crucial aspect and will depend on the facts of the case. In many commercial contracts, compensation will remain the appropriate means of protecting this interest. However, the court recognised that parties often have interests such as business disruption, which are not adequately protected by compensation. In such cases, it is now – in contrast to the traditional approach – permissible to protect these interests by using provisions designed to influence another party's conduct, including as deterrents.

For example in *Makdessi*, the Supreme Court held that Cavendish had a legitimate interest in the observance of the non-compete restrictions because their breach posed a significant business risk which could not easily be quantified. This justified the inclusion in the contract of clauses which had purposes other than compensation.

In *ParkingEye*, the Supreme Court said that it had a legitimate interest in preventing misuse of the car park and in generating the income needed to manage it. The charge for motorists exceeding the time limit was a justifiable way of meeting these objectives, even though it was clearly a deterrent/penal.

HFW perspective

The decision raises some important points which are relevant to many of HFW's clients.

Firstly, the compensation/genuine pre-estimate against deterrent/penal distinction is not entirely redundant. In straightforward, uncomplicated agreements it will remain the framework for analysing clauses. Such agreements generally cover simple legitimate interests which are adequately protected by monetary compensation and do not raise the same issues which arose in *Makdessi* and *ParkingEye*.

Secondly, the decision's impact will be felt in the context of more sophisticated agreements negotiated by commercially experienced parties who have a range of commercial interests at stake, not all of which can be precisely quantified in financial terms. The Supreme Court was clear that such parties should have more freedom to design clauses protecting their commercial interests without the risk that the courts will declare them unenforceable.

Thirdly, the court's finding that only secondary obligations can be penalties means that well-drafted clauses can avoid the rules on penalties altogether. Clauses expressed as primary obligations, for example price adjustment clauses as in *Cavendish*, are incapable of being penalties, and careful drafting will further minimise the risk that the courts will decline to enforce certain clauses.

An article on this topic was also included in our weekly Insurance Bulletin – http://www.hfw.com/Insurance-Bulletin-20-November-2015

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Research conducted by Strachan Gray, Trainee Solicitor.

Berezovsky's estate: High Court provides clarity over the interpretation of the Insolvency Act 1986 in the context of a deceased's insolvent estate

The High Court has upheld the *pari passu* principle central to English insolvency legislation when applied to a deceased's insolvent estate and interpreting legislation stated to be *"modified accordingly"*. This approach clarifies that foreign currency claims and claims for interest should be calculated for voting purposes as at the date of death, rather than the date an Insolvency Administration Order (IAO) is made. HFW acted for the respondent in this case.

Introduction

The Insolvency Act 1986 (Insolvency Act) and Insolvency Rules 1986 (Insolvency Rules) provide the statutory framework for dealing with insolvent individuals and corporate bodies. In the case of a deceased insolvent, it is the provisions of the Administration of Insolvent Estates of Deceased Persons Order 1986 (AIEDPO) that apply.

AIEDPO is a short piece of secondary legislation that essentially modifies provisions of the Insolvency Act to apply in circumstances where a deceased is insolvent.

The judgment of Mr Justice David Richards in *Lockston Group Inc v Wood*[1] is to date, the only case dealing with the determination of when a creditor's claim in a deceased's insolvent estate is to be quantified.

1 (2015) EWHC 2962 (Ch)



Background

Boris Berezovsky died on 23 March 2013. A petition for an IAO was presented by the General Administrators of his estate on 30 October 2014. The IAO was granted on 26 January 2015 – almost two years after Mr Berezovsky's death. At the first meeting of the creditors of the estate, Messrs Nicholas Wood, Kevin Hellard and Michael Leeds of Grant Thornton UK LLP were appointed as trustees of the insolvent estate (the Trustees).

One of Mr Berezovsky's creditors, Lockston Group Inc (Lockston), supported by another creditor, Baltic International Bank, disagreed with the two of the principles used by the chairman of the creditors' meeting when admitting claims to proof for the purposes of voting. Lockston made an application to court, arguing that the chairman was wrong to:

1. Limit the accrual of interest upon the sums admitted of all creditors up to the date of Mr Berezovsky's death.
2. Admit claims against the estate denominated in foreign currencies by converting those claims into Sterling at the relevant exchange rate prevailing at the date of Mr Berezovsky's death.

Lockston contended that the correct date for both purposes was the date on which the IAO was made, rather than the date of death. Were that contention correct, the effect would have been significant because in the two years since Mr Berezovsky had died, the Russian Rouble (the currency of a number of the creditors' claims) had devalued considerably against Sterling and very significant amounts of interest would have accrued on claims during the same period.

The case concerned the interpretation of AIEDPO, in particular the sections that modify the provisions of the Insolvency Act to apply in circumstances where the debtor died before the presentation of a bankruptcy petition.

Key points

1. Mr Justice David Richards stated that there are *"a number of grounds for rejecting Lockston's case, but the primary ground is that it is inconsistent with a fundamental feature of insolvency law, that there is to be a single date for the ascertainment of liabilities"*.
2. The judge found that the effect of section 382(1), the section that defines "bankruptcy debt", is that debts and liabilities are to be quantified as at a particular date. Further, the modifications to the Insolvency Act in the case of a deceased's insolvent estate confirm that the *"correct approach"* is to identify and quantify debts and liabilities at the same date, as in the case of a living bankrupt.
3. The conversion of foreign currency claims should also be at the same date. The Insolvency Rules, which are not specifically modified by AIEDPO, should be read *"accordingly"* with the modifications to the Insolvency Act. The judge found that in light of the substitution of the commencement of the bankruptcy with the date of death under section 382, *"the conclusion is inescapable"* that the rule relating to conversion of currencies, rule 6.111, is to be modified in the same way.
4. The judge concluded, *"Overall, I consider that, on their true construction, the relevant provisions fix one date, the date of death of the debtor, as the date as at which the assets comprising the insolvent estate are identified and as at which the debts and liabilities are identified and quantified... It produces a coherent and consistent regime*".

HFW perspective

The judgment in *Lockston Group Inc v Wood* provides clear authority for insolvency practitioners and their legal advisors on the method to quantify debts and liabilities for voting purposes in the administration of a deceased's insolvent estate under AIEDPO.

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Lockston contended that the correct date for both purposes was the date on which the IAO was made, rather than the date of death.

NOEL CAMPBELL, PARTNER

Menelaou v Bank of Cyprus: The Supreme Court subjects unpaid vendors' liens, unjust enrichment and the doctrine of subrogation to scrutiny

The Supreme Court has recently extended the doctrine of unjust enrichment. Deciding that the holder of defective security over a property may assert a subrogated unpaid vendor's lien in circumstances where it has not advanced funds for the purchase of the asset over which it held the defective security.

Introduction

In *Menelaou v Bank of Cyprus UK Limited*[1], a case of unjust enrichment, the Supreme Court held that in circumstances where a lender had discharged perfected security over a property and taken security over another property and the latter security was defective, the appropriate equitable remedy available to the lender is subrogated to an unpaid seller's lien.

The background

The appellant owned property, (the Property), bought by her parents in 2008 and gifted to her. The respondent bank had two charges, securing the parents' borrowing, over the previous family home owned by the parents. The bank agreed to release those charges in return for a lump sum payment discharging part of the debt and a fresh charge over the property to secure the remaining indebtedness. This left some money out of the sale proceeds for the purchase of the property. The appellant was registered as the proprietor of the property, with the bank as purported chargee. The appellant became aware of the existence of the charge some two years' later, discovering that the charge had not been properly executed and was in fact void as she had not signed it and that it had been altered without her knowledge. With defective security, the bank then invoked an 'unpaid vendor's lien', a type of charge which allows a seller of property to retain its rights in the property until all monies have been paid over by the buyer.

This type of lien usually arises during the sale and purchase of real property during the period between exchange of contracts and completion. The bank claimed the lien because the monies used to pay the seller of the property effectively originated from the bank's release of the charges over the previous property owned by the appellant's parents, and this sum was intended to be secured on the property. The bank claimed that it was entitled to be subrogated to the unpaid vendor's lien, and thereby to claim a charge over the property.

At first instance trial, the judge dismissed this claim, on appeal, it was granted by the Court of Appeal.

> What is clear is that the doctrine of unjust enrichment has been further developed and this decision evidences the court's willingness and flexibility to apply the doctrine when required.
>
> DAVID CHALCRAFT, ASSOCIATE

What happened in Menelaou?

The Supreme Court unanimously (although for different reasons) dismissed the appeal.

1. The Supreme Court held that whilst the appellant had been enriched, the question was whether she had been enriched at the expense of the bank because if so, that enrichment was unjust. The court found that this enrichment was unjust, because the appellant became the owner of the property following the bank's agreement to release part of the debt owed by the parents in return for the charge, which was ultimately defective. As a result, the bank suffered loss (both of the money used to pay for the property, and also because of the defective security), whereas the appellant gained, having received the freehold in the property for nothing.
2. The appropriate remedy is for the bank to be subrogated to an unpaid sellers' lien. This effectively grants the bank an equitable charge over the property, thereby providing the bank with security.

1 [2015] UKSC 66

3. Lord Neuberger also considered that in the alternative, the bank may have had a proprietary interest in the sum used to purchase the property, and that either the bank or the appellant's parents were the beneficial owners of that sum.

4. This decision reinstates the liability of the appellant (notwithstanding the defective security) to repay the sums outstanding to the bank either upon the sale of the property or upon enforcement of the lien by the bank.

HFW perspective

The remedy in this decision is complex and applicable to the facts of the case. What is clear is that the doctrine of unjust enrichment has been further developed and this decision evidences the court's willingness and flexibility to apply the doctrine when required. It also further demonstrates the inventiveness of the courts to take an established and common concept of the unpaid vendors lien and to combine it with the doctrine of subrogation (where one party is permitted to step into the shoes of another) to reach a just and equitable outcome for the party who has suffered the loss.

This decision is a reminder that if taking security, make sure that:

1. The value of the security is sufficient to discharge the liability in full; and

2. The documents creating that security are properly and validly executed.

Failure to do so may lead to costly and time consuming litigation (in this case, seven years since the date of purchase of the property) to rectify the situation.

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hfw Court confirms legal advice privilege will extend to continuum of communications in regulatory investigations

In a judgment that helps underpin the concept of legal advice privilege (LAP), the Chancery Division has clarified the scope of LAP in the context of a regulatory investigation. This will be of interest to, and reassuring for, corporations who may be the subject of a regulatory investigation, and provides guidance in other contexts.

Background

In *Property Alliance Group Ltd (PAG) v The Royal Bank of Scotland* (the Bank)[1], a case concerned with the LIBOR rate fixing scandal, the court considered whether LAP applied to documents prepared for the Bank by its external lawyers. The purpose of the documents was to update, inform and progress matters within the Bank's Executive Steering Group (ESG). The ESG was tasked with overseeing and coordinating the Bank's response to various regulatory investigations. The Bank's external lawyers attended and led the ESG meetings, provided advice on the investigations, and acted as the Bank's secretariat. It is probable that the ESG was established with a view to falling within the principles established by House of Lords in *Three Rivers (No 5)* [2003][2], i.e., to maintain LAP by limiting communications to a small dedicated group within the Bank.

This judgment follows an earlier decision in the case dated 8 June 2015[3], which dealt with 'without prejudice' (WP) privilege and the use of limited waiver agreements in the context of regulatory investigations. That decision confirmed that, in principle, privilege attached to both classes of documents.

- Settlement negotiations with regulators should be treated in broadly the same way as negotiations in civil proceedings, with the subtle but important difference that regulators often have statutory powers requiring them to act on the information received. In this case, the Bank was found to have waived WP privilege due to its reliance on the relevant matters in its pleadings.

- The express limited waiver agreements between the Bank and its regulators were upheld, protecting the documents from inspection in the civil proceedings. The agreements contained a carve-out enabling the regulator to disclose the information under their statutory powers but crucially, those powers were not exercised, and the protection remained in place.

The question for the court was whether the documents contained 'legal' or 'business' advice, or both, and whether LAP applied to the documents. It was held that LAP applied to all of the documents.

Mr Justice Snowden helpfully summarised the need for privilege in regulatory investigations, saying: *"there is a clear public interest in regulatory investigations being conducted efficiently and in accordance with law. That public interest will be advanced if the regulators can deal with experienced lawyers who can accurately advise their clients how to respond and co-operate. Such lawyers must be able to give their client candid factual briefings as well as legal advice, secure in the knowledge that any such communications and any record of their discussions and the decisions taken will not subsequently be disclosed without the client's consent."* In providing more general guidance on the correct way to

1 EWHC 3187 (Ch)
2 EWCA CIV 474
3 EWHC 1557 (Ch)

It will be interesting to see whether recent cases in other common law jurisdictions (and cases such as this) represent a move away from unfortunate Three Rivers lacuna for legal advice privilege in England.

ELEANOR MIDWINTER, ASSOCIATE

assess LAP, he also confirmed that LAP will normally apply to the *"continuum"* of documents exchanged between lawyers and their clients in a *"relevant legal context"*.

What does this mean for regulatory investigations?

1. Whilst this case is helpful for those facing an investigation, it should be read with a degree of caution. It is a case of first instance and does not set a binding precedent.

2. It remains good practice to follow the "client" group rule set out in *Three Rivers (No 5)*. This means keeping the group of those actually able to give instructions to and receive advice from the external legal team to a small number.

3. Care should also be taken to ensure consistency between negotiations and pleadings to avoid accidental waiver of privilege.

4. Advice need not be expressly sought to be privileged and indeed marking it as such will not automatically mean it is, however, it is good practice to do so. The continuum of correspondence is also likely to be privileged. It is not necessary to *"perform an exercise of redacting and disclosing privileged communications sent... in confidence"*. That would be unworkable and could place an unnecessary costs burden on parties to litigation.

HFW perspective

This case represents welcome confirmation of the principle that LAP will apply to regulatory investigations. Assuming that the usual requirements concerning scope and recipients are adhered to, advice and information can be shared freely between clients and their lawyers, without undue risk of later disclosure.

It will be interesting to see whether recent cases in other common law jurisdictions (and cases such as this) represent a move away from unfortunate *Three Rivers* lacuna for legal advice privilege in England.

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One step closer to Third Party Funding in Hong Kong

In October 2015, the Law Reform Commission of Hong Kong released its much anticipated Consultation Paper on Third Party Funding for Arbitration, recommending that third party funding should be permissible for arbitration proceedings taking place in Hong Kong.

Background

The 700 year old doctrines of maintenance and champerty still form part of Hong Kong law, operating to prohibit the third party funding of litigation in the jurisdiction both as a tort and as a criminal offence. The rationale behind the prohibition dates back to medieval England, when there was seen to be a need to prevent oppression of the poor by the rich through the "wanton and officious" intermeddling in the disputes of others, thereby subverting the course of justice.

Despite abolition of the criminal offences in England in 1967, champerty and maintenance remain a common law criminal offence in Hong Kong.

There are only three scenarios in which litigation funding is permitted in Hong Kong, as follows:

1. Where the third party funding the litigation has a legitimate interest in the outcome of the litigation.

2. Where there are access to justice issues.

3. As part of insolvency proceedings.

The types of funding arrangements that have been accepted by the Hong Kong courts as exceptions to the prohibition on third party funding have generally involved the provision of funding for arm's length commercial terms, on the basis


that if a claimant makes a successful recovery the funder receives a financial benefit. The funded party retains sole and exclusive control of the substantive dispute and conduct of the proceedings.

Hong Kong is one of the major international hubs for arbitration, however the question of whether the doctrines of maintenance and champerty apply to arbitration proceedings in the jurisdiction has yet to be definitively determined by the courts. In 2007, the question was left open by the Court of Final Appeal in the case of *Unruh v Seeberger*[1].

The Sub-Committee's recommendations

Although maintenance and champerty still form part of Hong Kong law, recent case law has shown increasing flexibility by the courts. The access to justice exception should not be considered static, but rather as having the potential to evolve to better suit modern requirements.

The Sub-Committee conducted a comprehensive study of the third party funding industry, looking at case law and legal regimes in a number of overseas jurisdictions. Following their review, the Sub-Committee made the following recommendations:

- The Arbitration Ordinance in Hong Kong should be amended to allow third party funding of arbitration in Hong Kong.
- Clear ethical and financial standards for third party funders should be developed.
- Submissions should be invited from the public on a number of issues, including whether:
  - Regulation should be by oversight from a government or statutory body, or self-regulating.
  - A funder should be liable for an adverse costs order (as in the case in other jurisdictions e.g. England).
  - The Arbitration Ordinance should give an arbitral tribunal power to award security for costs against a third party funder.

The Sub-Committee consultation runs until January 2016.

HFW perspective

Third party funding is still at a relatively early stage of development in Hong Kong, as compared with other common law jurisdictions. The jurisdiction is undergoing a slow but conscious liberalisation of the historical position. The Law Reform Commission's recommendation that third party funding for arbitrations should be permitted, will, if implemented, help ensure that Hong Kong remains competitive as an international arbitration centre.

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hfw Conferences and events

HFW Seminar – Offshore Contracts and the Storm of 2015: War Stories
Singapore
3 December 2015
Presenting: Chanaka Kumarasinghe

BIMCO Bills of Lading Masterclass
Dubai
8 December 2015
Presenting: Simon Cartwright and Yaman Al Hawamdeh

Commodities Breakfast
Singapore
8 December 2015
Presenting: Chris Swart, Suzanne Meiklejohn, Adam Richardson, Kimarie Cheang and Scott Pilkington

18th Annual Salvage & Wreck Removal Conference
London
9-11 December 2015
Presenting: Andrew Chamberlain and Toby Stephens

Metal Bulletin 19th Middle East Iron and Steel Conference
Dubai
14-16 December 2015
Attending: Simon Cartwright

Commodities Supper Seminar
HFW London
18 December 2015
Presenting: Brian Perrott, Simon Rainey QC and Robert Bright QC

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