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C H A N C E

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Contentious Commentary

Contract

On the penalty spot

The rule on penalty clauses is alive!

English contract law generally adopts a laissez faire approach – the parties can usually do what they want (at least, unless consumers are involved). The rule on penalty clauses is one of the few common law rules that controls what the parties can agree. It bans an agreement requiring a party in breach of contract to pay a sum out of all proportion to the losses caused by the breach in order to deter breach. Because of the rule's exceptional nature, it has always been controversial.

In *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, the Supreme Court was offered the option of abolishing the rule altogether or, like Australia, of enlarging its scope. The Supreme Court did neither. Instead, the Supreme Court fenced in the rule a little, but left it in place, though now with some uncertainty as to the exact location of its boundaries.

The Supreme Court decided that the rule only controls secondary obligations that arise on breach of contract. The rule does not enable the court to determine the fairness or otherwise of the primary obligations agreed by the parties, such as the price or when the price is payable. As a result

> "in some cases the application of the rule may depend upon how the relevant obligation is framed... [W]here a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty."

The rule can therefore be evaded by appropriate drafting in some – perhaps many – cases (though the court will look to the substance rather than the form).

When the rule applies, the test is no longer about reasonable pre-estimates of damages or whether a clause is a deterrent to breach. Instead, according to the majority reasoning, the question is whether the clause "imposes a detriment on the contract breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation".

The innocent party has no legitimate interest in punishing the contract-breaker, but may have a broader interest in performance than simply obtaining compensation. Equally, since the rule interferes with freedom of contract, the court should not be astute to find penalties, and the parties' bargaining power will be a relevant factor (shading into the territory occupied occasionally by the Unfair Contract Terms Act 1977). Basically, if the clause doesn't, overall, seem too outrageous, the clause will be enforceable.

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Makdessi concerned the sale of an advertising business. The sellers were paid certain sums up front, with two further payments to follow based on operating profits. However, if the sellers broke the restrictive covenants in the sale contract not to compete with the business they sold, the two further payments ceased to be due and, in addition, the buyer was entitled to exercise an option to buy the shares that the sellers retained at

a price that did not include goodwill, which formed a large part of the price otherwise paid

The Supreme Court decided that neither clause was subject to the rule on penalties because they were not secondary clauses. The disappearance of the two additional payments was a price adjustment clause, even though triggered by breach of contract. The upfront payments were all that the buyer was prepared to pay for the acquisition of a business from sellers who did not observe their restrictive covenants. The Supreme Court acknowledged that if the buyers could prove that they had suffered losses as a result of the breach of contract, they could recover those losses as well as avoiding the further payments. The same applied to the call option.

In any event, even if the law on penalties had applied, it is clear that the Supreme Court would have found the clauses to be legitimate and proportionate.

Makdessi was heard with *ParkingEye Ltd v Beavis*, which concerned an £85 charge imposed on anyone who parked for more than two hours at the Riverside Retail Park, next to Chelmsford railway station. The Supreme Court accepted that the charge was within the rule on penalty clauses but also that it was well within the legitimate and proportionate interests concerned. These interests were wider than those of the party that imposed the charge (a company that didn't own the shopping centre or the car park but ran the car park in return for collecting fines from overstayers). They included the interests of the owner of the shopping centre, which wished to ensure that commuters didn't use the car park and to ensure a good turnover of customers at the shops it rented out.

The Supreme Court also decided (Lord Toulson dissenting on this point) that the parking penalty charge did not offend the Unfair Terms in Consumer Contracts Regulations (the provisions of which are now the Consumer Rights Act 2015).

Whither the rule on penalty clauses? Wither it might well do. Cases holding clauses to be penalties have, historically, been rare. That's not likely to change - indeed, the Supreme Court's approach will make it harder still to show that a clause is a penalty. One might question whether a test that includes the words "proportion" and "legitimate" is really a test at all, but the Supreme Court clearly intended "legitimate interests" to be an expansive category, allowing the court to take into account more than just a comparison with damages. In practice, a clause will have to be seriously egregious to offend the courts' sensibilities. And the bigger the parties and the better their advice, the less likely that will be. The real issue may be how far contracting parties are prepared to push at the new boundaries.

Clifford Chance LLP acted for the defendant in *Makdessi*.

Immunity

Art of the state

A state's waiver of immunity does not need to mention injunctions expressly.

Sovereign states have immunity from the jurisdiction of the English courts and also a separate immunity from enforcement procedures. Waiver of jurisdictional immunity does not carry with it waiver for enforcement purposes. The provisions in the State Immunity Act 1978 dealing with enforcement refer, in section 14(2)(a), to injunctions and specific performance and, in section 14(2)(b), to enforcement against assets. In *Pearl Petroleum Co Ltd v Kurdistan Regional Government of Iraq* [2015] EWHC 3361 (Comm), Burton J held (obiter) that a contract under which a state waived "any claim to immunity for itself and assets" (sic) was enough to allow the court to grant an injunction. A waiver aimed at enforcement (the reference to assets) was enough to allow the grant of an injunction even though an injunction was not expressly mentioned, ie there need only be a dual waiver (jurisdiction and enforcement), not a triple waiver (jurisdiction, enforcement and injunctions).

In *Pearl Petroleum*, the judge also decided that the constituent parts of a federal state do not enjoy immunity; only the state itself has immunity. However, if the constituent part is a separate entity within the meaning of section 14 and is exercising the state's sovereign powers, it might still be immune. Though somewhat opaque on the point, Burton J indicated that this meant that if a constitution allocates certain responsibilities to the constituent part, which then carries out those responsibilities, that will not constitute the exercise of the state's sovereign authority even if the nature of the activity is such that it would have done if carried out by the state itself. Instead, it will constitute the performance of the constituent part's authority, and the constituent part has no sovereignty for the purposes of the Act. An appeal might be useful.

Toll gates

A tolling agreement covers claims in fraud.

C alleged that D had been negligent in its valuation of 49 properties. C and D then reached a tolling agreement that recited the allegations of negligence, defined "Dispute" as any claim "directly or indirectly arising out of or in any way connected with the matters referred to" in the recitals, and tolled any time-based defence "in connection with a Dispute". C later sued D for negligence in 46 valuations, adding a claim in fraud in respect of 41 of them. Are the fraud claims subject to the tolling agreement or can D rely on the passage of time otherwise excluded by the tolling agreement?

In *Mortgage Express v Countryside Surveyors Ltd* [2015] EWCA Civ 1110, the Court of Appeal decided that the fraud claims were subject to the tolling agreement. The Court of Appeal conceded that fraud and negligence are of a different character (and, as a result, that a claim in fraud does not arise from substantially the same facts as a negligence claim for the purposes of adding a new claim under CPR 17.4 after expiry of the limitation period), and that no claim in fraud had been intimated prior to the tolling agreement. Nevertheless, the Court of Appeal considered that the fraud claims were still sufficiently connected with the matters set out in the recitals. Perhaps a generous, if indirect, application of the maxim that fraud unravels all.

Counter-revolutionary fervour

The test for implication is necessity

The Neubergian counter-revolution is complete. Having side-lined Lord Hoffmann's views on contractual interpretation in *Arnold v Britton* [2015] UKSC 36, in *Marks & Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Ltd* [2015] UKSC 72 Lord Neuberger meted out the same treatment to Lord Hoffmann's views on implied terms. Implication of terms has different rules from interpretation. The test for implication is whether the term is necessary for the business efficacy of the contract in the sense that the contract would lack commercial or practical coherence without it. Reasonableness has nothing to do with it. We might even be allowed to refer again to the poor old officious bystander, who is testily and repeatedly suppressed by the parties with a curt "Oh, of course!".

Tort

A remote chance

Where there is concurrent liability in contract and tort, the contractual approach to remoteness of damages applies.

Remoteness in contract and in tort are not the same. In contract, the defendant is liable only for damages of a kind that were or should have been within its contemplation at the time the contract was entered into, in the sense that they were not unlikely to occur. In tort, the defendant is liable for any type of damage which is the reasonably foreseeable consequence of its wrongdoing. The tort measure of damages is therefore potentially wider than the contractual.

But what if there is concurrent liability in contract and tort, as allowed by the House of Lords in *Henderson v Merrett Syndicates Ltd* [1995] 1 AC 145? In principle, the claimant has two separate causes of action and can recover on whichever basis gives the higher figure – after all, the claimant can, if it matters, rely on whichever has the longer limitation period. But this has come in for academic criticism, which has favoured confining the claimant to the contractual measure of damages. In *Wellesley Partners LLP v Withers LLP* [2015] EWCA Civ 1146, the Court of Appeal agreed with the academics and concluded that where there are concurrent claims, in this case against solicitors, the claimant can only recover contractual damages. Unfortunately for D, the Court of Appeal disagreed with the first instance judge and decided that the damages claimed by C in *Wellesley* fell within both the tortious and contractual concepts of remoteness.

The reason given by the Court of Appeal is that liability in tort in this kind of case rests on an assumption of responsibility. Where that responsibility has been assumed by entering into and performing under a contract, it would be anomalous to assert that the tortious assumption is wider than the contractual assumption. Tort can't upset the contractual bargain. It may be possible to explain the decision as an extension of the House of Lord's approach to remoteness in *The Achilleas* [2008] UKHL 48 (ie there may be special circumstances that expand or restrict the scope of damages, though the Court of Appeal conceded that it was all but impossible to work out the ratio decidendi of *The Achilleas*), but the real point may be that concurrent liability is itself illogical. Why should performance under a contract also give rise to tortious liability? If it's the same as in contract, it adds nothing; if it's different, it undermines the parties' bargain. In the light of *Henderson v Merrett*, however, that is not something that the Court of Appeal could consider.

Wellesley concerned solicitors who had drafted an agreement providing for an investment in a firm of head hunters. The agreement allowed the investor to withdraw half its investment within 41 months, whereas it should have only allowed the investor to withdraw after 42 months. The investor did withdraw, taking cash out of the business that would otherwise have been used for expansion. This brought the vexed question of whether this was a loss of chance case. C's case was that it would have opened an office in the US, which would then have obtained highly profitable work from Nomura, and it should be compensated for the profits it would have earned on that work.

The Court of Appeal decided that C had to show on a balance of probabilities that it would have opened a US office. C did so. The profits this office would have made depended upon what a third party, Nomura, would have done. This required C to show that there was a real and substantial chance that Nomura would have awarded head hunting mandates to C's new US office, not that on a balance of probabilities Nomura would have done so. C also succeeded on this point.

These two successes were enough to show that D's negligence had caused C losses. That led to the quantification of those losses. For this purpose, a probabilistic approach was taken. There was a 15% chance that Nomura would have awarded C a sole mandate and a 45% chance that C would have obtained a joint mandate. C therefore recovered 15% of the profits it would have made from a sole mandate and 45% of those that would have flowed from a joint mandate.

In *Wellesley*, C's profits depended upon the decisions of one potential client. But suppose C had not been dependent on one client but had claimed profits from numerous transactions with numerous unknown clients, ie it would generally have been successful. It's not clear that damages in such a case should be discounted in a similar way (eg *Vasiliou v Hajigeorgiou* [2010] EWCA Civ 1475), nor what the difference is between the two situations.

Tort

Valuable security

A securitisation vehicle can sue valuers for negligence.

An issue of title to sue arose in *Titan Europe 2006-3 plc v Colliers International UK plc* [2015] EWCA Civ 1083. This was whether a securitisation vehicle could sue valuers for negligence or whether title to sue rested with the noteholders. The decision on this point was obiter because the Court of Appeal, reversing Blair J, decided that the valuers had not in fact been negligent.

The structure was that a securitisation vehicle, C, acquired with the proceeds of its note issue a loan secured on a property in Nuremburg. C "assigned by way of charge" (a concept not free from difficulties) the loan and its security to a security trustee for the noteholders. C was said to remain the legal and beneficial owner of the loan since notice of the assignment had not been given to the obligor. The valuers argued that C had no title to sue in respect of their valuation of the secured property or, if C did have title to sue, that C suffered no loss because any loss was suffered by the noteholders.

The Court of Appeal was satisfied that C's legal and beneficial ownership of the relevant property entitled C to sue the valuers for substantial losses. C suffered a loss when it acquired the loans for too high a price since the price depended on the valuation. The fact that C had entered arrangements under which the loss was passed to the noteholders was neither here nor there. The position was akin to a company and its shareholders: the fact that any loss is ultimately felt by shareholders does not mean that the company has no claim.

Privilege

Private property

The legal context for privilege is potentially wide-ranging.

The law on privilege is in, in some aspects at least, easy to state. It's the application that can be hard. So, legal advice privilege requires confidential communications between lawyer and client for the purpose of giving or obtaining legal advice. Legal advice includes telling a client what should prudently and sensibly be done in the relevant legal context. And the communications in question can be part of the ongoing process of keeping the lawyer generally up to date regarding the issues upon which advice is being sought. No great matters of principle there.

In *Property Alliance Group Ltd v The Royal Bank of Scotland plc* [2015] EWHC 1557 (Ch), Birss J had no difficulty in identifying these established principles but considerable difficulty in deciding, whether, in accordance with these principles, privilege extended to reports and minutes prepared by Clifford Chance for the bank as to the various regulatory investigations into LIBOR faced by the bank. C's hope

was that these documents might avoid its needing to look at the 25 million or so underlying documents. Birss J was worried that the firm might not have been acting in a sufficiently legal context to carry with it privilege. He thought it necessary to look at the documents to decide the issue, but the judge who did so could not be further involved in the case if the documents were in fact privileged. As the docketed judge, Birss J could not himself carry out the inspection.

As a result, a new judge on the Chancery block was appointed to look at the documents and decide whether they were privileged. At [2015] EWHC 3187 (Ch), Snowden J found his task rather easy. There was obviously a legal context - the investigations and the threat of subsequent litigation faced by the bank. And the documents were clearly part of the continuum of communications between lawyer and client aimed at giving legal advice, not just a record of discussions by non-lawyers. In the light of this, no question of redaction arose.

Generally, the judgment is useful in resisting a narrow approach either to the continuum of communications between lawyers and clients or to the legal context (but just copying everything to lawyers is not enough on its own). But there do remain other areas where the law of privilege is less clear.

Unwaiver

A waiver of privilege in pleadings can be withdrawn.

Property Alliance Group (above) relates to C's attempts to escape from the consequences of various interest rate swaps. C's pleadings echo those in *Graiseley v Barclays Bank plc* [2013] EWCA Civ 1372 in relying on D's alleged manipulation of LIBOR, as well as other matters.

In the application ([2015] EWHC 1557 (Ch)) that led to Snowden J's appointment, Birss J had also decided that by referring in its pleading to the fact that the FCA had made no adverse findings in relation to D's involvement with sterling LIBOR, D had put in issue the basis of the FCA's findings and, as a result, D had waived privilege in its settlement negotiations with the FCA. Faced with this decision, D applied to delete this reference from its pleadings. Birss J initially refused to allow the deletion because that would have left a bare denial of C's allegation, contrary to CPR 16.5(2) ([2015] EWHC 2365 (Ch)). So D applied to amend its pleadings again, this time with a more fulsome amendment.

But for other procedural issues, Birss J would have granted D's application to amend ([2015] EWHC 3272 (Ch)). A party can't be compelled to rely on anything, and D was entitled to withdraw the offending reference before it actually relied at trial on the substance of the FCA's finding.

C argued that D had already relied on the substance at interim hearings, which was itself an irrevocable waiver. Birss J accepted that if D had relied at an interim stage, D could not withhold the documents at trial on grounds of privilege. But the judge decided that D had not relied on the substance of its pleadings in the course of the interim issues on disclosure and pleadings. D could therefore in effect unwaive privilege in the documents because mere reference to privileged materials in pleadings is not an irrevocable waiver.

Property in a witness

Secret recordings are not privileged.

What is sauce for the goose is proverbially also sauce for the male of the species. In another instalment of *Property Alliance Group Ltd v The Royal Bank of Scotland plc*, D questioned some of C's claims to privilege. In particular, C had lured two of D's ex-employees to meetings with hints of work for them in their new jobs, but then asked about the subject matter of the litigation and secretly recorded the meetings. Both ex-employees declined to become involved in the litigation. C claimed that the recordings were subject to litigation privilege.

Birss J disagreed ([2015] EWHC 3341 (Ch)). He concluded that a recording of a non-privileged meeting could not be privileged even if made for the purposes of litigation. As a result, the question was whether the dominant purpose of the meeting was gathering evidence for the litigation. The judge decided that this could not be viewed solely from C's point of view, but must also take into account the two ex-employees. They were deceived into attending a meeting that, if the meeting had been for the purpose presented to them by C, would not have been privileged. Birss J considered that the deception of the witnesses was the key feature. C invited them to a meeting the purpose of which was not privileged (they would not have attended if they had been told the real reason), and C could not complain if the court took at face value the stated purpose of the meeting.

Sharing the goods

A company cannot assert privilege against its shareholders.

Sharp v Blank [2015] EWHC 2681 (Ch) does not break new legal ground, but it is a reminder of the principle that a company cannot in general assert privilege against its shareholders. Building, rather anachronistically, on the position of trustees and beneficiaries, legal advice taken by the directors of a company is treated as being done in the administration of the company for the benefit of the shareholders. The shareholders should not be prevented from seeing what has been done at their expense and for their benefit. The exception to this rule is where there is a dispute, actual or in contemplation, between the company and its shareholders. If so, the company can assert privilege in legal advice relating to the dispute.

Sharp arises from Lloyds Bank's takeover of HBOS following Lehman's collapse. Shareholders in Lloyds are suing the bank and its directors. It appears from the somewhat skeletal judgment that Lloyds asserted privilege over all the legal advice it received about the takeover, perhaps all advice received after the merger was announced on the basis that litigation was in contemplation from that date. Nugee J rejected this blanket claim. Some advice might be privileged, but the bank had to be more specific as to the grounds.

Just because a company cannot assert privilege against shareholders does not mean that shareholders are entitled to see all legal advice obtained by the company. Whether, outside a litigation disclosure process, shareholders can demand the company's papers depends upon wider issues of company law.

Unjust enrichment

A Trojan house

Unjust enrichment gives rise to a charge by way of subrogation.

A claim in unjust enrichment lies if D has been enriched at C's expense, that enrichment is unjust, and D has no defences. *Bank of Cyprus (UK) Ltd v Menelaou* [2015] UKSC 66 concerned when enrichment should be considered to be at C's expense and what the remedy should be.

The case involved a house charged by P to C. The sums secured by the charge exceeded the value of the property, but C agreed to P's selling the property, paying off part of the secured debt and using the balance to buy a smaller house, provided that the new house was charged in C's favour for the debt that remained outstanding. The new property was bought in the name of D, P's student daughter, who should therefore have executed the charge as security for her parent's debts. But D's signature on the charge was forged. C therefore did not get the charge it wanted over the new property. C claimed instead to be subrogated to the lien to which the seller of the new property would have been entitled had it not been paid. (The solicitors acting, a firm run by relatives of P, eventually admitted liability to C.)

The first question was whether D had been enriched at C's expense. The Supreme Court was in no doubt that she had been. The Supreme Court shunned any suggestion that rigid rules should apply to determine when enrichment was at the expense of another. D had been given the new property by P but, looking at the transaction in the round, it was clear that the property had been bought with money to which C was entitled and which C had only released on condition that it received a charge over the new property. D had been enriched by receiving a property that was not subject to a charge in C's favour, when she should have received from P a property subject to a charge. And the enrichment was unjust because D was the recipient of a gift and could be in no better position than P.

The remedy was more difficult. The Supreme Court's conclusion was that C was subrogated to the unpaid seller's lien because C's money had been used to pay the seller of the new property and C was therefore entitled to stand in the shoes of the seller (akin to a guarantor's right of subrogation). Lord Carnwath was not enthused by this approach; the rest recognised that it was somewhat artificial, but it was in line with authority and it got them where they wanted to be. This lien, however, covered only the price paid for the new property rather than all outstanding indebtedness owed by P to C, which is what C should have obtained. Assuming that the property has gone up in value, D can therefore keep the increase.

The Supreme Court raised, but did not answer, other possible approaches. For example, C might have had a personal claim against D rather than, or in addition to, a proprietary claim over the property. C might also have had a standard propriety claim: the sale proceeds of the old property were paid to the solicitors acting and were, as a result, held on trust for C and, perhaps, P; C's money was used to buy the property contrary to C's instructions since C did not get the charge it had made a condition of release of the monies; the property was therefore held by D, who was not a bona fide purchaser for value, on trust for C.

But these avenues of attack were not argued sufficiently for the SC to form a view.

Generally, the Supreme Court's approach was the C should win and get some sort of proprietary interest in the new property. Quite how they got there was of rather less importance - except as to the consistency and coherence of the law in future.

Courts

Drawing a blank

Summary judgment won't be granted where there may be a factual dispute.

The litigation brought by shareholders in Lloyds Bank against the bank and its directors over the bank's takeover of HBOS at the end of 2008 is generating a lot of interim applications. There is *Sharp v Blank* [2015] EWHC 2681 (Ch) on privilege (above), but there has also been a stream of decisions, not all reported, in which the Ds have applied to strike out, or for summary judgment on, certain of the shareholders' claims.

In *Sharp v Blank* [2015] EWHC 3219 (Ch), D applied to strike out an allegation that the directors of Lloyds knew that HBOS was manipulating LIBOR because Lloyds knew that HBOS could not borrow on the interbank market in 2008 and therefore that the LIBOR rates HBOS submitted to the (then) administrator of LIBOR were necessarily fictitious.

Nugee J declined to strike out this allegation. He accepted that the grounds of knowledge pleaded by the shareholders were thin and that it was not enough that something better might turn up on disclosure. What concerned the judge was that, as the case went on, it might be revealed that Lloyds had asked questions about HBOS's LIBOR submissions in its due diligence prior to the takeover. If so, the knowledge alleged might be made out, the judge's decision to strike out the allegation would look curious to say the least and it would be too late to bring the claim back (estoppel per rem judicatam). Absent evidence about the due diligence process, the judge therefore felt unable to conclude that the allegation had no reasonable chance of success.

The Ds had more success in *Sharp v Blank* [2015] EWHC 3220 (Ch), concerning the directors' fiduciary duties. C pleaded tortious failings in relation to the takeover, including in the information given to shareholders for their vote of approval, but also generalised fiduciary duties of a similar kind. It was accepted that the directors might owe an equitable duty to the shareholders to give the shareholders sufficient information to make an informed decision on the takeover, but Nugee J struck out allegations of wider fiduciary duties.

Directors owe their fiduciary duties to the company, not to individual shareholders absent special facts. There were no special facts in *Sharp* that gave rise to a duty to shareholders. In particular, the fact that there was a duty to give sufficient information and that this might be a fiduciary duty (open to question) was not enough automatically to generate other fiduciary duties: someone is not subject to fiduciary duties because he is a fiduciary; it is because he is subject to them that he is a fiduciary. It is necessary to identify the duties that arise on the facts, rather than apply a label in order to assert the existence of duties. A duty to give sufficient information did not automatically give rise to other, more usual, fiduciary duties, such as loyalty and good faith.

Holding serve

Personal service can be effected even if the document is not accepted.

Personal service is rare, but it can be important if the intended recipient is only in England on a transient basis or if it is one of the few instances where the CPR requires personal service. *Tseitline v Mikhelson* [2015] EWHC 3065 (Comm) was of the former sort, and involved process servers trying to serve a claim form on a Russian as the Russian arrived at an event at the Whitechapel Gallery.

Personal service can involve one of two steps: handing the document to the recipient; or, if he will not accept it, telling him what it is and leaving it near him (*Kenneth Allison Ltd v AE Limehouse & Co* [1992] 2 AC 105). In this case, an envelope was handed to D but, crucially, it was always held at one end by the process server. D released his grip, leaving the envelope in the server's hand. This did not constitute personal service because D never had dominion over the envelope; it would only have been good service if the process server had let go of his end of the envelope and provided that D understood that the envelope contained court documents as opposed to junk mail.

However, D was served by the envelope later being shoved at him, the judge concluding that D (despite speaking no English) understood by that time that the envelope contained court documents. The envelope fell to the floor, and the process server ultimately took it away, but this still constituted good service.

Interestingly, the process servers filmed their attempts at service, which prevented there being any real argument as to what had happened.

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