Financial institutions
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Corporate and commercial disputes review

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In this issue:

Will exclusive England and Wales jurisdiction clauses work after brexit?

The impact of Brexit on English litigation: service of process and enforcement of judgments

Supreme Court considers the irrevocability of an agent's authority

Illegality and unjust enrichment

Sale of goods and retention of title

When is a dividend unlawful?

Affirmation and repudiatory breach

The limits of witness preparation in German court and arbitration proceedings

The costs of third-party funding in arbitration

Culture and compliance – new best friends?

Contents

Will exclusive England and Wales jurisdiction clauses work after brexit? 03
The impact of Brexit on English litigation: service of process and enforcement of judgments 06
Supreme Court considers the irrevocability of an agent's authority 09
Illegality and unjust enrichment 12
Sale of goods and retention of title 14
When is a dividend unlawful? 16
Affirmation and repudiatory breach 20
The limits of witness preparation in German court and arbitration proceedings 22
The costs of third-party funding in arbitration 24
Culture and compliance – new best friends? 28

From the editor

Welcome to the fourth edition of *Corporate and commercial disputes review*, in which we examine developments that are likely to affect our corporate clients.

Since the UK's vote to leave the European Union in June, Brexit has become a key area of interest for companies across all industries. From a disputes perspective, we look at how Brexit could impact upon exclusive jurisdiction clauses, service of process and enforcement of judgments and see why, practically, there is likely to be little material change.

Away from Brexit, we examine several key recent cases, including decisions of the Supreme Court on illegality, retention of title and termination of agency arrangements. We also review two important decisions concerning repudiatory breach and directors' duties.

In other areas affecting companies, we look at establishing a culture of compliance and the rules governing witness preparation in Germany.

Finally, we consider a recent landmark decision on the recovery of third party funding costs in arbitration and the possible impact for the future of this growing area.

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Will exclusive England and Wales jurisdiction clauses work after Brexit?

Exclusive jurisdiction clauses are a common feature of cross-border trade. The existing regime for enforcement of exclusive jurisdiction clauses in the UK and throughout the EU contains some areas of uncertainty but is, overall, sufficiently robust to be used with confidence. Similarly, while any new regime post-Brexit will not be perfect, it will be robust enough for everyday use and may even avoid some of the problems of the existing regime.

How does the existing regime work?

Exclusive jurisdiction clauses are recognised in the UK (and throughout the EU) by virtue of Article 25 of the Brussels Regulation (Regulation (EU) 1215/2012). This requires courts in the EU to recognise a submission to jurisdiction agreed in a prescribed form by the parties in favour of the courts of a Member State. Even though Article 25 and its predecessors have been relied on by commercial and banking counterparties for many years, it is not free from legal risk as the following examples demonstrate.

- Asymmetric jurisdiction clauses: following decisions by the French courts, there is some doubt as to the efficacy of jurisdiction clauses that benefit only one party to a contract, as a matter of European law as well as French law. The series of French decisions in the *cour de cassation*, the highest French court, culminating in *Apple* (Cass. 1ere Civ., October 7, 2015, No 14-16.898), mean that an asymmetrical clause will be enforced by a French court providing that there is an objective standard which limits the choice of jurisdictions covered by the clause. The French courts base this restriction explicitly on purported compliance with the Brussels Regulation, as opposed to issues of purely French law. Courts of other European Member States have not taken a similar view and the English courts have pronounced these clauses as consistent with both English law and the Brussels Regulation. Given the difference of opinion, there is a possibility that the issue may be referred to the Court of Justice of the European Union (the CJEU). A decision by the CJEU would be binding on all Member States, so that the English courts could be prevented from taking their commercial approach to asymmetrical jurisdiction clauses.

  This is a legal risk for banks that commonly incorporate these types of clauses in their loan agreements.

- Choice of non-Member State courts: although Article 25 only explicitly refers to the courts of a Member State, it has been accepted by the courts at European and national level that a choice of the courts of a non-Member State is also effective. However, the basis for this rule remains unclear – it may be that the Brussels Regulation must be interpreted so as to apply to this situation, or it may fall to individual national rules that, in turn, generally respect choice of court agreements.

- Prospectus liability: as a result of recent decisions of the CJEU, investors are able to sue issuers and arrangers in their home courts when they have suffered a financial loss in their home jurisdiction. In *Kolassa v Barclays Bank plc* (Case C-375/13), the CJEU held that where an investor had a securities account with his bank in his home jurisdiction, that was sufficient for him to suffer the loss there. The CJEU has recently sought to limit this principle, for example in *Universal Music v Schilling* (Case C-12/15), stating that something above the mere presence of an account is required. Nevertheless, in the absence of clear criteria, there is still a risk that investors could start proceedings in multiple jurisdictions and leave the issuer battling on several fronts.

- Torpedoes: under the predecessor to the Brussels Regulation, an exclusive jurisdiction clause could be 'torpedoed' by starting proceedings in the courts of another Member State, so that the chosen Member State would have to wait until the first court decided that it did not have jurisdiction, a process that could take years. Although this loophole is now closed, a new provision of the Brussels Regulation may give a similar timing advantage for proceedings started in a non-Member State (Article 33 – 34).

- Anti-suit injunctions: this is an injunction granted by the court given exclusive jurisdiction to prevent proceedings in other jurisdictions from commencing or continuing. The Brussels Regulation is based on equal competence – courts in different countries should all agree on which country has jurisdiction – and so Member States are largely prevented from granting anti-suit injunctions in respect of proceedings in other Member States. It is up to the court in the other Member State to determine whether it has jurisdiction under the common set of rules set out in the Brussels Regulation and it would not be appropriate for courts in the first Member State to attempt to usurp this jurisdiction by granting an anti-suit injunction. This applies also to arbitrations, even though arbitration is outside the scope of the Brussels Regulation. That is, by being a member of the EU subject to the Brussels Regulation, the English courts have lost the power to grant anti-suit injunctions to restrain proceedings in other Member States in breach of arbitration clauses, even though arbitration is outside the scope of the Brussels Regulation. The limits of this ban have been considered several times by the CJEU – currently, as decided in *Gazprom* (Case C-536/13), a court may grant an anti-suit injunction to restrain proceedings in another Member State where it is enforcing an arbitral award, even though it would not have the power to do so otherwise. So if an arbitral tribunal in London grants an anti-suit injunction, the English courts may then enforce that injunction. This is a slightly tortuous dividing line that may still be revisited by the CJEU.

Negotiating the new regime

These current imperfections cannot be compared with the future post-Brexit arrangements because, of course, those arrangements have yet to be determined. Nevertheless, the parameters of negotiations to agree those arrangements are foreseeable. In particular, they will likely involve a triangulation between three possibilities.

- The UK remaining in the current Brussels Regulation regime (or subject to the closely related Lugano Convention).

- A fallback to the Brussels Convention (which would probably apply in the absence of any agreement) possibly supplemented by signing up to the Hague Choice of Courts Convention.

- Opting out of all international agreements so that the UK applies its previous common law rules and other countries apply their existing rules, treating the UK as a non-Member State or equivalent non-signatory country.

Wherever the UK ends up within this triangle, in general, English courts will in all probability continue to respect an exclusive choice of the courts of another country and courts within the EU will continue to respect the choice of English courts.

If the UK seeks an arrangement that is close to the status quo, it may request a special status as a non-Member State within the Brussels Regulation regime. If this is not politically feasible, perhaps because it would require accepting the continued primacy of the CJEU, the Lugano Convention would be a near alternative. But the EU may not be willing to allow the UK to remain within the existing regime, or something close to it. In that case, the UK could unilaterally decide to sign the Hague Choice of Courts Convention and to rely on its prior membership of the Brussels Convention. This gives a regime that includes a fair degree of reciprocity, especially for exclusive jurisdiction agreements.

The Brussels Convention remains in effect for territories excluded from the Brussels Regulation, but otherwise the Brussels Convention was 'superseded' by the Brussels Regulation (see Article 69 of the Brussels Regulation). As a result, it is not entirely clear that the UK would automatically fall back to the Brussels Convention if it is no longer bound by the Brussels Regulation. But, in a sense, it is irrelevant whether there is some doubt over this fallback position: it still gives the UK leverage in any negotiation, in that it would argue that there is a viable network of international agreements that could apply and so any agreement with the EU should be pitched somewhere between the existing regime and what could replace it.

The UK may prefer a solution that allows it to retain its freedom of manoeuvre, at the cost of a looser relationship with the existing international regime. This is the third option, where the UK opts out of international agreements and relies on its domestic rules of conflicts of law and the corresponding rules of other countries. It replaces the deficiencies of the Brussels regime with the limitations of a unilateral position that avoids reciprocity. It is not only an alternative fallback position for the UK in any

negotiation – it may be a favoured option if the UK wishes to prioritise control over co-operation.

These three positions represent the likely outer limits of what might be agreed. We consider how exclusive jurisdiction agreements will work for regimes falling within these limits.

How will the new regime work?

Any of the Brussels Convention, the Lugano Convention, the common law or some amalgam of those will provide for English courts to stay their proceedings in favour of another country chosen by the parties. The modalities of expressing that agreement and allowable exceptions may vary slightly from the current position. For instance, if English courts were no longer bound by international conventions, there might be more scope for stays to be refused on discretionary grounds – although the English courts would no doubt take a commercial approach to the exercise of any discretionary powers.

Similarly, whether the UK is a Brussels Convention state, a Lugano Convention state, or simply a non-Member State within the ambit of the Brussels Regulation, EU Member States will surely, in general, continue to respect exclusive jurisdiction clauses selecting the English courts. It may be that this is via their own national conflicts of law rules rather than international convention. It may be that this leads to increased scope for 'torpedoes' or other delaying tactics if the UK becomes just another non-Member State. However, if the UK's negotiated position is outside the Brussels regime, then it is likely that it will once again be able to use anti-suit injunctions. This powerful weapon to compel compliance with an exclusive jurisdiction clause was largely removed from the arsenal of the English courts by the Brussels Regulation, as set out above.

The net effect is that wherever the UK ends up, outside or within the Brussels Regulation or Convention or a similar regime, the legal risk of foreign non-compliance with English exclusive jurisdiction clauses will be little changed.

The other legal risks identified above – that is, the imperfections in the current system – may actually be reduced by any post-Brexit arrangement. English courts have supported asymmetric jurisdiction clauses of all types. If English courts post-Brexit are not subject to decisions of the CJEU, that removes the risk that they will be bound by a future CJEU decision not to enforce those clauses. Note that this does not improve the outlook for asymmetric jurisdiction clauses in courts outside the UK and these clauses fall outside the scope of the Hague Choice of Courts Convention. The extension of prospectus liability set out above only applies when the court that would otherwise have jurisdiction is located in a Member State. If UK issuers and arrangers are located in a non-Member State, this risk is inapplicable.

There is a trade-off. A position close to the status quo accepts the legal risks in the current consensual system. Moving towards a less consensual, more competitive, approach gives the opportunity to eliminate the existing risks but might create new awkward situations. Taking advantage of other international conventions adds another dimension to any negotiations that could help preserve freedom of action while limiting any new risks.

Conclusion

Exclusive jurisdiction clauses will continue to operate in the post-Brexit world. There will be uncertainties and inconsistencies – but these will be of a similar order of magnitude to those in the existing international regime and will not prevent the continuing orderly use of these clauses in international trade.

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The impact of Brexit on English litigation: service of process and enforcement of judgments

For many years, parties across the EU have regularly chosen the English courts to resolve international disputes. Many of the reasons for this are independent of the UK's membership of the European Union and should continue after it leaves: the reputation of the English courts for quality, consistency, honesty, transparency and technical knowledge; England's status as a global financial centre; no juries in civil cases; no awards of punitive or exemplary damages; and a 'loser pays' costs system.

Since the referendum result, concern has arisen as to whether the advantages of England as a dispute resolution centre might be diminished. Two perceived areas of risk relate to:
(i) service of process – whether it will become more difficult to serve the English court proceedings on parties in EU Member States post-Brexit; and
(ii) enforcement of judgments in EU Member States.

Service of process

For properly advised commercial parties there should, from a practical perspective, be little change – at least for claims arising out of a contractual relationship between the parties.

Currently, English court proceedings may be served on defendants in other EU member states in accordance with the Service Regulation, which can be relatively quick and cost effective. The Service Regulation permits a variety of methods of service including service between designated state central bodies (Article 4); postal service where proceedings are sent by the Member State (Article 14); and direct service where permitted under the law of the Member State (Article 15). As to the latter, it should be noted that several Member States, including Germany (for documents initiating proceedings), Spain and Poland do not permit direct service. Indeed, the UK is also opposed to direct service on parties in England and Wales under Article 15.

It may be that the UK is able to negotiate continued application of the Service Regulation or equivalent post-Brexit. However, even if no formal arrangements between the UK and the EU are put in place, claimants could instead effect service on defendants in other EU states in accordance with the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters. The Hague Convention provides that each contracting state designate a Central Authority to receive and execute requests for service originating in other contracting states. In some cases this is likely to be slower than service under the Service Regulation (at least under Article 14 of the Service Regulation).[1]

Although Article 10 of the Hague Convention provides that it does not interfere with the freedom to send judicial documents by post, directly to persons abroad, there is no obligation on contracting parties to allow service by such methods. In this regard, several EU states, including Germany, do not permit postal service under the Hague Convention.

In any event, notwithstanding potential benefits of the Service Regulation over the Hague Convention, well-advised parties would usually include within commercial agreements a contractual provision authorising service on a process agent at an address within England and Wales. Such service, in accordance with the Civil Procedure Rules (CPR 6.11), is quicker and simpler than service under the Service

1 At present Austria and Malta are not even parties to the Hague Convention – although the European Parliament has authorised Austria to sign and ratify, and Malta to accede to, the Hague Convention.

Regulation and will be unaffected by Brexit, whatever the outcome of negotiations.

To put it another way, even if the UK ceases to be party to the Service Regulation and no equivalent is put in place, the only real change would be an additional incentive to do what is often done as a matter of course.

Enforcement of judgments

The considerations relating to the enforcement of judgments are similar.

Enforcement of judgments from civil and commercial claims, a key plank of international trade, is governed by the recast Brussels Regulation. One of its principal aims is that judgments made by Member State courts should be easily recognisable and enforceable in other Member States.

Currently, under Articles 36 and 39 of the Brussels Regulation, a judgment given in a Member State is recognised and enforceable in all other Member States without any special procedure or declaration of enforceability being required. There are few defences available which could impede enforcement – essentially limited to

issues including public policy; failure of service of the claim; or where the judgment is irreconcilable with an earlier judgment.

In contrast, enforcement of a non-EU judgment in an EU Member State is a matter for the local law in the enforcing state. This is not to say, however, that enforcement of such judgments is unduly burdensome, although the procedure may not be as straightforward. Indeed, despite the uncertainty as to what post-Brexit arrangements will look like, there appears to be enthusiasm on both sides for continued close trade. To this end, it would be counter-productive to impose obstacles to the enforcement of judgments.

Even opting out of all international agreements so that the UK applies its previous common law rules and other EU countries apply their existing rules, treating the UK as a non-Member State or equivalent non-signatory country, should not result in significant difficulties in enforcing judgments in EU Member States.

As a matter of English common law, enforcement of foreign judgments in England (where there is no reciprocal enforcement treaty) requires the judgment creditor to commence a fresh cause of action against the judgment debtor in the English courts with the foreign judgment being the cause of action. This will generally be slower than the enforcement of judgments from EU Member State courts, but not so much as to make enforcement of such judgments impossible. For example, judgments from US courts are regularly enforced in England without undue difficulty, despite the fact that the UK and the US have no reciprocal enforcement agreement.

Similarly, for example, Germany and France have procedures under their own domestic law for the recognition and enforcement of judgments from third countries so that although it may take longer than enforcement under the Brussels Regulation, enforcement should not be unduly difficult. In both jurisdictions, the concepts underpinning the principal bars to enforcement are not dissimilar to those under the Brussels Regulation: failure of service; where the judgment is incompatible with public policy/ essential principles of domestic law; and in addition, recognition will also be refused where the original court did not have jurisdiction.

There are various other post-Brexit possibilities which could improve on the adequate baseline described above. These include the following.

- The UK remaining in the current Brussels Regulation regime.
- The UK entering into the closely related Lugano Convention, which currently applies as between the EU and Norway, Switzerland and Iceland.
- The UK ratifying the Hague Choice of Courts Convention: at present this has been ratified by the EU, Mexico and Singapore; it has also been signed by the USA.
- Reverting to the Brussels Convention on Jurisdiction and Enforcement of Judgments 1968: the Brussels Convention was signed by individual states, including the UK in 1978.

Accordingly, whether the UK ends up within the range of options above, or even if there is no formal arrangement, there is a strong argument for saying that recognition and enforcement of English judgments in Member State courts should not present undue difficulties for parties post-Brexit.

Comment

In general, uncertainty and change tend to trigger disputes – and there can be little doubt that disputes will generated by Brexit. Sharp dislocations in currencies, asset prices and other disruption in the financial markets may cause counterparties to look for ways to avoid their contractual obligations. Similarly, the assumptions behind contracts which form part of a European supply chain may no longer hold, again leading parties to look for exits. Contractual parties, including borrowers and lenders, will be examining their material adverse change or force majeure clauses and other events of default. These will work their way through the English courts over the next several years.

In the longer term, there is no reason why the English Courts should not continue to be the venue of choice for large commercial disputes. As noted above, the reasons for the popularity of the English Courts are independent of the UK's membership of the EU. Even if there are changes to the procedural mechanisms of enforcement and (to a lesser extent) service of process, they should not undermine the advantages that of litigating in the English courts.

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Supreme Court considers the irrevocability of an agent's authority

In *Bailey and Anor (Respondents) v Angove's PTY Limited (Appellant)* [2016] UKSC 47 the Supreme Court considered two important issues of agency law

- The circumstances in which the law will treat the authority of an agent as irrevocable
- Whether there is a liability to account as constructive trustee when a recipient of money knows that its imminent insolvency will prevent it from performing a corresponding obligation to account to a principal.

Summary

The Court confirmed that the authority of an agent is inherently terminable; and it is only in limited circumstances that the authority will be irrevocable. An agency may be held to be irrevocable where: (i) there is an agreement to that effect; and (ii) the authority has been given to secure an interest of the agent.[1] In this case, the Court held that the agent's authority had been revoked – and that the principal was entitled to recover sums collected by the agent after its insolvency. The Court stated obiter that there was no constructive trust.

Principals will invariably want to ensure that an agent's authority is revocable, particularly in the event of an agent's insolvency. Whether certain rights and obligations survive termination of a contract of agency depends on the interpretation of the contract's express and implied terms. The judgment shows the importance of drafting agency agreements to ensure that a principal's interests are fully protected (particularly as the decision indicates that the courts will be reluctant to impose a constructive trust upon an agent in favour of its principal where the agent has become insolvent). A principal should also consider what practical steps it can take to divert payments from an end customer when an intermediary enters into an insolvency process.

1 i.e. either a proprietary interest (e.g. a power of attorney given to enable the holder of an equitable interest to perfect it) or a liability (usually a debt) owed to the agent personally.

Facts

Angove's PTY Limited (Angove's) is an Australian winemaker. D & D Wines International Limited (D & D) acted as Angove's agent and distributor in the United Kingdom. D & D bought wine from Angove's and sold wine on its behalf. Angove's and D & D had entered into an Agency and Distribution Agreement (ADA) dated December 1, 2011.

The ADA was terminable by either party on six months' notice or immediately on the appointment of an administrator or liquidator. D & D entered into administration on April 21, 2012 and into creditors' voluntary liquidation on July 10, 2012. A$874,928.81 remained owing to D & D for wine sold to two retailers.

On April 23, 2012, Angove's terminated the ADA. The termination notice stated that Angove's would collect the unpaid sums and pay D & D its commission separately. However, the liquidators of D & D wanted to collect the sums, deduct D & D's commission and leave Angove's to prove for repayment of the balance in the winding up. The outstanding sums were received by D & D and Angove's after D & D received the termination notice. They were, therefore, held by the liquidators in an escrow account (and Angove's' solicitors' client account on the same terms), pending the outcome of the litigation. This meant that the sums could not be used by

either party until the issue of beneficial ownership and contractual entitlement was resolved and the customers had received good receipt for the payments that they had made.

Angove's applied pursuant to section 112 of the Insolvency Act 1986 for an order that the sums be paid over to it on the basis that: (i) the liquidators' right to collect the moneys had been revoked by the termination notice; and/or (ii) the sums were held by D & D on constructive trust for Angove's. The liquidators argued that D & D's liability to Angove's as at the commencement of the administration was a simple debt obligation to remit the purchase price for goods sold and delivered, net of D & D's commission.

High Court

It was held at first instance in 2013 that the relationship between D & D and Angove's was one of principal and agent only (rather than buyer and seller) and the termination of the ADA revoked D & D's authority to collect the sums from the customers. The liquidators of D & D appealed but did not challenge the Judge's finding that D & D acted as agent. Angove's constructive trust argument failed.

Court of Appeal

In 2014, the Court of Appeal allowed the liquidators' appeal and held that D & D's authority to accept payments was not revoked by the termination of the ADA. The Court of Appeal confirmed that termination of an agency does not necessarily bring to an end the agent's right to collect money already due to the principal (*Triffit Nurseries v Salads Etcetera Ltd*[2]). The Court of Appeal's view was that D & D had a continuing implicit right to collect the unpaid sums from the customers under the terms of the contract. The sums therefore fell to be distributed to D & D's creditors. With regard to the constructive trust argument, the Court considered that the result of Angove's only receiving a dividend in the insolvency was not an unconscionable outcome and was not enough to justify imposing a constructive trust.

2 [2000]2 Lloyd's Rep 74.

Supreme Court

Summary

The Supreme Court held that the agency was revoked by the termination of the ADA (and therefore Angove's did not have to prove in the liquidation). The Court added that the constructive trust argument would have failed had it been relevant. Lord Sumption delivered the leading judgment.

Revocation of authority

Lord Sumption's reasoning can be summarised as follows

- It is well established that the authority of an agent may be revoked by the principal at any time, even where it is agreed that the authority is irrevocable. The revocation may give rise to a claim for damages.
- The exception to the general rule on revocation is where the agent has "a relevant interest of his own in the exercise of his authority". There must be: (i) an agreement that the authority is irrevocable; and (ii) a subsisting proprietary interest or personal liability of the agent which the authority was given to secure. These conditions are reflected in the Powers of Attorney Act 1971 in relation to authority conferred by a power of attorney.

The Court held that neither of these conditions were satisfied on the facts of the case. The reasons for this included that the ADA did not state that the authority was irrevocable and there was no implied term to that effect either. Customers could pay Angove's directly, which made it difficult for the Court to regard the collection as a right or security of D & D and the deduction of commission was a mechanism not a security. An agent's interest in recovering a debt for already earned commission could be irrevocable, if the parties intended that the agent's authority would secure that interest. The Court also thought that it was "inherently improbable" that the parties intended the authority to be irrevocable as they had provided for a mutual right of termination in the event of insolvency. If D & D's authority survived termination, it would be entitled to five per cent commission in the event of Angove's insolvency but Angove's would have to prove as unsecured creditor in D & D's liquidation for the 95 per cent of the purchase price.

Constructive trust

It was not necessary to deal with this point but the Supreme Court did so because of its general importance. The Supreme Court stated that it is well established that an agent's duty does not necessarily give rise to a trust of money in the agent's hands in respect of which it is obliged to account to its principal. Generally, the relationship must be such that the agent is not able to treat money for the principal as part of the agent's general assets. This will usually involve segregation. The Supreme Court thought that there was no constructive trust in this case, because of the following factors.

- A constructive trust would result in the sums not forming part of the insolvent estate. This would give Angove's priority over similar creditors (the Court referred to the public policy behind the statutory insolvency rules).
- Where money is paid with the intention of transferring the entire beneficial interest to the payee, the least that must be shown for a constructive trust to arise is: (i) that intention was vitiated (e.g. payment by fundamental mistake); or (ii) irrespective of the intentions of the payer, in the eyes of equity it was paid into the wrong hands (e.g. as the result of fraud/theft).

Lord Sumption stated that the agency relationship between D & D and Angove's was one of debtor and creditor. D & D's inability to perform its obligation to Angove's made no difference to the basis on which the sums were held and the customers had not made a mistake. It was not unconscionable for D & D to retain the money just because the statutory insolvency regime intervened to require it to be shared in accordance with the insolvency rules. Therefore, a principal wishing to recover monies which its agent is obliged to pay will generally have to prove in the agent's liquidation unless the relationship was such as to make the agent an express trustee. The Court also considered and overruled *Neste Oy v Lloyd's Bank Plc*[3] and *In re Japan Leasing Europe Plc*[4], cases in which a constructive trust had been held to have arisen.

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3 [1983] 2 Lloyd's Rep 658.
4 [1999] BPIR 911.

Illegality and unjust enrichment

The Supreme Court in *Patel v Mirza* [2016] UKSC 42 has reviewed the doctrine of illegality and sought to clarify the extent to which it applies in civil proceedings.

It has long been established that illegality can provide a defence to civil claims under English law. As Lord Mansfield stated in *Holman v Johnson* (1775) 1 Cowp 341, "no court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act."

However, the limits of this doctrine have often been considered to be unclear and its application inconsistent. As Gloster LJ stated in *Patel v Mirza* in the Court of Appeal, it is almost impossible to ascertain or articulate principled rules from the authorities relating to the recovery of money or other assets paid or transferred under illegal contracts".

In the 2015 case of *Jetivia v Bilta*,[1] the Supreme Court touched on the question of illegality in connection with the issue of corporate attribution: Lord Neuberger commented that the defence of illegality needed to be addressed by the Supreme Court "as soon as appropriately possible" given the problems identified above. A year, later a nine-member Supreme Court was faced with an appeal directly concerning illegality in *Patel v Mirza*: this time in connection with an unjust enrichment claim. The Court was required, in particular, to consider whether the principle of illegality operates so as to prevent a party to a contract tainted by illegality from seeking restitution of money paid under the contract. The Court also took the opportunity to look at the doctrine of illegality more generally.

Patel v Mirza

The facts of the case were that the Respondent had given the Appellant £620,000 to bet on a bank's share price on the basis that the Appellant expected to be in receipt of inside information. However, the Appellant never received the inside information he had been expecting and as a result, the bet was never placed.

The Appellant did not return the £620,000 to the Respondent and when sued by him for that sum, argued that the Respondent's claim should fail because of the illegality affecting the contract. He succeeded at first instance; the decision was overturned by the Court of Appeal and the Appellant subsequently appealed to the Supreme Court.

The Supreme Court unanimously agreed that the appeal should be dismissed and that the Respondent was entitled to restitution of the £620,000. However, there were differences in the reasoning that was applied by the Justices.

The majority cited two policy reasons as to why illegality exists as a defence to civil claims: (i) a person should not profit from their own wrongdoing; and (ii) the law should be coherent rather than self-defeating and should not condone illegality. With these underlying considerations in mind, in determining whether the public interest would be harmed by enforcing a claim where to do so would be harmful to the legal system, the court had to consider the following factors.

- The underlying purpose of the prohibition that was being transgressed and whether that purpose would be enhanced by denial of the claim.
- Any other relevant public policy on which the denial of the claim might have impact.
- Whether the denial of the claim would be a proportionate response to the illegality. It was noted that civil courts (contrasted with the criminal courts) were primarily concerned with determining private rights and obligations and although they should not undermine the

1 [2015] UKSC 23.

effectiveness of the criminal courts, they should equally avoid imposing additional penalties which were disproportionate to the nature and seriousness of any wrongdoing.

Various factors would potentially be relevant to that determination. Examples given included the seriousness of the conduct, whether it was intentional and a comparison with the conduct of the other side. However, Lord Toulson made clear that although there was no fixed or definitive list, this did not mean that the court was free to decide the matter in an undisciplined way.

Applying these principles and considerations to the facts of the case, the majority agreed with the approach of Gloster LJ in the Court of Appeal: namely, to determine whether the policy underlying the rule which rendered the contract illegal would be ‘stultified’ if the claim were allowed. The majority took the view that there was no policy reason why the Respondent should forfeit the money paid to the Appellant given that he was seeking to unwind the arrangement as opposed to profit from it. Generally, where a claimant has satisfied the requirements for an unjust enrichment claim, the claim should not fail merely because the money which was the subject of the claim had been advanced for an unlawful purpose. On the facts of the case, the mischief that the ban on insider trading was aimed at, preventing market abuse, had not occurred and accordingly there was no obvious policy reason why the money should not be returned.

Lords Neuberger, Mance, Clarke and Sumption similarly took the view that provided restitution could be achieved and the result was consistent with public policy and proportionality, a claimant should be able to recover money paid under a contract to carry out an illegal activity.

In so reasoning, the Supreme Court rejected the previously applicable test, from the case of *Tinsley v Milligan* [1994] 1 AC 340, that operated to bar a claim which had been brought in reliance on an illegality. Indeed, in rejecting the reliance test, Lord Toulson noted that unless a statute provides otherwise, it is possible for property to pass under a transaction which is illegal as a contract.

The one significant area of difference between the Court members’ judgments arose out of Lord Toulson’s reasoning (with which the majority agreed) that in determining whether it would be disproportionate to dismiss a claim on grounds of public policy, various factors could be relevant: such as the seriousness of the conduct, whether it was intended, whether both sides were equally culpable or how central it was to the contract. In contrast, Lords Mance, Clarke and Sumption were of the view that conceptually, this changed a legal principle into an exercise of discretion, and from a practical perspective would lead to uncertainty and arbitrariness in this area of the law.

Comment

The result reached in the appeal is unlikely to cause consternation. On the facts, it is difficult to make a case for why the Appellant should enjoy a windfall by being able to retain the £620,000 given to him by the Respondent.

The reasoning and rejection of *Tinsley v Milligan* adds flexibility to the principle of illegality – and could in turn lead to fairer outcomes. While it could be argued, as the minority have done, that that this increases the possibility for uncertainty, given that illegality is concerned with questions of public policy, it is hard to see how it could be otherwise. Moreover, the doctrine of illegality had previously been rife with uncertainty. The fact that the Court will have regard to various factors need not turn the law into a question of discretion, but should instead provide a greater degree of guidance as to how illegality will be applied in practice.

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Sale of goods and retention of title

PST Energy 7 Shipping LLC v O W Bunker Malta Limited [2016] UKSC 23

Following the Supreme Court's decision in OW Bunkers in May this year, industry standard terms in bunker supply contracts may well need to be re-visited to consider whether the Sale of Goods Act 1979 (SOGA) will apply to them. However, the decision could also have wider implications for retention of title clauses generally.

Background

In October 2014, PST Energy 7 Shipping LLC and Product Shipping and Trading S.A. (together, the Owners) entered into a contract to purchase marine fuel (or 'bunkers') from OW Bunker Malta Ltd (OWB).

OWB's standard contract terms included a credit period requiring the Owners to make payment within 60 days. The terms also included a retention of title clause, which provided that title would not pass until payment and also that the Owners were permitted to use the bunkers for the propulsion of their vessel during the 60 day credit period. The contract was the first in a chain of supply contracts, each of which contained various credit periods and retention of title clauses.

The Owners received and consumed the bunkers, but did not make payment. In turn, OWB did not make payment to its parent from which it had purchased the bunkers. In November 2014, OWB's parent encountered financial difficulties. Concerned that they would be liable to both OWB and OWB's parent under the retention of title provisions, the Owners commenced arbitration proceedings seeking a declaration that they were not bound to pay OWB for the bunkers or damages for breach of contract. They claimed that the contract was a contract of sale within the definition of section 2(1) of SOGA which, they argued, meant that one of the circumstances set out in section 49 of SOGA would need to apply in order for OWB to recover the price of the bunkers.

The arbitral tribunal rejected the Owners' arguments and held that OWB would be entitled to payment, a decision with which the High Court and the Court of Appeal subsequently agreed. In May, Lord Mance handed down the Supreme Court's unanimous judgment, rejecting the Owners' appeal and upholding the previous decisions in favour of OWB – the result being that the price under the contract could be recovered as a simple debt at common law.

Judgment

The Supreme Court addressed three central questions.

Was the contract a contract of sale of goods within the meaning of section 2(1) SOGA?
Section 2(1) defines a contract of sale of goods as "a contract by which the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price".

The Supreme Court held that although the basic form of contract was one of sale (i.e. it was a straightforward agreement to transfer the property in the bunkers to the Owners for the price), it was not a contract of sale within the definition of section 2(1) and so the SOGA did not apply.

Instead, the contract was a unique agreement with two key features: (i) it permitted consumption prior to payment, without title ever passing in the bunkers consumed; and (ii) only if and so far as the bunkers remained unconsumed, it transferred the property in the remaining fuel. Consequently, the price was not the price of the bunkers in respect of which property was passing; it was the price payable for all of the bunkers, whether or not consumed at the time of payment.

As the contract was not one of sale, the Owners could not seek to rely on section 49 of SOGA as a defence to a claim for the price.

If the contract was not one of sale, was there an implied term that OWB would perform its obligations to its parent, in particular by making payment in good time?
The Supreme Court held that OWB's only implied undertaking in respect of the bunkers was that it was entitled to give the Owners permission to consume the bunkers before payment was made. OWB did not need to acquire title to the bunkers; it only needed to have acquired the right to authorise the use under the contractual supply chain which, the Supreme Court held, it had.

Should the Supreme Court overrule the Court of Appeal decision in *FG Wilson (Engineering) Ltd v John Hold & Co (Ltd)* [2014] 1 WLR 2365 (Caterpillar)?
Although the contract was not one of sale, because the case had been fully argued and has general significance, Lord Mance considered in his judgment whether he agreed with the Court of Appeal's decision in *Caterpillar.*

In *Caterpillar*, it was held that section 49 of SOGA constituted a code which precluded an action for the price outside the section's terms. Section 49(1) provides that where, under a contract of sale, the property in the goods has passed to the buyer but payment has not yet been made, the seller may bring a claim against the buyer for the price. Consistent with its general findings, the Court of Appeal found that the seller could not enforce payment of the price against the buyer because title to the goods had been reserved pending payment.

Lord Mance, however, disagreed. He considered a number of early authorities in support of his view that section 49 does not provide a complete code of circumstances where the price may be recoverable under a contract of sale. He also noted that in OWB's case, the price would have been recoverable in any event due to the supply contract's express terms, namely the complete consumption of the bunkers supplied.

While Lord Mance counselled that courts should be cautious about recognising claims to the price of goods in cases not falling within section 49 of SOGA, he said there was at least some room for claims for the price in circumstances other than those covered by the section. In respect of the scope for such claims though, in particular where a retention of title clause is combined both with physical delivery of the goods and the transfer of risk, he said the limits were to be left for "determination on some future occasion."

Comment

At the beginning of his judgment, Lord Mance acknowledged that "many similar cases worldwide await our decision with interest". Though no doubt his comment was a reference to the many other owners and charterers also facing claims from the OWB Group on the same terms, the case will also have implications for owners and charterers more generally. Many parties had been operating on the (now mistaken) understanding that SOGA applied to supply contracts with similar terms to those in OW Bunkers.

While the decision that SOGA did not apply assisted OWB to recover the purchase price, parties may nevertheless prefer the relative certainty afforded by the application of SOGA. Whether they seek to achieve this by including terms in their contracts to state expressly that SOGA applies, by re-visiting the relative merits and de-merits of retention of title clauses or by some other means, remains to be seen.

More broadly still, the decision is potentially significant in the context of many other SOGA claims. Standard industry terms and conditions – not just those relating to bunker supply contracts – may need to be re-considered in order to manage risk in commodity transactions and to protect the position of buyers.

Finally, although the Supreme Court has not overruled the *Caterpillar* decision, the next court to consider these issues will want to take into account the detailed and considered comments made by Lord Mance. Until that time, the uncertainty as to the application of section 49 of SOGA and the possibility of any claims outside of its scope will remain.

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When is a dividend unlawful?

In BTI 2014 *LLC v Sequana & Ors* [2016] EWHC 1686 (Ch), a case that will be of interest for company directors, the Chancery Division of the High Court addressed questions of corporate governance, the justification for capital reductions, the validity of dividend payments and the role of a company's directors in such matters.

Background

The company in question, Windward Prospects Limited (Windward), was responsible for indemnifying the principal claimant, B.A.T. Industries PLC (BAT), in respect of certain potential liabilities. BAT had found itself facing the prospect of a substantial US pollution liability and although it had been under the impression that Windward was sufficiently capitalised to discharge its obligations, this was no longer the case.

In December 2008 and May 2009, the directors of Windward had resolved to pay Windward's parent company and sole shareholder, Sequana S.A. (Sequana), two dividends with a total value of approximately €580 million. These dividends were paid following a reduction in Windward's capital carried out under section 642 of the Companies Act 2006 on the basis of solvency statements from Windward's directors (the "CA 2006").

All of the directors of Windward at the relevant time were named as defendants to BAT's claim. Their decision to authorise the dividends was called into question, on grounds which included claims that they had acted in breach of their duty to promote the success of the company under section 172 of the CA 2006, and that they acted with the intention of defrauding Windward's creditors under section 423 of the Insolvency Act 1986 (the "IA 1986"). These allegations were made even though the directors appear to have acted with the benefit of advice from respected solicitors and accountants.

If Part 23 of the CA 2006 (which deals with distributions by companies) – or, for that matter, section 423 of the IA 1986 – had been contravened, the strong likelihood is that Sequana would have been required to surrender some or all of the benefit of the considerable dividends it had received from Windward.

Although the background to this case is complex, the judgment addresses some important legal questions of corporate governance and the role and duty of company directors.

The Lower Fox River

The case had its origins in Wisconsin where, for a period of approximately twenty years until the early 1970s, paper recycling mills discharged highly toxic polychlorinated biphenyls (PCBs) into the Lower Fox River. In the 1990s, a number of companies were identified as 'potentially responsible parties' (PRPs) by the US Environmental Protection Agency (the "EPA") under the Comprehensive Environmental Response Compensation and Liability Act, commonly known as "CERCLA". As such, the companies faced strict liability on a joint and several basis for the costs of cleaning up the Lower Fox River.

Among those identified as PRPs was a company called Appleton Papers Inc (API). API was given this designation because in 1978, it acquired a paper business whose practice had been to create carbonless copy paper by coating paper with an emulsion containing PCBs. At the time of the acquisition, API was a wholly owned subsidiary of BAT,

When API acquired the paper business in 1978 it had agreed to indemnify the previous owner against any environmental liabilities; a historic liability which therefore passed to BAT. However, in 1990, BAT demerged API. At that point, BAT was itself indemnified by API and its new holding company; the entity that was later to become Windward. In 2000, that same entity was acquired by Sequana. In 2001, API was sold by Sequana, but on the basis that all liability in respect of the Lower Fox River stayed with Windward.

By 2008, Windward had ceased to be a trading company and had become a vehicle for meeting Lower Fox River pollution liabilities. There was also a large receivable on Windward's balance sheet owed to it by Sequana.

The evolution of API/ Windward's Lower Fox River exposure

In the early and mid-2000s, there was a degree of disagreement between API, Windward and the original owner of the paper business as to the extent and scope of the indemnities which had been given and received. In short, Windward was liable to indemnify BAT against its own liability to indemnify the original seller. In order to meet that liability, Windward had however been assigned the benefit of a number of historic insurance policies purporting to provide coverage to API, and a further policy which had been specifically purchased in order to meet Lower Fox River pollution liabilities, which was referred to as the "Maris Policy".

In the years leading up to 2008, attempts were made by the EPA and the PRPs to agree the scope and cost of the remediation works needed to restore the Lower Fox River and the level of contribution that was to be required from each PRP. By the time of the first dividend payment, API's contribution had not been agreed.

At the start of 2008 therefore, the level of API's contribution to the clean-up costs (and hence Windward's) was uncertain. While it had initially been thought that the Maris Policy would be sufficient to cover Windward's exposure, by this time Windward was carrying a provision in its accounts against future Lower Fox River liabilities with a value of around £50 million.

The 2008 and 2009 dividends

Ordinarily, it would be entirely proper for a substantial inter-company receivable between a parent company and a non-trading subsidiary to be removed. This can be effected by way of a reduction in the subsidiary's capital (by virtue of section 642 and Part 23 of the CA 2006).

However, in the case of the Windward/ Sequana receivable (which by 2005 stood at over £450 million), the position was complicated by the fact that the Lower Fox River exposure was very difficult to ascertain.

In 2008, the directors of Windward resolved to undertake the exercise of working out how much money could be taken out by way of dividend to Sequana. In consultation with various professional advisers and consultants, the directors took steps to ascertain the exposure net of the Maris Policy based on current expectations as to the various components of the exposure, arriving at a provision of approximately €60 million. On that basis, the directors resolved at a meeting in December 2008 (based on interim accounts) to reduce the company's share capital and pay a dividend of around €440 million, leaving an outstanding inter-company debt of around €140 million.

Following the December 2008 dividend, Windward and its advisers focused on a US Supreme Court decision relating to CERCLA which was taken to suggest that API's share of the liability could be significantly reduced. This expectation was reflected in Windward's audited final accounts for the year ended December 2008 which reduced the provision to zero. This in turn created additional distributable reserves and, in consequence, a further dividend of approximately €130 million was paid to Sequana in May 2009. Very shortly afterwards, Windward was sold, thereby removing any exposure to the Lower Fox River from Sequana.

In these proceedings, BAT challenged the payment of the two dividends on a number of grounds, all of which involved the Court assessing what the directors knew and thought in December 2008 and May 2009. While the Court was at pains to point out that it had shielded its eyes from subsequent events in order to avoid its assessment being coloured by hindsight, it is to be presumed that Windward's share of the Lower Fox River clean-up costs have exceeded, or will exceed, the sums available to Windward from the historic insurance policies and the Maris Policy (hence the need for these proceedings).

The 'Could Not' claims: did the dividends contravene Part 23 of the CA 2006?

The first ground on which BAT challenged the dividends was that they contravened Part 23 of the CA 2006 and, accordingly, that they were capable of being clawed back under section 847 of the CA 2006. This

was said to be because the annual accounts used to justify the May 2009 dividend were not 'properly prepared' in accordance with section 837(2) of the CA 2006, and because the interim accounts on which the December 2008 dividend relied did not enable a reasonable judgment to be made as to the amounts of the items on which the justification of the dividend depended.

Three aspects of both sets of accounts were challenged. First, it was said that the capital reduction which preceded the December 2009 dividend was invalid because it did not comply with the relevant legislation. Second, it was said that the accounts made inadequate provision for the Lower Fox River liability. Third, it was also said that the accounts failed to give adequate disclosure about Windward's contingent liabilities in a technical accounting sense.

The Court rejected all three challenges to the accounts.

- As regards the capital reduction, the Court was required to construe the underlying provisions of the CA 2006 (sections 642 to 644) in order to determine how a company's directors are required to go about the task of a reduction in capital which is supported by a solvency statement. Amongst other issues, it was held (importantly) that the test to be applied when determining if a director has correctly formed the opinion that there is no ground on which the company could be unable to pay its debts following the proposed capital reduction was, simply, "to look at the situation of the company at the date of the statement and, taking into account contingent or prospective liabilities, form an opinion as to whether the company is able to pay its debts" regardless of whether the opinion so formed was reasonable. In light of the facts, the capital reduction was held to be effective.
- As regards the adequacy of the Lower Fox River provision, the question was whether the accounts gave a "true and fair view" of the state of affairs of the company for the purpose of section 226A of the CA 2006, by reference to the relevant accounting standards. This entailed a careful review of the calculations which underpinned the two sets of accounts but the particular features of the calculations (and supporting judgements) which BAT complained about were upheld.
- As for the alleged lack of disclosure in the accounts about contingent liabilities, a key question was whether the accounts should have made some disclosure in relation to another PCB pollution site, the Kalamazoo River in Michigan. However, the Court held that there was no breach of the applicable accounting standards arising from the absence of any such disclosure and, at a more general level, that the absence of disclosure in both accounts did not result in the distributions contravening Part 23 of the CA 2006.

The 'Should Not' claims: did the directors breach their fiduciary duties under sections 171 to 174 of the CA 2006?

The second ground of challenge was that, in any event, the Windward directors acted in breach of their duties under the CA 2006 by declaring dividends of the distributable reserves, on the basis that the directors were aware that the estimate of Windward's liability was surrounded by great uncertainty and there was a risk that the liability would prove much greater than the estimate.

Specifically, BAT alleged that the Windward directors' actions were in breach of their duty under section 172 of the CA 2006 to promote the success of the company by acting in the interests of the company's creditors, which duty had arisen by the time of the dividends.

Therefore, the question to be answered was whether the creditors' interest duty had arisen at the time of the dividends, in the sense laid down in the authorities that Windward was "on the verge of insolvency or of doubtful insolvency, or as being in a precarious or parlous financial state". Taking all of the factors into account, the Court decided that Windward was not.

The claim under Section 423 of the IA 1986

BAT also claimed in its own right against Sequana under Section 423 of the IA 1986, alleging that the two dividends also amounted to transactions entered into at an undervalue for the dominant purpose of putting assets beyond the reach of Windward's main creditor, BAT.

Sequana's first answer to this claim was that a dividend paid by a company to its shareholder was incapable of being characterised as a transaction for no consideration or at an undervalue. The Court rejected this submission, holding that the terms of section 423 were "deliberately wide".

Next, Sequana argued that the directors of Windward did not have the section 423 purpose in relation to either dividend. However, while the Court was prepared to accept that submission

as to the December 2008 dividend, it found for BAT on the May 2009 dividend. This was on the basis that the May 2009 dividend was undertaken with the intention of putting assets beyond the reach of BAT in the event that the Maris and historic insurance policies were not enough to meet the indemnity liability.

Finally, the Court rejected Sequana's further defence that it had changed position by selling Windward and losing control of the Lower Fox River litigation.

Having found that the section 423 claim succeeded to an extent, it was agreed that the Court should not identify the remedy, as this depended on events in respect of the Lower Fox River post May 2009. However, the judge indicated that she did not simply have in mind that the May 2009 dividend would be repaid.

Comment

It is hopefully apparent, even from this brief summary, that this was a factually and legally complex case which raised a number of issues of significance for company directors and those otherwise involved in capital reductions or decisions to pay dividends.

Legally, the case is interesting because it considered a number of issues relating to the construction and application of provisions of the CA 2006 on which there was previously no authority (in connection with capital reductions in particular). It also demonstrates the difficult considerations which come into play for directors when assessing the lawfulness of a dividend, where the company making the dividend is faced with substantial contingent liabilities.

As this case shows, even where care is taken, it is difficult for directors to exercise their powers in this area appropriately. Moreover, the case shows that in this situation a creditor may still have a remedy under the IA 1986, even if the company making the dividend does not have a remedy under the CA 2006.

It is also worth noting that the proceedings against Sequana and the Windward directors appear to have been the culmination of a lengthy process. Based on published judgments, this matter first came before the Courts in *BAT Industries Plc v Windward Prospects Ltd & Anor* [2013] EWHC 4087 (Comm), when API applied to set aside an order permitting service of proceedings out of the jurisdiction. It appears that those proceedings concerned the scope and extent of Windward's and API's collective obligations to indemnify BAT, which were in issue at the time. Shortly after the hearing in that case, BAT successfully applied for a receiver to be appointed over Windward's claims against Sequana in *BAT Industries Plc v Windward Prospects Ltd* [2013] EWHC 3612 (Comm) in order to commence proceedings and protect the limitation position. It seems reasonable to infer that Windward subsequently accepted its indemnity obligations as to BAT and that the receiver assigned Windward's claims against Sequana to BAT. A lengthy campaign of litigation and related steps had therefore been required in order for BAT to get to the point at which it could attempt to claw back or ring-fence the dividends.

It is understood that an appeal is pending. If, on appeal, it is found that the dividends did contravene Part 23, we may also find out the nature and basis of the relief for a contravention of this type – an issue which it was unnecessary to decide at first instance.

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MSC Mediterranean Shipping Company S.A. v Cottonex Anstalt [2016] EWCA Civ 789

Can an innocent party affirm a contract following repudiation where performance by the party in breach is no longer possible? The Court of Appeal has considered this question in connection with a contract for the consignment of cotton.

The facts

Between April and June 2011, the claimant contracted with the defendant to carry 35 containers of raw cotton to the port of Chittagong in Bangladesh. The cargo was shipped in three consignments under five bills of lading. The defendant sold the cotton to a company in Bangladesh which was named as the consignee on the bills of landing; payment was to be made by letter of credit.

The bills of lading provided that the defendant was entitled to 'free time' of 14 days for the use of the containers after they were discharged at port. After this point, the defendant was obliged to return the empty containers to a place nominated to the claimant, otherwise demurrage accrued at a daily rate.

The containers were discharged at Chittagong between May and June 2011. However, a dispute arose between the consignee and the defendant; as a result, the consignee did not take delivery of the cotton and the containers remained at port. The claimant and defendant corresponded about resolving this issue; in the course of these discussions, the claimant requested payment of outstanding demurrage. On September 27, 2011, the defendant wrote to the claimant stating it did not have legal title to the cotton as it had received payment from the issuer of the letter of credit and suggested that the bank would pay the outstanding demurrage. However, the demurrage remained unpaid and the containers remained at port. On February 2, 2012, in a practical attempt to resolve the issue, the claimant offered to sell the containers to the defendant; the parties could not agree a price. In April 2013, the claimant issued proceedings against the defendant for accrued demurrage of US$577,184, alleged to be continuing to accrue at US$844 per day.

First instance judgment

At first instance, the judge concluded that the central issue was whether the defendant had repudiated the contracts of carriage. Drawing on authorities relating to charterparties, he found that delay will amount to a repudiatory breach of contract when it becomes so prolonged as to frustrate the commercial purpose of the venture. On the facts, the judge held that the defendant was in repudiatory breach of the contracts from September 27, 2011. He found that the claimant would have understood from the defendant's message that there was no reasonable prospect of the defendant being able to arrange for the return of the containers and in any event, at this point, the delay in collecting the cotton was so prolonged as to frustrate the commercial purpose of the venture.

The judge noted that it was settled law that, upon a repudiatory breach of contract, the innocent party may elect to accept the repudiatory breach as terminating the contract or to treat the contract as continuing, i.e. "affirm" the contract. He went on to consider the "legitimate interest" principle (*White v Carter*), which indicates that an innocent party may not be able to affirm a contract "if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages". The judge remarked that the principle should be seen in the context of "increasing recognition in the common law world of the need for good faith in contractual dealings". Applying the principle, the judge held that, by September 27, 2011, the claimant did not have a "legitimate interest" in keeping the contracts alive for the purposes of claiming demurrage.

Appeal judgment

The claimant appealed, including on the issue of whether the commercial purpose of the venture had been frustrated by September 27, 2011. The Court of Appeal held that the relevant test for whether the defendant's failure to redeliver the containers amounted to repudiatory breach was in substance the same as for frustration: whether the delay was such as to

render performance of the remaining obligations under the contracts radically different from those which the parties had originally undertaken. On the facts, this had occurred on February 2, 2012. The court relied both on timing and the parties' actions. The delay by September 27, 2011 was relatively short; insufficient (without special circumstances) to justify a finding that the commercial purpose of the contracts had been frustrated. By February 2, 2012, the delay had continued for another four months. Further, the claimant's offer to sell the containers to the defendant on February 2, 2012 was a clear indication that the commercial purpose of the contracts had been frustrated (sale would have discharged the defendant's obligation to redeliver the containers).

The Court of Appeal also held that the legitimate interest principle did not arise. By February 2, 2012, the claimant could not elect to affirm the contract because the defendant was no longer capable of performing the contract as agreed, due to the frustration of the commercial purpose of the contracts. The court noted that the claimant had continued to press the defendant for performance beyond this date (requests for redelivery of the containers and payment of demurrage), but these were "acts in vain, unrelated to an existing contract". Obiter, the Court suggested that had it been open to the claimant to affirm the contract, it would have been unreasonable to do so, given that the accrued demurrage exceeded the value of the containers by a considerable amount. Moore-Bick LJ also criticised the judge's approach to good faith, distinguishing between the application of "broad concepts of fair dealing" to contractual construction and a general principle of good faith, which did not exist in English contract law. In his view, it was better for the law to develop along established lines rather than for judges to look for "some 'general organising principle' drawn from cases of disparate kinds." He also pointed out that a general duty of good faith would risk undermining the terms agreed by the parties, in a similar way to an excessively liberal approach to contractual construction (noting the Supreme Court's recent decision on that topic in *Arnold v Britton*).

As to damages, the Court of Appeal held that the claimant was entitled to demurrage up to February 1, 2012 and to damages for the loss of the containers (treated to have been lost on February 2, 2012), assessed as the replacement cost of the containers on that date.

Comment

This decision indicates that upon a repudiatory breach of contract the innocent party will not be able to affirm the contract if further performance by the defaulting party is not possible. This may arise where the repudiatory breach has the effect of frustrating the commercial purpose of the contract. These considerations may also be relevant to other cases where the contract provides for the accrual of liquidated damages. Contracting parties should be alive to these considerations, particularly when faced with a prolonged delay in the performance of the other's obligations (for example in relation to contractual correspondence, which is likely to be relevant to the court's approach to whether/when the commercial purpose of the contract was frustrated).

The Court of Appeal's obiter comments regarding the legitimate interest principle also suggest that an innocent party will be unable to affirm a contract upon a repudiatory breach if it does not have a "legitimate interest" in keeping the contract alive, for example, where it would be affirming for the sole purpose of continuing claiming damages.

Finally, Moore-Bick LJ's remarks suggest that the courts will be reluctant to recognise "good faith" as a principle of general application. His comments suggest that there are at least two overarching reasons for this: (i) lack of support in the authorities for a general duty of good faith; and (ii) the risk that importing principles of good faith into contractual construction would cause the Court to depart from the terms agreed between the parties. This suggests that, in a situation where there is no authority or express contractual wording for the application of "good faith" to the exercise of contractual discretion by a party, then for parties seeking to challenge the exercise of that discretion, the better approach may be to rely on concepts of "fairness" or "reasonableness", rather than "good faith".

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The limits of witness preparation in German court and arbitration proceedings

The extent to which witness preparation is permissible in German civil proceedings has been the subject of intense discussions following a controversial recent case involving a major German bank. The German authorities went so far as to initiate a criminal investigation against the bank's former CEO, and four other former bank officials on grounds of alleged fraudulent conduct in court. These witnesses had been prepared in a mock trial and written answers had been drafted by their lawyers.

Strong public feelings about this case might create the mistaken impression that the German law prohibits witness preparation per se. Statutory guidelines on this issue which would be of practical relevance for civil proceedings as well as for arbitration proceedings are, however, largely absent in Germany and other civil jurisdictions. In contrast a limited set of professional guidelines can be found in several of the main common law jurisdictions.

As a result, it is open to question at what point a lawyer crosses the line between the legitimate developing of a testimony so it will be effective and telling the witness what to say. In particular, it is questionable whether: a lawyer is permitted to hold a practice run with a witness; agreements regarding witness remuneration are allowed; and to what extent the opposing lawyer or judge may question a witness on the extent of his prior preparation. Having regard to US law studies, some conclusions can be drawn following the rule "everything which is not forbidden is permitted".

Witness preparation in civil proceedings

In German civil proceedings witnesses are supposed to testify only according to their "vivid memory", in order to give their best evidence at the hearing. With regard to witness credibility it is therefore advisable not to get in touch with witnesses before their testimony. However, the German Code of Civil Procedure encourages witnesses to prepare for giving evidence by refreshing their memory – if possible – by going through their records and documents. Hence, presenting well prepared witnesses at court hearings can further the principle of establishment of the truth in civil proceedings. The lawyer can therefore question the witness prior to his testimony in order to explore the whole truth and all necessary information for the court proceedings. Previously, the German Professional Guidelines contained a broad prohibition on witness preparation which can create the appearance of an influenced witness. This provision was abolished by the Federal Constitutional Court in 1987. Since there are merely ethical but no statutory provisions limiting the lawyer from preparing the witness before a deposition, it appears likely that witness preparation is legally permissible in Germany. The only sanction a lawyer faces is a possible criminal prosecution for intentionally inducing a witness to give a false testimony.

In European civil law jurisdictions only the Swiss Canton of Geneva prohibits the lawyer from discussing the witnesses future testimony and from influencing witnesses of any kind. In England and Wales, a common law jurisdiction, witness coaching is prohibited. The Court of Appeal has stated that "the witness should give his or her own evidence, so far as practicable uninfluenced by what anyone else has said, whether in formal discussions or informal conversations." In contrast, lawyers are permitted to 'familiarise' witnesses with the process of the trial and giving evidence. Therefore witness training and mock

trials are only legitimate if they are not in reference to the specific case, although in a recent Commercial Court case, the judge commented that even witness training is to be discouraged since it tends to reflect badly on the witness who, perhaps through no fault of his or her own, may appear evasive because he or she has been “trained” to give evidence in a particular way.

In the US, professional rules normally permit witness preparation on the basis that it can help the witness to give truthful evidence in favour of the lawyer’s client. In addition, there are a handful of decisions from the US Supreme Court and other state courts acknowledging the legitimacy of witness preparation and coaching, as long as the witness is not induced to give a false testimony. Witness preparation is typically protected from discovery under the work-product doctrine or the attorney-client privilege. Therefore the court or the opposing party are in principle only entitled to question whether a witness has been prepared for the deposition, while the substance of the witness preparation itself is protected under US rules of privilege. In Germany however, there is no equivalent privilege. Only the lawyer is entitled to refuse to give evidence.

Witness preparation in arbitration proceedings

The issue of witness preparation is of special interest for arbitration proceedings, since there is generally no obligation for witnesses to testify in arbitration proceedings (unless one of the parties applies for a judicial interrogation of the witness, which rarely occurs).

For Germany-seated international arbitrations there are no statutory provisions regarding witness preparation equivalent to civil proceedings. The only limitations arise from contractual agreements or procedural injunctions, which are rare.

It has become common in arbitration proceedings to present written rather than oral testimony. There is no statutory provision preventing the lawyer from preparing the written testimony of the witness, as long as he is convinced that the written testimony is true. Furthermore, there is no obligation for the written testimony to be complete in every respect. It is permissible to use a witness testimony to contest only certain allegations of the opposing party.

The question of the remuneration of a witness is crucial in arbitration proceedings since there is no duty to testify for the witness and no right of reimbursement of expenses. Witnesses in arbitration proceedings often work in high-ranked positions and are well-paid. It is therefore usually regarded as permissible to remunerate a witness in arbitration proceedings to the amount of his normal wage including preparation and travel time. To preserve the credibility of the witness it is advisable to remunerate him or her prior to giving evidence.

In the US, a comment to the Model Rules of Professional Conduct of the ABA suggests the prohibition of remuneration of witnesses, since the law obliges witnesses to answer truthfully. There is case law in which the courts have dismissed the witness or disqualified the lawyers involved in the case.

Summary

In Germany as in the US, witness preparation in civil proceedings as well as in arbitration proceedings is per se legitimate. Neither statutory provisions nor professional guidelines prohibit witness preparation, although it is possible that the German legislature will enact new provisions on witness preparation in the future. At present, it is left to the criminal law to penalise lawyers for intentionally inducing witnesses to give a false testimony and witnesses for perjury. Accordingly, it is not surprising in the recent bank case that witness preparation was held to be legitimate. Furthermore, the high-ranked bank’s employees have been cleared of all criminal charges, since it could not have been proven that they intentionally made false statements before the court.

In contrast, the applicable rules in England and Wales are tougher, as witness preparation is unlawful.

With regard to arbitration proceedings there are currently no general regulations – lawyers will be bound by the conduct rules governing where they are admitted to practise.

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English High Court confirms costs of third-party funding of arbitration are recoverable

In a controversial decision, the English High Court has confirmed that tribunals in London-seated arbitral proceedings have the power to award parties non-legal costs – in this case, the costs of obtaining third-party funding (*Essar Oilfields Services Limited v Norscot Rig Management PVT Limited* [2016] EWHC 2361 (Comm)).

This is the first time the English courts have considered whether such an award is within a tribunal's power, although, according to the 2015 ICC Report on decisions of costs in international arbitration, there have been other instances where tribunals have awarded parties their costs of such funding[1]. This is accordingly a landmark decision and one which may have wide ramifications for arbitration and for the third-party funding industry.

Background

The substantive dispute concerned the termination of an operations management agreement for an offshore drilling platform. In a London-seated arbitration under the 1998 ICC Rules, the arbitrator (Sir Philip Otton, a retired English Court of Appeal judge) found that Essar was in repudiatory breach of the agreement and awarded Norscot in excess of US$8 million for sums payable under the agreement and damages. In addition, he awarded Norscot its legal costs on an indemnity basis plus, controversially, its costs of obtaining third-party funding. Norscot had obtained £647,000 of third-party funding at market rates which meant that, if Norscot's claim was successful, the third-party funder would be paid a fee of 300 per cent of the amount funded or 35 per cent of the recovered proceeds, whichever was the higher. In this case, the funder's fee amounted to £1.94 million.

The arbitrator's findings in relation to Essar's conduct during both the term of the contract and the arbitral proceedings were damning. He found that Essar drove Norscot into expensive litigation to vindicate its rights, Essar's own reprehensible conduct went far beyond technical breaches of contract and moreover that, due to Essar's conduct, Norscot was left with no alternative but to obtain third-party funding. The decision on costs appears heavily influenced by these unusual circumstances.

Sir Philip set out the basis of his power to make the costs award as sections 63(3) and 59(1)(c) of the Arbitration Act 1996 which respectively provide that a tribunal may determine the recoverable costs of the arbitration on such basis as it thinks fit, and that "costs of the arbitration" include "the legal or other costs of the parties". He referred also to Article 37 of the ICC Rules which is similarly worded, empowering a tribunal to award "reasonable legal and other costs incurred by the parties for the arbitration". He concluded that the combined effect of these provisions gave him a wide discretion as to the costs he could award.

The High Court challenge

Essar challenged the arbitrator's award on costs in the English High Court under section 68(2)(b) of the Arbitration Act on the grounds that "other costs" do not include the costs of litigation funding as a matter of construction of section 59(1)(c) of the Arbitration Act and therefore the arbitrator had exceeded his powers, amounting to a serious irregularity that caused substantial injustice to Essar.

The Court (Judge Waksman QC, sitting as a Deputy High Court Judge) rejected Essar's claim and upheld the arbitrator's award, accepting the construction of the Arbitration Act and the ICC Rules that costs of third-party funding fell within "legal or other costs". The Court confirmed

1 ICC Arbitration and ADR Commission Report, Decisions on Costs in International Arbitration, December 1, 2015, paragraphs 92 and 93 as mentioned in paragraphs 61 to 67 of the judgment.

that arbitrators have a broad power to award costs, and the question of scope is within the tribunal's discretion.

The Court further held that even if the arbitrator had been wrong on his construction of the Arbitration Act, it would not amount to a serious irregularity. It would be an error of law and the parties had, by inclusion of the ICC Rules, waived any right to appeal on points of law under section 69 of the Arbitration Act. Moreover, the Court held that Essar had waived its right to object under section 73 of the Arbitration Act. In making these findings, the Court effectively closed off any further challenge.

A divergence between litigation and arbitration

This is the first time an English Court has considered a tribunal's power to award the costs of third-party funding. Prior to this decision, it was an open question whether arbitrators (and English courts acting in support of arbitration) would follow the position in English litigation, where such costs are not recoverable. The Civil Procedure Rules (CPR) do not allow recovery of such costs. Moreover, recovery of costs payable only upon success offends the so-called "indemnity principle", pursuant to which parties are only entitled to recover sums payable by them in any event, i.e. win or lose. Conditional fee arrangements are a statutory exception to this rule.

However, as the Court reiterated in its decision, the CPR do not apply to arbitration. Chirag Karia QC of Quadrant Chambers, who appeared for Norscot in the case, explained that the Court rejected Essar's central argument that the Arbitration Act and the ICC Rules had to be read down to be consistent with common law rules applicable to court proceedings, such as the alleged non-recoverability of financing costs and the "indemnity principle". Instead, the Court construed the Arbitration Act as a code and gave effect to its clear words. Under the Arbitration Act (and ICC Rules) an award of "other costs" such as costs of third-party funding is within a tribunal's discretion. Unless parties have retained the right to appeal on a point of law, the court will be unable to review the tribunal's exercise of its discretion.

Potential for wider application

In light of the Court's wide construction of "legal or other costs" it is increasingly likely that parties to London-seated arbitration will look to recover assorted other costs, such as after the event insurance premiums. In English litigation, success fees or premiums for arrangements entered into after April 1, 2013 cannot be recovered from a losing party. If such fees prove recoverable in arbitration, it would widen the divide between London-seated arbitration and English litigation.

The impact of this decision may not be limited to London-seated ICC arbitration. As the Court's judgment turned on a point of construction of the arbitration statute and arbitral rules, it is very possible that we will see the same arguments made in arbitration conducted under other rules or in other seats where the arbitration law and/or rules contain similar language regarding costs. For example, the LCIA Rules provide for recovery of "legal or other expenses incurred by a party (Legal Costs)" and the UNCITRAL Rules provide for recovery of "[t]he legal and other costs incurred by the parties in relation to the arbitration".

The difficulty parties will face when making claims for "other costs", is that it is not clear whether this decision represents the orthodoxy and the (new) rule or is simply an unusual exception and exercise of discretion due to the extreme facts of the case. The Court has confirmed unambiguously that tribunals have this wide power to award costs under section 59(1)(c), but declined to offer guidance as to the scope of the power or how it may be exercised.

The requirement of reasonableness

An important limit on the tribunal's power is the frequent requirement that any award on costs is reasonable. Section 63(5) of the Arbitration Act provides that costs must be of a reasonable amount and reasonably incurred. Many arbitral rules contain similar requirements, for example, Article 37(1) of the ICC Rules provides that "[t]he costs of the arbitration shall include ... reasonable legal and other costs incurred by the parties for the arbitration".

In this case, it appears that when looking at reasonableness the arbitrator considered evidence adduced on both the parties' conduct and also whether the third-party funder's fee reflected the market rate. He did not appear to consider whether it was reasonable for the losing party to have to bear the additional cost.

In different circumstances, such as where a party might have chosen to obtain third-party funding not due to necessity but simply to share the risk of litigation or as an alternative form of capital (particularly where it is obtained on a portfolio basis), a tribunal might consider that the reasonableness requirement is not satisfied. Such arrangements may also face other challenges, including that the third-party funder's fee is not properly a "cost of the arbitration".

But pending any guidance on exercise of this power, these are muddy waters which tribunals will need to wade

through and, at least in London-seated arbitration, English courts will not willingly intervene.

The good, the bad and the just plain ugly

This decision is very good news for third-party funded parties. The practical effect of prohibiting recovery of costs of third-party funding has meant that a funded party, if successful, will inevitably be out of pocket for the third-party funder's (often significant) fee. Courts have to date viewed this issue somewhat unsympathetically. Lord Justice Jackson, for example, stated in his report on third-party funding that "it is better for [a party] to recover a substantial part of [its] damages than nothing at all"[2]. One might argue that this ignores the harsh reality that in some instances a successful party might end up paying all of the sums recovered to the third-party funder. That seems an unfair outcome, especially where a party would have been unable to proceed without third-party funding, even more so if the other side's conduct had put it in that position (as in this case).

The third-party funding market is also likely to benefit from this decision as the potential recoverability of costs of third-party funding may serve to increase parties' appetite for obtaining third-party funding of arbitration. It may also serve to increase the popularity of arbitration and London as a seat, particularly for parties that are likely to face a substantially better resourced opponent, as is often the case for investor-state disputes.

Conversely, the decision raises serious concerns for parties facing a third-party funded opponent. For example, in London-seated arbitration under ICC Rules, there is currently no obligation to disclose the existence of third-party funding arrangements let alone the detailed terms of such funding. There is some guidance (such as the *ICC Guidance Note for the Disclosure of Conflicts by Arbitrators*) which recommends that parties disclose third-party funding arrangements, if only to exclude the risk of arbitrator conflict or bias that might arise due to the existence of such arrangements. But it is non-binding and, in practice, may often not be followed. Therefore, in many instances, parties might not even know that they are at risk of facing a very significantly inflated adverse costs award if they lose, although the risk is perhaps ameliorated by the need to adduce evidence of the funding and market rates in order to obtain recovery.

Moreover, parties facing a third-party funded opponent face difficulties even if they win. If the third-party funded opponent is impecunious, a successful party is unlikely to be able to recover its costs from that party. In English

2 Lord Justice Jackson, Review of Civil Litigation Costs: Final Report, page 117

litigation, courts may hold the third-party funder liable for the successful party's costs – currently this liability is capped at the amount funded though there is some suggestion this cap may be removed. However, that is not the case in London-seated arbitration. Generally an arbitral tribunal will have no jurisdiction over a third-party funder to award costs against it – the third-party funder is normally not a party to the arbitration nor to the arbitration agreement. This risk is again compounded where the existence of third-party funding is not disclosed.

Practical considerations

There are a number of practical considerations that may arise, including the following, for example.

- When drafting any arbitration agreement, commercially-savvy parties may seek either expressly to preclude or permit (or simply stay silent on) recovery of such costs, depending on whether they or the counterparty are or are not likely to use third-party funding. Given that we do not yet know whether this decision will have an impact on recoverability of costs in arbitration under other rules and in other jurisdictions, it is advisable that this issue be considered in respect of any arbitration agreement, not just those specifying ICC Rules and a London seat. For those parties that have already concluded contracts containing agreements to arbitrate the issue is unlikely to warrant renegotiation of them; but may be a material factor in evaluating tactics and strategy in any looming dispute.

- Parties negotiating third-party funding should carefully structure the funding arrangements and terms of the agreement in order to put themselves in the best position for recovery of associated costs.

- From a procedural perspective, parties facing an impecunious or third-party funded opponent should consider whether (and if so, when) to seek disclosure of third-party funding arrangements and/or interim or conservatory measures to protect their costs position, such as obtaining security for costs, a guarantee or insurance. There is likely be a corresponding increase in applications for disclosure and/or conservatory measures. It is possible we may also see an increase in arbitrators exercising case management powers, including the costs-capping powers under section 65 of the Arbitration Act (currently an under-utilised provision).

Conclusion

Only time will tell how significant and far reaching the impact of this decision will be, but in the short term there is like to be an increase in claims by third-party funded parties in any London-seated arbitration – and perhaps, depending on the view taken by the applicable curial law, in arbitrations under ICC Rules seated outside England and Wales as well – for recovery of their costs of such funding. We may also see an increase in similar claims in arbitrations under other arbitral rules or in other jurisdictions where similar language to the Arbitration Act and ICC Rules is used. Parties seeking recovery of the costs of third-party funding will need to consider whether (and if so, when and how) they should disclose the existence and terms of funding.

Most major arbitral institutions will be alive to the issues discussed above. We anticipate that guidance for parties and arbitrators on recoverability of the costs of third-party funding and other costs may be forthcoming and that amendments to arbitral rules may also follow – at minimum in respect to the disclosure of third-party funding. It is foreseeable that some jurisdictions, particularly those with nascent third-party funding markets such as Singapore and Hong Kong, will look to introduce statutory controls.

Almost without a doubt, this decision will spark further discussion about the appropriateness of external regulation of third-party funding. In the meantime, this decision will continue to generate interesting debate on what costs of arbitration should and should not be recoverable.

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Culture and compliance – new best friends?

Following the release by the United States Department of Justice (DoJ) of new remediation standards for FCPA compliance programmes (see: DOJ launches pilot program for FCPA cases), compliance professionals are once again revisiting the key components of their programmes. Beyond the US, the standards reinforce the requirements of the Bribery Act in the UK[1] and prospective legislation in other jurisdictions which is seeking to place a similar onus on businesses to prevent, detect and report financial crime.

Key elements the DoJ will assess in determining effectiveness of a compliance programme are

- The 'culture of compliance'
- The resources dedicated to the compliance function
- The quality of the compliance personnel
- The independence of the compliance function
- Whether the compliance programme has performed an effective risk assessment
- How compliance personnel are compensated and promoted
- Auditing of the compliance programme
- The reporting structure of compliance personnel within the company.

The challenge for businesses is to go beyond a 'tick- box' approach to compliance, to implementing, and maintaining, a positive culture of compliance. The above criteria alone may prove challenging for businesses headquartered beyond the United States in jurisdictions where compliance and its associated concepts may be less developed. Below, we consider how organisations might steer their employees towards complying both with the letter of the law and, just as critically, the spirit of the law.

1 Note that the UK Ministry of Justice is now consulting on plans to extend the scope of the criminal offence of a corporate "failing to prevent" beyond bribery and tax evasion to other economic crimes.

Establishing a culture of compliance

'Culture' in this context is not easily defined and will vary between businesses. An organisation should have a clear sense of purpose, with every employee, wherever located or in whichever business line, knowing what the organisation stands for. In large multi-nationals, this will be difficult. The more remote an office in terms of its geography, including distance from and degree of control by 'headquarters', the harder it can be to assert a particular global culture. As Hui Chen, DoJ Compliance Expert has acknowledged[1], compliance officers often have to 'help their colleagues ... navigate towards [compliance] expectations in societies that are not necessarily accustomed to these behaviours'.

The establishment of a robust sense of purpose that can withstand the pressures of the local environment is not easy. A concise set of values, communicated both internally and externally, is a first step, providing a reference point for the standards according to which an organisation wishes to conduct its business and by which it would like to be judged. Those values need to be reiterated at the start of every new policy, survey or training so that all rules and guidance are set out in context.

1 Interview with *Ethics & Compliance Initiative*, February 1, 2016.

The recent Deferred Prosecution Agreement agreed between the UK's Serious Fraud Office (SFO) and Standard Bank Plc[2] reveals the extent to which the SFO, and indeed the courts, will test the underlying culture of compliance within an organisation when considering a potential settlement; in this case, the compliance training was deemed to be inadequate and the internal policies not sufficiently well-understood. Combined with a lack of co-ordination between group entities, this resulted in the compliance procedures as a whole being found to be lacking taking into account the risks posed.

The senior management of a company, including the most senior executives, undoubtedly have the greatest influence in driving a particular culture. They need to lead by example and establish the appropriate 'tone from the top'. A compliance programme that lacks the visible and demonstrable backing of senior management will have limited effect. Senior management should make ethical conduct and ethical decision-making normal business practice and emphasise, through their messaging and conduct, the importance of a compliant culture. To do so, they will need to be well-informed about each element of the compliance programme, being provided with high-quality management information and updated risk assessments. That way, they can ensure that the programme is embedded across the business when visiting different offices, communicating with country or divisional management, and generally on a day-to-day basis.

Regular communication by leadership, both internally and externally, about the company's values, compliance initiatives, and stakeholder response to any compliance progress made, will serve to promote effective compliance as a key business strategy. Thus, responsibility for 'compliance' should be shared across the company and compliance fully integrated with other risk management functions. The HR function, for example, should be aligned with compliance to conduct background checks, to test attitudes to compliance during recruitment and promotion, to assess the impact of remuneration practices and incentives on culture, to engage in relevant disciplinary action and to report on 'lessons learned'. As Hui Chen has stated[3], "compliance can identify issues in a company's financial controls, HR processes, or sales strategy but … without the commitment of finance, HR or sales leadership, these issues cannot be remediated."

A framework of employee engagement, feedback and review is important to sustain the established culture. The results of this engagement should be subject to review and analysis which should in turn inform changes to the programme. Following instances of unethical behaviour, there should be demonstrable sanctions, which could include such things as claw-back of bonuses and demotion. Equally critical, appraisals should start rewarding behaviours that go toward embedding the company's values and move away from traditional metrics that often have a narrow focus on achieving financial targets.

Dedicating sufficient resources to the compliance function

Embedding a compliant culture takes more than 'tone from the top'. The most demonstrable evidence of a company's commitment to a compliant culture is the extent of the resources allocated to the compliance function.

Human resource and budget (with compliance having its own independent budget, rather than shared with, say, the office of the General Counsel) is key. These resources should be sufficient to allow effective integration across the business, proportionate to the size of the organisation, and reflect the risk of doing business in the relevant sectors and jurisdictions. An effective compliance programme cannot be static. A company should periodically review its compliance programme and update in light of new developments, such as changes in business focus, new regulatory pronouncements or other developments pertinent to the company's operations. Ideally, resources should extend to the periodic engagement of external consultants to provide an independent analysis of the effectiveness of the compliance programme and insight on how to build or sustain the desired culture.

Ms Chen[4] argues that, in all areas, "strong compliance must be data driven". Therefore, resources should also allow a compliance function to use technology to facilitate the assessment, limitation and detection of risk, taking into account the proliferation of ever-changing business systems.

2 *SFO v Standard Bank Plc*, November 30, 2015 – Case no: U20150854.

3 Interview with *Ethics & Compliance Initiative*, February 1, 2016.

4 Ibid.

A compliance function created as an after-thought out of necessity in, say, rushed remediation efforts will struggle to be effective. However, a function established to work in tandem with senior management, which is fully and thoughtfully resourced and integrated with other risk management functions, will play a significant role in an organisation meeting its strategic compliance objectives.

Quality and experience of compliance personnel

The DoJ considers whether compliance personnel can understand and identify transactions identified as posing a potential risk. Compliance professionals should have relevant qualifications and experience for the role. Personal qualities are equally important; the head of compliance should be an individual of sufficient gravitas to reinforce the importance which management places on compliance and ethical conduct.

According to Hui Chen[5], being in compliance requires "backbone and good judgment and excellent people skills". With the right characteristics, a successful head of compliance can engage effectively to attract the support of the entire work-force. This support will underpin changes in compliance culture far more effectively than, say, a whistleblowing hotline or online training programme.

Compliance personnel should be proactive in learning about the risks implicit in their organisation's sector including continually anticipating new, emerging risks. They should learn from their peers through networking at industry events and sharing best practice.

It is often instructive to learn from those operating in sectors with greater exposure to risk or more experience in establishing effective compliance.

Independence of the compliance function

The DoJ expects that compliance personnel and, in particular, the head of compliance, are not placed in a position of possible conflict of interest between their compliance work and other responsibilities. It is thus prudent for an organisation, where possible, to require compliance personnel only to perform compliance tasks. If this is not realistic, such as in smaller companies, appropriate steps should be taken to ensure potential conflicts of interest are avoided.

The concept of independence does not rule out close co-operation between the compliance function, management and staff. This relationship will be crucial if compliance risks are to be detected early and managed effectively.

Whether the compliance programme has performed an effective risk assessment and tailored the compliance programme accordingly

The most effective compliance programmes are underpinned by regular risk assessments. The concept of 'compliance by design', pursuant to which the compliance programme is tailored according to the sector that the organisation is operating in, its geographical spread, case studies based on issues faced by competitors and the organisation's own historical issues, is the most effective basis.

A risk assessment cannot be a one-off exercise but should be carried out as regularly as practicable. Businesses should assess the risks to which they are subject, analyse the most significant risks and allocate sufficient resource to remediate accordingly.

Broader questions of culture, attitude and knowledge should be tested, measured and the information gleaned then used to enhance the programme.

How a company's compliance personnel are compensated and promoted

If the commitment to a compliant culture truly exists, the management of regulatory risk will be afforded the same importance as that of other senior management positions. Consequently, businesses should assess carefully whether the pay and promotion prospects of its compliance personnel reflect this principle.

In a large organisation, one would expect the remuneration of the head of compliance to be in line with other heads of department. To maintain independence, a sub-committee of the Board should determine the level of remuneration.

Any remuneration linked to the financial performance of the business line for which an individual exercises compliance responsibilities may undermine his/her independence and should be avoided. Remuneration related to the financial performance of the organisation as a whole, however, is generally deemed to be acceptable. Promotion should be linked to the effective management of risk over a defined period, combined with noticeable improvements in culture.

5 Ibid.

Auditing of the compliance programme to assure its effectiveness

The DoJ takes into account whether the compliance programme has been the subject of an external or in-house audit, including whether it has been designed appropriately to identify key risks and, if so, what action has been taken. Any gaps noted should be remediated as soon as practicable and the programme improved accordingly, not allowed to remain unchanged and stagnant until a particular event provides the necessary impetus for change.

In order to maintain a compliant culture, regular feedback (from both management and employees) on the compliance programme, including levels of confidence in the ethical conduct of the leadership team, and monitoring to ensure continuous improvement, are crucial.

Reporting structure of compliance personnel within the company

The DoJ expects that the head of compliance should have formal reporting obligations directly to the board, or at the least the senior management team, to facilitate sufficient influence among leadership. Reporting too far down in a company structure may limit the effectiveness of a compliance leader.

The nature of the reporting line between the remainder of the compliance team and the head of compliance will depend on how the organisation has chosen to organise its compliance function. Some companies opt for stand-alone compliance reporting lines; others report through the risk function; others report through the office of the General Counsel.

However structured, organisations must have in place reporting lines that are clearly articulated and operationally effective.

Reporting outcomes (negative or positive) to management makes leaders accountable for compliance and allows them to assess how well the organisation is managing its compliance risk.

There should be clear policies in place concerning the escalation of, and response to, significant issues. Direct access to the board should be granted to the head of compliance where necessary, such as in the case of possible breaches identified during the course of an investigation.

Conclusion

While there is no shortage of guidance concerning compliance ‘best practice’, the more intangible concept of ‘culture’ is more difficult to define.

At its most basic, culture should be the creation of a common purpose across an organisation, with a set of values reinforced from the top that permeate through every aspect of the business. In contrast to a time when too many organisations’ cultures were found by regulators and prosecutors to be failing, a compliant culture may start to become a company’s most valuable asset. The challenge for businesses globally is to establish, maintain and resource an effective framework to support their desired culture of compliance.

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