MACFARLANES

2015: AN OVERVIEW OF IMPORTANT CASES AND DEVELOPMENTS

SUPREME COURT RECONSIDERS THE RULES ON IMPLIED TERMS

In Marks & Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Ltd and another [2015] UKSC 72, the Supreme Court considered the rules on implying terms into contracts. The majority held that the Privy Council decision in *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988, which had previously been considered to be the leading case on implied terms, should no longer be regarded as authoritative. This means that the courts are now likely to revert to the more traditional tests of obviousness or necessity when considering whether a term should be implied into a contract.

In *Attorney General of Belize*, Lord Hoffmann said that implying terms into contracts was part of the same process as interpreting the express terms, that "*[t]here is only one question: is that what the instrument, read as a whole against the relevant background, would reasonably be understood to mean?*". In *Marks & Spencer*, Lord Neuberger disagreed with this approach for two reasons. First, he thought it could be misinterpreted as diluting the test for implying terms to one of reasonableness. Second, he said that implying terms and construing express terms are separate processes which are governed by different rules.

In *Marks & Spencer*, Lord Neuberger also made the following points:

- A term should only be implied into a contract where this is (1) necessary to give business efficacy to the contract or (2) so obvious that it goes without saying.
- These are alternative tests: it is not necessary to satisfy both of them. However, it will be a rare case where one test is satisfied and the other is not.
- It is not sufficient to show that the proposed implied term is fair or reasonable, or that the parties would have agreed to the implied term if it had been suggested to them.
- The question of whether a term should be implied should be determined as at the date of the contract. Hindsight should not be applied.
- No term can be implied into a contract if it contradicts an express term.
- Terms are less likely to be implied in lengthy and detailed contracts which have been entered into by sophisticated parties with the benefit of legal advice.

SUPREME COURT REWRITES THE RULES ON PENALTY CLAUSES

In the conjoined appeals of *Cavendish Square Holding BV v Makdessi and ParkingEye Ltd v Beavis* [2015] UKSC 67, the rules on penalty clauses were considered at the highest level for the first time in a hundred years.

In *Cavendish v Makdessi*, Mr Makdessi sold his controlling interest in a marketing and advertising business to Cavendish. The share sale agreement contained restrictive covenants and provided, in effect, that Mr Makdessi could be deprived of certain deferred consideration and be required to transfer his remaining shares to the buyer, at a price excluding the value of goodwill, if he breached those restrictive covenants.

In *ParkingEye Ltd v Beavis*, Mr Beavis entered into a contract with a car park operator by using a car park. He overstayed a two hour period of free parking and was required to pay a charge of £85.

Both Mr Makdessi and Mr Beavis argued that the clauses described above were unenforceable penalties. Overturning the Court of Appeal decision in *Cavendish* and upholding the decision in *Parkingeye*, the Supreme Court disagreed in both cases and held that the clauses were enforceable.

The Supreme Court extensively reviewed the authorities in this area and concluded that a provision is not penal where: (i) the sanction it imposes protects a legitimate interest of the innocent party; and (ii) the impact of the sanction is proportionate to the defence of that legitimate interest.

This is a new test. A clause may now be enforceable even if it is not a genuine pre-estimate of the innocent party's loss or if it is designed to deter a breach of contract. This is a significant change in the law because concepts of deterrence and genuine pre-estimates of loss have historically been regarded as fundamental to the question of whether or not a clause is an unenforceable penalty.

The Supreme Court also confirmed that the rules on penalties apply only to the agreed consequences of a breach of contract, not to the fairness of parties' primary obligations. For example, in Makdessi, the relevant clauses provided for an adjustment to the purchase price. As such, they were primary obligations and the rules on penalties were not engaged. In some circumstances, this may mean that it is possible to "draft around" the rules on penalties, although the court will look at the substance rather than the form of a provision.

For more information on the impact of this decision on corporate transactions, click here.

RIGHT TO TERMINATE A CONTRACT FOR REPUDIATORY BREACH MUST NOT BE EXERCISED ARBITRARILY, CAPRICIOUSLY OR IRRATIONALLY

A repudiatory breach deprives the innocent party of substantially all the benefit of a contract or which indicates an intention to abandon performance of a contract. Where a repudiatory breach has been committed, the normal rule is that the innocent party can choose whether to accept the repudiatory breach as terminating the contract or affirm the contract and insist on its continued performance (in both cases, the innocent party will have a damages claim).

The decision in *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2015] EWHC 283 (Comm) suggests that there are limits to the innocent party's freedom of choice in this situation. In this case, the claimant elected not to bring a contract to an end and to continue to claim liquidated damages in accordance with the terms of the contract. The judge held that the discretion whether to terminate the contract should be treated in the same way as an express contractual discretion. This meant that the right must be exercised for the purpose for which it is given and not arbitrarily, capriciously or irrationally.

In this case, the claimant did not suffer any loss as a result of the defendant's continuing breach of contract and there was no prospect of the defendant being able to resume performance of the contract. As such, the claimant had no legitimate interest in keeping the contract in force solely in order to continue claiming liquidated damages.

This case is also interesting because the judge confirmed that a party claiming under a liquidated damages clause is under no obligation to mitigate its losses. This is on the basis that the purpose of a liquidated damages clause is to make proof of the claimant's actual loss unnecessary and irrelevant. Since the claimant's entitlement to the agreed damages does not depend on whether the claimant has in fact suffered any loss at all, its entitlement cannot depend on whether any loss that it did suffer ought reasonably to have been mitigated.

DIRECTORS' POWERS MUST BE USED FOR THEIR PROPER PURPOSE

In *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71, the Supreme Court considered the rule that directors must exercise their powers for the purpose for which they are given.

In this case, JKX Oil & Gas Plc was the subject of an alleged "corporate raid" (an attempt by the minority shareholders to gain effective control of the company). The directors used a power in the company's articles to restrict the voting rights of minority shareholders after they failed to respond to a notice requiring them to provide information about persons interested in their shares. In doing so, the directors' intention was to alter the votes at a forthcoming AGM, to allow certain resolutions to be passed.

The directors considered their actions to be in the best interests of the company. Nevertheless, the Supreme Court set aside the notices restricting the minority shareholders' voting rights and the board resolutions authorising them. This was because the purpose of the power to restrict voting rights was to induce shareholders to provide the information required by the statutory notice, to provide a sanction for non-compliance and to protect a company and its shareholders against having to make decisions about their interests in ignorance of relevant information. The purpose of the power to restrict voting rights was not to influence the outcome of resolutions at a general meeting. There was "*in principle a clear line between protecting the company and its shareholders against the consequences of non-provision of the information, and seeking to manipulate the fate of particular shareholders' resolutions or to alter the balance of forces at the company's general meetings*."

In reaching this conclusion, the Supreme Court rejected the submission (which had found favour before the Court of Appeal) that the "proper purpose" rule did not apply to the same degree in the context of a battle for the control of a company. Lord Sumption said that, on the contrary, this was precisely the type of situation where the rule was most important.

Often, the purpose of a power is not expressed in the company's articles. In that situation, the purpose should be ascertained from the mischief which the power is intended to deal with. This, in turn, is to be determined by an analysis of the provisions conferring the power, their effect and from the court's understanding of the business context.

For more information on this case, click here.

COSTS MANAGEMENT RULES USED TO REDUCE "GROSSLY EXCESSIVE COSTS BUDGETS"

The rules on costs management continue to make the legal headlines. The rules, which were a central pillar of the Jackson costs reforms, require parties in claims of less than £10m (and in other cases at the judge's discretion) to produce budgets which set out the costs they have already incurred and those that they anticipate incurring in the future. At an early stage of the claim, a judge will review the parties' costs budgets and, if appropriate, approve them. A successful party will not normally be able to recover more costs than the amount set out in the approved budget. The aim of the rules is to ensure that costs are proportionate and predictable.

In *GSK Project Management Limited (in liquidation) v QPR Holdings Limited* [2015] EWHC 2274 (TCC), the judge was faced with a claimant's proposed costs budget totalling £825,000 (including £312,000 already incurred), where the total value of the claimant's claim was only £805,000. He held that the claimant's proposed costs budget was "*so disproportionate to the sums at stake or the length and complexity of the case that something has clearly gone wrong*".

The judge proceeded to set budget figures for each phase of the litigation (including those phases already undertaken) that it would be reasonable for the claimant to incur, resulting in a total costs budget of £425,000. In doing so, the judge carefully examined the number of hours spent and proposed to be spent by the claimant's solicitors, barrister and experts and adjusted these figures significantly downwards so as to ensure that the claimant's costs of the litigation were proportionate. The court will only usually undertake a detailed examination of a costs budget in exceptional circumstances - but in this case, the claimant's costs budget clearly justified that approach. The judge criticised some of the incurred and estimated hours in the strongest terms: as "*astonishing*"; "*quite simply absurd*"; "*exorbitant*"; and "*grossly excessive*".

CONTRACTUAL OBLIGATIONS OF GOOD FAITH CONTINUE TO BE LITIGATED

In the 2013 case of *Yam Seng PTE Ltd v International Trade Corporation Ltd* [2013] EWHC 111(QBD), the claimant successfully argued that a duty to act in good faith should be implied into an agreement for the distribution of certain "Manchester United" branded products. The courts have been required to consider the impact of his controversial decision on numerous occasions and 2015 was no exception. Three cases are worth mentioning:

- In *D&G Cars Ltd v Essex Police Authority* [2015] EWHC 226 (QB), the High Court held that there was an implied term in a commercial contract to act with honesty and integrity. As in Yam Seng, the contract under consideration was a "relational" one because of its length, the fact that it would govern a large number of individual transactions and its subject matter (the recovery and handling of vehicles for the police). The judge said that acts which would "*compromise the mutual trust and confidence*" between the parties would be a key factor in considering what would be a breach of this implied term.

- In *Myers v Kestrel Acquisitions* [2015] EWHC 916 (Ch), the High Court rejected an argument that the power to amend the terms of a loan note instrument was subject to an implied term that the modification had to be in good faith. This was (partly) because the relevant contract was detailed and had been carefully drafted. The judge said that, if the parties had intended an obligation of good faith, they would have written it into the contract. (For more information on this case, click here.

- In *Portsmouth City Council v Ensign Highways Ltd* [2015] EWHC 1969 (TCC), the High Court rejected the contention that an express duty of good faith stated in part of a contract operated across the contract as a whole. The key point arising out of this case is that, where the parties have identified specific situations in which they will be required to act in good faith, it is less likely that the court will find that there is a general duty to perform a contract in good faith.

COMMERCIAL COMMON SENSE SHOULD NOT BE INVOKED TO UNDERMINE THE IMPORTANCE OF THE LANGUAGE USED IN A CONTRACT

In *Arnold v Britton and others* [2015] UKSC 36, the Supreme Court addressed the tension between "literal" and "purposive" approaches to the interpretation of contracts and came down on the side of giving words their natural meaning.

The dispute concerned the meaning of a service charge clause in lease agreements for several long lease holiday chalets. The lease agreements contained a covenant whereby the lessees agreed to pay an annual service charge of £90, rising by 10 per cent a year. The landlord argued that the service charge was a fixed fee, which would result in the tenants making a very high payment – by 2072 each tenant would be paying a service charge of over £550,000 per annum, regardless of what the landlord had actually spent on services. Unsurprisingly, the tenants argued that this was "*absurdly high*". They said that the

relevant provision set out the maximum service charges payable – all they were required to pay was their share of the landlord's actual cost of providing services up to the level of the cap.

The Supreme Court reiterated that the court's task is to identify the parties' intentions by reference to what a reasonable person, having all the relevant background knowledge available to the parties, would understand the contract to mean. Though commercial common sense is an important factor (which should be assessed at the date of the agreement rather than retrospectively), the court should be slow to reject the natural meaning of a provision. The clearer the natural meaning of the words, the more difficult it will be for the court to justify departing from those words. The subjective intentions of the parties are not relevant.

Applying those principles, the Supreme Court found in favour of the landlord. The clause was clear and there was no reason to depart from the natural meaning. Furthermore, the 10 per cent yearly increase to the service charge was in keeping with the prevailing rates of inflation at the time the leases were entered into. The fact that, in hindsight, this produced an unfortunate outcome for the tenants was not relevant. Lord Neuberger commented that parties frequently make bad bargains and it is not the job of the court to rescue them from the consequences of their imprudence or poor advice.

COURT OF APPEAL ADOPTS "BACK TO BASICS APPROACH" TO ISSUES OF FORUM CONVENIENS

Jurisdiction disputes often turn on the question of whether England is "*clearly or distinctly the appropriate forum*" to hear a dispute ("*forum conveniens*"). In the case of *Erste Group Bank A.G. v JSC "VMZ Red October" and others* [2015] EWCA Civ 379, the Court of Appeal said that it should take a practical approach to this issue, and not attach too much importance to technical considerations. This involves standing back and identifying where the fundamental focus of the litigation is to be found. In this case, England was not the appropriate forum to determine what was "*overwhelmingly a Russian case*".

The case is also interesting because the Court of Appeal considered the use of "anchor defendants". This involves issuing proceedings against a party over whom the English courts have jurisdiction and joining foreign defendants to the proceedings on the basis that they are "*necessary and proper parties*" to those proceedings. This can be a useful way of bringing the real target of a claim before the English courts. However, the Court of Appeal reduced the scope for using this tactic by holding that the rules not only require a claimant to show that it has an arguable claim against an "anchor defendant" but also that it is reasonable for the English court to try that claim.

ASSESSING LOSS: MITIGATION AND BETTERMENT

In *Thai Airways International Public Company Limited v KI Holdings Co Limited* [2015] EWCH 1250 (Comm) the High Court clarified the circumstances in which a claimant is obliged to give credit for benefits or betterment obtained as a result of steps taken to mitigate losses and provided guidance on the burden of proof when a party is seeking recovery of its mitigation costs.

The claimant (Thai) contracted with the defendant (Koito), a Japanese seat manufacturer for the delivery of seats for certain of its aircraft. Some seats were delivered late and others not at all. As a consequence, Thai was unable to use five new A330 aircraft for around 18 months until new seats could be sourced and fitted. In order to maintain capacity in its fleet, Thai leased three nearly-new B777s from Jet Airways for three years, at a cost of just over $50m per year. Thai also sourced alternative seats from two different manufacturers (Zim and Recaro), which were lighter but more expensive than the Koito seats.

Thai sued Koito to recover the cost of the Jet leases and the enhanced cost of replacement seats. Koito admitted that it had breached the contracts; and, in the course of trial, conceded that Thai had acted reasonably in leasing the Jet aircraft. However, Koito argued that:

1. Thai was not entitled to recover any costs for leasing the Jet aircraft unless it could establish a loss of profits (and, it was argued, Thai bore the burden of proving those losses); and

2. Thai must give credit for the benefit of the lighter replacement seats.

In relation to the first point, the judge accepted Thai's argument that, as it was claiming only the costs of mitigation rather than any loss of profit, the burden was on Koito to prove that Thai's loss of profit would have been less than the cost of taking the Jet leases. The burden of proof was important because the judge recognised that it would be extremely complicated for Thai to quantify its loss of profits and that it might be unable to do so. Koito could not prove that Thai suffered a loss less than $107 million (the cost of leasing the Jet aircraft for two years). Therefore, Thai was entitled to recover damages for its mitigation costs without needing to prove first what the loss of profits would have been. However, on the evidence, Thai was unable to recover the cost of leasing the Jet aircraft for a third year because the judge found that this was an independent business decision taken by Thai that was not driven by Koito's breach.

As to the second point, Thai argued that it should not be required to give credit for the for the fuel saving it would make as a result of fitting lighter Zim and Recaro replacement seats because there were no other reasonable seat choices available to it (due to a general shortage of aircraft seats at the relevant time) and it would be unjust to require a party to give credit for a benefit which he had not chosen to receive.

The judge rejected this argument. Following a detailed examination of the case law, he concluded that the test for when credit must be given for the benefit of a mitigating step is whether the benefit can be measured in monetary terms. Since money is entirely fungible, credit must be given if the benefit is pecuniary. The judge also held that a party may need to give credit for a benefit which he has not yet realised, provided that the benefit can be calculated with sufficient certainty.

In this case, in relation to the Zim seats, the judge concluded that there was sufficient evidence to prove that Thai would, over the life of the seats, make a fuel saving which could be determined. Thai was therefore required to give credit for that saving. However, in relation to the Recaro seats, the judge concluded that there was insufficient evidence from which to calculate any fuel saving. Thai was not required to give credit for a speculative saving that could not properly be calculated.

This is an important judgment from a mitigation perspective. Customers who are let down by suppliers should consider these principles when considering what steps to take in response and what damages may be recoverable.

PROCEEDS OF A LOAN AGREEMENT ARE ASSETS FOR THE PURPOSE OF THE STANDARD FORM FREEZING ORDER

In *JSC BTA Bank v Ablyazov* [2015] UKSC 64, the Supreme Court held that the proceeds of a loan agreement fell within the meaning of "asset" as described in the standard-form freezing order (Commercial Court) to which the defendant (Mukhtar Ablyazov) was subject. As a result, Mr Ablyazov was prevented from disposing of or dealing with loan proceeds (which were being used by him for living and legal expenses) whilst he was subject to the order. Respondents are therefore not permitted to exceed their weekly or monthly spending allowance, by using borrowing or credit facilities whilst subject to the standard form freezing order.

Lord Clarke (who gave the only reasoned judgment) made the point that, when considering the scope of a freezing order, the court should focus exclusively on what the order meant and not on the respondent's conduct. The court should resist the temptation to stretch legal analysis to capture the merits or lack of merits of the case before it. Freezing orders should be restrictively construed because the consequences of breaching them are serious and respondents need to be certain as to where they stand.

However, even on that basis, the Supreme Court held that the proceeds of the loans were to be considered "assets" within the meaning of the order. It noted that the most recent freezing order standard forms had extended the definition of assets in paragraph 5, and that this extension was designed to cover assets which the Respondent controlled, not just assets which he legally or beneficially owned. The Respondent was in fact dealing with the assets of the lender as if they were his own. Therefore, the powers under the loan agreement were affected by the freezing order: As Lord Clarke said, "*[t]he whole focus… of the paragraph is the Respondent's power to deal with the lender's assets as if they were his own. It follows that the focus … is not on assets which the Defendant owns (whether legally or beneficially), but on assets which he does not own but which he has power to dispose of or deal with as if he did*".

CONTACT DETAILS
If you would like further information or specific advice please contact:

GEOFF STEWARD
PARTNER
LITIGATION
DD: +44 (0)20 7849 2341
geoff.steward@macfarlanes.com

BARRY DONNELLY
PARTNER
LITIGATION
DD: +44 (0)20 7849 2950
barry.donnelly@macfarlanes.com

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MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT
T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com