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CMS legal update

Quarterly round up of key developments under English law

Summer 2015

Contents

Introduction

Welcome to the Second Edition of the CMS Quarterly Legal Update.

English law continues to be the default choice of law for many contracting parties across the globe. In the Middle East, it accounts for almost two-thirds of all M&A and half of all joint venture transactions. Accordingly, it is important for local counsel of businesses which contract under English law, or which have interests in the UK, to keep up to date with developments which can materially impact their business.

Our First Edition of the Quarterly Legal Update (Spring 2015) covered a broad range of topics, including issues around breach of warranty, confidentiality agreements, joint venture arrangement and the principles of reflective loss, amongst others. The feedback received from that First Edition has been overwhelmingly positive, and so we are delighted to present this Second Edition.

In this Edition, we cover topics such as nominee directors and their use in holding company structures (commonly used in tax-efficient investment structures or structural security arrangements) and issues around consequential loss. We also discuss the ability for parties to unilaterally terminate contracts which might no longer be commercially viable for them – a particularly topical matter given the current macro-economic climate, volatility of oil prices and situations in Syria, Yemen and Iraq.

If you would like any further details on any of the matters discussed in this Edition, please feel free to get in touch.

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http://www.cms-cmck.com/cms-legal-update-key-developments

No other firm completed more M&A deals than CMS in Europe last year

2014	**1st** in Europe
2013	**1st** in Europe
2012	**3rd** in Europe
2011	**1st** in Europe
2010	**1st** in Europe

(Source: Bloomberg/Thomson Reuters 2010, 2011, 2012, 2013, 2014, by deal count)

Ranked No.1 for M&A in Europe 2014

THOMSON REUTERS

Lessons for nominee directors and their appointing shareholders

Where offshore holding companies are used as part of a corporate group, it is not uncommon to find that the local directors are appointed by, and follow the orders of, its parent company. The recent Privy Council case of *Central Bank of Ecuador and ors v Conticorp SA and ors*[1] provides a striking illustration of how, in the use of offshore companies managed by nominee directors, care must be taken to ensure those companies are run properly as separate and independent legal entities.

Background

Conticorp SA, a company based in Ecuador, owned Groupo Financiero Conticorp SA (**GFC**) and in turn, two banks (the **Banks**). Through the Banks, Conticorp had invested heavily in Interamerican Asset Management Fund Limited (**IAMF**), a company based in the Bahamas.

IAMF held itself out as an independent investment management fund, with an individual – Mr Taylor – as its sole director and nominated investment advisor. However, through its various holdings, Conticorp in reality owned and controlled IAMF and Mr Taylor acted in accordance with the instructions of Conticorp.

Following financial uncertainties in late 1995, the Central Bank of Ecuador (**Central Bank**) provided emergency subordinated loans to the Banks in order to keep them from collapse. The Central Bank thereby became a major creditor of the Banks.

Over the course of three transactions executed during 1995/1996 (**the GDR Transactions**), IAMF transferred to Conticorp substantially all of its assets, comprising a valuable loan portfolio and interests in various companies with an aggregate face value of more than US$190 million (the **Portfolio**). In return, Conticorp procured that certain Global Depository Receipts and other securities in its subsidiary, GFC, were issued to IAMF.

The central point was that the Global Depository Receipts and other securities received by IAMF turned out to be worth substantially less than the value of the Portfolio. At the time the Portfolio was transferred, GFC and its subsidiary entities – the Banks – were in significant financial difficulties, and accordingly the Global Depository Receipts and other securities *'could not honestly have been thought to have value, or at least value in any way commensurate with that of the* [Portfolio]. Further, it was determined that there was no realistic prospects of IAMF selling the Global Depository Receipts on the open market – so in essence, IAMF paid $190 million for securities which were worthless.

On those facts, it seems a clear case of a transaction orchestrated by shareholders – Conticorp – in order to illegally extract value from its failing subsidiaries before the Central Bank exercised its rights as a creditor to seize the remaining valuable assets. This is of course precisely the kind of mischief that most insolvency legislation seeks to guard against.

[1](2015) UKPC 11

The Claims

The Central Bank eventually became the ultimate owner of GFC, and therefore the Banks and IAMF. Having analysed the circumstances of the GDR Transactions, the Central Bank joined IAMF in a series of claims against Conticorp and certain individuals who were part of the family that ultimately controlled Conticorp (the **Respondents**) seeking to recover some or all of the assets lost by IAMF through the GDR Transactions.

The Central Bank's claims were dismissed at first instance, and again in the Court of Appeal, but the claims were successful on further appeal to the Privy Council. In the Privy Council, the claims were distilled down to an analysis of: (a) whether, by carrying out instructions given ultimately by Conticorp, without exercising any independent judgement, Mr Taylor had acted in breach of his director's duties to IAMF; and (b) whether Conticorp and the other Respondents were guilty of dishonestly assisting in the breach by Mr Taylor of his duties.

We look at both of those crucial points further below, but first, a point on procedure.

Procedure

Although the Privy Council accepted that only in very limited circumstances should it interfere with findings of pure fact made by a trial judge, in this case the lower courts had made a number of glaring errors. In particular, they had 'failed to appreciate or address a central aspect of IAMF's case on dishonesty', focussed on irrelevant aspects of the circumstances of the case, and were 'fundamentally flawed'. Critically, the courts below had failed to analyse whether the Respondents believed, or could honestly have believed, that the value received by IAMF pursuant to the GDR Transactions was at least equivalent to the value of the Portfolio transferred by IAMF in return and, in turn, whether the GDR Transactions could honestly have been regarded as in the best interests of IAMF.

Accordingly, given such flawed earlier judgments, the Privy Council reopened the analysis around the probity of the Respondents in this case: '*The Board* (of the Privy Council) *regards it as necessary, in the…circumstances, to review for itself whether there was a sound basis for the general finding of honesty which was made by the courts below, when this finding was made without analysis of the factors … indicating that the transactions, when agreed, served no purpose of IAMR's and no useful purpose of anyone other than the Respondents.*'

Nominee directors and fiduciary duties

When appointed, Mr Taylor would have been fully aware of the fact that Conticorp did not want or expect him to question their instructions as to how IAMF was to be run. The Privy Council concluded that '*from all the evidence, IAMF at all times acted, and acted only, on and in accordance with the instructions of the Respondents*' (para 111).

As Lord Denning said in his well-known speech in *Boulting v Association of Cinematograph Technicians*[2], there is nothing wrong with a director being nominated by a shareholder to represent his interests *'so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful.'*

Based on the principle set out by Ungoed-Thomas J in *Selangor United Rubber Estates v Cradock*[3] that a director *'who acts without exercising any discretion, at the direction of a stranger to the company is fixed with the stranger's knowledge of the transaction'*, Mr Taylor was deemed fixed with the knowledge of Conticorp and specifically its knowledge that the Global Depository Receipts were worth much less than the Portfolio.

On this basis, the Privy Council had no difficulty in concluding that Mr Taylor had breached his duties to IAMF: in particular, his duty to exercise independent judgement, and his failure to act in what he considered to be in the best interests of IAMF. Had he exercised independent judgement and considered whether the GDR Transactions were in the best interests of IAMF then, being fixed with the knowledge of Conticorp as to the value of the Global Depository Receipts and other securities, he would surely have concluded that the GDR Transactions were not, and would not have caused the company to enter into them.

The fact that Mr Taylor was appointed as a nominee director and paid only $2,500 per annum for his services was held irrelevant: the level of remuneration paid, and the circumstances and manner of a director's appointment, cannot exempt or in any way relieve a director from the duties he owes.

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[2](1963) 2 QB 606

[3](1968) 1 WLR 1555

Dishonest assistance

Thus far, IAMF would only have had a claim against Mr Taylor personally – which might have bankrupted him but which would not have enabled IAMF to recover anything like the full value of the Portfolio. However, IAMF went on to make claims against Conticorp and the other Respondents on the basis that they had dishonestly assisted in a breach of fiduciary duty by their nominee, Mr Taylor.

Lord Mance summed up this head of claim at para 50: *'Acting as an officer of one company, a person may dishonestly procure or assist a breach of duty by the director of another company, in which case such person may make liable for dishonest assistance both himself personally and the company of which he is an officer. Otherwise, individuals acting as officers of a company could never commit any wrong tortious or equitable. What matters in the present context are, in short, the factual questions whether the Respondents procured or assisted Mr Taylor's breaches of duty, what knowledge they had when giving such assistance, and whether any honest person(s) in their position giving such assistance with that knowledge could have believed that the relevant transaction was in IAMF's interest.'*

That Conticorp procured Mr Taylor's breaches was readily established.

As to their knowledge, Conticorp would have been well aware of the financial difficulties of the Banks, of the value of the Portfolio, and of the risk that if it did not intervene the Portfolio might be lost to creditors of the Banks. The Privy Council therefore found that the GDR Transactions were, when entered into, not transactions which persons in the Respondents' position could honestly have considered to be in IAMF's interests, in the light of what they knew. Further, IAMF was regarded as a tool used by the Respondents at their behest and for their own purposes, without thought being given to what was in the best interests of IAMF as a separate entity.

The Respondents were therefore liable for having dishonestly assisted Mr Taylor in his breach of duty and were liable to repay the full face value of the Portfolio, amounting to some $192 million.

The sting in the tail

In addition to awarding that the full face value of the Portfolio be repaid to the Central Bank, the Privy Council also awarded compound interest by way of equitable compensation which, based on US$ prime rates, amounted to an extra $382 million, plus costs.

Commentary

GDR Transactions aside, the circumstances of this case are very common. Many international corporates use offshore holding entities as part of their group structures and often for good reason. What lessons can be learned from the case? (Although the following is based on the rules applicable to directors and shareholders of *UK companies,* it would be prudent to assume that similar rules will apply in other jurisdictions, as was the case in *Conticorp.*)

Lessons for appointing shareholders and parent companies

— When setting up an intermediate holding company and appointing directors to the board, a parent company must remember that the holding company is a separate legal entity, and that the directors are likely to have duties to act in the best interests of the company. The directors must therefore be allowed actually to direct – i.e. decide for themselves, using their independent judgement, what is in the best interests of their company. Appointing someone as a director who is simply a 'stooge' is very likely to put the director himself in breach of duty, and could well cause the appointing or controlling shareholder to be liable too.

— In circumstances where the interests of the company do not coincide with the interests of the parent, both the directors of the company, and the parent, will expose themselves to liability if they simply cause the company to do the parent's bidding. The risk is multiplied if the company is facing financial difficulties and carries out a course of action that is designed to benefit the parent company at the expense of the company's creditors.

— Broadly speaking, the more a parent interferes in decision-making by the board of the company – in terms of both the frequency and magnitude of its interference – the greater the risk of the parent being liable to compensate the company if it suffers loss as a result. Such liability could arise through (among other things) the parent being found to have dishonestly assisted in a breach of duty by the directors (as in the Conticorp case) or through the parent being treated as a 'shadow director' of the company. In effect, such interference could cost the parent the protection it would otherwise have had through using a limited liability holding company.

— However, there is usually nothing wrong with a parent or appointing shareholder conveying to its nominee how it would like him to act, or what course of action it considers would be in the best interests of the company, provided that the director is then allowed to make up his own mind. But if the circumstances are such that the director has little choice but to do what the parent 'wishes', even if no direct instruction is given, both the director and the shareholder will expose themselves to the risk of liability.

Lessons for nominee directors

— In the UK at least, there are no special rules for 'nominee' directors – i.e. those who are appointed by one or more shareholders to represent their interests. They are subject to the same director's duties as any other director. Surprising as it may seem, a nominee director of a holding company being paid £100 per year will owe the same fiduciary duties to his company as the CEO of a FTSE100 company.

— Before accepting an appointment, ask yourself whether the level of remuneration you will receive from acting as a director is sufficient to compensate you for the risk of personal liability that you will assume. Note also that following recent amendments to the UK Company Directors Disqualification Act 1986 you could be disqualified from acting as a director of a UK company for up to 15 years if you are found guilty of an offence relating to the running of an overseas company: for further details see our LawNow articles on the amendments and the original proposals.

— Take advice from lawyers who are qualified to advise on the company law of the country in which the holding company is incorporated on matters such as:

- what are the duties of a director, and how do they compare with international best practice;
- to what extent can these duties be cut down or modified – e.g. by means of provisions in the company's constitution;
- to what extent can the company or its shareholders release a director from breach of duty either in advance or retrospectively, or indemnify him against any liability he incurs for acting in breach of duty;
- whether the company can purchase directors and officers insurance.

— Remember that if you act in breach of duty, it is possible that you could be liable to pay money to the company even if it suffers no loss.

— Make sure you will have access to sufficient information about the business, activities and financial position and prospects of the company to make an informed decision about what is in its best interests. In particular, you will need to know about any commitments or events that could threaten the company's ability to continue trading on a solvent basis.

— Be particularly cautious about approving any course of action that seems to provide little or no benefit to the company, either directly or indirectly – e.g. where the company is being asked to assume or guarantee a liability of its parent or a sister company – or where the consideration or other quid pro quo to be provided by the counterparty in return for a transfer of the company's assets may not be worth its face value – e.g. where (as in *Conticorp*) the consideration is in the form of securities or other assets that are illiquid and/or difficult to value.

— Remember that it is not just where the company goes insolvent that you could be at risk of a claim being made against you. If your company is sold, and the new owner considers that, for example, the company's position or prospects were worsened by transactions that you approved, they could cause the company to bring claims against you. And, depending on the company's activities, a regulator might be able to bring criminal or civil proceedings against you – e.g. where your company or its subsidiaries have been involved in breaching legislation relating to bribery, anti-competitive practices or environmental damage.

— Record in the board minutes or related documents the reasons why you believe a course of action is in the best interests of your company. Consider obtaining confirmation or advice from an independent third party – e.g. to value illiquid assets.

— Under UK law at least, you are entitled *to take into account* the interests of your appointing shareholder provided that ultimately your decision as to whether the company should follow a course of action is based on your own independent view of what is in the best interests of your company. Often you may be able to decide that the course of action preferred by your appointing shareholder is also in the company's best interests. But where the best interests of your company differ from those of your appointing shareholder, you must do what is in the best interests of your company – even where you risk incurring the wrath of your appointor, losing your appointment and/or damaging your career prospects.

— If in doubt, ask the company's shareholders to approve the relevant course of action. Such an approval is unlikely to completely protect a director against personal liability, particularly if the course of action is plainly not in the company's best interests and/or the company is or may be insolvent, but in some circumstances it may help. Taking local law advice is of course also a good idea.

— Avoid referring to yourself as a 'nominee' director, because the term 'nominee' tends to connote a person who is appointed solely to carry out a task (e.g. to hold and deal with property) for the benefit of another and who will act only in accordance with the other's instructions. Referring to yourself as a 'nominee director' could therefore create the impression that you have surrendered all discretion to your appointor, which might encourage, say, a liquidator or regulator to bring a claim against you for breach of duty and/or a claim against your appointor. Instead, refer to yourself as a 'nominated director', 'shareholder-appointed director' or something similar.

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'Consequential loss' clause may result in injunctive relief

International commercial contracts regularly contain some form of limitation of liability clause, purportedly capping a party's liability under that contract. In today's uncertain global economic environment, some parties to contracts may decide to rely on their limitation of liability clause and decide to deliberately terminate/breach a contract which may have become unfavorable for them.

In a totemic decision that has important implications for drafting of international commercial contracts, the English courts have decided that the existence of on an extensive exclusion or limitation of liability clause might give rise to unforeseen consequences. Specifically, this may make it easier for the innocent party to obtain an interim injunction to compel a party to continue to perform its contractual obligations in the event of an alleged/threatened breach.

Facts

The parties were involved in an arbitration dispute concerning the terms of a licence agreement when 'AB' (the appellant) sought an interim injunction that required 'CD' (the respondent) to continue performing its obligations under the disputed agreement. The appellant wished to restrain the respondent from terminating or suspending the agreement pending the arbitration award.

The licence agreement under consideration contained a broad 'consequential loss' clause, which excluded liability for '*loss of data, lost profits, costs of procurement of substitute goods or services, or any exemplary, putative, indirect, special, consequential or incidental damages*' and also contained a limitation of liability (cap) on other damages that might nevertheless be recoverable.

Issues

Interim injunctions are generally used in circumstances where a party wishes to preserve the status quo until a broader dispute between the parties has been resolved.

Under English law, when exercising its discretion to grant an interim injunction, the court relies the guidelines set out in *American Cyanamid v Ethicon* (2001) 1 WLR 194. The second stage of the test under these guidelines is to consider whether damages would be an adequate remedy to the applicant. An injunction is not generally granted in cases where damages would be an adequate remedy.

In this case, the issue of the adequacy of damages was complicated by the broad 'consequential loss' and limitation clause in the contract. In the decision at first instance, the English High Court noted that any award of damages would – by reason of the 'consequential loss' and limitation clause – be far less than the loss which could otherwise be recovered at common law. However, the High Court found that this was what the parties had agreed as 'adequate damages' in the event of a breach and the application for an injunction should be refused, as the applicant had an adequate remedy in damages in the agreed contractual sum.

The implication of this decision, if correct, was that it would be extremely difficult for an innocent party to succeed in an application for an interim injunction where a broad 'consequential loss' or other exclusion clause applied, as even though all damages may be excluded by the contract the court would consider there to be 'adequate damages' available.

Permission to appeal was granted.

Court of Appeal Decision

The Court of Appeal overturned the High Court decision and granted an interim injunction to restrain the attempted termination of contract.

The Court of Appeal decided that the '*primary commercial expectation*' under an English law contract is one of performance. In contrast, the expectations created by 'consequential loss' or limitation clauses are concerned with the damages that will be recoverable in the event of breach and are therefore secondary to the performance obligation. Underhill LJ explained that '*an agreement to restrict the recoverability of damages in the event of a breach cannot be treated as an agreement to excuse performance of that primary obligation*' and he thought that the importance of protecting the 'primary commercial expectation' of performance seemed to '*sit better with the acceptance by this Court that an injunction may in an appropriate case be granted even where the loss caused by the threatened breach would not sound in damages*'.

Counsel for the respondent noted the far reaching impact of the Court of Appeal's approach and argued that it would not be right that in every case where the innocent party of a threatened breach of contract sought an interim injunction it could rely on the existence of an exclusion or limitation clause to claim that damages would not be an adequate remedy.

However, in rejecting this submission, Underhill LJ explained that he thought this overstated the consequences of the case and that a 'claimant will still have to show that if the threatened breach occurs there is (at least) a substantial risk that he will suffer loss that would otherwise be recoverable but for which he will (or at least may) be prevented from recovering in full, or at all, by the provision in question'.

Comment

Wide 'consequential loss', exclusion and limitation clauses are commonplace in numerous international commercial contracts. Such broad exclusions had previously been understood to remove the possibility of obtaining any remedy (whether by damages or interim injunctive relief), as the 'damages' specified in the contract have been agreed to be the 'adequate' remedy for a breach.

However, AB v CD suggests that broad exclusion clauses could actually have the opposite impact and increase the likelihood of the courts granting interim injunctive relief to an innocent party to restrain a threatened breach of contract. As Laws LJ noted, in the Court of Appeal, in circumstances where a limitation clause exists in a contract, justice will tend to '*favour the grant of an injunction to prohibit the breach in the first place*'.

It is unlikely that this case will mean that parties refrain from putting 'consequential loss' or limitation of liability clauses in contracts. However, it serves as a reminder that such clauses may not prevent interim injunctive relief being granted to restrain a breach. In fact, it seems that they will make the grant of such interim relief more likely. As a consequence, a party's usual ability to walk away from a contractual obligation by paying damages for its breach should it later turn out to have acted wrongfully might be restricted by the existence of such a clause.

Whilst the case is of direct relevance to disputes in the English Courts, the same issues would arise in any tribunal or jurisdiction applying the test in *American Cyanamid v Ethicon* to an application for an interim measure (for example, the DIFC Courts in Dubai or in Singapore). The reasoning also seems to hold true to any tribunal or jurisdiction where the test for granting interim measures includes the claimant showing that it may suffer some form of irrepressible harm in the event of breach.

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Termination for breach: wording of clause critical

Shifts in the economics or risks of a project can result in parties carefully reviewing their contractual commitments with a view to termination. Where termination for convenience is not available (or commercially realistic) attention naturally turns to a party's ability to terminate for default.

If the contract is governed by English law, two recent cases illustrate how an arbitral tribunal or court applying English law will approach the issue. They show how under English law, a party's ability to terminate for default will vary with the drafting of the termination clause. The cases give an insight into:

1. How the seriousness of the breach needed to justify termination may be reduced by including a default notice and remedy period in the contract; and
2. What is meant by remedying a default to the satisfaction of the innocent party, where this is a requirement of the termination clause.

Such provisions are regularly found in procurement contracts governed by English law. Whilst these cases concern procurement contracts, and are therefore most relevant for procurement contract situations, the principles derived from these cases can be applied in other long-term contracts governed by English law, such as franchise agreements, licences, distribution contracts, joint ventures and outsourcing agreements.

Termination after notice not the same as termination for 'any default'

In the case *Obrascon Huarte Lain SA v Attorney General of Gibraltar*,[1] the English High Court considered a contract containing a clause that allowed a party to terminate if the other failed to comply with a notice of default.

The English High Court decided that this allowed the court to apply a lower standard to the severity of breaches needed for termination than if the clause had simply allowed termination for 'any default' without notice. The court also gave guidance to the parties on when a default notice may properly be issued.

Facts

The case related to a construction contract based on the FIDIC Yellow Book, a model-form contract that is often used in construction projects governed by English law (a common format used in various regions across the globe).[2] Obrascon Huarte Lain SA ('OHL'), a substantial Spanish civil engineering contractor, and the Government of Gibraltar ('GOG'), had signed a contract for the design and construction of a road and tunnel under the eastern end of the runway of Gibraltar Airport.

After over 2½ years of work on the 2 year project and when little more than 25% of the work had been done, the contract was terminated. Issues arise as to who was legally and factually responsible.

The termination clause at Clause 15.1[1] of the General Conditions of Contract required that:

— '15.1 If the Contractor fails to carry out any obligation under the Contract, the Engineer may by notice require the Contractor to make good the failure and to remedy it within a specified reasonable time.

[1](2014) EWHC 1028 (TCC).

[2]I.e. it was based on the FIDIC Conditions of Contract for Plant and Design-build for building and engineering works designed by the Contractor 1st Edition 1999, with some minor changes.

— 15.2 The Employer shall be entitled to terminate the Contract if the Contractor:

- (a) fails to comply…with a notice under Sub-Clause 15.1…
- (b) …plainly demonstrates the intention not to continue performance of his obligations under the Contract,...In any of these events or circumstances, the Employer may, upon giving 14 days' notice to the Contractor, terminate the Contract and expel the Contractor from Site.'

OHL argued that 'a contract contains a provision such as Clause 15.2 which entitles an employer to terminate by reason of a failure to remedy a breach of contract which has been the subject of a Clause 15.1 notice… the breach of contract that is relied upon must be serious and one which is analogous to a repudiatory breach of contract'.

A breach will be a repudiatory breach only if it is 'so grave as to go to the root of the contract' and 'deprive(s) the party … of substantially the whole benefit' of the contract. It follows that it will be in relatively rare circumstances that a party commits a repudiatory breach.

In support of its argument, OHL referred to the decision made in the *Antaios* case by the House of Lords (the highest court in the United Kingdom at the time, which has since been replaced by the United Kingdom Supreme Court in legal reforms). In the *Antaios* decision, the House of Lords decided that arbitrators were right to have decided that a clause in a charterparty that provided that the owners were entitled to withdraw 'on any breach' only gave a right to withdraw where there was a repudiatory breach.

The question arose whether the default notice provision in Clause 15.1, when taken together with the Clause 15.2(a) right to termination, meant that the English High Court was entitled to apply a different (lower) standard in deciding whether termination was permitted.

Decision

The English High Court decided that it was entitled to apply a lower standard to the employer's right to terminate for failure to comply with a notice than the repudiatory breach. It further decided that GOG was entitled to terminate the contract.

In upholding GOG's right to terminate, the court decided a number of points that will be of particular interest to companies that enter into English-law contracts that allow termination for breach, and particularly procurement contracts:

— Each contract should be considered on its own terms. For instance, if the termination clause allowed termination 'for any breach of contract no matter how minor', the meaning is clear and would not require some repudiatory breach (i.e. a breach depriving the innocent party of substantially the whole benefit of the contract).

— The notice provision in Clause 15.1 relates only to more than insignificant contractual failures by the Contractor.

— The specified time for compliance with the Clause 15.1 notice must be reasonable in all the circumstances prevailing at the time of the notice. What is reasonable is fact-sensitive.

— Clause 15.1 is designed to give the Contractor an opportunity and a right to correct an identified contractual failure.

— Most of the cases that found that 'any breach' meant any repudiatory breach, did not involve contracts like the contract in this case. The contract in this case gives a list of grounds on which termination can take place that includes one which is not unlike the test for English-law repudiation, namely Clause 15.2 (b) (where the Contractor 'plainly demonstrates the intention not to continue performance of his obligations under the Contract'). The existence of Clause 15.2(b) might be said to indicate that Clause 15.1(a) governs something different to a repudiatory breach.

— The cases relied upon by OHL in this context had a relatively simple right to terminate (for a, or any, breach). The contract here at least for the Clause 15.2(a) basis (failure 'to comply…with a notice under Sub-Clause 15.1') had a warning mechanism whereby termination could be avoided by the contractor's compliance with the Clause 15.1 notice. In that sense, the contractor is given the chance to avoid termination whilst the simple termination for any breach can come out of the blue.

— Commercial parties would sensibly understand that this contractual chance is a warning as well to the contractor and the remedy is in its hands in that sense.

Comment

This case provides some useful guidance on the drafting and application of termination clauses governed by English law. The following principles transpire:

General rule

— Each contract and termination clause must be construed on its own terms. It is therefore important to avoid broad generalisations as to the meaning and effect of termination clauses (and contracts) of differing drafting.

Repudiatory breach or lesser default

— Where the contract provides for the innocent party to issue a default notice where 'Contractor fails to carry out any obligation under the Contract', and terminate for failure to remedy the default identified in that notice, English law will likely allow termination for breaches of a lesser severity than repudiatory breaches. In *Obrascon Huarte Lain SA v Attorney General of Gibraltar*, the High Court decided that the contract entitled the employer to issue a default notice provided that the breach was not 'insignificant' or 'trivial'. If the contractor did not then remedy the defect in a reasonable time, the employer was then entitled to terminate the contract.

— It remains to be seen whether other courts will adopt an analogous approach to all termination clauses that contain notice provisions. It is important to be aware that the relationship between the notice provision, the words of the termination clause and the parties' respective rights upon termination might have a material impact on the scope of the termination right.

Room for appeal?

— It should also be noted that in reaching its decision in *Obrascon Huarte Lain SA v Attorney General of Gibraltar*, the court appeared to place some weight on the fact that Clause 15.2(b) allowed termination where the Contractor 'plainly demonstrates the intention not to continue performance'. The court suggested that giving an *Antaios* type (repudiatory breach) meaning to the construction and interpretation of 15.1 and 15.2(a) might have the effect of robbing 15.2(b) of any meaning. However, another interpretation could be that 15.2(b) is intended to deal with a renunciation of contract and Clauses 15.1 and 15.2(a) to deal with a material, repudiatory, breach. This might be an interesting avenue for the parties to explore on appeal.

Remedying default to the innocent party's satisfaction

A second case of interest is the English High Court's decision in *Bluewater Energy Services BV v Mercon Steel Structures BV*.[3] It sheds light on a different aspect of termination provisions, but is also of particular relevance to procurement contracts. In this case, the English High Court decided the standard to be applied to a contractor's obligation, upon notice, to remedy a defect to the 'satisfaction of' the company/employer or risk termination by the company/employer.

The English High Court decided that the company/employer was largely entitled to take a subjective view of what it considered satisfactory. English law did not require the court to carry out an after-the-event review of the company/employer's decision based on an objective standard of reasonableness. However, the company/employer must act honestly, in good faith and genuinely. An arbitrary, capricious, perverse or irrational decision by the company/employer would amount to a breach of contract.

Facts

Bluewater entered into a sub-contract with Mercon to construct and install some facilities at the Yuri Korchagain oil field in the Caspian Sea.

The termination provisions of the sub-contract stated:[4]

- '30.1 BLUEWATER shall have the right by giving notice to terminate all or any part of the WORK or the CONTRACT at such time or times as BLUEWATER may consider necessary for any or all of the following issues:
- (a) To suit the convenience of BLUEWATER
- (b) Subject only to Clause 30.2 in the event of any default on the part of the CONTRACTOR; or
- 30.2 In the event of a default on the part of the CONTACTOR and before the issue by BLUEWATER of an order of termination of all or any part of the WORK of the CONTRACT, BLUEWATER shall give notice of default to the CONTRACTOR giving the details of such default. If the CONTRACTOR upon receipt of such notice does not immediately commence and thereafter continuously proceed with action satisfactory to BLUEWATER to remedy such default BLUEWATER may issue a notice of termination in accordance with the provisions of Clause 30.1.'

[3](2014) EWHC 2132 (TCC).

[4]The clause was based on the LOGIC model form procurement contracts used in the oil and gas sector.

Various disputes arose between the parties in relation to alleged defects and delays. On 23 January 2009 Bluewater served a Notice of Default, which was followed by a Notice of Termination on 3 February 2009. Mercon claimed that Bluewater's Notice of Termination amounted to a repudiatory breach of contract.

An issue arose as to the standard to be applied under Clause 30.2 to determine whether or not action taken by Mercon was satisfactory. Bluewater argued that the words 'action satisfactory to BLUEWATER' meant the subjective view taken by Bluewater and there was no objective reasonableness to be imported. It argued that it was not open to the court to retrospectively superimpose its own view on what Bluewater may or may not have found to be satisfactory.

Mercon argued that Bluewater's actions had to be objectively reasonable, so that it was not a question of the subjective satisfaction of Bluewater. In this regard, Mercon relied upon Clause 33.1 of Section 2 (a) of the sub-contract, which provided:

- 'Both the CONTRACTOR and BLUEWATER shall uphold the highest standards of business ethics in the performance of the CONTRACT. Honesty, fairness and integrity shall be paramount principles in the dealings between the parties.'

It also relied upon an existing decision by the English Court of Appeal in the case *Socimer International Bank Ltd (in liquidation) v Standard Bank London Ltd.*[5] On the basis of this case, it argued that the exercise of contractual discretion should not be abused and must be exercised within boundaries of rationality.

Decision

The English High Court decided that Clause 30.2 was not one which must be construed by reference to an objective standard. The clause did not permit a review, after the event, of whether the action taken to remedy the defect was or was not objectively satisfactory. However, there was a limitation on the ability of Bluewater to come to a decision on whether the action was satisfactory. That limitation, as expressed in *Socimer*, is a limitation by reference to concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The court did not consider that this limitation depended on the presence of Clause 33.1 of Section 2(a) of the Contract. However, it was consistent with the inclusion of such clause.

[5](2008) EWCA Civ 116.

The question of whether the action taken by Mercon was satisfactory to Bluewater was therefore a matter for the subjective view of Bluewater, subject to the implied limitation summarised in *Socimer.*

On the facts, Bluewater was able to establish that one, or more, of the grounds relied upon was a situation where Mercon had failed to remedy a defect to its satisfaction, and that it was therefore entitled to terminate.

Comment

The following principles can be drawn from this case:

Remedy to the satisfaction of innocent party

— The decision of the English High Court in *Bluewater Energy Services BV* v Mercon Steel Structures BV is a useful reminder that where an English-law contract confers discretion on one party, it will usually be implicit that the discretion must be exercised honestly and rationally and for the purpose for which it was conferred. If the right to terminate requires the company/employer to exercise discretion, the English High Court has indicated that this will apply to such clauses as well.

— It follows that in terminating contracts, or exercising other contractual discretion, in the absence of express wording, parties should keep in mind that their discretion is likely to be subject to an implied restriction. If a dispute arises, document disclosure will likely be sought of a party's decision-making process. As a consequence, board minutes, internal meeting notes, emails etc. relating to the reasons for termination will likely become key documents.

— In drafting contracts that contain a discretion conferred upon the company/employer concerning the remedy of defects, parties should consider whether they are content that the implied restriction alluded to in *Bluewater Energy Services BV v Mercon Steel Structures BV* is appropriate, or whether express wording of the same, or a differing, standard should be agreed.

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FCA reminder that overseas subsidiaries of a UK listed parent must comply with UK Listing Rules too

The UK Financial Conduct Authority has recently imposed on Asia Resource Minerals plc (formerly Bumi plc) a £4.6 million fine for breaching the Listing Rules in connection with the company's failure to properly implement its policy and procedures on related party transactions. This fine has highlighted the importance of ensuring that all subsidiaries of listed companies, wherever incorporated and whatever their local governance arrangements, have in place proper systems and controls that ensure the subsidiaries comply with the Listing Rules. Among other things, local managers who are unfamiliar with the Listing Rules will need to be given appropriate training and regular refreshers.

Overview

On 17 June 2015 the UK Financial Conduct Authority (the **FCA**) published a final notice imposing a fine of £4.6 million on Asia Resource Minerals plc (**ARM**) for breaches of the UK Listing Principles, Listing Rules and Disclosure and Transparency Rules (**DTRs**). The breaches occurred as a result of ARM having failed to ensure that its related party transactions policy was understood and implemented by all the relevant individuals responsible for running and overseeing the operations of its Indonesian subsidiary, PT Berau Coal Energy Tbk (**PT Berau Coal**).

As a result of the failures, PT Berau Coal entered into a number of transactions with related parties (**RPTs**), totalling US$12,700,000 in value, without ARM having consulted its sponsor as to whether the transactions in question could be RPTs or, where they were, informing the UK Listing Authority (**UKLA**) in writing of the proposed transactions and taking the other steps required by Chapter 11 of the Listing Rules.

Discovery of the related party transactions, together with other financial irregularities, meant ARM could not publish its annual financial results for 2012 within four months of the financial year end, as required by the DTRs, which resulted in trading in the company's shares being suspended. Trading eventually resumed in July 2013, after the company had confirmed, at the request of the UKLA, that it was compliant with the relevant Listing Principles.

Relevant Listing Rules and Listing Principles

Chapter 11 of the Listing Rules sets out rules designed to prevent persons who are in a position to influence decision-making by the parent company's board from taking advantage of their position, and to prevent any perception that they may have done so. Such persons, who are known as related parties, include (i) current and recent directors of the listed company or any of its subsidiary undertakings (for convenience referred to below as 'subsidiaries'); (ii) substantial shareholders – i.e. those owning or controlling 10% or more of the share capital of the listed company or any of its subsidiaries; and (iii) 'associates' of such persons.

In most cases, a stock market announcement must be made and shareholder approval obtained before a listed company – *or any of its subsidiaries* – completes a non-ordinary course transaction or arrangement with, or that benefits, a related party. However, for certain 'smaller' transactions these requirements are modified; and certain other transactions are completely exempt.

If a listed company or any of its subsidiaries proposes to enter into a transaction that *could be* a RPT it must obtain the guidance of a sponsor to assess the potential application of LR 11. (In the final notice, the FCA helpfully notes: *'A transaction which is in the ordinary course of business or clearly falls beneath the percentage threshold set out in LR 11 Annex 1(1)* (for 'small' transactions, which are exempt from LR 11) *will not amount to an RPT. A listed company may itself be well placed to determine whether a transaction is an RPT – for example, where the transaction is clearly in the ordinary course of business or falls within the small transaction exemption. However, where there is sufficient uncertainty as to whether a proposed transaction is an RPT, a Sponsor must be consulted.*')

Under the Listing Principles a listed company must take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations as a listed company. In practice, before joining the Main Market a company will usually work with its sponsor and advisers to (i) identify and maintain a list of all persons who are or could be related parties; (ii) put in place internal policies and procedures designed to ensure that any transaction that could be a RPT is identified at an early stage and brought to the attention of executives, internal lawyers and/or compliance officers who are familiar with the requirements of LR 11; and (iii) provide training on the policies and procedures to all relevant employees and executives.

Where the listed company has subsidiaries outside the UK, it can be challenging to ensure that the policies and procedures are communicated to and understood by all local management, that all relevant individuals attend appropriate training sessions and that the policies and procedures are actually implemented in practice. Difficulties can include simple logistics, language barriers, different time-zones, cultural differences, competing legal regimes and different standards of record-keeping and transparency. The latter, in particular, can make it difficult to identify persons who are associates of a related party. **However, the FCA's view is that the existence of such difficulties merely serves to highlight areas where extra efforts should be made to ensure compliance.**

If a company that is already listed subsequently acquires a new business, it must similarly ensure that appropriate procedures, systems and controls are put in place in the acquired entity.

ARM's overseas subsidiary

PT Berau Coal was listed on the Indonesian Stock Exchange. In 2011, before ARM joined the UK Main Market, ARM had acquired 84.7% of the shares in PT Berau Coal. The local management of PT Berau Coal were therefore presumably familiar with the requirements of the Indonesian Stock Exchange, but the Listing Rule requirements would have been new to them.

Problems at ARM

ARM announced in September 2012 that it had become aware of allegations of potential irregularities in PT Berau Coal's operations, and shortly afterwards conducted an internal investigation of certain historic potential RPTs entered into by PT Berau Coal. The investigation identified a number of transactions, three of which were determined by ARM's financial advisers as being RPTs, plus a number of other transactions totalling $225,300,000 in value where the ultimate third party could not be identified.

The identified counterparties were companies associated with Mr Rosan Roeslani, who was a non-executive director of ARM from 11 April 2011 to 19 December 2012 and President Director (equivalent to CEO) of PT Berau Coal from July 2010 to 7 March 2013. These transactions comprised: (a) a loan to a company where the interest rate was lower than the normal commercial rate; (b) costs incurred by PT Berau Coal for private jet hire where the majority of use was not in the ordinary course of business; and (c) the purchase of a vessel which was not in the ordinary course of business. Mr Roeslani was therefore a related party of ARM. Because he also controlled the Recapital group, and the counterparties to the transactions were all entities within the Recapital group, the transactions were entered into with an associate of a related party and were therefore RPTs.

As a result, at the time when PT Berau Coal proposed to enter into these transactions it should have escalated them to appropriate individuals within ARM, so that if necessary ARM could consult its sponsor to determine whether or not the transactions did in fact constitute RPTs. If they did so, ARM should have complied with the relevant requirements of LR 11.

Red flags

In the FCA's view, various factors should have made ARM aware that members of its group, especially PT Berau Coal, might well enter into RPTs and therefore of the importance of having in place across the group robust systems, procedures and controls to ensure that it complied with the Listing Rules on related party transactions. In particular:

— the fact the subsidiary was an Indonesian company with senior management who were unfamiliar with rules and regulations applicable to companies listed in the UK;

— the increased risk of potential RPTs given that a number of board directors of both ARM and PT Berau Coal held senior management or board positions in other companies in the same industry and were involved in other operations and financial interests in Indonesia; and

— past concerns that had been identified in an independent analyst report published shortly before ARM's UK listing.

Failure to implement the RPT policy

Prior to listing, ARM created and approved an RPT policy (the **Policy**) to identify such transactions before they were entered into. But for a number of reasons the Policy was not effectively implemented. In particular:

— ARM's Conflicts Committee, which was responsible for implementing the Policy, only met infrequently and its members had only limited oversight of PT Berau Coal.

— Certain key members of the board of PT Berau Coal did not attend training sessions, and there was a failure to follow up on attendance or keep a record of who had attended the training, as well as a failure to provide training to employees below director or senior management level.

— ARM was over-reliant on the senior management of PT Berau Coal implementing the Policy.

— There was a delay of four months post-listing before the Policy was communicated to PT Berau Coal, a further month's delay before the Policy was approved by PT Berau Coal, and a total of eight months delay post-listing before the Policy was communicated to members of senior management of PT Berau Coal.

— Neither ARM nor PT Berau Coal kept a complete list of RPTs by PT Berau Coal, and ARM failed to check the adequacy of the information it received from PT Berau Coal.

— PT Berau Coal did not provide ARM with adequate financial information. This was due to a mixture of incompetence, lack of resources, a lack of quality processes and skilled professionals, and uncooperative behaviour by the relevant individuals.

Breaches

ARM therefore breached:

— The Listing Principle that required it to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations as a listed company. The FCA emphasised that simply having a relevant policy and board committee is not enough: the company must ensure that the policy and associated procedures are implemented effectively. This is particularly important where the history and governance arrangements of the group mean that there is an increased risk of RPTs.

— The relevant rules in LR 11 for 'smaller' transactions, by failing to inform the UKLA in writing of the proposed transactions; failing to provide written confirmation from an independent adviser that the terms of the transactions were fair and reasonable; and failing to undertake to include details of the transactions in ARM's next published annual accounts. ARM also failed to aggregate the three RPTs that were entered into with the same related party or its associates within a 12 month period.

— The requirement in LR 8 for the company to obtain the guidance of its sponsor when a transaction was proposed that could be a RPT.

— The obligation in DTR 4 for the company to publish its annual financial report for 2012 within four months of the year end.

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Contractual interpretation: supremacy of the natural and ordinary meaning

In the recent case of *Arnold v Britton and others* (2015) UKSC 36, the Supreme Court has restrained the recent approach of applying commercial common sense when interpreting contracts.

Development of business common sense approach

Commercial common sense as an aid to interpretation was propagated by Lord Hoffmann, first in *Investors Compensation Scheme Ltd v West Bromwich Building Society* (1998) 1 WLR 896 and then more recently in *Chartbrook Ltd v Persimmon Homes Ltd* (2009) 1 AC 1101. This approach was developed further by the Supreme Court in *Rainy Sky S.A. & Ors v Kookmin Bank* (2011) UKSC 50. In Rainy Sky the Supreme Court held that, where language used in a contract has more than one potential meaning, it is generally appropriate to adopt the construction that is most consistent with business common sense. Since *Rainy Sky* parties routinely argue commercial common sense in support of their construction of disputed terms in contracts.

The recent decision in *Arnold* follows Lord Neuberger's comments in *Marley v Rawlings* (2014) UKSC 2 last year. In *Marley* Lord Neuberger described Lord Hoffmann's approach as 'controversial' and highlighted academic commentary at the time which suggested that adopting Lord Hoffmann's approach to contractual interpretation diminished the difference between interpretation and rectification of contracts. The difference is key because interpretation of contracts requires the court to determine the meaning and effect of a contract whereas rectification involves giving the contract a different meaning from that which it appears to have on its face and will result in the change of actual words used.

Rules of construction

In *Arnold* Lord Neuberger, giving the leading judgment, summarised that when interpreting a contract the court should identify the intention of the parties by reference to what a reasonable person having all the background knowledge which would have been available to the parties would have understood the contract to mean. The court then set out the following aids to construction:

1. The clause in dispute should be given its natural and ordinary meaning.
2. Any other relevant provisions of the agreement should be taken into consideration.
3. The overall purpose of the clause in dispute and the agreement should be considered.
4. Facts and circumstances known or assumed by the parties at the time that the document was executed are admissible.
5. Commercial common sense can be applied.
6. The subjective evidence of any party's intentions should be disregarded.

Commercial common sense – restricted

In the only dissenting judgment, Lord Carnwath recognised that there is often a tension between the principle that the parties' common intention should be derived from the words they used and the need to avoid a nonsensical result.

Lord Carnwath emphasised that in *Rainy Sky* Lord Clarke had specifically rejected the previous proposition that unless the natural meaning of the words produces a result so extreme as to suggest that it is unintended, the court must give effect to that meaning. Lord Clarke's view in *Rainy Sky* was that it was only if the words were unambiguous that the court had no choice in the matter.

Whilst the court accepted that commercial common sense was an aid to construction, Lord Neuberger (with whom the majority agreed) emphasised the following, to restrict the extent to which the court can rely on commercial common sense as an aid to depart from the actual language used in a contract:

1. Commercial common sense and surrounding circumstances should not be invoked to undervalue the importance of the language of the provision which is to be construed.
2. The clearer the natural meaning of the words in the contract the more difficult it is to depart from it.
3. Commercial common sense is not to be invoked retrospectively. The mere fact that the natural meaning of a contract leads to a disastrous result for one party is not a reason for departing from the natural language.
4. The purpose of interpretation is to identify what the parties have agreed not what they should have agreed. A court should be slow to depart from the natural meaning simply because it appears to be an imprudent term for one of the parties, even at the time that they entered into it. As Lord Hodge highlighted, there must nevertheless be a basis in the words used and the factual matrix for identifying a rival meaning.
5. When interpreting a contract, only those facts or circumstances which existed at the time that the contract was made and which were known or reasonably available to both parties should be taken into account. It was not right to take into account a fact or circumstance known only to one of the parties.
6. When an event occurs which, judging from the language used, was plainly not intended or contemplated by the parties, the court will give effect to the intention of the parties, if it is clear what the parties would have intended in that situation.

Conclusion

The decision in *Arnold* emphasises the importance of the actual words used in a contract. The court highlighted that, unlike commercial common sense, the parties have control over the words they use in a contract and are focussed on the issue covered by a provision when agreeing the words of that provision.

Lord Neuberger's approach reinforces the distinction between a claim for interpretation of a contract and rectification of a contract. However, Lord Carnwath (who gave the dissenting judgment) noted that this distinction was unnecessary and unhelpful. Lord Carnwath's view was that interpretation of contracts and correction of mistakes were aspects of the same task of interpreting a contract in its context, in order to get as close as possible to the meaning which the parties intended. Lord Carnwath also considered that implication of terms to give business efficacy to a contract was another permissible route for the court to achieve a commercially sensible result in cases of intractable language in a contract.

It is likely that Lord Neuberger's approach may result in additional claims for rectification of a contract in the alternative to a claim for interpretation of a contract. A key practical effect of this is that when seeking rectification, parties are entitled to rely on evidence of the parties' negotiations at the time the contract was entered into, which would not be the case in a claim for contractual interpretation.

More interestingly, Lord Neuberger's approach may herald the start of a trend away from the increasingly commercial construction of contracts towards a more traditional 'black letter' analysis of contracts.

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Rules of mitigation: which costs and expenses can an innocent party recover in damages from a contract-breaker?

A recent case involving a contractual dispute between an airline and a seat manufacturer has nicely illustrated the English courts' approach to the question of which costs and expenses incurred by an innocent party in attempting to avoid or mitigate the consequences of a contract breach can be recovered in damages from the contract-breaker.

Imagine you're a national airline and you're upgrading and expanding your fleet of aircraft. You order economy seats from a manufacturer, to be delivered over a period of time and fitted to six of your existing Boeing B777-300 aircraft and to fourteen new aircraft you're buying (eight A330-300 aircraft and six huge A380-800 aircraft). The manufacturer has problems ensuring that the seats comply with safety and quality standards and fails to deliver most of them by the deadlines. As a result, you end up with five brand new A330-300 aircraft sitting in a hangar in Bordeaux that cannot be used because they have no economy seats in them; and one existing B777-300 aircraft with old, uncomfortable seats that passengers are grumbling about. A significant proportion of your fleet is therefore grounded or unable to operate to its full capacity, and you face losing large amounts of revenue and profit until the new seats are delivered – if they are ever delivered. What do you do?

Although of course the manufacturer does not admit it's in breach of contract, you and your lawyers think you have a very strong case and a court or arbitrator will award you damages to compensate for losses that flow from the breach. But getting an award of damages could take years and of course the amount awarded might not in fact cover all the costs, expenses and loss of profits etc that you suffer.

You consider some options:

1. You could terminate your contract with the seat manufacturer and try to obtain replacement seats from someone else. Your programme engineers tell you that getting equivalent replacement seats manufactured and fitted will probably take about 18 months, possibly longer; and that the price per seat will be higher than in your original contract (around US$20 million higher in total). For aircraft that you're buying but that are still being made, you could try to get the aircraft manufacturer (Airbus) to delay delivery to give you time to agree terms with a replacement seat manufacturer. This could reduce or eliminate the amount of time you have new aircraft sitting around unable to be used.
2. As a temporary measure, you could bring some old aircraft back into service to fill the gaps in your fleet and/or reinstall old economy class seats in place of the missing seats. Doing this will incur some moderate fitting and maintenance costs, but the bigger problem is that you will find it difficult to attract and retain customers when other airlines can offer them more modern and comfortable seats on the same routes.

3. You could lease some modern replacement aircraft from one of the various leasing companies and try to operate them at sufficient capacity to cover the leasing costs (as well as other normal running costs). Rental payments will be substantial (around US$160 million for three years) but a current over-supply in the market means that rates are low enough that you should be able to make a profit. But how long should you lease them for? (If you go for a longer lease the price may come down, and there may be other advantages.) And would it be better to lease slightly larger and/or longer-range aircraft to give you greater flexibility with your fleet?

In broad terms, these were the circumstances faced by Thai Airlines in early 2010. They decided to pursue all three options. In relation to option 2 (above), they entered into three year leases with Jet Airways of three longer-range B777-300ER aircraft with seating capacity equivalent to the new A330-300 aircraft languishing in Bordeaux but smaller than the new A380-800 aircraft on order from Airbus. When their claim for damages against the seat manufacturer, Koito, reached the High Court in England, the judge had to decide which of the costs and expenses incurred by the airline as a result of what it decided to do should be compensated in damages. (The airline did not claim for its lost profits.) As part of this, the judge had to decide whether and to what extent damages should be reduced by savings that the airline made – e.g. because the replacement seats were lighter in weight and resulted in lower fuel costs – and benefits it received – e.g. because in the event the leased aircraft made a positive contribution to the airline's profits after deduction of their rental and running costs.

Although the case concerned aircraft, the sort of dilemma faced by the customer (the airline) could equally be faced by customers purchasing other types of revenue-generating assets, and the principles set out by the court are of general application.

Principles of mitigation

The court found:

— The essential purpose of the mitigation rules is to identify – in the light of what the innocent party has done or not done to avoid loss resulting from the wrongdoer's breach of contract or other legal wrong – which costs and benefits accruing to the innocent party are to be treated as consequences of the wrongdoer's wrong and which are to be treated as caused by the innocent party's own action or inaction. The basic test is whether the innocent party has acted reasonably in response to the wrongdoer's wrong. Insofar as the innocent party has acted reasonably, costs and benefits accruing to the innocent party are included in the calculation of damages. Insofar as the innocent party has not acted reasonably, the innocent party's damages are assessed as if it had acted reasonably.

— Although it is commonly said that the innocent party has a 'duty' to take reasonable steps to mitigate its loss, this is potentially misleading in at least two ways:

- In the absence of a contrary agreement, an innocent party is free to act as it wishes following a breach of contract and does not owe any duty in law to the wrongdoer or anyone else to mitigate its loss. Mitigation is not a duty but an assumption; damages are calculated on the assumption that the innocent party has taken reasonable steps in mitigation, whether it has in fact done so or not.
- The test of what is 'reasonable' in this context is not simply one of general rationality but is governed by legal rules. Various norms of reasonable conduct have become settled: where there is an available market, the innocent party will go into the market as soon as possible and obtain a substitute for the wrongdoer's performance. Where that does not apply, and more than one option is reasonably available, the innocent party is expected to adopt the one that is or is likely to be the least expensive. One result of these rules is that the innocent party may have acted in a way that was reasonable from the point of view of its own business interests or personal objectives and yet not have adopted what the law regards as a reasonable response to the wrongdoer's breach of contract or other wrong for the purpose of assessing damages.

— The standard of reasonableness is, however, applied with some generosity towards the innocent party, having regard to the fact that the innocent party's predicament has been caused by the wrongdoer's breach of contract. The burden of proof is on the wrongdoer to show that there was a course of action which it was reasonable to expect the innocent party to adopt that would have avoided all or an identifiable part of the innocent party's loss.

— In assessing damages for breach of contract, credit must be given for any proven monetary benefit (which either takes the form of money or which the innocent party could reasonably be expected to realise in terms of money), whether chosen by the innocent party or not, which the innocent party has received or will receive as a result of an action reasonably taken to mitigate its loss. No account is taken of 'betterment' that does not confer any pecuniary advantage or is not a benefit that either takes the form of money or could be readily realised or expected to be realised in terms of money. Justice requires the sum received to be brought into action, whether its receipt was an unavoidable consequence of mitigation or not. There is generally no material difference between incurring a cost which results in the receipt of money back and simply incurring a lower cost.

Which costs and expenses could the airline recover in damages?

Although the airline's decision to lease the three replacement aircraft for three years, rather than two, was commercially reasonable in light of various advantages that would accrue, the best evidence available to the airline at the time indicated that it would take no more than two years to get replacement seats delivered and fitted by an alternative seat manufacturer and therefore, for the purposes of mitigation, it was reasonable to assume that the leases should have been for two years only. The rental costs for the third year were therefore not recoverable.

The airline could recover the extra costs of buying replacement seats from alternative manufacturers. These amounted to around US$4 million. However, because the replacement seats were lighter in weight and Koito could demonstrate that this would reduce the airline's fuel costs over the life of the seats by around US$1.9 million, a net amount of US$2.1 million was recoverable under this head.

Costs of storing the brand new aircraft in Bordeaux (around US$3.2 million) were also recoverable. Koito could not show that lower storage costs could or should reasonably have been incurred. But credit was given for a price reduction that the airline obtained from Airbus by agreeing that the A330-300 aircraft could be delivered late. This reduced the total amount of damages by US$9.44 million.

The most difficult issue, and the one with the highest amount at stake, was whether and to what extent damages should be reduced by monetary benefits received by the airline as a result of leasing the replacement aircraft. As the airline had acted reasonably in leasing replacement aircraft for two years, its leasing costs over that period were recoverable in damages. But if the profits earned by the airline in operating the replacement aircraft during the first two years of the leases exceeded the profits the airline would have made through operating its own aircraft over that period had the breach of contract not occurred, the 'excess' profits would be a benefit that should be deducted from the leasing costs. Since it was the seat manufacturer that sought to show that the airline had so benefited and that damages should be reduced accordingly, it was up to the seat manufacturer to prove it. But attempting to estimate with any precision what the airline's financial position would have been if the seat manufacturer had delivered all the seats on time would have been an extremely complicated task, mainly because

'the airline manages its entire fleet of aircraft in a way that is constantly adjusted to maximise efficiency. To reconstruct what would have happened if the five A330-300 aircraft which were delayed as a result of Koito's breaches of contract had been delivered on time, it would first of all be necessary to identify what routes they would have flown and to estimate the gross profits which would have been earned on those routes. If those routes were in fact flown by other aircraft, it would then be necessary to determine not only what profits were in fact earned on those routes but on what routes, if any, those other aircraft would have been deployed if the A330-300 aircraft had been available. Then a similar enquiry would need to be made for the routes which the other aircraft would have flown; and so on. Furthermore, in order to construct the relevant counterfactual scenario it would be necessary to remove from what actually happened the consequences of leasing the three B777-300ER aircraft from Jet – with all the knock-on consequences of their deployment across Thai's flight schedules.'

Unsurprisingly, given these complexities, Koito was unable to prove that the actual profits made by the airline from operating the replacement aircraft exceeded the profits it would have made absent the breach of contract. The whole amount of the leasing costs – around US$107 million – were therefore recoverable in damages.

In total, Koito was ordered to pay the airline damages of US$82,732,284, EUR19,857,165 and THB 4,640,417 (approximately US$105 million in total) plus interest and costs.

Permission to appeal and cross-appeal has been refused by the High Court, but may be granted by the Court of Appeal.

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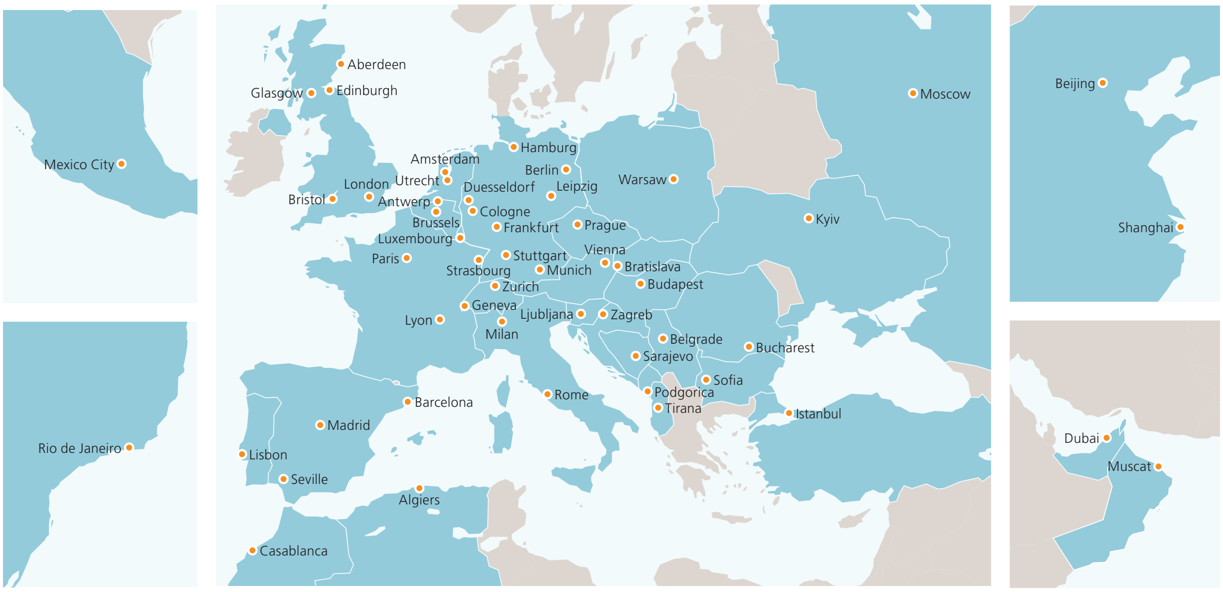

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