

October 2009

Commercial Dispute Resolution Legal Update

OLSWANG



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The anti-deprivation principle applied - (1) *Butters* (2) *Kahn* (3) *Dargan* (as Joint Administrators of *WW Realisation 8 Ltd* (formerly known as *Woolworths Media Plc*)) v *BBC Worldwide Ltd* and others [2009] EWHC 1954 (Ch)

On 20 August, the High Court handed down judgment in *Butters and others v BBC Worldwide*¹ concerning the application of the principle known as the "bankruptcy principle", or perhaps more accurately as the "anti-deprivation principle". The anti-deprivation principle arises in the common law on insolvency and originated in 19th Century jurisprudence. It has been summarised as follows:

*"there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors"*².

Hence, any clause whereby a property owner contracts for its assets to be transferred away from its creditors in the event of it becoming insolvent will be considered to be void and unenforceable as a matter of public policy. The reasoning for this relies on the analysis that the effect is to deprive the party's creditors of what they would otherwise have been entitled to receive under the statutory bankruptcy regime. A typical example of such a "fraud on the bankruptcy laws" developed in case law is a provision for the sale of shares in the event of bankruptcy at something less than the price they would otherwise obtain, though conversely it is established law that owners of property are free to terminate licences of that property upon the insolvency of the licensee.

In *Woolworths Media v BBC Worldwide*, a case concerning BBC Worldwide's purchase of shares in its joint venture with Woolworths called 2 Entertain Ltd ("2e"), the Administrators of Woolworths sought to argue that certain clauses in contracts between the parties were void because they decreased the price payable by BBC Worldwide for the shares as a result of Woolworths' insolvency.

In July 2004, BBC Worldwide and a subsidiary of the Woolworths Group ("Woolworths Media") agreed to incorporate 2e as a joint venture to publish music and DVDs. BBC Worldwide subscribed to 60% of the shares in 2e, and Woolworths Media subscribed to 40%, and both parties contributed valuable intellectual property rights to the company. BBC Worldwide's rights, including rights to

the BBC's existing and future DVD titles, were granted to 2e by way of a Master Licence Agreement (the "Licence").

The joint venture agreement between the parties (the "JVA") contained termination rights for both parties, including the right for either party to buy out the other's shareholding in the event that the other party became insolvent. Upon the occurrence of such an "Insolvency Event", the solvent counterparty would have the right to serve a notice which would: (1) trigger a mandatory buy out of the insolvent party's shares (at a value to be determined by an independent investment bank according to a fair market valuation formula set out in the JVA, if not agreed by the parties); and (2) terminate the solvent party's licensing arrangements, such that the buyer would not be paying value for the rights which it had contributed to the joint venture.

Following the insolvency of the Woolworths Group in late 2008, BBC Worldwide served such a notice on Woolworths Media in January 2009, stating its intention to buy out Woolworths Media's 40% stake, and terminating the Licence with immediate effect. However, in subsequent negotiations the parties could not agree a consensual figure for the shares. In May 2009, the Administrators applied to the Companies Court for directions under the procedure available to companies in administration set out in paragraph 63 of Schedule B1 to the Insolvency Act 1986.

As originally framed, the Administrators' application only sought directions in relation to how the fair market valuation clauses of the JVA should be interpreted by the investment bank. However, shortly before the first instance hearing in June, the Administrators revised their application to include a new argument to the effect that the clauses which linked the buy out right to the termination of the Licence infringed the anti-deprivation principle, and so were void as a matter of public policy. The effect on the valuation, if this argument succeeded, would be significant for Woolworths Media's creditors, as the Licence contributed over half of 2e's annual revenues.

Mr Justice Peter Smith accepted that it was uncontroversial for commercial licences to be terminated on insolvency and hence BBC Worldwide was free to use Woolworths Media's insolvency as an event which terminated the Licence. However, what infringed the anti-deprivation principle was the fact that this termination was automatically linked to BBC Worldwide's buy out rights, which meant that, construed as a whole, the effect of the clauses was to decrease the assets available to Woolworths Media's creditors on insolvency.

The judge went on to determine that this was an inadvertent result of the drafting of the JVA, which could be remedied by simply ordering that the relevant clauses be deemed to be re-drafted to remove the automatic linkage between the buy out

and the termination of the Licence. The judge then held that the Licence had in fact been terminated separately by one of two separate factual events: either (1) by Woolworth's insolvency in December 2008, some two months before BBC Worldwide served its notice, or (2) by implied surrender since on 5 February 2009 BBC Worldwide granted 2e a temporary licence to replace the Licence whilst BBC Worldwide completed its share purchase. As a result, when BBC Worldwide came to serve notice that it wished to buy out Woolworths Media's shares, the Licence had already terminated as a matter of fact, which meant the notice could not have the effect of driving the price down and so could not offend the anti-deprivation principle.

The judge also held that if the above solution did not work, because the anti-deprivation principle did in fact render the clauses void in their entirety such that deemed re-drafting was not possible, the parties should negotiate in good faith to redraft the JVA so as to sever the two clauses. In doing so, he ordered performance of an express provision in the JVA which required the parties to negotiate in good faith in the event of a clause being found to be unenforceable. This adopted the analysis of Longmore LJ in *Petromec Inc and others v Petrolio Brasileiro SA Petrobras and others* [2005] EWCA Civ 891, allowing the clause to be distinguished from the *Walford v Miles* principle against enforcing agreements to agree.

Accordingly, the net result of the judgment was in BBC Worldwide's favour: the valuation of 2e would indeed proceed without the extra value of BBC Worldwide's Licence. The Administrators have obtained permission to appeal (and BBC Worldwide to cross-appeal) against Peter Smith J's judgment, and the appeals are being heard in the Court of Appeal on an expedited basis during October. They are being heard at the same time as the appeal in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd and another* [2009] EWHC 1912 (Ch), a case arising out of the collapse of Lehman Brothers, in which Sir Andrew Morritt held that the anti-deprivation principle did not apply to certain clauses which granted priority to noteholders in a credit insurance programme in the event that Lehman's became insolvent.

Given that clauses terminating rights upon insolvency are extremely common in modern commercial contracts, it is to be hoped that the Court of Appeal will give clear guidance on the circumstances in which the anti-deprivation principle applies, and clarify the dividing line between the judgments in *Perpetual* and *Woolworths Media v BBC Worldwide*.

¹ Olswang (Alex Gerbi and Oliver Gayner) acted for BBC Worldwide.

² Per Cotton LJ in *ex p Jay, in re Harrison* [1880] 14 Ch D 19 at 26, adopted by Neuberger J in *Money Markets International Stockbrokers v London Stock Exchange Ltd* [2002] 1 WLR 1150.

High Court rules Foxtons' letting terms unfair - Office of Fair Trading v Foxtons Ltd [2009] EWHC 1681 (Ch)

The latest skirmish in the long running battle between the OFT and London's biggest estate agent has gone the way of the consumer as the High Court ruled that certain of Foxtons' standard terms in letting agreements were unfair. In a judgment which will prove popular with landlords up and down the country, Mr Justice Mann held that a term which meant that Foxtons could charge repeat commissions on letting renewals, even where they had played no part in the renewal, was contrary to the Unfair Terms in Consumer Contracts Regulations 1999 ("UTCCR"). The same also applied to other similar terms which allowed for commission to be claimed in circumstances unlikely to have been envisaged by landlords at the time they engaged Foxtons' services.

The issues in dispute primarily concerned three terms which, for a time, featured in Foxtons' standard form letting agreement. These obliged landlords to:

- pay an 11% commission where a tenant continued to occupy the property after the initial fixed period of the tenancy had expired, even if Foxtons had played no part in persuading the tenant to stay and did not collect the rent or otherwise manage the property;
- continue paying that renewal commission to Foxtons even after the landlord had sold the property; and
- pay a 2.5% commission to Foxtons upon the sale of the property to a tenant.

In each case, the relevant clauses were contained in small print that was unlikely to be read thoroughly by landlords. As such, the OFT's case was both that the provisions were inherently unfair, and also in the case of renewal commissions that the term was expressed in language which was not plain and intelligible. Foxtons' position, on the other hand, was that not only were all the terms clearly expressed, but that in themselves they provided a fair reward for Foxtons having introduced a long term tenant who would generate a steady income stream for the landlord.

During the period of dispute with the OFT, Foxtons changed its standard terms on more than one occasion, and ultimately abolished the last two of the three offending terms. The issue for the court was therefore the extent to which the original terms, and also the revised term in relation to renewal commissions, breached the UTCCR. In this regard, it was common ground from the start that the protection afforded by the UTCCR was only enjoyed by "consumer" landlords - in

other words, those who let no more than a small number of properties and for whom property letting was not their primary occupation. The court was not asked to make any findings in relation to "professional" landlords.

As an introductory point, under Reg. 6(2) it is not open to the court to make an assessment of fairness under the UTCCR if the term in question is core to the bargain between the parties (as otherwise the consumer will be taken to be sufficiently well informed as to what the bargain is). There is an exception to this in Reg. 6(2) to the effect that where a term is core to the bargain but the term is not in plain and intelligible language, the court can assess it for fairness (because in that scenario the consumer cannot be expected to understand what he is agreeing to). This point was only relevant in relation to the renewal commission issue, there being no suggestion that either of the other types of commission were core terms of the contract.

Applying the test of what both parties would view as core terms, Mann J held that this could not be said to include renewal commissions as, even if Foxtons considered it to be central to the agreement, this was not a perception which would be shared by the majority of landlords, whose primary concern was simply to fill a vacant property. As such, it was not strictly necessary to consider whether the term was expressed in plain and intelligible language, but Mann J held that in any event it was not, with the result that even if the renewal commission had been part of the core bargain between the parties, it would not escape a fairness enquiry on that basis.

Those decisions having been made, the question was whether each of the three terms in question were fair, adopting the test in Reg. 5(1) of whether "*contrary to the requirement of good faith, [the term] causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer*". In relation to each of the three terms, the court found that the term was not fair, taking into account in particular the lack of additional work required of Foxtons in order to secure the additional commission.

In terms of where this leaves those involved in the letting business, and other analogous businesses, this is clearly a highly significant judgment, restricting as it does an all too familiar and highly lucrative business practice. Contrary to a number of media reports, Mann J's judgment does not however go as far as outlawing renewal commissions per se. The main error on Foxtons' part was the failure to draw these onerous provisions sufficiently to the landlords' attention. Had Foxtons done so, it is likely that a different result would have been reached, and it is clear from the judgment that there remains scope for contracting on such terms, but only where both parties are aware that that is what they doing and are therefore able to bargain accordingly.

Construction of contractual terms - Oxonica Energy Ltd v Neuftec Ltd [2009] EWCA Civ 668

The modern approach to the construction of contracts was famously set out by Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 (at 912). Rather than looking at what one or other of the parties meant or understood by the words used, the court must consider: "*the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract*".

But what happens when the court is presented with a particularly badly drafted document? The Court of Appeal addressed this scenario last month in *Oxonica Energy Ltd v Neuftec Ltd*.

Neuftec had the idea of using additives to improve fuel efficiency and believed that delivery of the additives in nanoparticles might be beneficial. It sought a partner with expertise in nanoparticle delivery and found Oxonica. The claimant subsidiary was formed and two agreements were entered into: "the main agreement" and the "licence deed". Under the licence deed, Oxonica was to pay royalties to Neuftec in respect of sales of products "*falling within the scope of claims in the Licensed Application or Licensed Patent*". Prior to the agreements, Neuftec had filed a patent application under the Patent Co-operation Treaty ("PCT") and the application was attached as a schedule to the licence deed. "*Licensed Application*" was defined with reference to the scheduled PCT application. After the agreements, the application matured into various patents; in some regions, however, the scope of patent granted was narrower than that of the application.

Oxonica went on to develop a product known as "Envirox 2", which fell outside the scope of the narrower patent. A dispute arose as to whether, according to the correct construction of the agreements, royalties were payable on Envirox 2. Three possible interpretations of a product "*falling within the scope of claims in the Licensed Application or Licensed Patent*" were put to the court:

1. that it meant any product covered by the claims of the PCT Application (the interpretation adopted by the judge at first instance);
2. that the use of "*or*" meant that royalties were due on any product within the meaning of either "*Licensed Application*" or "*Licensed Patent*" (Neuftec's interpretation, submitted to the Court of Appeal by way of its respondent's notice); and

3. that the phrase should be read as if the words "*as the case may be*" were added, i.e. the payment of royalties depended on the patent position in the country of any relevant sale of products at the time such sale took place (Oxonica's interpretation).

Each side said that the other's approach was re-writing rather than construing the contract.

The Court of Appeal resorted to two well-established adjuncts to *Investors Compensation v West Bromwich*:

1. *Mitsui Construction Co Ltd v Att-Gen of Hong Kong* (1986) 33 BLR 14, which provided guidance as to the approach to be taken when faced with a particularly defective contract: "*the poorer the quality of the drafting, the less willing any court should be to be driven by semantic niceties to attribute to the parties an improbable and unbusinesslike intention*"; and
2. *Wickman Machine Tool v L Schuler* [1974] AC 235, where Lord Reid commented that "*the fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they shall make that intention abundantly clear*".

In *Oxonica*, the Court of Appeal held that it had to look at the big picture and upheld the judge's construction. The reasonable reader of the agreements could only assume that what the parties at the time regarded as a significant body of know-how was being licensed by Neuftec. It offended business sense to say that Oxonica should get free use of the know-how in every country where there was to be no patent or a restricted patent.

Oxonica objected that the result would be that, in contrast to its competitors, it would have to pay royalties to Neuftec in countries where the narrower patent applied. However, the Court's view was that Oxonica had contracted to pay in part for the know-how received from Neuftec, whereas competitors would have to develop their own know-how from scratch.

This left the problem of what significance, if any, the words "*or Licensed Patent*" had in the drafting, given the conclusion that the scope of "*Licensed Application*" determined whether royalties were payable. Jacob LJ expressed discomfort with ignoring the words but concluded that the words had to be ignored "*to make rational sense of this appallingly drafted document*".

It is often wrongly assumed that judges will never find words to be redundant. Certainly they will do their utmost to find meaning in the words written by parties, but there will be extreme occasions like these when the Court can do nothing else.

Court of Appeal rules default interest rate of 15% not a penalty - *Taiwan Scot Co Ltd v The Masters Golf Company Ltd* [2009] EWCA Civ 685

It is well known that a clause which provides for a genuine pre-estimate of loss in the event of a breach will be enforceable as a liquidated damages clause, while a clause which provides for an amount to be paid in order to deter a party from breaching is a penalty clause and therefore unenforceable. Sometimes overlooked is the fact that, in the context of agreements under which payments are owed, this issue arises in the context of a default interest provision. The issue is now particularly topical in the current climate of low interest rates.

A statutory regime for default interest provisions is found in the Late Payment of Commercial Debts (Interest) Act 1998, which provides for a statutory rate of interest of 8% above the Bank of England's base rate to be payable on late payments of debts arising under business-to-business contracts for the supply of goods or services. Parties can contract out of the Act's provisions only if they agree a "*substantial contractual remedy*" for late payment, with a fairly standard contractual rate being 3-4% above a high street bank's base lending rate.

By contrast, a contractual interest rate which is unreasonably high is likely to be struck down on the ground that it is a penalty. The question whether an obligation to pay a particular sum is a penalty is assessed by reference to the time the contract was made and not the time of the breach which triggers the obligation to pay¹. This last point was aptly illustrated in the recent Court of Appeal judgment in *Taiwan Scot Co Ltd v The Masters Golf Company Ltd*. The case involved an agreement entered into in July 2001, under which The Masters Golf Company ("Masters Golf") had to pay certain sums to Taiwan Scot Co ("Taiwan Scot"), with a contractual interest rate on late payments of 15% per annum. Masters Golf refused to make certain payments due under the agreement and Taiwan Scot issued proceedings. The judge ordered Masters Golf to make the disputed payments, but refused to order it to pay interest on the sums due at the contractual rate on the basis that it was "*an unreasonably high rate, and more inclined towards a penalty than a genuine estimate of loss*". Masters Golf appealed against the order that it had to pay the disputed sums and Taiwan Scot cross-appealed on the issue of interest.

The Court of Appeal dismissed Masters Golf's appeal, but allowed the cross-appeal. Longmore LJ pointed out that the judge had erred by stating that the rate was more inclined to a penalty than a genuine estimate of loss, as the contractual rate was either a penalty or it was not. The Court of Appeal held that the contractual rate of 15% was not in any way exorbitant, bearing in mind that the agreement was made back in July

2001, when interest rates were considerably higher. At the time, the statutory rate of default interest under the Late Payment of Commercial Debts (Interest) Act 1998 was 13.25%, and a contractual interest rate of 4% above a high street bank's base rate would have been approximately 9%. Longmore LJ went on to state that the rate was one *"agreed by two commercial concerns in the economic circumstances of the time and it should not lightly be set aside"*.

This decision has made it clear that the court will look at the economic circumstances at the time the agreement was entered into in deciding whether or not the default interest provision in an agreement is a penalty clause. It is by no means an indication that 15% per annum default interest would be enforceable in a contract made today, with the Bank of England base rate presently at 0.5%.

Other factors the court may look at include the equality of arms between the parties and whether the contractual provision is part of a standard form contract or a bespoke term specifically agreed between the parties, and it is worth noting that the court is likely to be stricter in determining whether an interest rate is penal where the case involves a consumer. However, in all cases the issue will come down to the court's assessment of whether the clause is a true attempt to compensate the innocent party for default or is there to deter the party in breach from committing that breach.

¹ *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79.

The UK's first ever Supreme Court

On 1 October 2009, the United Kingdom gained its first ever Supreme Court. This was a historic development, as since 1399 the UK's final court of appeal has been located within the upper chamber of the British Parliament, the House of Lords. However, in 2003, Tony Blair's government took the decision to establish an independent court, primarily in order to reinforce the principle of separation of powers by isolating the judiciary from the legislature. This led to the establishment of the UK Supreme Court under the Constitutional Reform Act 2005. The Supreme Court is now sitting in Parliament Square in Westminster, alongside Parliament and close to the centre of government in Whitehall.

There has been widespread speculation that this physical relocation will be mirrored by a shift in the approach of the court and its users, particularly by accelerating the development of "constitutional" law in the UK, analogous to that of the US Supreme Court. The UK has never had a formal written constitution; however, the Human Rights Act 1998, which gave domestic effect to the European Convention on Human Rights, has resulted in a growing number of legal challenges to the government. Typically, these cases arise in the human rights context: in its final term, the House of Lords dealt with challenges to anti-terror legislation and the rules on assisted suicide. There is also an increasing nexus between human rights and

commercial matters. For instance, institutional shareholders in Northern Rock, the UK's first major victim of the credit crunch, recently mounted a challenge to the government's refusal to pay compensation following the bank's nationalisation. In September, one of the UK's most senior judges, Lord Neuberger, warned of the danger of the new Supreme Court asserting itself against the government. The court is therefore likely to come under close scrutiny in this inaugural term.

To mark this development, Olswang's litigation department and Matrix Chambers have joined forces to create an innovative new blog dedicated to the court at www.ukscblog.com. Its editors will be Hugh Tomlinson QC, Matthew Ryder and Anthony Fairclough of Matrix, and Dan Tench, Ned Beale and Oliver Gayner of Olswang. It is modelled on the hugely successful SCOTUS Blog (www.scotusblog.com) which is devoted to the US Supreme Court, and will provide commentary on and analysis of the decisions of the Supreme Court, up-to-date information on the Court's news, and a forum for discussion about legal developments in the UK.

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