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PH Insight for News and Analysis of the Latest Developments from the Courts of England and Wales

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PH*lit* is our London litigation know-how blog, where you will find the latest developments on commercial litigation topics delivered in a monthly round-up of the most important topics addressed by the Courts of England and Wales, as well as key regulatory and legislative updates. You can subscribe to this site if you would like our updates sent to you by email as soon as they are posted.

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In this edition…

- We consider a recent decision of the High Court whereby advice obtained from accountants on a proposed new tax structure was found not to be protected by litigation privilege as its prevailing purpose was to plot a new tax strategy;
- We review a landmark Supreme Court ruling which addresses the principles for ascertaining the proper governing law of an arbitration agreement: a topic on which commentators, practitioners and the courts have long been divided;
- We analyse an interesting High Court decision which considers the application of a Material Adverse Effect (MAE) clause to changes in company finances arising out of the COVID-19 pandemic. Such clauses are rarely deployed by parties (and even less frequently opined upon by the courts) and the scope of their use has been speculative only until now; and
- We note two decisions of the Supreme Court regarding the application of the *Patel v Mirza* test for the illegality defence: the first considers the proper application of the three-stage test set out in *Patel* and the second considers the precedential value of case law which pre-dates the *Patel* decision. Both decisions will provide much needed clarity for practitioners in a landscape which has witnessed an apparent uptick in the use of the illegality defence in commercial cases as a result of behaviours connected to the financial crisis of 2008 (and subsequent economic stress) and will no doubt also flow from the current COVID-19 pandemic.

Accountants' advice on new tax structure not protected by litigation privilege

Financial Reporting Council v Frasers Group Plc **[2020] EWHC 2607 (Ch) (judgment available here)**

5 October 2020

- The High Court has recently held that advice obtained from accountants on a proposed new tax structure, which identified legal and commercial constraints with the proposed arrangements, was not protected by litigation privilege, even where the advice was obtained to prevent future litigation from occurring.

- The dispute related to distance selling arrangements adopted by Sports Direct International Plc (now Frasers Group Plc). The arrangements were designed to ensure that VAT was paid in the U.K. rather than the EU member state where the customer resided. Relevant information on these arrangements was disclosed to Frasers Group's statutory auditors.

- The Financial Reporting Council ("**FRC**") commenced an investigation into the conduct of the statutory auditor which carried out a 2016 audit of Sports Direct International's financial statements and, pursuant to its investigation, sought production of three documents over which Frasers Group asserted litigation privilege. Privileged documents are exempt from the FRC's authority to compel the production of material from entities subject to its regulation.

- The High Court held that the dominant purpose test for litigation privilege was not satisfied, as the documents were not prepared for the dominant purpose of obtaining advice or evidence in relation to litigation that was reasonably in contemplation. The judge made clear that even if it is contemplated that a particular tax structure will be subject to challenge, advice on how to implement a new structure is not primarily advice as to the conduct of potential litigation. As the judge stated: *"a taxpayer who takes advice as to how to structure his affairs does not do so for litigation purposes. He does so because he wants to achieve a particular result for tax purposes"*.

PH*lit* comment:

While this decision should not be overly surprising to practitioners, it does illustrate the point that even if a particular course of action is expected to lead to litigation, advice on how to change direction and plot a new course of action will not be covered by litigation privilege if such action serves another prevailing purpose.

Ascertaining the proper law of an arbitration agreement

Enka Insaat Ve Sanayi AS v OOO Insurance Company Chubb **[2020] UKSC 38 (judgment available here)**

9 October 2020

- The Supreme Court has addressed the principles for ascertaining the proper law governing the scope and validity of an arbitration agreement, where the law applicable to the underlying contract containing the arbitration agreement is different to the law of the seat of arbitration.

- In 2012, the claimant agreed to provide services in relation to the construction of a power plant. There was a fire at the plant in 2016 and Chubb (the defendant insurer) claimed to have paid $400 million to the owner of the plant in damages. The insurer then commenced proceedings in the Moscow courts as subrogee against numerous contractors (including

the claimant) alleging that they were responsible for the fire. The claimant's contract contained an arbitration agreement providing for ICC arbitration in London, and so the claimant issued a claim for an injunction restraining Chubb from pursuing proceedings in Russia.

- At first instance, the claim was dismissed on the basis that the English Court was not the *forum conveniens*. However, the Court of Appeal allowed the claimant's appeal on the basis that *forum conveniens* considerations were irrelevant and it was the fact that the arbitration agreement was governed by English law that was important. Chubb appealed that decision.

- In contrast to the Court of Appeal's approach, the Supreme Court held that a choice of law for the main contract should generally be treated as a choice of law for the arbitration agreement, but in the absence of a choice of law in the contract, the arbitration agreement should be governed by the law of the seat. As there was no choice of law in the main contract, the arbitration agreement was to be governed by the law of the seat. The Supreme Court did, however, agree with the Court of Appeal that *forum conveniens* is not a relevant consideration in these circumstances.

PH*lit* comment:

Although experienced commercial draftsmen will rarely neglect to consider the importance of a governing law clause in a contract, it is unusual to find separate consideration being given to the question of whether it is desirable to have the same governing law for the arbitration agreement contained within the contract. The issue of the governing law of an arbitration agreement has long been a topic on which commentators, practitioners and the courts have been divided. Accordingly, this decision from the Supreme Court is likely to be a landmark decision in this area and, it is hoped, will provide the desired clarity. However, the fact that the decision was made on a 3-2 majority basis indicates that there remains scope for debate amongst arbitration professionals.

Application of a Material Adverse Effect clause to changes in company finances arising out of COVID-19 pandemic

***Travelport & Ors v WEX, Inc.* [2020] EWHC 2670 (Comm) (judgment available here)**

12 October 2020

- The dispute concerned the issue of whether or not the occurrence of the global COVID-19 pandemic engaged the material adverse effect ("**MAE**") provisions in a share purchase agreement ("**SPA**") and whether the purchaser under the SPA was therefore entitled to refuse to close the transaction. The significance of MAE clauses in the wake of the COVID-19 pandemic has been much discussed, but as such clauses are rarely deployed by parties (and even less frequently opined upon by the courts), the scope of their use has been speculative only.

- The SPA was entered into in January 2020. It set out various conditions precedent to the purchaser's obligation to close the transaction. These included a MAE clause. The effect of the clause was that the purchaser could invoke the MAE clause if conditions resulting from the pandemic caused a disproportionate effect on either the target companies or (if applicable) their group, taken as a whole, compared to other participants in the same industry. The purchaser asserted MAE and refused to close the transaction. The selling shareholders brought proceedings against the purchaser seeking a declaration that no MAE had occurred.

- The case would ultimately turn on which *"industry"* the target companies operated in, as this would determine whether they were disproportionately impacted by the pandemic for the purposes of the MAE clause. The selling shareholders argued that the relevant industry was the *"travel payments industry"* but the purchaser argued that there is no such industry and the relevant industry is the *"payments industry"* more broadly.

- As there is a dearth of relevant English authority on the operation of MAE clauses, the High Court considered the more developed body of US decisions. These judgments, although not binding or formally persuasive, provided valuable thinking and, in particular, highlighted the importance of establishing where the risk is intended to sit in any M&A transaction. The judge considered that the purpose of the transaction was not just the purchase of a travel payments business - the acquisition carried with it future value in other markets.

- Ultimately, the High Court held that *"industry"* is a broad term and the selling shareholders could have chosen to use a much narrower term (such as *"markets"*, *"sectors"* or *"competitors"*) for the purposes of the MAE clause. Consequently, the operation of the MAE clause should be assessed in the context of the broader payments industry, rather than the narrower travel payments industry.

PH*lit* comment:

This decision highlights the importance of determining your reference point against which to measure the effect or change under your MAE clause. The particular words chosen will be strictly adhered to, and it is important to test their meanings, ambiguities and application before the contract is agreed.

For more information on this case and its implications see the detailed case update from our Corporate team here.

Supreme Court considers the correct approach to the three-stage "Patel v Mirza" test for the illegality defence

***Stoffel & Co v Grondona* [2020] UKSC 42 (judgment available here)**

30 October 2020

- The Supreme Court has considered the correct approach to the application of the three-stage test for illegality laid down in *Patel v Mirza* [2016] UKSC 42.

- The *Patel* test requires the Court to consider whether allowing a claim that is some way tainted in illegality would be contrary to public interest, and harmful to the integrity of the legal system, by reference to three stages. These are: (i) considering the underlying purpose of the prohibition which has been transgressed and whether it would be enhanced by denial of the claim; (ii) considering any countervailing public policies which may be rendered ineffective or less effective by allowing the claim; and (iii) applying the law with a due sense of proportionality. Since the decision in *Patel*, questions have arisen in the lower courts as to the correct way to apply the test and the present case has presented the Supreme Court with its first opportunity to provide useful clarification.

- The facts of this case are simple. Ms Grondona obtained mortgage finance from Birmingham Midshires to purchase a leasehold. The mortgage advance was procured by fraud. A solicitors firm, Stoffel & Co, acted for Ms Grondona and for Birmingham Midshires in the transaction. Stoffel & Co failed to register the sale at the Land Registry and failed to

register the new charge in favour of Birmingham Midshires. Stoffel & Co admitted negligence, but argued that Ms Grondona's claim should be barred due to mortgage fraud.

- The Court of Appeal applied the three-stage test set out in *Patel* and concluded that barring the claim against the negligent solicitors would be disproportionate and would not enhance the fight against mortgage fraud. In addition, there was a countervailing public policy of ensuring that civil redress was available to clients of negligent solicitors. Stoffel & Co was granted permission to appeal to the Supreme Court on the basis that the Court of Appeal had erred in its application of the *Patel* test.

- The Supreme Court held that it will not be necessary in every case to complete an exhaustive examination of all stages of the test. If a clear conclusion emerges that the defence should not be allowed on examination of the relevant policy considerations at stages (i) and (ii), there will be no need to go on to consider proportionality under stage (iii). In addition, assessment of the relevant policy considerations should not give rise to a mini-trial: they should usually be capable of being addressed as a matter of argument and at a level of generality that does not make adducing evidence on the point necessary.

- In the present case the Court considered that the public policy considerations in permitting Ms Grondona's claim outweighed the public policy considerations for denying the claim and, as such, there was no need to consider proportionality under stage (iii) of the test. However, if they were to consider proportionality under stage (iii), the Court would be persuaded by the fact that the lack of centrality of the mortgage fraud to Ms Grondona's case against Stoffel & Co would mean that it would be disproportionate to deny her a remedy: Stoffel & Co's negligence was conceptually entirely separate from the fraud.

PH*lit* comment:

This decision will provide much needed clarity to the lower courts on the application of the three-stage illegality test, including how the parties should present their arguments around "policy considerations" under stages (i) and (ii) of the test. This will also be welcome news for practitioners looking to run an illegality argument.

For more information on this case and its implications see our detailed case update here.

Supreme Court considers precedential value of pre "Patel v Mirza" case law

***Henderson v Dorset Healthcare University NHS Foundation Trust* [2020] UKSC 43 (judgment available here)**

30 October 2020

- The Supreme Court has also considered the precedential value of authorities which pre-date the three-stage illegality test laid down in *Patel v Mirza* [2016] UKSC 42. Since *Patel* was decided, one of the more difficult questions for the lower courts when applying the test has been whether to apply the test in isolation, or whether to continue to consider and apply the factually analogous authorities which pre-date it.

- In the present case, Ms Henderson stabbed her mother to death whilst experiencing a severe psychotic episode and was convicted of manslaughter by reason of diminished responsibility. Dorset Healthcare University NHS Foundation Trust (the "**Trust**") admitted liability in negligence for failing to return Ms Henderson to hospital earlier. Ms Henderson sought damages from the Trust for this failing and the Trust sought to rely on the doctrine of illegality to bar Ms Henderson's claim.

- Both the High Court and the Court of Appeal considered themselves bound by the House of Lords decision in *Gray v Thames Trains Ltd* [2009] AC 1339 which was materially identical on the facts. The question for the Supreme Court was whether *Gray* should be departed from in light of the new three-stage test set out in *Patel*.

- The Supreme Court held that the three-stage test set out in *Patel* does not represent *"year zero"* for illegality cases. Prior decisions remain of precedential value unless it can be shown that they are not compatible with *Patel* in the sense that they cannot stand with the reasoning in *Patel*. In this case, the application of the three-stage *Patel* test did not lead to a different outcome than the application of *Gray* and, accordingly, the Supreme Court affirmed that the decision in *Gray* was *"Patel compliant"*.

PH*lit* comment:

This decision should not come as a surprise to practitioners, given that this is generally the way the common law operates. However, the approach in Patel was a sufficiently radical departure from prior authority on the illegality defence that the continuing applicability of previous authorities had been questioned by some. It is now clear that unless a prior decision cannot be reconciled with the approach in Patel, it remains good law and applicable to any analogous factual scenario.

For more information on this case and its implications see our detailed case update here.

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Our London litigators understand the business implications of litigation and are trusted by clients to counsel them through their most complex and significant disputes. Please do not hesitate to contact any of the following Paul Hastings' London litigators:

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