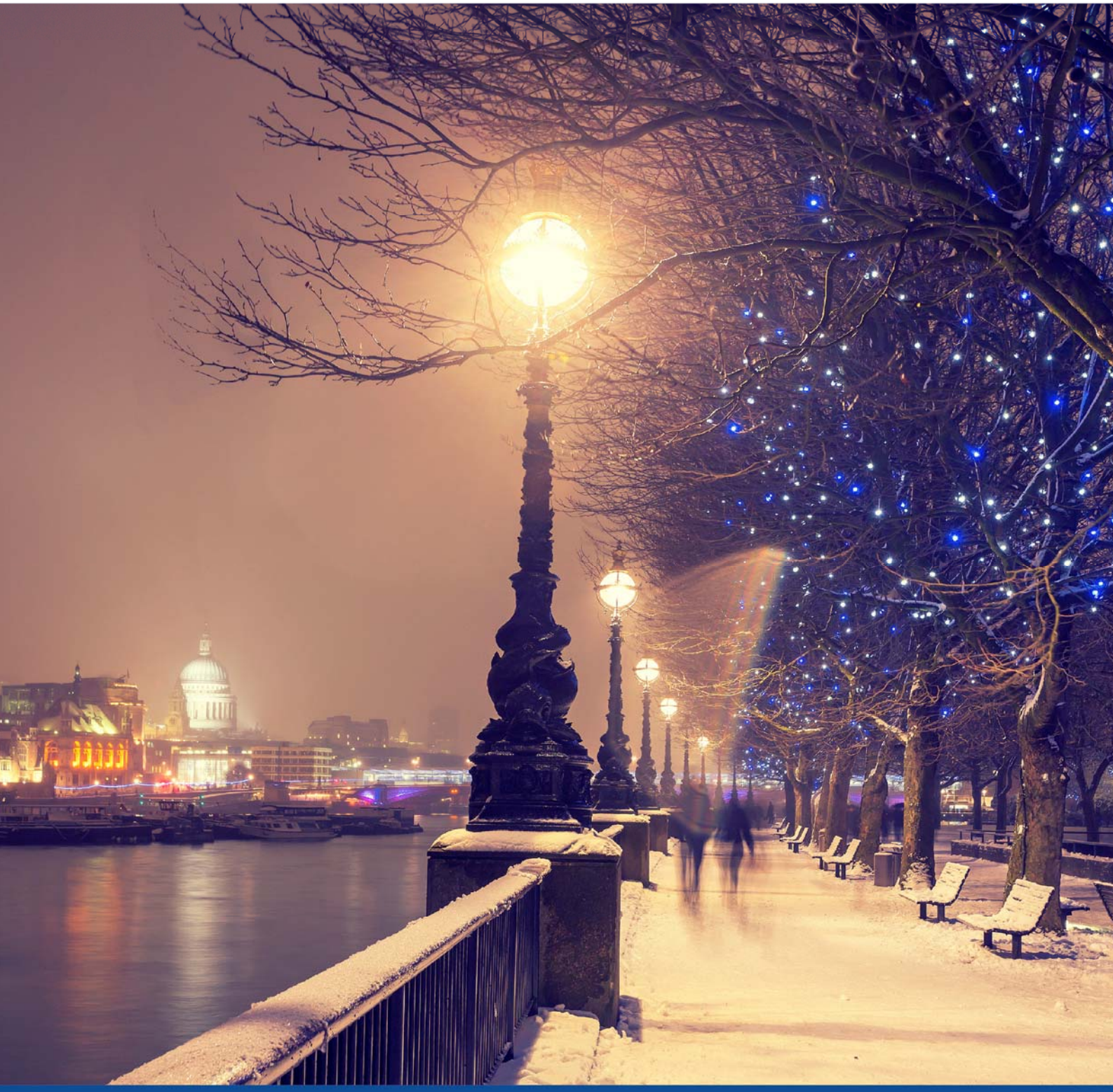
THE ARBITER

International Disputes Newsletter



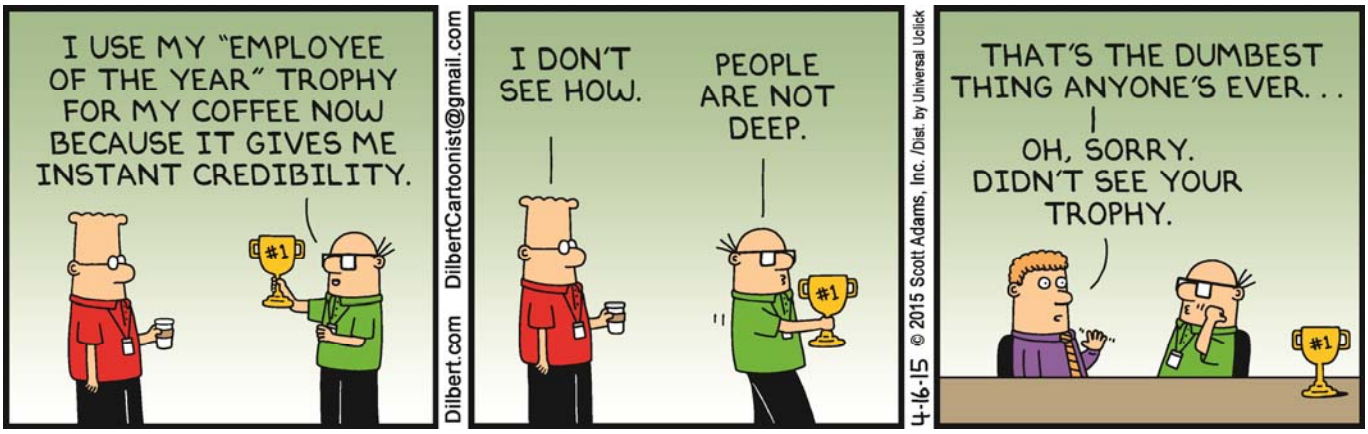
Winter 2015

Editor: Melanie Willems

ANDREWS KURTH

THE ARBITER
International Disputes Newsletter

IN THIS ISSUE



Pathetically pathological—a stumble through the maze of defective dispute resolution clauses?

by Melanie Willems

Arbitration is intended to be a more efficient and commercial alternative to litigating in the courts. As we all know, arbitration is strictly consensual and contractual. The basic principle is that absent agreement, nobody can be compelled to arbitrate, so the arbitration clause is of fundamental importance. In this article, we look at some recent decisions illustrating how far the English Courts will go in helping parties who have signed up to a defective arbitration.

A reminder: what to address in your arbitration clause

In an ideal world, there is a fairly lengthy 'wish list' of procedural or administrative matters that the parties ought to address in their arbitration clause. There are also a number of legal systems (or 'applicable laws') that come into play - and it is here that difficulties can arise. The following may serve as a reminder:

Key procedural matter	**Options for the parties**
What kind of disputes should be referred to arbitration?	It generally makes most sense to provide that each and every dispute that relates to the contract, or which arises out of or in connection with the contract, should be referred to arbitration (so including claims in tort, equitable claims and claims about the validity or termination of the contract). English law strives to construe arbitration clauses generously - they cast a very wide net over the types of dispute that may arise.
Should an arbitral institution administer the proceedings?	Institutions such as the ICC or the LCIA provide administrative support, and publish their own set of (tried and tested) procedural rules for any arbitration proceedings under their auspices. They can also assist with appointing arbitrators. The involvement of institutions is not, however, compulsory or necessary. Whether you should use one will depend on each case - check with your arbitration lawyer.
How many arbitrators?	A tribunal usually consists of either one or three arbitrators. Some institutional rules have a preference in favour of one or the other. The ideal size of the tribunal (or whether to leave this point open in the contract) is something that is best considered in each particular case.
What should be the language of the arbitration proceedings?	The parties have complete freedom of choice in this regard.
Where should the arbitration hearings take place?	Again, the parties have complete freedom of choice, but they need to choose their words carefully. References to a 'venue' or a 'place' of the arbitration may be taken to amount to a choice of the juridical seat, not just the physical location of the hearing.
Should there be any right of appeal from the tribunal's decision?	Arbitration awards are meant to be final and binding, but some seats provide for a (usually limited) right to appeal. If this is not desired, it needs to be expressly excluded. The appeal on a point of law under Section 69 of the English Arbitration Act 1996 is an example of a right that can be excluded by the parties contractually. Note that by adopting the rules of arbitration of a major institution such as the ICC and the LCIA, rights of recourse against an award are likely to be limited to matters that the parties cannot exclude as a matter of law, such as serious procedural irregularities, bias on the part of the tribunal or lack of due process.

Choices implicating a jurisdiction or an	Options for the parties
What is the seat of the arbitration?	The choice of the seat of the arbitration brings with it the supervisory jurisdiction of the local courts in that jurisdiction, applying their own local laws governing arbitration proceedings. Those courts, and the local laws, are likely to be the first, or perhaps the exclusive, port of call for key matters such as: • Granting interim, provisional or supportive measures that require the backing of the judicial, or state, enforcement mechanism with contempt of court as the ultimate sanction (such as effective freezing injunctions or orders compelling the attendance of witnesses). Welcome court support can sometimes turn into unwelcome court intervention, so the seat should be chosen carefully. • Rules safeguarding due process of the arbitration proceedings, including standards of impartiality and fairness required of arbitrators, and the mechanism for challenges to, and removal or disqualification, of arbitrators. • Enforcing the arbitration agreement, including the application of any specific formal requirements (i.e. does the arbitration agreement have to be in a particular form in writing?). The courts of the seat may also assist in restraining tactical, or troublesome, litigation that is commenced in breach of the arbitration in another jurisdiction. The parties should investigate whether effective injunctive relief is available from the courts in this regard. • Challenging or enforcing the award. The courts of the seat should have the final word in determining any challenges to the award (or purported appeals). They may also be asked to enforce the award.
	• Whether the subject matter of any particular dispute is legally capably of being referred to arbitration. This is called 'arbitrability', and it can give rise to unforeseen complications. By way of example, the national arbitration laws of some jurisdictions may exclude disputes over natural resources or other interests deemed to be of national strategic importance from the jurisdiction of any arbitral tribunal.
What is the governing law of the arbitration clause?	The arbitration clause itself is generally understood to be self-standing and separate from the underlying contract. It therefore has its own governing law, which may well differ from the law governing the main agreement between the parties. Issues relating to the substantive validity, scope and meaning of the arbitration agreement (including issues as to the scope of the tribunal's jurisdiction) are governed by the proper law of the arbitration agreement. Many arbitration clauses omit to specify this governing law, and so it falls to the courts of the seat or the arbitral tribunal to determine this. For example, the English Court of Appeal has said that absent an express choice governing the arbitration clause, the court will look to see whether there has been an implied choice. They will consider the closest and most real connection between the arbitration clause and any applicable law (*Sulamerica CIA Nacional de Seguros SA v Enesa Engenharia* SA [2012] EWCA Civ 638). Applying that test can lead to the arbitration agreement being governed by the law of the seat, and not the law of the underlying contract.
What is the governing law of the contract?	The governing law of the contract will determine the substantive rights and obligations of the parties, and will be applied to decide the claims on the merits. Again, the parties have freedom of choice, but it is a choice that should not be made lightly. The governing law can have a very real impact on the outcome of any dispute.

How not to draft your dispute resolution clause

In early November 2015, in *Exmek Pharmaceuticals SAC v Alkem Laboratories Ltd* [2015] EWHC 3158, the Commercial Court had to consider the following dispute resolution provision in a distribution agreement:

> "*Article 13: PROPER LAW*
>
> *The proper law of this Agreement is the law of the UK, and the Parties submit to the exclusive jurisdiction of the Courts of the UK and of all Courts having jurisdiction in appeal from the Courts of the UK.*
>
> *Article 14: ARBITRATION*
>
> *All disputes and differences whatsoever which will at any time hereafter arise between the parties in relation to this Agreement which the Parties using their best endeavors in good faith cannot resolve shall be referred to arbitration before any legal proceedings are initiated. The arbitration shall be conducted in the UK in accordance with the provisions of the law in the UK in effect at the time of the arbitration and shall be conducted by one or more arbitrators appointed there under.*"

This is a terrible clause. It provides for two things (exclusive jurisdiction of the courts and arbitration) that are inconsistent and directly contradictory. The decision in *Exmek* is, however, the latest in a fairly long line of authorities where judges have had to wrestle with such provisions.

Burton J concluded that there was an effective arbitration agreement. Pausing here briefly, the general principles of contractual interpretation under English law will also apply to arbitration clauses (or mangled dispute resolution provisions). In summary, the contractual wording will be given the meaning it would have, objectively, to a reasonable person. If one particular reading of the words is more commercially sensible, then that meaning will be adopted. In the context of arbitration clauses, an additional principle comes into play. It militates in favour of upholding even badly drafted arbitration clauses. In *Fiona Trust & Holding Corp v Privalov* [2007] UKHL 40, the House of Lords said:

> "*In my opinion the construction of an arbitration clause should start from the assumption that the parties, as rational businessmen, are likely to have intended any dispute arising out of the relationship into which they have entered or purported to enter to be decided by the same tribunal. The clause should be construed in accordance with this presumption unless the language makes it clear that certain questions were intended to be excluded from the arbitrator's jurisdiction. … if any businessman did want to exclude disputes about the validity of a contract, it would be comparatively easy to say so.*"

This illustrates the wider notion that English law prefers to construe contractual provisions so that they are valid, rather than striking them down.

Saving the parties from their own drafting

Just how far the Commercial Court goes in interpreting the contractual wording in applying these principles can be seen from the following comparisons.

	What the defective clause said	What it really meant
What is the governing law?	"*… the law of the UK …*"	The law of England and Wales (with apologies to Scotland and Northern Ireland).
Which courts have jurisdiction?	"*… the exclusive jurisdiction of the Courts of the UK and of all Courts having jurisdiction in appeal from the Courts of the UK …*"	The Courts of England and Wales did not really have exclusive jurisdiction. The Courts of Scotland and Northern Ireland did not have any jurisdiction.
Over what do these courts have jurisdiction?	"*… exclusive jurisdiction …*"	Such matters as the English Courts are entitled to determine under the Arbitration Act 1996, in support of arbitration proceedings.
Do disputes have to be referred to arbitration?	"*All disputes and differences whatsoever which will at any time hereafter arise … shall be referred to arbitration before any legal proceedings are initiated.*"	All disputes and differences must be referred to arbitration.
What is the seat of any arbitration?	"*The arbitration shall be conducted in the UK …*"	London (with apologies to the rest of the United Kingdom).
Is the arbitration final and binding?	Nothing, beyond suggesting that there might be more 'legal proceedings' to come after a reference to arbitration.	Definitely final and binding, because that is what Section 58(1) of the Arbitration Act 1996 says.

Burton J's decision in *Exmek* is the latest example of the English Courts striving to give effect to arbitration clauses, and construing any references to the courts having jurisdiction as being limited to

the supervisory powers given to the court in support of arbitration proceedings under the Arbitration Act 1996 (other decisions include *Axa Re v Ace Global Markets Ltd* [2006] EWHC 216 and *Paul Smith v H&S International Holding Inc* [1991] 2 Lloyd's Law Rep).

Arbitration tends to win out where it makes an appearance in the contract, even in the face of references to the jurisdiction, or exclusive jurisdiction, of the Courts elsewhere. No doubt there is legal policy at play here, for it is difficult to justify how such inconsistent clauses can be construed harmoniously by reference to the established principles of contractual interpretation (of which 'rewriting the clause so that it makes sense' is not one).

If certain courts are given exclusive jurisdiction, then it is a leap to say that this exclusivity is meant to apply only to a very limited aspect of what would ordinarily fall within the purview of the courts - be it the supervisory functions in support of arbitral proceedings, or (perhaps even more artificially) only those disputes that arise under the particular provision in which the parties made reference to the courts.

The latter situation arose *in Shell International Petroleum Co Ltd v Coral Oil Co Ltd* [1999] 1 Lloyd's Law Rep 72. The pathological clause in that case stated:

> "*13. Applicable law*
>
> *This Agreement, its interpretation and the relationship of the parties hereto shall be governed and construed in accordance with English law and any dispute under this provision shall be referred to the jurisdiction of the English Courts.*"

There are no prizes for guessing that Clause 14 went on to state that every dispute had to be submitted to arbitration. The way in which the court construed these two provisions harmoniously was to say that the English Courts had jurisdiction over all disputes concerning the applicable law. On that basis, if a party to this contract wanted to make a hopeless argument that any law other than that of England and Wales applied to anything regarding this contract, they had to go to the Commercial Court to be told 'no'. On this reading of the contract, arbitrators appointed under Clause 14 faced with the same untenable suggestion in an arbitration would have to decline to say 'no', and ask the parties to have the Court decide the point. It just seems implausible that any commercial party would have agreed to this arrangement. One may (perhaps safely) speculate that what really happened is that the parties stopped paying close attention to the contract when they reached Clause 13, and that, consequently, a mistake was made in what is still considered to be a 'boilerplate' clause.

A contrasting approach

Cases resolving conflicts between the courts and arbitration may be in a special category. This seems apparent when considering a recent, contrasting, example of the English Courts construing an arbitration clause that was internally inconsistent. The problem in that clause was that the objective reader did not know which kind of arbitration the parties had wanted, rather than the parties saying that they wanted 'court and arbitration' to apply.

In *Shagang South-Asia (Hong Kong) Trading Co Ltd v Daewoo Logistics* [2015] EWHC 194, the Commercial Court set aside an arbitration award because the arbitrator had been appointed in the wrong seat. The decision illustrates that while the Courts will strive to uphold an unclear arbitration clause, they are less likely to step in and help a party who has embarked on the 'wrong kind' of arbitration proceedings under an ambiguous clause.

The arbitral seat is the juridical base of the arbitration. By selecting a given state as the seat of arbitration, the parties place their arbitral process within the framework of that state's national laws. The law of the seat (*lex arbitri,* or curial law) will define many of the procedural aspects of the arbitration. Although the seat is frequently the same as the hearing location, it does not have to be.

Shagang was a dispute concerning a cargo of steel that had been shipped out of China. The cargo was not discharged at the port of destination. The party who was meant to have received the steel incurred substantial costs. A settlement was reached, and the owners of the vessel sought to pass the loss on to the charterers.

The two key clauses of the fixture note for the charterparty (usually a short document) provided:

> "*23. ARBITRATION: ARBITRATION TO BE HELD IN HONG KONG. ENGLISH LAW TO BE APPLIED.*
>
> *24. OTHER TERMS/CONDITIONS AND CHARTER PARTY DETAILS BASE ON GENCON 1994 CHARTER PARTY.*"

The Gencon 1994 form consisted of numbered boxes to be filled in. One such box was intended to deal with the arbitration clause for the charterparty in more detail than one would usually find on the fixture note. It listed out a number of sub-clauses of Clause 19, which all set out different arbitration proceedings. One of the provision was Clause 19 (a), which provided as follows:

> "*This Charter Party shall be governed by and construed in accordance with English law and any dispute arising out of this Charter Party shall be referred to arbitration in London in accordance with the Arbitration Acts 1950 and 1979 or any statutory modification or re-enactment thereof for the time being in force …*"

However, Gencon 1994 also said that Clause 19(a) would apply if the parties did not choose any of these options, which they had not done. The claimants commenced arbitration proceedings in London, and purported to appoint a sole arbitrator under Clause 19(a).

If one were to take the holistic approach, and sought to construe the provision harmoniously, one might say that Clause 23 ("*Arbitration held in Hong Kong*") meant the place where the hear-

ings were to take place. The expression 'holding a hearing' does not sound particularly odd. It could well be what the parties meant here. One might then go on to say that Clause 19(a) ought to have some meaning as well, as the parties do not lightly include superfluous words (or even entire redundant clauses) in their contracts. This provision also states that it was to apply 'by default', which points towards it being automatically effective. The reference to the precursors of the Arbitration Act 1996 suggests that this clause was intended to choose London as the seat. This would produce a harmonious result, with English law governing both substance and procedure of the arbitration.

That is not how the Court read the clause. Instead, Hamblen J focused on Clause 23, noting that it had two limbs, the first stating where the arbitration was "*to be held*", and the second what law was "*to be applied*". Even though the parties had not made reference to the 'place' of the arbitration (which is usually taken to mean the seat), the link they had made between the arbitration and Hong Kong was sufficient to bring with it the choice of Hong Kong law as the law of the seat. As the judge explained at paragraphs 19 to 22:

> "*It is logical and sensible for a dispute resolution clause to address both the issue of where and how disputes are to be resolved and the law governing such resolution and such clauses commonly do so. Agreeing that an arbitration is "to be held" in a particular country suggests that all aspects of the arbitration process are to take place there. That would include any supervisory court proceedings which might be required in relation to that process. Agreeing that a law is "to be applied" to disputes between parties is a common means of expressing a choice of substantive law, a choice that is frequently made express.*"

What of Clause 19(a)? The judge found that since the parties had adopted Hong Kong as the seat, Clause 19(a) could have no application as it was simply inconsistent.

While a governing is usually chosen expressly, the parties frequently do not say anything about which curial law (the law of the seat) they have chosen. References to 'holding' an arbitration somewhere, or it 'taking place' may well be taken to amount to a choice of seat. In particular, referring to the 'venue' for an arbitration is particularly likely to mean the seat. In *Enercon GmbH v Enercon (India) Ltd* [2012] 1 Lloyds Rep. 519, the parties had agreed that:

> "*The venue of the arbitration proceedings shall be London. The provisions of the Indian Arbitration and Conciliation Act, 1996 shall apply.*"

Applying the Indian Arbitration Act is inconsistent with the seat of the arbitration being in London (which leads to the English Arbitration Act applying). Nonetheless, Eder J found that the word 'venue' settled the question in favour of London as the seat, and so overrode an express reference to Indian legislation. The majority of the provisions of the Indian Arbitration Act would, however, only apply if the seat of the arbitration was India, so there seems to have been little point in making a reference to the whole statute unless it was meant to apply. In this particular case, one may wonder whether London as the seat did not benefit from a home advantage in the Commercial Court.

Conclusion

Badly drafted dispute resolution clauses still abound. The number of cases decided in the English Courts is testament to that. These decisions also show that where the Courts and arbitration clash in conflicting clauses, arbitration is likely to prevail. That bias is likely to reflect policy considerations, as the English Courts are strong supporters of arbitration. In some of the decisions, however, that support has led to the principles of contractual interpretation apparently being thrown overboard. The final word is, as always, pay close attention to your arbitration, and watch out for inconsistencies that will test the sanity of your lawyers creeping in.

Excluding consequential loss—does it matter if you've been naughty or nice?

by Markus Esly

Attempts to exclude or limit liability for consequential loss have given rise to considerable litigation, across industries. As two recent decisions in the energy sector have illustrated, adopting apparently wide-ranging and legalistic phraseology in such clauses may not have the desired result for the party seeking to limit its exposure.

It remains paramount to say clearly and precisely in the contract what losses are excluded. While English contract law generally allows the parties great freedom to allocate risk and liabilities, exclusion and limitation clauses are construed narrowly such that a more balanced, fairer result might be achieved.

In this article, we revisit the basic principles governing damages for breach of contract and liability for financial loss in particular, before reviewing *Transocean v Providence* (2014), a dispute under a contract for the hire of a drilling rig, and *Scottish Power v BP Exploration Operating Company* (2015), a case arising under a gas sales agreement relating to the Andrew Field in the North Sea.

A case of two limbs

When reviewing damages for breach of contract, one usually starts about 160 years ago with the famous decision in *Hadley v Baxendale* [1854] EWHC Exch J70. The general rule is that damages are meant to compensate the innocent party for the bargain it lost, by putting it into the position it would have been if the contract had been performed. Damages for breach of contract can be awarded for any loss that falls within the contemplation of the parties. *Hadley v Baxendale* has divided recoverable losses into two categories, or limbs: direct and indirect loss.

Direct losses

As a matter of law, all losses that occur as a direct, ordinary or natural consequence of the breach - or, to put it differently, which arise in the usual course of things - are deemed to be reasonably foreseeable, and within the contemplation of the parties. That means the parties are objectively taken to have foreseen that particular loss at the time of entering into the contract, whether or not they actually did. These 'direct losses' are often referred to as coming within the first limb of the rule in *Hadley v Baxendale*, and they generally have to be 'not unlikely' (and hence reasonably foreseeable) to be recoverable (see *Koufos v C Czarnikow Ltd (The Heron II)* [1969] 1 AC 350).

Special or indirect losses

But there may be other, more unusual and generally more extensive, losses that do not fall within the first limb, but for which damages are nevertheless recoverable because these losses are foreseeable in the particular circumstances of the case, and hence not 'too remote'. That, however, requires that the special circumstances which give rise to these losses were in fact brought within the contemplation of the parties, for instance by having been communicated, or otherwise become apparent, at the time of contracting.

The example that is often used to illustrate this 'second limb' of *Hadley v Baxendale* is found in *Victoria Laundry (Windsor) v Newman Industries* [1949] 2 K.B. 528. The defendant seriously delayed delivery of a new boiler for the claimant's laundry business. As a result, the claimant lost considerable business, including an especially lucrative Government contract. The Court of Appeal held that the loss of profit under the Government contract was not recoverable. The defendant had neither been told about this deal, nor could he reasonably have expected to have known about it, when signing the agreement. The other party has to be made aware of any special circumstances at the time of entering into the contract. That is the temporal cut off point (as reaffirmed, for instance, by the House of Lords in *Jackson v Royal Bank of Scotland* [2005] UKHL 3). So, things would have been different if Victoria Laundry had said 'You do realise we might lose the deal of the century if you are very late with this boiler' when signing the agreement - but not if they had only remembered to mention the profitable contract the following week.

Economic or financial loss can be within either limb

Economic or financial loss is often equated with the notion of 'consequential loss'. Over the years, there have been a number of decisions, including by the Court of Appeal, which have held that under English law 'consequential loss' however means 'indirect loss' falling within the second limb of *Hadley v Baxendale* (see for instance *Croudace Construction v Cawoods* 8 BLR 20, and *British Sugar Plc v Nei Power Projects Ltd* [1997] EWCA Civ 2438). Referring to 'consequential loss' in an exclusion clause does not, therefore, shed any light on what kind of economic or financial loss, or loss of profit or revenue, has been excluded. All these types of monetary losses can either be direct, or indirect ('consequential'). Taking the *Victoria Laundry* case as an example, damages would be recoverable for all loss of profit that would follow in the ordinary course of business, by the laundry not being able to serve customers without the delayed boiler. Certainly, loss of profit that could have been earned as a result of the performance of the contract itself is likely to be direct loss (see *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [1997] EWCA Civ 1822).

The decision in *McCain Foods (GB) Ltd v Eco-Tec (Europe) Ltd* [2011] EWHC 66 further illustrates that liability for direct financial loss (within the first limb) can be significant. McCain operated a waste water treatment system, which produced biogas. It then bought a system from Eco-Tec that was meant to generate electricity from biogas. The system was, however, unfit for its purpose and could not be installed and commissioned. The contract excluded any liability for "*indirect, special, incidental and consequential damages*". Nonetheless, the Court found that McCain could recover for all of the following financial loss as a direct consequence of the breach:

- the cost of buying and installing a working replacement system to generate electricity from biogas;
- the cost of buying electricity instead of generating it from the time that the system should have been operational;
- loss of revenue from operating the system, in particular revenue that could have been earned by selling Certificates of Renewable Energy Production;
- the additional cost of employing contractors, site mangers and health and safety personnel while the system was being worked on; and
- the cost of personnel already employed whose time was taken up by the defects, the cost of expert analysis and testing, and the cost of additional equipment and further construction work purchased from Eco-Tec and others in an attempt to get the system to work.

All of this was found to be loss that resulted in the ordinary course from the failure to provide a working system.

A new consideration: the 'assumption of responsibility' for particular losses

The law as to what damages were recoverable for breach of contract had changed little since *Hadley v Baxendale* until 2008, when the House of Lords decided *Transfield Shipping Inc v Mercator Shipping Inc* [2008] UKHL 48. In *Transfield*, their Lordships considered the policy reasons behind the law on damages, identifying an assumption of responsibility (by the contracting parties) as the basis on which liability for losses of a particular kind was imposed. *Transfield* concerned the late redelivery of a vessel by the charterers to the owners. The owners were forced to renegotiate the subsequent charter, since the vessel could not be tendered on the agreed date. The market was exceptionally volatile during that period, and the renegotiations led to a much lower rate than had previously been agreed, based on the prevailing market price at that time (which seemed to have fallen by 20 per cent over a few days).

An arbitral tribunal found that all the losses incurred by the owners as a consequence of having to renegotiate the subsequent fixture had been reasonably foreseeable. The House of Lords, however, disagreed, and in so doing reformulated the test for remoteness. Lord Hoffman in particular stressed that damages are awarded not purely based on what losses a reasonable person could foresee, but only for those losses for which the contracting parties would have 'assumed responsibility' (reflecting the consensual nature of contracts). A significant factor in this case was the very widespread acceptance or practice in the shipping industry that charterers did not assume the full risk of the owner losing out on subsequent fixtures if they delayed redelivery: charterers instead only expected to pay the difference between their charter rate and the market rate (if any) during the period of delay. It followed that the entire loss arising under the less favourable follow-on fixture was not loss for which the charterers could be deemed to have assumed responsibility at the time of contracting.

Transfield Shipping gave rise to some debate, not least because the five Law Lords expressed themselves in different ways, and not all of them seemed to expressly endorse the 'assumption of responsibility' test. The Court of Appeal provided some guidance two years later, confirming that assumption of responsibility was now part of the law, in *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] EWCA Civ 7. Toulson LJ explained that while *Hadley v Baxendale* remained the standard rule:

> *"… Transfield Shipping [is] authority that there may be cases where the court, on examining the contract and the commercial background, decides that the standard approach would not reflect the expectation or intention reasonably to be imputed to the parties."*

This introduces a further element of judicial discretion into the recoverability of damages. Whether the parties may have contemplated a particular loss when they entered into the agreement is no longer the end of the matter: one may now also ask whether it is commercially reasonable that they should be taken to have 'accepted the risk'.

In *Transfield* itself, Lord Hope pointed out that a party to a contract who wishes to protect itself from a particular risk can always draw the other party's attention to it - thus bringing it within their contemplation. If the other party does not wish to assume responsibility for that risk, they can then ask for an appropriate exclusion. His Lordship noted that the charterer in *Transfield* could not be expected to assume responsibility for something they did not control, and knew nothing about, and for which he could not therefore quantify the exposure. It was not enough for the charterer "*… to know in general and on open-ended terms that there is likely to be a follow-on fixture*." On this approach, the owners could never have provided the relevant information at the time of entering into the original charter, because they too had no idea by how much they would lose out subsequently when the market fell and they had to accept a lower rate. This does seem to go against previous decisions to the effect that it was sufficient that the type of the loss was foreseeable, but not the extent of the loss (*Hill v Ashington Piggeries* [1969] 3 All ER 1496), the detail of it, or manner in which it came about (*Parsons (H) (Livestock) Ltd v Uttley, Ingham & Co Ltd* [1978] QB 791).

Unlikely loss may be recoverable if preventing it falls within a contractual duty

One way of explaining *Transfield* is to treat it as being concerned with an exceptionally large loss, caused by the highly volatile and unpredictable market at the time, that was simply unforeseeable by either owner or charter and could never have been brought within the contemplation of the parties. However, subsequent decisions have shown that *Transfield* did introduce a new legal principle, and was not just limited to its particular facts. In *Supershield v Siemens,* applying the 'assumption of responsibility' test had the opposite result and led to a party being liable for damages for loss that was unforeseeable, or unlikely. The Court of Appeal held that:

> *"… logically the same principle may have an inclusionary effect. If, on the proper analysis of the contract against its commercial background, the loss was within the scope of the duty, it cannot be regarded as too remote, even if it would not have occurred in ordinary circumstances."*

The case concerned a flood in an office building caused by a sprinkler system. A ball valve and drains were both aimed at preventing such a flood. The evidence showed that this was an unlikely, possibly unprecedented, failure of both these protection measures. The Court of Appeal noted that such unlikely loss would still be recoverable if it came within a contractual duty to prevent it from occurring. In complex projects, designers may well incorporate several redundant protection or 'failsafe' measures, but it

would be no excuse to say that the circumstances in which they all failed were unlikely - if it was the duty of the designers to protect against flooding, fire or the like. The Court of Appeal held that:

> "*If … the unlikely happens, it should be no answer for one of them to say that the occurrence was unlikely, when it was that party's responsibility to see that it did not occur. … the reason for having a number of precautionary measures is for them to serve as a mutual back up, and it would be a perverse result if the greater the number of precautionary measures, the less the legal remedy available to the victim in the case of multiple failures.*"

Liability for economic or financial loss will also be assessed under the above principles. What is more, contractual provisions seeking to preclude or limit liability for any types of losses that are recoverable in principle will be treated as 'exclusion clauses', and they will be construed strictly, as can be seen from the two recent decisions in *Transocean v Providence and Scottish Power v BP Exploration Operating Company*.

Transocean Drilling UK Ltd v Providence Resources Plc [2014] EWHC 4260

The decision of the Commercial Court in *Transocean Drilling UK Ltd v Providence Resources Plc* [2014] EWHC 4260 (Comm) shows that contractors relying on apparently comprehensively drafted exclusion and limitation clauses in industry standard form contracts may nonetheless be in for an unwelcome surprise if they fail to perform to the contractual standard.

Transocean had agreed to provide a semi-submersible drilling rig, the 'Artic III' to Providence, under a drilling contract based on the LOGIC form. The Artic III was to drill an appraisal well in the Barryroe Field, located in the Celtic Sea south of Cork, Ireland. Transocean's remuneration provisions in the drilling contract provided for a daily operating rate of US$ 250,000, with slightly lower rates for waiting on instructions and repair (the latter being US$ 245,000 per day).

Drilling was delayed for 46 days, between 18 December 2011 and 2 February 2012, due to problems caused by the blow-out preventer ("**BOP**") stack. While the BOP problems prevented drilling, Providence incurred substantial marine spread costs - being the daily rates payable to all the other contractors providing support services for the drilling operations (Providence was responsible for well logging, testing, cementing, mud engineering and logging, geological services, casings, directional drilling, diving and ROVs). Providence's spread losses came to about US$ 10 million. Transocean commenced the litigation, claiming unpaid sums under the drilling including approximately US$ 7.6 million calculated based on day rates for the period of the delays. Providence resisted that claim, and counterclaimed for its spread losses.

Standing in Transocean's shoes at the outset of the proceedings, one might have felt fairly confident because (certainly at first blush) the LOGIC form appears to favour the drilling contractor. Transocean's first argument was that Providence had to pay the applicable day rates (based on the particular activity of the rig on any given day) irrespective of whether the BOP problems were Transocean's fault under the contract. It pointed to a number of specified rates (all close to US$ 250,000 per day) that were said to be payable even if the rig happened to be doing something that could be the result of Transocean's negligence - examples being the 'redrill rate' or the 'fishing rate' (which applies when some object has fallen into the well bore and has to be retrieved).

Counsel for Transocean argued that a risk allocation that was not fault-based made sense: failures affect drilling operations are often technically complex, and can require lengthy investigations to determine the cause of the failure, and whether any breaches of the drilling contractor's obligations or standards of performance might be involved. Transocean said that the simple allocation of risk provided for by its reading of the remuneration clause as a complete code gave everyone clarity and certainty: one could not expect expensive drilling operations to grind to a halt, with support services and third parties all having been mobilised, while the parties went off to the Commercial Court or an arbitral tribunal to find out who was to blame.

Mr Justice Popplewell disagreed. He referred to three principles or propositions of English contract law that could only be displaced by very clear words in the contract:

- firstly ,that a party to a contract should not be able to take advantage of, or benefit from, its own breach (found in *Alghussein Establishment v Eton College* [1988] 1 WLR 587);
- secondly, that exemption clauses which could be taken on their face to refer only to non-negligent breaches will be so construed, unless a very clear intention to extend their scope to negligence is apparent; and
- thirdly, that when construing a contract "*… one starts with the presumption that neither party intends to abandon any remedies for its breach arising by operation of law, and clear express words must be used in order to rebut this presumption.*" (*Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689).

Following on from the third principle, it is a fundamental right, recognised by the common law, that a buyer does not have to pay for defective, or deficient, goods and services - this is the venerable remedy of 'abatement' which ultimately allowed Providence to defeat Transocean's claim.

The judge also relied on a previous Court of Appeal decision, in *Sonat Offshore SA v Amerada Hess* [1998] 1 Lloyd's Rep 145, concerning another rig, which had suffered a fire due to lack of maintenance by the owner. The Court of Appeal held that that contract, too, did not amount to an agreement that 'something would be paid for nothing', and that an obligation to pay during a period when no services were performed would only be implied absent any other reasonable alternative. The manner in which

Parker LJ phrased the question in *Sonat* illustrates how English contract law approaches the issue:

"[*The main issue] is whether the company, having been deprived of all benefit from the rig for one month due to the negligence and breach of contract of the contractor, is nevertheless obliged to pay, during that period, the equipment breakdown rate without any right of reduction, set-off or counterclaim. Unless the terms of the agreement are such as to exclude such a right, the company is clearly not so obliged*."

It can be seen that it is the purchaser's right not to pay when no services are being performed, and it is that right that needs to be given up, or excluded. A clause merely referring to rates being payable in circumstances that might or might not involve a period without services or delays due to negligence may very well fall short of having that exclusionary effect. This is even more likely the result where the remuneration provision in question is expressed to be in return for the provision of services, rather than being expressed purely by reference to periods of time elapsed under the contract.

Popplewell J also expressly stated that a rig contract was no different from any other contract for goods and services. Drilling contractors or operators sometimes rely on the inherent risk in offshore exploration works, or the 'knock-for-knock' indemnities which provide that each party is responsible for loss of or damage to their own equipment and personnel, even though that may have been caused by the negligence of the other party, stating that these contracts are 'special'. They are not, and fall to be construed just like an ordinary agreement for the hire of a car:

> "*… hirers of a rig are no more likely than any other person who contracts for the provision of goods and services to agree to pay something for nothing, particularly if the failure to perform is due to the negligence or default of the payee .*"

One key provision that Transocean was relying on was the repair rate clause:

> "*3.9 Repair Rate $245,000*
>
> *Except as otherwise provided, the Repair Rate will apply in the event of any failure of [Transocean's] equipment (including without limitation, non-routine inspection, repair and replacement which results in shutdown of operations under this CONTRACT …*"

The judge found that the reference to the rate being payable regardless of "*any failure*" of Transocean's equipment did not mean that Providence had agreed to pay Transocean when the rig was not performing the required work because of a breach by Transocean. "*Any failure*" really meant 'a failure for which Transocean was not responsible under the contract'. Indeed, if Transocean were right, Transocean would have to be paid if it deliberately sabotaged the rig and then claimed the repair rate, and that, the judge found, simply could not have been intended.

The judge went on to find that the BOP problems had been caused by breaches of contract, on the part of Transocean, largely by reason of poor maintenance. At the time, Transocean had carried out an internal investigation into the causes of the relevant failures, on the understanding that Providence would be supplied with a copy of the resulting report. Unhappily for Transocean, initial drafts that identified lack of proper maintenance of BOP elements as the root cause were 'doctored', and any references to inadequate maintenance were removed, before Providence was given the report. Popplewell J noted that this amounted to deception which "*reflect[ed] no credit on Transocean's senior management*".

Was Providence's spread loss excluded by virtue of being 'Consequential Loss'?

Transocean's breach in turn entitled Providence to rely on abatement as a defence to Transocean's claim for payment. Of course, Providence also wanted to recover the US$ 10 million in spread costs that it had incurred. The obstacle to overcome in that endeavour was Clause 20, which excluded liability for 'Consequential Loss' (as defined) and provided for knock-for-knock indemnities as regards such losses affecting the property, equipment and so on of Providence and Transocean respectively.

Breaking the clause down into its constituent parts, the first limb of the definition of Consequential Loss referred to "*(i) any indirect or consequential loss or damages under English law*." This was a reference to the second limb in *Hadley Baxendale*, meaning losses that did not result in the ordinary course of things as a direct consequence of the breach, and which would only be recoverable if the special circumstances that gave rise to the relevant loss were within the contemplation of the parties. The parties were agreed that Providence's spread losses were direct losses, and hence not caught under this heading.

The next part of the definition of Consequential Loss sought to widen the concept to certain direct losses (under the first limb), and was so widely drafted that it might - on a cursory read - be thought to capture Providence's spread loss:

> "*(ii) to the extent not covered by (i) above, loss or deferment of production, loss of product, loss of use (including, without limitation, loss of use or the cost of use of property, equipment, materials and services including without limitation, those provided by contractors or subcontractors of every tier or by third parties), loss of business and business interruption, loss of revenue (which for the avoidance of doubt shall not include payments due to [Transocean] by way of remuneration under this CONTRACT), loss of profit or anticipated profit, loss and/or deferral of drilling rights and/or loss, restriction or forfeiture of licence, concession or field interests …*"

The above was the critical wording on which Transocean's case

rested. Once again, the Court applied the principle in *Gilbert-Ash*, that commercial parties (even those entering into a rig contract, with all the attendant risk and exposure) were unlikely to give up their basic rights at common law - and the right to recover damages for direct losses flowing from a breach of contract is such an entitlement.

The judge held that sub-paragraph (ii):

> *"must be construed in the context of it being a specifically defined incursion into the territory of the first limb of Hadley v Baxendale, and should therefore be approached by treating the enumerated types of loss as incremental incursions into that territory, construed narrowly to limit the scope to specific categories narrowly defined rather than a widespread redefinition of excluded loss."*

The fact that there was a mutual indemnity regime (knock-for-knock) in the contract did not displace that assumption, as the Court of Appeal had noted in *EE Caledonia Ltd v Orbit Valve Co Europe Plc* [1994] 1 WLR 1515.

Stacking the odds further against Transocean was the "*contra proferentem*" rule of contractual interpretation, which provides that exclusion clauses are to be interpreted narrowly and against the party seeking to rely on them.

Returning to the contract wording, eight different types of loss were enumerated in the clause:

(i) loss or deferment of production;
(ii) loss of product;
(iii) loss of use (including, without limitation, loss of use or the cost of use of property, equipment, materials and services including without limitation, those provided by contractors or subcontractors of every tier or by third parties);
(iv) loss of business and business interruption;
(v) loss of revenue;
(vi) loss of profit or anticipated profit;
(vii) loss/deferral of drilling rights; and
(viii) loss/restriction/forfeiture of licence, concession or field interests.

The Court found that all these types of loss were concerned with losing income or revenue that would have been generated but for the breach. Spread costs fall into a different category - as they are costs incurred for (usually) plant and equipment that is on hire, but cannot be 'used' effectively.

Transocean however argued that the spread costs claim was for 'loss of use of the property, equipment, materials and services provided by contractors, subcontractors and third parties', and so squarely within the excluded category of loss at item (iii) above. The judge did not accept that. He concluded that 'loss of use', when looked at together with its contractual neighbours (all concerned with loss of revenue), was more naturally to be read as "*… connoting the loss of expected profit or benefit to be derived from the use of property or equipment.*"

The Court further noted that:

> "*Cost of use … is an example given within the parenthesis of a loss of use. It covers the cost of hiring in equipment or services, or replacing property the benefit of which has been lost, in order to mitigate the loss of benefit. It has no application to the spread costs where the costs are for equipment and services which were provided. Providence did not lose the use of that equipment or those services, which remained available to it, which is why Providence incurred wasted expenditure in paying for them.*"

Finally, and picking up the thread running through the judgment, Popplewell J noted that if Transocean's reading were right, then the exclusion would cover each and every kind of loss that Providence might conceivably suffer. English law does not easily accept such a result in a commercial contract. As the House of Lords noted in *Suisse Atlantique Societe d'Armement Maritime SA v NV Rotterdamsche Kolen Centrale* [1967] 1 AC 361

> "*… the parties cannot, in a contract, have contemplated that the clause should have so wide an ambit as in effect to deprive one party's stipulations of all contractual force; to do so would be to reduce the contract to a mere declaration of intent.*"

Transocean lost because the judge felt that the drafting in the LOGIC form, whilst certainly effusive, was not actually wide enough to cover the spread cost. It is at least plausible, if not likely, that a contrary result was intended by the drafter, and that industry players had been operating on the assumption that such a result had been achieved. Not so.

Scottish Power UK Plc v BP Exploration Operating Company Ltd [2015] EWHC 2658

In late September 2015, the Commercial Court had a further opportunity to construe an exclusion clause concerned with consequential loss, in a long term gas sales agreement. Scottish Power had contracted to buy natural gas under a series of virtually identical agreements with the owners of the Andrew Field in the North Sea. The Andrew owners had shut down production for about three and half years, from May 2011 to December 2014. The shutdown was required to allow for works to tie in the Andrew facilities with the neighbouring Kinnoull Field. The Commercial Court found it was a breach of the gas sales agreement.

During the shutdown period, Scottish Power had continued to make daily nominations for quantities of gas (even though nothing would be delivered), and had gone into the market to purchase replacement gas, at a price greater than that which would have applied under the gas sales agreements with the Andrew owners. These agreements also provided for a particular contractual regime or remedy, whereby the Andrew owners were required to deliver an equivalent quantity of so-called Default Gas at a lower price,

once production and deliveries had resumed, to make up for the shortfall.

Scottish Power claimed damages based on the additional cost of having to buy replacement gas, whilst giving credit for the value of Default Gas that would be provided by the sellers under the contract.

Mr Justice Leggatt decided a number of preliminary issues, one being whether such a claim for damages would be excluded by Article 4.6 of the agreements, which provided:

> *"Save as expressly provided elsewhere in this Agreement, neither Party shall be liable to the other Party for any loss of use, profits, contracts, production or revenue or for business interruption howsoever caused and even where the same is caused by the negligence or breach of duty of the other Party."*

The Andrew owners claimed that this precluded a claim for the additional cost incurred in procuring replacement gas in the open market. Leggatt J gave this argument short shrift, describing it as an untenable contention. As in *Transocean*, he had in mind the principle in *Gilbert-Ash* - that parties do not easily give up the entitlement or remedy they have at law (though in the end found it unnecessary to even bring it into play). Damages for a failure to deliver in a contract for the sale of goods would in the ordinary course be assessed under the Sale of Goods Act 1979. Section 51 (2) provides that the measure of damages is "*the estimated loss directly and naturally resulting, in the ordinary course of events, from the seller's breach of contract*", while subsection (3) goes on to provide that if there is an available market, the loss is taken to be the difference between the contract price and the market price for the goods at the time the goods were meant to have been delivered.

Article 4.6 did not seek to draw a distinction between direct and indirect loss, and did not make reference to 'consequential loss'. Instead, it referred to types of loss. One may assume that the intention behind the clause was to exclude all losses that were of the relevant types listed out, regardless of whether they were direct, or indirect. The loss that Scottish Power sought to recover was certainly 'direct', as is apparent from the Sale of Goods Act, but was it of the requisite (excluded) type? The judgment gives a brief commentary on how these types were construed by the Court:

(i) Loss of profits concerns the situation where Scottish Power was unable to resell gas at a profit. Loss of revenue was similar.

(ii) Loss of contracts applied to any agreements that might be cancelled, or opportunities to enter into new agreements that Scottish Power lost, because it did not have the gas promised by the Andrew owners.

(iii) Loss of production referred to any inability to produce other products - such as electricity - because there was no gas from the Andrew Field, but it was not aimed at the gas that was sold itself. Business interruption was similar in nature.

(iv) Finally, loss of use was also concerned with a secondary loss, which might result from Scottish Power being unable to use the gas it had contracted for in its own business.

All these losses were of a kind that went beyond the basic measure, and were concerned with future benefits that could be earned if the contract had been performed (so indirect losses), not with the cost of replacing the very same goods that had been promised under the contract.

The Andrew owners however also raised another point, arguing that losses incurred in mitigating an excluded type of loss were themselves also excluded. Hence, since Scottish Power could not have claimed for losses relating to other contracts (such as loss of profits) that it intended to fulfill with the (more expensive) replacement gas, then (it was submitted) neither could Scottish Power claim for the additional cost of purchasing that replacement gas that was going to be used to perform those other contracts.

Leggatt J held that there was no principle of law that required a loss incurred in mitigating an excluded loss as also being (itself) excluded. He noted that if this argument worked, one would not find it very difficult to exclude a great many (direct) losses, because they would have been incurred in the attempt to mitigate other (indirect) losses. But this relationship of mitigation did not mean that a clause that was concerned with indirect losses could, as if by magic, also apply to direct losses.

The Andrew owners relied on a judgment by Rix J in *BHP Petroleum Ltd v British Steel plc* [1999] 2 All ER (Comm) 544, where he said that:

> *"… in many instances losses are claimed on the basis of mitigation; a greater loss of one kind is avoided by the incurring of a lesser loss of another kind in mitigation of the first. In my judgment, such mitigated loss must be regarded as though it was, for the purpose of [the exclusion clause in question] a loss of the kind sought to be avoided …"*

BHP v British Steel concerned a failed pipeline that had to be replaced. The contract provided that British Steel was not liable for "*loss of production*". Leggatt J explained that BHP had been allowed to recover the cost of replacing the pipeline itself (a direct loss, like Scottish Power's cost of replacing the gas), whilst it had been unable to recover certain additional costs in producing oil and gas that had resulted from the pipeline failure: that was 'loss of production', even though these costs may have been incurred in order to mitigate the loss, by (for example) restoring production sooner rather than later.

The Sole Remedies Clause

So far, so good for Scottish Power: the loss incurred in buying the more expensive replacement gas was not excluded. However, the gas sales agreement also included a 'sole remedy' provision that referred to the supply of Default Gas at the agreed, reduced

price as being the only redress for the buyer. Article 16.6, the key clause, stated:

> "*The delivery of Natural Gas at the Default Gas Price and the payment of the sums due in accordance with the provisions of Clause 16.4 shall be in full satisfaction and discharge of all rights, remedies and claims howsoever arising whether in contract or in tort or otherwise in law on the part of the Buyer against the Seller in respect of underdeliveries by the Seller under this Agreement, and save for the rights and remedies set out in Clauses 16.1 to 16.5 (inclusive) and any claims arising pursuant thereto, the Buyer shall have no right or remedy and shall not be entitled to make any claims in respect of any such underdelivery.*"

Leggatt J upheld that clause (widely drafted as it was) as excluding Scottish Power's claim for anything other than delivery of Default Gas at the agreed discount, since Scottish Power's claim was in 'respect of underdeliveries'. The gas sales agreement required Scottish Power to continue to make daily nominations even during the period of the shutdown, and any shortfall in deliveries against nominations were in effect 'underdeliveries' (and hence within Article 16.6). The judge found it did not matter that this clause could enable the Andrew field owners to breach the contract deliberately, by selling gas to someone other than Scottish Power at a higher price, and intentionally causing an underdelivery.

The judgment provides a neat reminder that an award of damages or compensation under English contract law is not concerned with punishing the contract-breaker for any fault or wrongdoing:

> "*It is a basic principle that the object of an award of damages for breach of contract is to compensate the claimant for loss sustained as a result of the defendant's breach and not to deprive the defendant of any gain. Moreover, this principle applies and the measure of damages is the same irrespective of whether the breach was deliberate, careless or entirely innocent. I see no reason to infer that the contractual remedy with which the remedy of damages is replaced by Article 16 was intended to operate differently.*"

One limit of Article 16, however, would have been a claim for damages for repudiatory breach (i.e. a serious breach that went to the root of the bargain between the parties). If the sellers deliberately decided to shut down the production facilities for good, or without any kind of commitment to resume production at some point in the future, that breach might entitle Scottish Power to terminate the contract by accepting the Andrew field owners' repudiatory breach. A sole remedies clause could not then save the sellers from a claim for damages based on the cost of obtaining all gas that should have been delivered over the remaining term of the contract, at the market price. But that was not the situation, as the Andrew field owners had no such intent.

Discussion

It has to be recalled that when it comes to the interpretation of contracts, each case will depend on the words used in the particular contract, interpreted in the usual way (so objectively and in the light of the factual background and the commercial purpose of the transaction). Strictly speaking, it is possible that expressions such as 'consequential loss', 'loss of use' or 'loss of production' might be given different interpretations where they appear in different agreements. In practice, however, this is unlikely: for one thing, decisions interpreting these particular expressions are often cited - as *Transocean* was cited in *Scottish Power*.

Following the decisions of Popplewell J and Leggatt J (and further authorities they both rely on in their judgments), one can identify certain points or approaches to construction which are likely to feature in subsequent cases dealing with similar clauses:

- High-value, complex agreements in the energy industry (be they rig hire or drilling contracts or long term gas sales agreements) are not exempt from basic principles of construction: no commercial party is easily presumed to have agreed to pay something for nothing, and basic rights and remedies at common law must be expressly excluded.
- The reported decisions suggest that expressions such as 'loss of use', 'cost of use' or 'loss of production' may well be taken to refer to indirect losses, within the second limb of *Hadley v Baxendale*, and, to the extent that a clause tries to make inroads into the recoverability of direct losses that fall within the first limb of *Hadley v Baxendale*, such a provision will be construed narrowly. This is illustrated by *Transocean v Providence*.
- It may serve parties well to consider abandoning some of these phrases often found in exclusion or limitation clauses, and say more plainly what they mean by reference to the particular transaction: if everyone agrees that the cost of keeping support services and logistics (including the marine spread) mobilised while a drilling is non-productive, then say precisely that in the contract.
- Although clear words are needed to exclude the ordinary remedies that the law provides, it is still necessary to keep a cool head and not be influenced by perceived 'bad behaviour' (or deliberate breaches) by any party. A contract breaker is generally free to make gains, provided that the innocent party is compensated for its (recoverable) losses.

In conclusion, if the allocation of risks or liabilities is really intended to favour one party in particular, then you need to be very careful to spell this out, and (ideally) explain why this has been agreed in the contractual wording. A judge or arbitrator, who comes to the agreement cold some years later, might otherwise apply the principles of construction discussed in this article to achieve a different, more balanced, result.

Winter is Coming: The Expanding Definition of Assets in Freezing Injunctions

by Ryan Deane

In the recent case of *JSC BTA Bank* v *Ablyazov* [2015] UKSC 64, the UK Supreme Court has given important guidance on the scope of the standard form of freezing order issued by the English courts.

Background

Muktar Ablyazov was once a member of the political elite in Kazakhstan and a protégé of its president, Nursultan Nazarbayev. In 1998 he was appointed to the coveted post of Minister of Energy, Industry and Trade. He used his position of influence to secure favourable business deals, including the acquisition of shares in Bank TuranAlem, which later came to be known as BTA Bank ("BTA").

In late 2001, Ablyazov broke ranks with Nazarbayev's ruling party, citing disenchantment with corruption in the president's inner circle. He co-founded an opposition movement, Democratic Choice of Kazakhstan, to challenge the Nazarbayev regime. It was not long before Ablyazov was arrested. The charge was 'abusing official powers as a minister'. Unsurprisingly, the arrest was deemed by Amnesty International and the European Parliament to be 'politically motivated'.

Ablyazov was convicted and sentenced to six years in prison, where he alleged that he was subjected to regular beatings and torture, but was released after only ten months on the condition that he renounce politics. On his release from prison, however, Ablyazov continued to fund independent media and political groups opposed to Nazarbayev. He used his new-found freedom to re-establish ties with BTA, and in 2005 became its chairman. He held this position until early 2009, when BTA executives accused him of illicitly transferring vast sums of money from the bank to companies beneficially owned by him. Kazakhstan's sovereign wealth fund, Samruk-Kazyna, subsequently injected significant funds into BTA and became the majority shareholder, effectively nationalising the bank. Ablyazov claimed that the allegations and the state's takeover of BTA were all part of Nazarbayev's plan to ruin him by any means possible.

Fearing being put on trial again in Kazakhstan, Ablyazov fled to England, where he had substantial assets, including a property in North London on The Bishop's Avenue (known as "Billionaire's Row"), and a 100 acre country estate in Surrey. In March 2009, BTA commenced proceedings in the English High Court to recover the assets Ablyazov had allegedly misappropriated. This marked the beginning of what one judge described as "extraordinary litigation on a huge scale", consisting of dozens of claims and counterclaims between Ablyazov and BTA.

One of the earliest applications made by BTA was for a worldwide freezing order ("WFO") over Mr Ablyazov's assets. BTA argued that there was a real risk that Ablyazov would dissipate his assets before any judgment in their favour could be enforced. Mr Justice Blair agreed with BTA and, in August 2009, ordered a WFO in the following terms:

> *"4. Until judgment or further order … the respondent must not, except with the prior written consent of the Bank's solicitors –*
>
> *a. Remove from England and Wales any of his assets which are in England and Wales … up to the value of £451,130,000 …*
>
> *b. In any way dispose of, deal with or diminish the value of any of his assets in England and Wales up to the value of … £451,130,000 …*
>
> *c. In any way dispose of, deal with or diminish the value of any of his assets outside England and Wales unless the total unencumbered value … of all his assets in England and Wales … exceeds £451,130,000 …*
>
> *5. Paragraph 4 applies to all the respondents' assets whether or not they are in their own name and whether they are solely or jointly owned and whether or not the respondent asserts a beneficial interest in them. For the purpose of this Order the respondents' assets include any asset which they have power, directly or indirectly, to dispose of, or deal with as if it were their own. The respondents are to be regarded as having such power if a third party holds or controls the assets in accordance with their direct or indirect instructions."*

The WFO contained a standard exception to these terms, namely that Ablyazov was permitted to spend a reasonable amount on legal representation and a fixed amount on "ordinary living expenses". It is some indication of Ablyazov's wealth that the court deemed his ordinary living expenses to be £10,000 per week.

Shortly after the WFO was issued, Ablyazov entered into two loan facility agreements with a BVI company called Wintrop Services Limited ("Wintrop") and a further two agreements, in materially the same terms, with another BVI company called Fitcherly Holdings Limited ("Fitcherly"), (collectively, "the Loan Agreements"). Each of the Loan Agreements provided for a facility of £10 million to be made available to Ablyazov. The terms of the Loan Agreements were highly favourable to Ablyazov: he was not required to provide security for the loans (which would be 'dealing' with his assets within the meaning of the WFO) and the lenders

were not entitled to demand repayment until four years after the commencement of the facility.

Ablyazov subsequently drew down the full amount of £40 million allowed by the Loan Agreements, directing that Wintrop and Fitcherly make the payments directly to various third parties. The majority of the money was used to fund Ablyazov's gargantuan legal bill. Payments were made to over ten leading counsel, more than 20 juniors and to 75 other lawyers from at least eight different firms. Over £10 million was paid to one firm of solicitors alone: Christmas had certainly come early. Smaller amounts (relatively speaking) were also used to pay various personal expenses, such as approximately £350,000 in connection with Ablyazov's property on The Bishop's Avenue.

In 2012, BTA brought proceedings in the High Court seeking a declaration that Ablyazov's rights under the Loan Agreements were "assets" within the meaning of the WFO. It would follow that Ablyazov had breached the WFO by spending more than a reasonable amount on legal representation and more than £10,000 per week on living expenses. BTA also sought disclosure of all drawings made pursuant to the Loan Agreements to enable it to trace, and if possible recover, the proceeds.

BTA's primary position was that the Loan Agreements were a sham and that Ablyazov was in ultimate control of both Wintrop and Fitcherly. Mr Justice Clarke, in related proceedings between BTA and Ablyazov, said that there was good reason to suppose that this was the case, but declined to decide the point on the basis that it had not been fully argued before him. Ablyazov maintained that the loans were made to him by trusted friends and associates in control of Wintrop and Fitcherly. In any event, BTA was prepared to accept for the purpose of the proceedings that the Loan Agreements were validly entered into at arm's length between commercial parties.

The Parties' Arguments

BTA put forward two arguments explaining why Mr Ablyazov's rights under the Loan Agreements were assets within the meaning of the WFO. Its primary argument was that a right to borrow money from a lender under a loan facility is a 'chose in action' (a property right in something intangible) and English law has long classified choses in action as assets. BTA's secondary argument was that, if a right to borrow money is not usually classified as an asset in the context of a freezing order, the extended definition of asset in paragraph 5 of the WTO was broad enough to cover Ablyazov's rights under the Loan Agreements. In either case, Ablyazov had 'dealt' with that asset by directing payments pursuant to the Loan Agreements to third parties.

BTA argued that if the position were otherwise, a defendant subject to a WFO could borrow a large sum of money, thereby reducing his overall net asset position by that amount, and potentially reducing the amount available for the claimant by the full extent of the loan if, say, the lender obtained a judgment for that amount before the claimant's claim was established. The defendant would therefore in effect be allowed to make payments out of his assets without regard to the restrictions imposed on him by the WFO.

Ablyazov's counter argument rested on direct legal authority. Neuberger J, as he then was, in *Cantor Index Ltd v Lister* [2002] CP Rep 25, held that a defendant who borrows money increases his indebtedness but does not dispose of, deal with or diminish the value of his assets within the meaning of a freezing order. In response to the argument that this approach would allow a defendant to in effect circumvent a freezing order by reducing his net asset position, Neuberger J said the following (emphasis in original):

> *"I see the force of that submission as a matter of good sense and practicality. However I do not think that it is right, in light of the words of paragraphs 1(1) and 1(2) of the order. They provide that the defendant should not "dispose of, deal with or diminish the value of any of his assets". For a debtor to increase his indebtedness by borrowing from an existing creditor or even to create an indebtedness by borrowing from a new creditor, at least where the creditor is not secured on any of the debtor's assets, does not to my mind, as a matter of ordinary language, involve disposing of or dealing with or diminishing the value of any of the debtor's assets . I accept that it results in a diminution of the debtor's net asset position, but that is not what paragraphs 1(1) and 1(2) of the Freezing Order refer to."*

BTA submitted that *Cantor Index* could be distinguished on the facts because the freezing order Neuberger J was referring to did not contain the extended definition of 'assets' present in paragraph 5 of the WFO. The definition, it was argued, was wide enough to cover an intangible right which, if exercised, which would indirectly diminish the value of a debtor's assets.

Ablyazov submitted that the new wording made no difference to the position as it was under *Cantor Index*. The expanded definition was directed at a different situation, namely where the asset in question is held by a third party in circumstances where the respondent has the power to control the asset but may hold something short of a legal or beneficial title (e.g. because he is a trustee or nominee of the asset). Ablyazov argued that the expanded definition was aimed at clarifying what *type* of interest the respondent must have in the property rather than the *nature* of the assets in which an interest may be had for the purposes of the freezing order. A right to borrow money under a loan facility was not an asset within the meaning of the WFO because it was not something that could be diminished in value.

Decision of the High Court

The judge, at first instance, agreed with Ablyazov. He held that the right to borrow money was not to be regarded as an 'asset' within the meaning of the WFO. The purpose of the WFO was to prevent Ablyazov from disposing of his assets so as to frustrate an

attempt by BTA to enforce any future judgment it might secure against him. It followed that the assets to which the WFO referred are assets which could be of some value to BTA and against which BTA would be capable of securing execution.

The judge found the rights to borrow under the Loan Agreements had no monetary value that BTA could realise. There was no secondary market for such rights. The loan facility was non-assignable, and the lenders would have no incentive to agree to transfer the rights by novation to BTA on the same favourable terms as the original lending facility. Because Ablyazov's rights had no value to BTA, it could not have been intended that the exercise of those rights should be subject to the WFO.

The judge held that the extended definition of assets in the WFO did not change this position. Ablyazov did not deal with any asset as if it was his own. He could only exercise his right to direct money to be paid under the loan facility. Until the money reached the payees, the lenders owned and controlled that asset and they alone had the power to deal with it as their own. For these reasons, BTA's application was dismissed.

Decision of the Court of Appeal

The Court of Appeal upheld the first instance decision. The leading judgment was given by Beatson LJ, whose judgment focused on three principles that he held were relevant to the construction of a freezing order.

The first, and most important, of these was the 'enforcement principle', which he expressed as follows:

> "*the purpose of a freezing order is to stop the injuncted defendant dissipating or disposing of property which could be the subject of enforcement if the claimant goes on to win the case it has brought, and not to give the claimant security for his claim*".

The second was the 'flexibility principle', namely:

> "*the jurisdiction to make a freezing order should be exercised in a flexible and adaptable manner so as to be able to deal with new situations and new ways used by sophisticated and wily operators to make themselves immune to the courts' orders or deliberately to thwart the effective enforcement of those orders*"

The third was the 'strict construction principle':

> "*because of the penal consequences of breaching a freezing order and the need of the defendant to know where he, she or it stands, such orders should be clear and unequivocal, and should be strictly construed*"

Beatson LJ held that there was a tension between the application of these principles to the interpretation of any freezing order. The first two principles weigh in favour of a broad, purposive interpretation of freezing orders to prevent unscrupulous defendants from creatively evading their intended application. On the other hand, the third principle weighs in favour of a narrow, literal construction because of the potentially draconian effect of a freezing order on the economic freedom of an individual against whom no judgment has yet been granted.

In applying these principles to the WFO over Ablyazov's assets, Beatson LJ reiterated many of the points raised by the judge at first instance. In particular, he emphasised that fact that the rights under the Loan Agreements had no value to BTA and therefore the enforcement principle could not support their construction of the WFO. In summary he held that, applying the strict construction principle, the words of the order were not clear enough to bring the rights under the Loan Agreement within the remit of the WFO. Additional words would need to be added to the standard form freezing order for such rights to be deemed 'assets'.

Neither did the expanded definition of assets in paragraph 5 of the WFO assist BTA. Beatson LJ agreed with Ablyazov that the purpose of the expanded definition was to cover assets that were not beneficially or legally owned by a defendant but over which he had control, for example in his capacity as a trustee or nominee. The control a trustee or nominee has over an asset is very different from the control that Ablyazov had over the money borrowed under the Loan Agreements. A strict construction did not permit a wider interpretation of the expanded definition in paragraph 5 in circumstances where that definition was clearly directed at a different category of asset.

Decision of the Supreme Court

In a short, 12 page judgment, the Supreme Court overturned the decisions of the High Court and the Court of Appeal. Lord Clarke, with whom Lords Neuberger, Mance, Kerr and Hodge agreed, began his judgment by noting that BTA had, by this point, obtained a number of judgments against Ablyazov in the English courts, amounting to a total of $4.4 billion. He then set out what he saw as the key issues before the court:

> "*(1) whether the respondent's right to draw down under certain loan agreements is an "asset" within the meaning of the Freezing Order;*
>
> *(2) if so, whether the exercise of that right by directing the lender to pay the sum to a third party constitutes "disposing of" or "dealing with" or "diminishing the value" of an "asset"; and*
>
> *(3) whether the proceeds of the loan agreements were "assets" within the meaning of the extended definition in paragraph 5 of the Freezing Order on the basis that the respondent had power "directly or indirectly to dispose of, or deal with [the proceeds] as if they were his own.*"

All of these issues were questions of construction of the WFO. The sole question was what the WFO meant. It followed that the Court of Appeal had been wrong to have regard to the 'flexibility principle' in its analysis. The flexibility principle was concerned only with the court's jurisdiction to make a new freezing order. Lord Clarke agreed that the courts should be *"agile in this game of cat and mouse between claimants and defendants to make sure that it is making new orders to meet new avoidance measures"* but that was not a justification for expansively interpreting an order which had already been made.

The first and second issues of construction related to the standard form of freezing order, which did not contain the extended definition of assets as appeared in paragraph 5 of the WFO. Lord Clarke referred to *Cantor Index* as authority for the proposition that rights to borrow money were not assets under that form of order. It was also authority for the proposition that exercising a right was not 'dealing' with an asset within the meaning of that standard form.

Lord Clarke stressed the importance of clarity and certainty in the interpretation of penal orders. The courts should be slow to depart from an interpretation that has stood for many years. The prudent course for the Supreme Court was to interpret the normal standard form freezing order consistently with the previous understanding of the courts, legal writers and the legal profession.

The same reasoning did not apply to the most recent standard form of freezing order, which included an extended definition of assets in paragraph 5 (set out here again for convenience):

> *"5. Paragraph 4 applies to all the respondents' assets whether or not they are in their own name and whether they are solely or jointly owned and whether or not the respondent asserts a beneficial interest in them. For the purpose of this Order the respondents' assets include any asset which they have power, directly or indirectly, to dispose of, or deal with as if it were their own. The respondents are to be regarded as having such power if a third party holds or controls the assets in accordance with their direct or indirect instructions."*

Lord Clarke held that the rights under the Loan Agreements were assets within the meaning of this paragraph. An instruction to a lender to pay the lender's money to a third party is dealing with the lender's assets as if they were his own. That was the natural reading of the second sentence of paragraph 5. The relevant question was whether Ablyazov had the power to direct the lenders what to do with the funds that they were contractually obliged to make available to him. The court found that he did have that power, and so the rights were assets caught by the WFO.

Lord Clarke dismissed the objections to this interpretation of the WFO that had been given by the courts below. In particular, he rejected the contention that paragraph 5 was primarily designed to catch assets that a defendant claims he holds on trust or as a nominee. That was only the aim of the first sentence. By contrast, the last two sentences of paragraph 5 have no specific target, but are simply designed to catch assets which are not owned legally or beneficially, but over which the defendant has control. Lord Clarke clarified that the third sentence of the definition was not a restriction on the scope of the second sentence, but was expansionary.

Comment

The decision of the Supreme Court is welcome news for creditors concerned about an individual indirectly reducing their net asset position by using unsecured borrowing or credit facilities. Any application for a freezing order (whether in English court proceedings or in an application ancillary to an English law arbitration) should seek to include the extended definition of assets in the order as a matter of course. The effect of this is that it will no longer be possible for a defendant to indirectly circumvent the standard exceptions to a freezing order by using borrowing or credit facilities, without facing the serious consequences that a breach of a court order entails.

The decision may also have implications for the question of whether a freezing order made against a sole shareholder and director of a company extends so as to cover that company's assets. In the case of *Lakatamia Shipping* v *Su* [2015] 1 WLR 291, the Court of Appeal said that in those circumstances the company's assets were not covered by the extended definition of assets in the new standard form freezing order. The reason given was that the paragraph 5 *"was not intended to include the assets of another person"*. The Supreme Court has now held the opposite. The extended definition may catch the assets of another person if they are in the control of the defendant. It remains to be seen whether the courts will attempt to distinguish this set of circumstances or follow through with the logical consequence of the Supreme Court's reasoning.

Conclusion

It is fitting to conclude by telling the remainder of Ablyazov's story. By the time the Supreme Court was delivering its judgment in October 2015, Ablyazov's concerns were much bigger. In February 2012 he had been found guilty of three deliberate and substantial contempts of court for failing to disclose the location of assets he had fraudulently misappropriated from BTA. Maurice Kay LJ, sitting in the Court of Appeal in the contempt proceedings went so far as to say:

> *"It is difficult to imagine a party to commercial litigation who has acted with more cynicism, opportunism and deviousness towards court orders than Mr Ablyazov."*

Ablyazov was given three consecutive 22 month prison sentences. Just before the sentencing hearing, however, Ablyazov fled the country and went into hiding. He was eventually tracked down in July 2013, by private investigators working for BTA, when they fol-

lowed one of Ablyazov's associates from the High Court in London to Heathrow airport, and onto a villa in the south of France. Ablyazov was subsequently arrested by the French police in a dramatic dawn raid. He is now awaiting extradition to Russia to face a long list of charges for embezzlement and fraud.

To all a very Happy Holiday Season from the Disputes Team at Andrews Kurth

AUSTIN
111 Congress Avenue
Suite 1700
Austin, TX 78701
+1.512.320.9200

BEIJING
Room 2007, Capital Mansion
No. 6 Xin Yuan Nan Lu
Chao Yang District
Beijing, China 100004
+86.10.8486.2699

DALLAS
1717 Main Street
Suite 3700
Dallas, TX 75201
+1.214.659.4400

DUBAI
Andrews Kurth (Middle East) DMCC
45th Floor
Mazaya Business Avenue, BB2
Jumeirah Lakes Towers
P.O. Box 111587
Dubai, UAE
+971.4.567.0767

HOUSTON
600 Travis Street
Suite 4200
Houston, TX 77002
+1.713.220.4200

LONDON
Andews Kurth (UK) LLP
16 Old Bailey
London EC4M 7EG
United Kingdom
+44.20.3053.8300

NEW YORK
450 Lexington Avenue
New York, NY 10017
+1.212.850.2800

RESEARCH TRIANGLE PARK
4505 Emperor Boulevard
Suite 330
Durham, NC 27703
+1.919.864.7200

THE WOODLANDS
Waterway Plaza Two
10001 Woodloch Forest Dr.
Suite 200
The Woodlands, TX 77380
+1.713.220.4800

WASHINGTON, DC
1350 I Street, NW
Suite 1100
Washington, DC 20005
+1.202.662.2700

For complimentary copies or changes of address, please contact Leanne Power at leannepower@andrewskurth.com. For more information about our practice, visit us at andrewskurth.com.

ANDREWS KURTH

STRAIGHT TALK IS GOOD BUSINESS.®

AUSTIN BEIJING DALLAS DUBAI HOUSTON LONDON NEW YORK
RESEARCH TRIANGLE PARK THE WOODLANDS WASHINGTON, DC

andrewskurth.com