

## Hard times and desperate remedies

Well organised auditors will ride out today's rough economic and litigious climate.

**“Sorry but desperate times call for desperate measures.” This was not the start of a party political broadcast but an apology in a letter of claim to a company’s advisers. It encapsulates the increased risk of litigation facing professionals in the current economic conditions.**

This article addresses the implications for auditors, in terms of the potential for claims (with a particular focus on actions by liquidators), the various commercial pressures facing auditors and the recent trend for claims against international networks.

### Basic legal principles

Auditors owe their duties to the company and its shareholders as a body (*Caparo Industries plc v Dickman*), not to the public or any individual shareholder.

Their duty reflects the fact that the purpose of an audit is to provide an opinion on whether or not the audited company’s financial statements show a true and fair view of its financial position, so that the company’s shareholders are fully informed at the company’s general meeting.

If it breaches its duties, an auditor will be liable for the financial loss that its conduct has caused. Every case is different, but, in broad terms, this means putting the company (or other third party, if it can establish that it properly relied on the audited financial statements) back into the position



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Until recently, an auditor's potential liability in damages for a breach of duty could not be limited. (We look at this issue in more detail in *Defences*, below.) Originally, this was a *quid pro quo* for limiting the right to audit to members of recognised bodies.

### **Circumstances prompting claims**

The two traditional sources for claims against auditors are corporate collapse and fraud.

Both types of claim increase in hard economic times. If you factor in the growing use of conditional fee arrangements and the introduction of third-party funding, then a rise in the volume of claims against auditors is almost inevitable.

A further problem for auditors is the fact that their own (legitimate) actions can prompt corporate collapse and, therefore, become a risk

event. This includes issues such as "going concern" assessments. Part of the audit function is to assess whether or not the audited business can remain a going concern in the coming financial period. In poor economic conditions, that role becomes both harder and more important. The Auditing Practices Board has issued guidance, emphasising the need not to prompt concern at a company's finances (thereby possibly triggering collapse), while underlining the importance of identifying genuine problems and protecting the auditor from a potential omission claim – a Catch-22 situation if ever there was one. The Financial Reporting Council preaches a pragmatic approach, but ultimately the matter remains a question of judgment for the auditor.

### **Liquidators' claims**

The risk of legal action by liquidators is prevalent in the current climate. However, the substance of such claims is not unique. The company or shareholders can bring the same types of action. (This reflects the fact that the liquidator is essentially pursuing a claim for the company. So, for example, the liquidator need not prove that the creditors relied on audited accounts to pursue a claim, as it is claiming for the company, not the creditors.) What is different is the increased motivation of – and the investigative powers available to – a liquidator.

A liquidator has an obligation to realise assets for distribution, to investigate reasons for the company's failure and to pursue the parties responsible for an insolvent collapse. It has extensive investigatory powers under sections 234-236 of the Insolvency Act 1986. These include, for instance, being able to compel third parties to deliver up property, books and records to which the company appears entitled, and to

apply to the court to summon any person to give an account of their dealings with the company.

When it comes to recovering assets or losses, the auditor will often look like a soft target. While the directors may have been responsible for the company's failure, and might have moved assets out of the company, a liquidator must weigh the cost of pursuing delinquent directors against the prospect of recovering assets. The auditor will generally have professional indemnity insurance. This enables the liquidator to justify the cost of a recovery action.

In deciding whether or not to pursue an auditor, the liquidator will be looking for evidence of missing documentation. It must consider whether or not it can prove (on a balance of probabilities) that a reasonable auditor, following audit procedures, should have discovered that the company was technically insolvent or had suffered fraud. In so doing, the liquidator must assess whether or not the picture painted by the directors and employees (who may be covering up things) is accurate.

However, experience shows a clear preference for pursuing auditors rather than tracking down

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assets. There is a rich history of auditors being pursued following large company failures – classic examples being *Barings v Coopers & Lybrand* and *BCCI v Price Waterhouse*.

If a liquidator uncovers fraud, it must consider whether to pursue the fraudster – who will probably have disposed of the stolen assets and will be unable to make repayment following their arrest – or the (insured) auditor who allegedly failed to spot the original dishonesty. Inevitably, therefore, frauds by individuals leave an auditor extremely vulnerable.

Where the fraud is essentially by the company, it has been unclear how accountable the auditor will be. Some clarity was brought by the Court of Appeal in *Stone & Rolls Ltd v Moore Stephens*. The claimant was essentially a one-man company controlled by a Mr Stojevic. He and the company defrauded Komerčni Banka SA of \$174m. Reassuringly for auditors, Moore Stephens was not liable for the consequences, as the Court of Appeal, upheld by the House of Lords, found that Stone & Rolls was the perpetrator, not the victim, of the fraud.

But the decision still leaves open the possibility of auditors being rendered liable for their failure to identify fraud by individuals in large organisations, as, to borrow from Lord Justice Mummery in *Stone & Rolls*, it will not be the case that "the knowledge of the fraudulent mastermind and the knowledge of his creature company are identical in targeting the victim". The company is the victim.

### **Defences**

Given all these factors, auditors might be forgiven for thinking these are desperate times and that, therefore, they have to resort to desperate

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measures in response. This would be an overreaction, though, particularly for well-organised and well risk-managed auditing practices.

The most basic defence is the common law principle that an auditor, in common with all professionals, need only exercise a reasonable standard of care when assessed against its peers (*Bolam v Friern Hospital Management Committee*).

In addition, sections 534-536 of the Companies Act 2006 now permit limited liability agreements (LLAs) between auditors and audit clients. An LLA does not, of course, alter the extent of the auditor's duty or the consequences of any breach. It does, however, cap the recoverable damages. The Act does not specify the extent of the cap: this is something to be agreed between auditor and client and must only be fair and reasonable in all the circumstances of the case. It might be a fixed sum or a sum proportionate to the auditor's fee. Institutional investors and their representatives (such as the Association of British Insurers) favour proportionate limits.

However, their choices may be limited by the robust stance of the Securities and Exchange

Commission (SEC) in the US, which has said that it will not accept any LLAs entered into by English companies registered with the SEC. Lobbying is ongoing but if the SEC does not change its approach, one option would be for LLAs to be made mandatory under English law. This would effectively force the SEC to accept them. In practice, that might lead to a fixed cap, if only for legislative convenience.

Other action that auditors can take to minimise risk includes ensuring that the terms of engagement are clear, that fee arrangements are transparent and that (despite cost pressures) they continue to invest in their staff and assistants. Experienced staff will be at a premium, a fact now appreciated by banks caught out by the financial downturn.

### **International networks**

Many accounting practices operate (or participate in) international networks. These are generally structured as associations of independent firms, linked together by a non-trading umbrella entity. Neither profits nor risks are shared, but the member firms benefit from referrals and general networking. The umbrella entity administers the network and may monitor any measures intended to ensure consistency of approach and standards.

The independence of member firms is the key to the arrangement. This is particularly important to those members practising in less litigious jurisdictions, and who have no desire to share the risk run by members operating in more exposed regimes. This would include the United States, where recent case law poses a far-reaching threat to such networks.

In 2007, Banco Espirito Santo (BES) obtained a

\$521m judgment against BDO Seidman of New York, for the grossly negligent auditing of BES's factoring company, Bankest. BES also sued BDO International, the relevant umbrella entity, alleging that it was vicariously liable for BDO Seidman's acts and omissions. The case against BDO International failed, but BES has appealed. Separately, in New York, former investors in Parmalat are suing Deloitte Touche Tohmatsu (DTT) as principal of Deloitte Italy, the former auditor of the failed Parmalat. DTT sought summary dismissal but failed.

Finally, the trustee of collapsed US subprime lender, New Century Financial, has filed suit in California against its auditor, KPMG LLP. It has, though, also started legal proceedings in New York against KPMG's international parent, alleging that it "failed in its watchdog role" and is, therefore, responsible for the acts of KPMG LLP as its agent.

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The feature common to all these cases is the plaintiffs' attempt to prove that the umbrella entity had control over the local member. According to BES's lawyer, "BDO International controls BDO Seidman right down to how they type their letters". BDO robustly rejects this and points out that the only area in which its

network has a common approach is in transnational audits, and Bankest's audit did not fall into that category.

Pending further developments in these cases, it is obviously premature to draw any firm conclusions. However, there is only a low risk of any such litigation developing in the UK, since courts here have traditionally required a claimant to demonstrate the existence of a direct duty and a causal link between any breach and alleged loss.

The real danger for UK-based umbrella entities and UK members lies in any judgment obtained against an umbrella entity in the US, which the claimant then seeks to enforce against other network members. As the current US litigation is clearly focused on the concepts of "control" and "agency", the practical response of international networks should be to ensure that their structural agreements do not give the umbrella entity the right to control the acts of its members. Similarly, it is essential that no individual member can exert (or be regarded as exerting) an overt influence on the direction of the network as a whole. Indeed, there should be clear evidence of the absence of control. At a practical level, while there has been a move in recent years towards closer integration of international networks, this present spate of US litigation could well reverse that trend.

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# “Who’s to say who’s an expert?”

Paul Newman (1925 – 2008)

## In the first of a series of articles on the court expert’s role in European jurisdictions, The Key sets the scene and looks at the position in France.

In general, Western legal systems (whether based on civil or common law principles) usually demand that the facts on which courts reach their judgment are proved by direct evidence. Generally speaking, this takes the form of evidence based on either contemporaneous documents or oral testimony given by witnesses who observed the events at the centre of the dispute.

### Using expert witnesses

However, on occasions, the outcome will depend on a consideration of technical issues or accepted practice. In such cases, a court may hear evidence based on the opinion of expert witnesses to help it make a decision.

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In the courts of England and Wales (in line with the British adversarial tradition), the parties have historically appointed their own experts. Usually, these are specialists who can, within the bounds of independent opinion, support the case advanced by the instructing party. The presiding judge then has to decide which opinion is more persuasive in the light of the facts of the particular case.

The potential for widespread abuse of the expert’s independence was recognised by the Woolf reforms of 1999, which limited

- the scope of the opinion to what was necessary and proportionate;
- the type of evidence that could be given and the issues that could be covered; and
- the number and types of experts that could be instructed.

The reforms also introduced the idea of an agreed or court appointed expert.

### Tackling the expert’s findings

European civil jurists are comfortable with the concept of a court expert, whose role will often be crucial in determining the facts and liability. Indeed, the expert may well have completed their investigation of these two elements before the claimant raises a single allegation of fault against a defendant. So the litigant who fails to

deal with the expert’s investigation in these circumstances will risk losing their case before they have even had a chance to argue it.

Claimants and defendants will also be making a mistake if they think their disclosure obligations will be limited to the documents on which they rely. A court expert may be authorised to require the parties to disclose any paperwork of relevance to the investigation. Usually, this will consist of documents that establish the facts or otherwise help the court to determine liability. The expert’s investigation will often be the key battleground, with the losing party being forced to rely on purely legal arguments in the final hearing in a bid to retrieve their position.

### Structure of series

To provide a comparative framework, this series of articles will look at five aspects of court experts:

- how and where their evidence can be used;
- their appointment;
- how they carry out their job;
- the opportunities for challenging their evidence; and
- their remuneration.

As the French legal system is usually seen as the embodiment of the modern civil law system, the

remainder of this article and its sequel will look at how things work in France.

### France

#### Where and how expert evidence can be used

In France, judges are not practising *avocats* who have been promoted to the bench. It is a separate career path. In the Tribunal de Commerce, they are business people chosen from the local community. The courts’ inquisitorial approach makes the expert’s role central to the evidence-gathering process. It is for the judge to decide whether or not to appoint an expert.

The French courts use experts for three things (measures d’instruction):

- (1) the *constatation* (i.e. an assessment, recording the facts and/or verifying the loss or damage, and which is usually ordered in straightforward cases);
- (2) the *consultation* (where the facts are easily established, the court may only require an opinion on a technique or practice); and
- (3) the *expertise* (i.e. a full investigation that is ordered in complex cases involving scientific, technical or other specialised issues).

#### The expertise

In this first instalment of our coverage of the

French system, we focus particularly on the last format of the court expert's job – the *expertise*.

In common law jurisdictions, experts historically became involved when pleadings and disclosure were completed. In standard cases, the same approach is adopted in France. However, an *expertise* can be ordered before a detailed complaint is made against a defendant, on summary application to the *juge des référés*. There does not have to be an emergency before such an application can be made.

This summary procedure may be used to preserve or establish evidence.

It does not require an absence of serious dispute on the merits. It is not precluded by a serious dispute, as it does not involve prejudging the parties or the prospects of any subsequent proceedings. It is sufficient that:

- such subsequent proceedings are possible;
- there is a sufficiently defined purpose and basis to the application;

- the resolution of the case may depend on the summary expertise requested; and
- the application does not unlawfully infringe fundamental rights and liberties.

A summary application for an expertise can be made to the *Tribunal Administratif*, the *Tribunal de Commerce* and the *Tribunal de Grande Instance*. It can be challenged on appeal. However, a summary *expertise* cannot be ordered where there are extant legal proceedings dealing with the merits of the case in which an *expertise* has already been requested by the same claimant.

Examples of where this summary procedure might be used include the following:

- where a building defect becomes apparent;
- a turbine generator fails due to defect;
- industrial machinery fails with a possible risk of business interruption; or
- a supermarket or warehouse roof collapses in bad weather, suggesting defective construction or design.

On average, an *expertise* is normally concluded in 9-18 months. The findings will usually (but not invariably) be adopted by the court.

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If the report does not implicate the respondent parties, the *expertise* can effectively kill off the case, as the claimant is very unlikely to sue. Conversely, if the report criticises the respondents, they may be prompted to reach a negotiated settlement.

The *expertise* proceedings close on the filing of the report.

If there is no need to invoke the summary procedure, the decision to order an *expertise* will be made at the hearing following the closure of pleadings. The judge may make the order at the request of one or more parties – which is the more usual course – or on his or her own initiative.

The next article will look at the procedural aspects of the expert's investigation in France.

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# Group actions for damages

A brief comparison between English and Italian law.



## The English perspective

### Procedural law

There is no set procedural mechanism for claimants with similar grievances to bring a collective action. However, a group litigation order (GLO) can be made under the Civil Procedure Rules (CPR 19.11) for claims that “give rise to common or related issues of fact or law” (GLO issues).

A GLO must:

- (1) contain directions about setting up a register where the claims managed under the GLO will be entered;

- (2) specify the GLO issues that will identify the claims to be managed for the group under the GLO; and
- (3) specify the court that will manage the claims entered into the group register.

Where a judgment is given (or an order is made) regarding a claim in the group register in relation to one or more GLO issues:

- (1) The judgment or order will bind the parties to all other claims that are in the group register at the time the judgment is given or when the order is made, unless the court orders otherwise.
- (2) The court may give directions about the

extent to which that judgment or order is binding on the parties to any claim that is subsequently entered in the group register.

Any party who is adversely affected by a judgment or order that binds them may seek permission to appeal against that decision. However, a party to a claim that was entered in the group register after the judgment was given or the order was made may not appeal against the decision, or ask for it to be set aside, varied or stayed. They can, though, ask the court to order that the judgment or order does not bind them.

### Opt in, opt out?

Unlike US class actions (where all potential claimants are bound unless they opt out of the class), all claimants wishing to join the group litigation must apply to be entered in the group register (ie they must opt in) by a date specified by the court. Judgment on one or more of the GLO issues will then bind all the claimants in the group register. Any non-GLO issues (such as compensation, for instance) will be determined in each individual case.

In December 2008, the Civil Justice Council (CJC), a body charged with advising the government on the modernisation of the civil justice system, published its report on collective actions. In it, the CJC said that the existing mechanisms in the UK for collective actions do

not provide sufficient or effective access to justice for a wide range of citizens, and that meritorious claims which could be brought are not in fact being pursued.

The government responded to the CJC’s publication with its own report on 20 July 2009. This concluded that the creation of a generic collective right of action would not be appropriate in the UK.

Instead, the government thought that rights of collective actions should be introduced on a sector-by-sector basis, with the government departments concerned taking responsibility for introducing the necessary primary legislation. The government would also work with the CJC to develop proposals for procedural rules to be put before the civil procedure rule committee.

Consequently, the procedure in England will be on an opt-in basis for the foreseeable future. However, the issue of collective actions is ongoing and will probably feature prominently on government departments’ agendas in early 2010.

### Costs

The claimants must be prepared to take the risk of paying the other side’s costs if they lose. They must also find funding for the class action, which is heavily frontloaded since the claimants must plead their fully formulated claim at the outset.

These rules are intended to promote flexibility and not be too prescriptive. It is usually more cost effective to proceed along the GLO route. However, as the frontloading of costs is a significant element, it is probably only worth applying for a GLO if there is a significant number of claimants. The court can, though, make a GLO of its own volition.

What has become apparent since the introduction of GLOs is that claimants are finding the costs burden difficult to bear and, as a result, there are relatively few GLOs currently in existence. Sadly for claimants, the government, like the CJC, remains in favour of retaining the usual loser-pays principle in relation to class actions.

### Funding

The conditional fee agreement (CFA) was introduced for personal injury claims in 1995. The CFA only allows an uplift in the fees recoverable by the successful claimant from the losing defendant. Theoretically, a claimant's solicitor can, on a no win/no fee basis, earn up to 100% uplift in the hourly rate. However, this is not always achieved, as the level of costs recovered may be challenged before a costs judge.

In *AB in the matter of Nationwide Organ Group Litigation* [2003] EWHC 1034 QB, the High Court allowed an application by the defendants for an order to cap the costs of the claimants both retrospectively and prospectively in relation to a case that was being dealt with under a GLO. There were approximately 2,100 potential claims notified but four lead cases had been identified and were being dealt with under a GLO. The court allowed the defendant's application, ruling that (in GLO cases) the court did not require exceptional circumstances to be shown before exercising its discretion to make a costs cap

order. In this case, the claimants assessed the total sum in damages in excess of £15m.

The application for the costs cap was made in May 2003. It was to apply retrospectively (starting from 10 February 2003) and to continue up to and including the end of the forthcoming trial. The judge capped the claimant's costs for that period at £506,500. In addition, the claimants could only apply to vary the order in the event of some future unforeseen and exceptional factor. This case is highly significant for defendant manufacturers who face group actions, as they can now have significant input into controlling the level of the claimants' costs during the currency of the litigation.

In conventional litigation, the defendant can usually exercise no such control over a claimant's costs. At best, they can query a claimant's bill of costs retrospectively – but not prospectively.

Another problem with funding group actions through CFAs is that, to be workable, a CFA must be backed by adequate litigation protection insurance. However, such policies come at a high price and, in some instances, do not provide adequate protection for the claimants, so CFAs are consequently not appropriate. Also, the CFA requires significant investment from claimant lawyers, many of whom are now less inclined than previously to take on risky multiparty litigation for what appears to be very little reward.

The other way that group actions achieve financial backing is via the Legal Services Commission (LSC) funding system. However, it is becoming harder and harder for claimants to obtain such funding for multiparty actions. Withdrawal of funding decisions by the LSC include the MMR litigation and the Seroxat group action.

While the growing trend is for LSC funding to be withdrawn from group actions where causation is a problem, it does not mean that funding will be unavailable where the claimant's case on causation is more clear-cut. However, the likelihood is that for a class action to get off the ground, funding will come via the CFA/insurance route, which (as explained earlier) has its own problems.

The net effect is that fewer and fewer group actions are being launched in England. This is, of course, very good news for defendant manufacturers and their insurers.

## The Italian perspective

### Procedural law

Group actions for damages – azione di classe – were first introduced into Italian law in 2007 by article 140-bis of the Consumer Code.

Article 140-bis was approved by Italian lawmakers on 1 July 2009 and will become fully effective in January 2010. However, it will only apply to conduct that occurred after 15 August 2009. As Italian law has no retroactive effect, it cannot, therefore, be used to support class actions for past conduct.

The right to sue does not belong to individuals but to the 16 accredited consumer associations with a nationwide presence, as well as to ad hoc committees that are sufficiently representative of collective interests, as assessed by a judge. These representative entities can bring an action against any commercial, financial, banking or insurance enterprise on behalf of all consumers who have been injured by the same action.

According to the Italian consumer code (codice dei consumatori), the representative entities

can claim that individual consumer rights of the same type have been violated by:

- a breach of contract;
- a tort;
- unfair trade practices; and/or
- breaches of competition law.

In the preliminary hearing, the court must verify that the class action is admissible and determine that:

- the action is not preposterous;
- there is no conflict of interest; and
- the action is being taken to protect individual consumer rights.

If the group action is deemed admissible, the claimant will be ordered to advertise the content of the claim, in order to enable consumers to opt into the action if they so wish.

The second stage of the proceedings consists of a trial. If the court rules in favour of the claimants, it does not award a specific amount of damages. Instead, the judge makes a substantive declaration and sets out the criteria that will be useful in calculating the amount to be paid to the individual consumers and users who have joined the class action or intervened in the proceedings. Where possible, the court will also establish the minimum amount payable or refundable to each consumer.

Within 60 days of the service of the court's judgment, the relevant defendant company can make a written proposal of payment. Any form of proposal accepted by the consumer will be enforceable. If the company fails to make its offer within 60 days, or if the offer is not accepted during that time, the president of the court will appoint a conciliation committee (camera di conciliazione) to set the amounts to

be paid or given back to the consumers who have joined the class action or intervened, and who have asked the conciliation committee to rule on this issue.

### Opt in opt out?

Consumers may opt into the collective action by way of a simple written notice (without any particular formality) to the plaintiff. This must be sent before the final hearing giving the results of the appeal. Only opt-in consumers will be bound by the result. As a result, many consumers may decide to opt in only if the action succeeds in the first round of legal proceedings.

The final decision will also have a legal impact on the consumers and users (intervententi) who have joined the class action.

Individual consumers or users who have not joined the class action or intervened in the proceedings will still be able to bring individual actions under the civil procedure code. If they prove their case, damages will be calculated in line with the criteria laid down by the court in the judgment given in the collective action.

The opt-in process will apply after either the court has given judgment determining liability and quantifying damages, or a court settlement has been reached.

### Costs

Generally speaking, the loser-pays principle also applies in Italian law. However, when it comes to group actions, the legal rules are silent.

Most costs disputes for collective redress will probably relate to:

- the percentage of the winner's costs that must

- be paid by the losers; and/or
- the amount that would have to be paid by consumers participating in the action if the case is lost.

In certain circumstances the claimants may also be liable for the defendant's legal costs if the action fails.

### Funding

Under Italian law, public funding (gratuito patrocinio) is available for any type of civil litigation and it covers all the legal costs related to a claim.

CFAs were legalised in Italy in 2006 and can also be used by claimants as a way of financing legal action. Third party funding is allowed too.

### Conclusion

Overall, whilst group actions are available under English and Italian law, it is important to note that whilst a number of well known group actions have been made in England the procedure has not been regularly utilised in Italy.

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*Kennedys would like to thank Marco Bonci for his help over this article. Marco is an Italian undergraduate law student from Genova, who was on a recent work experience programme with the firm.*

# Not playing ball

## What happens when an insured does not co-operate with its insurers over a claim?

**An insured usually has an obligation under the policy to co-operate with an insurance company's investigation of a claim. But insurers are put in a difficult position when an insured does not co-operate as fully as they would like – or even does not co-operate at all.**

Most insureds are, of course, keen to co-operate with insurers and get the claim resolved as quickly and painlessly as possible. However, sometimes an insured will make a claim but then fail to provide the further information requested by the insurance company. This makes life tricky for insurers, as they have been notified of a claim but may well have no real idea of its value or merit. To make things worse, they do not know when – or indeed if – the insured will ultimately provide the further facts required.

What then is a reasonable timeframe for the insured to respond to the insurers' inquiries? Can insurers refuse to meet a claim where an insured fails to provide information when requested, or must they just keep on endlessly requesting the information, despite the insured's silence?

This issue has come before the court in recent years. Intriguingly, a different decision has been delivered on each occasion. This article looks at these different conclusions and the effect they have on an insurer whose insured fails to co-operate with the claims process.

### The Shinedean case

In the Court of Appeal case of *Shinedean v Alldown Demolition* [2006] EWCA Civ 939, Axa (the appellant insurance company) appealed against a finding by the trial judge that the insured's failure to provide claim-related documentation within a reasonable time had not materially prejudiced Axa.

The facts were these. Shinedean had employed Alldown to carry out demolition and excavation work. Alldown's work caused the partial collapse of a wall on a neighbouring property. Alldown had a public liability all-risks insurance policy with Axa and told Axa about the damage. Under the terms of policy, Alldown had to supply Axa with all documentation and information in relation to any claims. Virtually no documentation was provided, however, despite many requests by Axa's loss adjusters.

Shinedean paid the owner of the damaged property a substantial sum in settlement of his claim for damages and subsequently obtained a default judgment against Alldown for damages to be assessed. Axa refused to indemnify Alldown, as it had failed to provide the documentation required and, consequently, had not complied with the claims control clause in the insurance policy. Before the assessment hearing, Axa was added as a party to the proceedings and Shinedean claimed against Axa for an indemnity.

The trial judge ruled that it was an implied condition of the policy that documentation should be provided by the insured within a reasonable time. However, while Alldown had failed to give Axa the required information for two years prior to the litigation, the insurer had not been prejudiced in any material way by this failure. Consequently, it could not refuse to indemnify Shinedean.

Axa appealed, arguing that whether or not it had been prejudiced by Alldown's failure to supply the information was irrelevant in law. Shinedean countered by saying that what constitutes a reasonable period of time depends on the circumstances, and prejudice to the insurer is one of those circumstances.

While being careful to stress that each case turns on its own facts, the Court of Appeal agreed with Axa. There is, said the court, no legal

principle to the effect that an insured will breach its obligation to provide information only if the insurer suffers material prejudice as a result of the insured's failure to give such information. What is a reasonable period of time is inextricably linked to the purpose of a claims control provision, which is to enable an insurer to investigate claims as soon as possible. An insurer is entitled to know where it stands.

In this instance, the court ruled, Alldown's failure to produce readily-available documentation for two years (and then only in the course of litigation) was unreasonably late. Consequently, it had plainly breached the conditions of the policy. Whether Axa had, in fact, been prejudiced by Alldown's failure to provide the documents was irrelevant. Until it possessed that information, Axa could not make a decision about how it ought to proceed. Consequently, it was entitled to avoid liability in this instance.

### **Porter v Zurich**

The recent English High Court case of *Porter v Zurich* [2009] EWHC 376 (QB) looked in detail at an insured's obligation to provide further information about a claim made to its insurers.

The key part of the case related to three separate thefts in 2001 from Mr Porter's fire-damaged and empty property. In the first theft, the wrought-iron gates at the front entrance of the property were stolen. In the second and third thefts, various other items were stolen from the house, including the whole of the fitted kitchen.

The insurers were concerned because there appeared to be some duplication between the items stolen and property included in a previous claim made by the insured following a fire at the property but for which the insurers had refused cover. If the items stolen had already been damaged by the blaze – as they must have been to warrant their inclusion in the claim relating to fire damage – then there could be no claim for the theft unless it could be shown that the items involved had retained some residual value despite their damaged state. Obviously, without further investigation, this could not be established.

The insurers (via their loss adjusters) tried to contact Mr Porter and his solicitors in order to obtain more information regarding the thefts. The loss adjusters wished to conduct a site visit as well as instigate further inquiries regarding the stolen items. They also wanted an additional statement from Mr Porter. Numerous attempts were made by the loss adjusters to arrange a meeting with Mr Porter. They tried to contact him and his solicitors repeatedly from July 2001 until December 2001, but received no response. Sometime in 2002, the insurers closed their file. In 2007, shortly before the expiry of the

limitation period, Mr Porter started legal proceedings against the insurers, incorporating a claim for payment under the three theft claims.

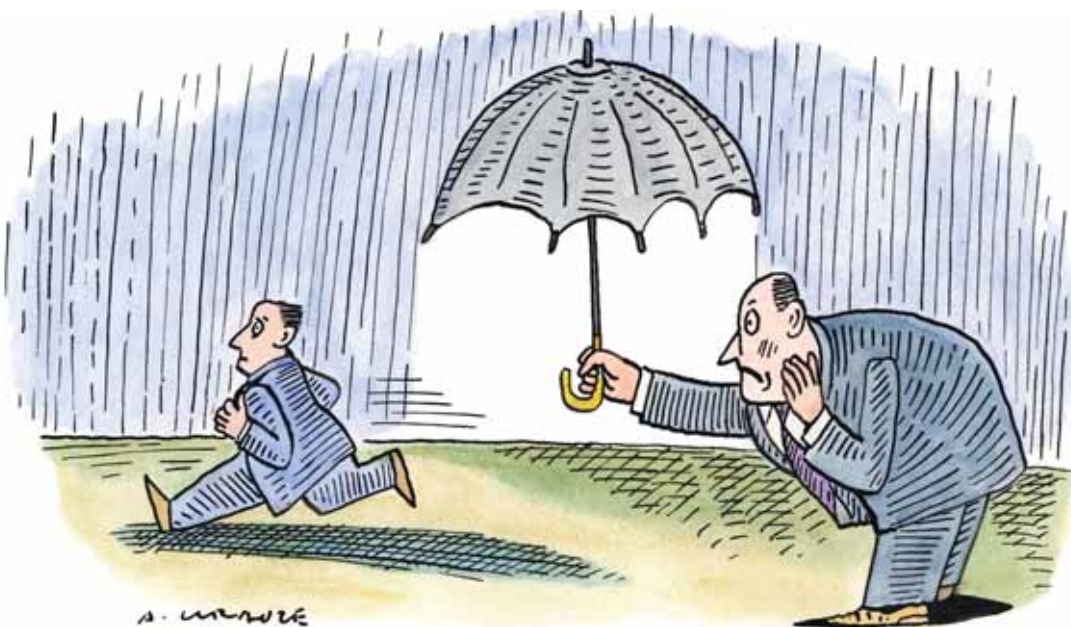
The insurers' main response to the theft claims was that, in breach of the policy, Mr Porter had not made it possible for their loss adjusters to investigate the circumstances of the case. However, the insurers did not argue that compliance with the relevant part of the policy was a condition precedent to liability. Instead, they claimed damages for breach of contract.

The court was satisfied that Mr Porter had breached the policy. But it rejected the insurers' claim that the breach had caused them a loss that was equivalent to the sums claimed under the policy.

The insurers' central concern was the duplication in the theft claims of items previously included in the rejected fire claim. They argued that if Mr Porter had co-operated and enabled them to investigate the thefts, then it would have become apparent that many of the stolen items had been previously damaged by fire and were consequently worthless.

The court ruled that for the insurers to show that Mr Porter's breach of the policy had caused them loss, they would need to demonstrate that, on a balance of probabilities, investigations into the theft claims would have led to zero recovery for the claimant. The lack of contemporaneous investigations did not automatically give rise to any loss at all, let alone a loss equivalent to the full sum claimed. In fact, although there had clearly been a breach of contract by Mr Porter, there was no evidence that the breach had actually caused any loss at all.

The court concluded that the theft claims should



not be dismissed at this stage but should be dealt with instead at a court hearing dealing specifically with damages. At that hearing, the insurers would have the opportunity to demonstrate, if they could, that the claimant's lack of co-operation had caused them loss.

Of course, this is not particularly helpful to insurers who are battling with an unco-operative insured. The decision suggests that a court will not look favourably on an attempt by insurers to refuse to make a payment on the grounds of the insured's failure to co-operate with investigations – even when the failure is as lengthy as it was in this instance – except perhaps in a case where investigations into the claim would result in zero recovery for the insured.

### Conclusion

The decisions in *Porter v Zurich* and *Shinedean v Alldown Demolition* are not easy to reconcile. It may be that the different conclusions stem from the fact that the insurers in *Porter* did not say that compliance with the policy was a condition precedent to liability, claiming damages for breach of contract instead, while the insurer's argument in *Shinedean* hinged on the fact that the provision of the requested information was a condition precedent. In addition, in *Shinedean* the information was only finally supplied during the course of the litigation, and the court thought it would be particularly unreasonable if such a gross delay stopped the insurers from refusing to cover the claim.

Nevertheless, the split in legal reasoning between the two cases is still curious. In *Shinedean* in 2006, the Court of Appeal ruled that – in circumstances where the delay in providing documents (before the insured became insolvent) was only a matter of months – there

was no absolute principle, one way or the other, as to whether an insurance company's being prejudiced should, or should not be, included when assessing the matter of reasonable time. By comparison, in *Porter* in 2009, the court decided that the insurer could not refuse to meet the claim because of the insured's six-year delay in providing the requested information. It is also strange that *Shinedean* was not cited in *Porter*, as the facts seem sufficiently similar to merit at least a reference or, better still, an explanation as to why the decisions are so different. It is particularly odd given the scarcity of authority relating to an insured's duty to co-operate with the handling of a claim.

While *Porter* is the more recent decision, as it is a High Court case it does not overrule the Court of Appeal's decision in *Shinedean*. So there is no reason why insurers could not rely on *Shinedean* (at least, to some degree) when considering the reasonableness of eventually declining cover to an insured because he or she has not provided the requested information. Although a court today would probably pay more regard to the more recent (and less favourable) case, in the absence of a House of Lords ruling on the matter, *Shinedean* is still good law. So while it is important not to ignore the court's explicit warning in *Shinedean* that each case will turn on its own facts, insurers can still draw some comfort from *Shinedean* when faced with an intransigent insured who does not co-operate with them.

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# Adjudication: an increasing trend

More and more disputing parties are turning to adjudication.



**It is becoming increasingly common to use adjudication – rather than litigation – as a way of resolving disputes in professional negligence claims.**

Usually, parties use adjudication during a construction project or shortly afterwards, so as to resolve contractual disputes quickly. The

advantage is that a decision can be reached in 28 days so that delay and costs are kept to a minimum. However, the downside is that the justice provided via adjudication is rough and ready as the timescale does not allow for detailed consideration of the issues, making it a generally unsuitable forum for resolving professional negligence claims.

## Statutory framework

The right to refer a dispute to adjudication arises from section 108 of the Housing Grants, Construction and Regeneration Act 1996.

The Act says that, for adjudication to be possible, a dispute must exist between the contracting parties: there must be some disagreement between them or some question which one party has either ignored or rejected. Only one dispute at a time can be referred to adjudication and the dispute must be of a contractual nature. It is important to note that section 108 includes the phrase “any difference” so that if there is a difference of opinion which needs to be resolved, this can be referred to adjudication. Under the Act, the parties to a construction contract have a right to adjudicate at any time. That right cannot be excluded by the contractual terms.

Some types of contract are specifically excluded from the definition of a construction contract, including contracts for supply only, contracts for extracting natural gas, oil and minerals, and contracts relating to work on process plant and on work which is purely artistic. The Act does not apply to contracts made with residential occupiers or to contracts concerning the financing of works.

To be the subject of adjudication, the contract between the parties must be “in writing” (which has a wide definition and will, for example, include an exchange of letters setting out the agreement). The contract may specify that particular adjudication rules apply, such as those of the TeSCA (Technology and Construction Solicitors’ Association) or of the CIC (Construction Industry Council). If no particular rules are specified or if the contract is silent in respect of adjudication, the Act provides a scheme setting

out the procedure that will apply. This scheme takes precedence over any contractual provisions or rules which conflict with the Act.

## Procedure

Although the procedure varies according to the particular rules applying, all adjudications start with a notice of adjudication. After the appointment of the adjudicator, the notice is followed by a fuller referral notice (setting out the claim, similar to particulars of claim). A reply is served by the responding party, usually within 14 days, though it may be quicker.

An adjudicator has a wide discretion to conduct the adjudication as they see fit. For example, they may decide that a meeting of the parties is required, that a site visit is necessary or that further documents or statements should be provided by both parties. But many adjudications will be conducted by way of a paper exercise only.

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### *A decision (or award) must be made within 28 days of the referral notice.*

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A decision (or award) must be made within 28 days of the referral notice. This timescale can be extended by agreement but does not usually go beyond 42 days. Depending on the particular adjudication rules that apply, the adjudicator may or may not give written reasons for the decision.

The decision will be binding on the parties but can be challenged, on limited grounds, in subsequent legal proceedings or arbitration (if the contract provides for it or if the parties agree to arbitrate). If a party fails to comply with an adjudicator’s award, an application is made to

court for summary judgment to enforce it.

Here are two aspects in respect of costs: the adjudicator’s fee and the costs of the parties in dealing with the dispute. Under the scheme, the adjudicator will decide who pays their fee, as part of the decision. However, this is a joint and several liability. As for the parties’ legal costs, this will, again, depend on the rules and contractual provisions that apply. Under the Act’s scheme, the adjudicator does not have power to award costs. The usual position is that each party will bear their own costs – though this can be varied by the parties’ agreement.

## Recourse to the courts

The courts are reluctant to overturn decisions reached in adjudications unless the adjudicator has acted outside their jurisdiction or breached the rules of natural justice.

Examples of challenges:

- when the adjudicator has decided something they were not asked to decide in the original notice;
- when a contract is an excluded contract;
- when the adjudicator has been appointed incorrectly; and
- when a dispute did not actually exist.

To challenge an adjudicator’s decision on the basis of breach of the rules of natural justice, it is necessary to establish that the adjudicator has not acted with procedural fairness in the conduct of the adjudication.

In *Primus Build Ltd v Pompey Centre Ltd* [2009] EWHC 1487 (TCC), the decision of the adjudicator was challenged on the basis of lack of jurisdiction and breach of natural justice. It was argued that the notice of adjudication was invalid

because, while clause 26 of the contract provided that notices “shall be delivered personally” or sent by fax, the notice had, in fact, been sent by post.

The second ground of challenge was that the adjudicator had made an award of loss of profit which he had calculated from the referring party’s accounts and that he had done so using an approach which had not been suggested by either party.

It was decided that “delivered personally” meant actual delivery by an appropriate individual within the referring party to a similarly appropriate individual within the responding party. The method of delivery was irrelevant, provided that the document was actually delivered to the named address for service. That is what had happened and so there was no breach of clause 26. In respect of the use of the referring party’s accounts, the parties were agreed that the accounts were irrelevant and the court held that the adjudicator had exceeded his jurisdiction by making reference to them. In the alternative, the rules of natural justice required the adjudicator to obtain the parties’ submissions before deciding to approach the assessment of the claim in the way he had done.

In *Adonis Construction v O’Keefe Soil Remediation* [2009] EWHC 2047 (TCC), the referring party had served a notice of adjudication in respect of outstanding fees in connection with remedial works. The responding party contested jurisdiction on the basis that there was no contract in writing within the meaning of the Act. The referring party had sent a draft subcontract order and the official order was to be issued in due course. The draft subcontract order incorporated an adjudication clause but was never signed. The responding party alleged that they had not received the draft order until after commencement of the works.

It was found that the draft order did not amount to an offer and was not capable of acceptance by conduct. The requirement that the attestation page should be signed under seal and returned in seven days was the required mode of acceptance. The adjudicator had acted without jurisdiction and the application for summary judgment was refused.

### Pros, cons and bad timing

The case law highlights some of the issues that can be encountered when an adjudication decision has been made and subsequent enforcement is attempted.

When facing a notice of adjudication, it is important to be mindful of procedural and jurisdiction issues at the outset so that challenges can be made quickly. For construction professionals and their insurers, facing adjudication long after a project is completed, the process can be expensive: there is the cost, which may be significant, of preparing a reply and securing witness and expert evidence (if required) in a short timescale. The identity of the adjudicator can also be a cause for concern, particularly when complex legal issues come into play and the nominated adjudicator does not have a legal background. Although adjudication will be seen by some as the quickest way to resolve a dispute, it is not necessarily cheap and there is no guarantee of producing the right result, particularly when such a restrictive timetable exists.

There are some advantages – most notably, speed and the certainty of resolving the dispute. There are also benefits in not being bound by strict evidential rules, which allows flexibility in the presentation of a reply, and the opportunity of controlling costs to some extent.

The timing of a notice can be crucial. Most referring parties will be highly aware of bank holidays and holiday periods generally and it is often the case that adjudications will be commenced shortly before Easter and Christmas because this puts the responding party under considerable time pressure. When the other side has little time to prepare their reply, this can give the referring party a clear advantage!

### Key questions

If an adjudication notice is received, some initial questions should be considered:

- Has the notice been served in accordance with any contractual provisions?
- Is the contract covered by the Act?
- Has a dispute arisen?
- If a dispute does exist, is it a dispute under the contract?
- Is there a named adjudicator/nominating body in the contract? Has the referring party sent their notice to the correct person/nominating body?
- If there is a concern that a dispute should be decided by an adjudicator in a particular field,

is there scope for agreeing the identity of the adjudicator between the parties?

- Has the referring party attempted to refer more than one dispute to adjudication?

In the current economic climate, there is a drive to minimise costs and recoup money where possible and this is giving rise to an increasing number of adjudications. Where the financial position of the responding party is precarious, a quick process may lead to recovery, while protracted litigation may not.

This article is a brief summary of the procedural aspects of adjudications and some of the issues that require consideration. It cannot address all the various rules that apply or all the issues that can arise. It is important that anyone faced with a notice of adjudication should obtain early advice on the strategy to be adopted in responding to it and on any challenges that may be appropriate.

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