Liabilities arising from funding agreement caught by debts and trading liabilities exclusion

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Impact Funding Solutions Limited v AIG Europe Insurance Ltd [2016] UKSC 57

In an appeal that raised a question of general public importance, the Supreme Court has today (26 October 2016) clarified the scope of the *"debts and trading liabilities"* exclusion contained in the SRA's Minimum Terms and Conditions (**MTCs**) required to be incorporated into all solicitors' professional indemnity policies.

The appeal concerned a litigation funding agreement which put solicitors in funds to make disbursements in the conduct of their clients' litigation. The issue on appeal was whether the liability of the solicitors to the litigation funder for losses arising from breach of the funding agreement fell within the scope of the MTCs or whether it was excluded from cover.

The Supreme Court allowed, by a majority of 4 to 1, the appeal of insurers and held that the losses being claimed by the funder were covered by the *"Trade Debts"* policy exclusion which was substantially the same as the *"debts and trading liabilities"* exclusion in the MTCs. In doing so, the court construed the policy in the context of the regulatory background which aimed to make sure that protection was provided to the clients of solicitors.

This is a very helpful decision for insurers. Please click here to access the judgment.

Facts

Impact Funding Solutions Limited (**Impact**) entered into a funding agreement with Barrington Support Services Limited (**B**), a firm of solicitors. Pursuant to the arrangement, Impact, by entering into loan agreements with B's clients, provided funds to B to hold on behalf of its clients and to pay disbursements incurred in the conduct of its clients' litigation in pursuit of damages for industrial deafness. B failed to perform its professional duties towards its clients in the conduct of the litigation, by not investigating the merits of their claims adequately and through the misapplication of funds provided by Impact, breaching their duty of care to them. B thereby put itself in breach of a warranty in its contract with Impact.

B's clients were not able to repay their loans, and Impact sought to recover from B the losses which it suffered on those loans by seeking damages for the breach of the warranty. In May 2013, the High Court (His Honour Judge Waksman QC) awarded Impact damages of £581,353.80, which represented the principal elements of the loans that would not have been made if B had not breached the funding agreement. Impact then sought to recover those losses from B's insurers (AIG) under the Third Parties (Rights against Insurers) Act 1930.

The MTCs

The MTCs provide that *"the insurance must indemnify each insured against civil liability to the extent that it arises from private legal practice in connection with the insured firm's practice…"* This wide scope of general cover is qualified by a number of exclusions. The insurance policies issued must not exclude or limit the liability of the insurer except to the extent that any claim arises from the exclusions permitted in section 6 of the MTCs.

Insurers argued that the liability they were being asked to indemnify was excluded from cover under the policy term equivalent to clause 6.6(b) of the applicable MTCs, namely losses arising from *"breach by any insured of the terms of any contract or arrangement for the supply to, or use by, any insured of goods or services in the course of the insured firm's practice"*.

The earlier decisions

In a judgment given in December 2013, His Honour Judge Waksman QC analysed the nature of the arrangements between Impact and B, and construing the words in the policy, held that the losses being claimed by Impact fell firmly within the exclusion clause. The losses arose out of breach by B of the terms of the funding agreement; and looked at realistically and commercially, Impact was providing a service to B under the agreement, namely the disbursement funding for a particular claim, which enabled B to trade by bringing in more cases and thus the opportunity to generate profit for itself.

That decision was reversed by the Court of Appeal in February 2015, as considered in our earlier alert. Lord Justice Longmore, with whom the other judges agreed, concluded that the loans which Impact gave to cover disbursements in intended litigation were inherently part of the solicitors' professional practice and that the liabilities which B incurred under

its warranties to Impact were liabilities professionally incurred which were not covered by the *"Trade Debts"* exclusion.

The Supreme Court

The Supreme Court granted permission to appeal in May 2015, and the appeal was heard on 30 June 2016; accordingly its decision was eagerly awaited.

The Supreme Court (Lord Carnwath dissenting) allowed the appeal of insurers and held that the loss being claimed by Impact was covered by the *"Trade Debts"* policy exclusion which was substantially the same as the *"debts and trading liabilities"* exclusion in the MTCs. The majority concluded that the funding agreement was a contract for the supply of services to B; Impact contracted to supply those services to B in the course of B's provision of legal services; and Impact's claim against B arose out of the latter's breach of that contract. Prima facie, therefore, the exclusion applied to defeat Impact's claim against insurers, and there was no basis for implying a restriction into that exclusion in order to limit its scope.

Lord Hodge, who gave the lead judgment (with which Lord Mance, Lord Sumption and Lord Toulson agreed), started by construing the relevant terms of the policy against its factual matrix and construing the relevant terms of the funding agreement also against its factual matrix. The approach to construction was to look to the meaning of the relevant words in their documentary, factual and commercial context.

Lord Hodge said that the boundaries of insurer's liability was ascertained by construing the broad statement of cover (*"The Insurer will pay on behalf of any Insured all Loss resulting from any Claim for any civil liability of the Insured which arises from the performance of or failure to perform Legal Services"*, with the latter being defined broadly to include *"the provision of services in private practice as a solicitor…"*) and also the broad exclusions in the context of the regulatory background which aimed to make sure that protection was provided to the clients of solicitors.

Significantly, Lord Hodge went on to find that the general doctrine that exemption clauses should be construed narrowly had no application to the *"Trade Debts"* exclusion in the policy. *"An exemption clause, to which that doctrine applies, excludes or limits a legal liability which arises by operation of law, such as liability for negligence or liability in contract arising by implication of law…The relevant exclusion clause in this policy is not of that nature. The extent of the cover in the policy is therefore ascertained by construction of all its relevant terms without recourse to a doctrine relating to exemption clauses."*

He said the extent of insurer's liability *"is a matter of contract and is ascertained by reading together the statement of cover and the exclusions in the policy. An exclusion clause must be read in the context of the contract of insurance as a whole. It must be construed in a manner which is consistent with and not repugnant to the purpose of the insurance contract"*. He acknowledged that there may be circumstances in which in order to achieve that end, the court may construe the exclusions in an insurance contract narrowly.

Lord Hodge considered the funding agreement in its commercial context and, against that background, concluded that it was a contract for the supply of services to B for the following four reasons:

(i) B contracted as a principal with Impact and not as an agent for its clients;

(ii) B clearly obtained a benefit from the funding of its disbursements. *"Solicitors are personally responsible for paying the persons whom they instruct to do work or provide services in relation to a particular case, whether or not they receive funds from their clients. But for that funding from Impact, B would have had to obtain funds from its clients, who might not have been able to afford to pay, thus making pursuit of the claim impossible, unless B itself funded the disbursements in the hope of recovering its outlays through success in the claim. Impact's loans were available to fund not only the disbursements but also the premiums on the legal expenses insurance, thereby enabling the litigation to be fully funded"*;

(iii) this was not an incidental or collateral benefit to B derived from a service provided to its clients but was part of a wider arrangement, by which solicitors were able to take up claims, which their clients could not otherwise fund, and earn fees and success fees if the claim succeeded; and

(iv) it was a service for which B paid an administration fee, undertook the onerous obligation to repay Impact if a client breached the credit agreement, and entered into obligations and warranties on which Impact won its claim for damages against B.

Finally, Lord Hodge could see no basis for implying additional words into the exclusion in order to limit its scope. In his view, it could not be said that the policy would lack commercial or practical coherence if a term restricting the scope of the exclusion were not implied.

Lord Toulson, who gave a concurring judgment, added that:

"B and Impact made a commercial agreement as principals for their mutual benefit, as well as for the benefit of B's clients. Impact was not a client or quasi-client of B, and the promise by B which led to the judgment obtained by Impact was part of the commercial bargain struck by them. It did not resemble a solicitor's professional undertaking as ordinarily understood, and it falls aptly within the description of a "trading liability" which the minimum terms were not intended to cover. "

Lord Carnforth gave a dissenting judgment. In his view the exclusion clause, which directed attention to the purpose of the contract or arrangement, was to be construed narrowly. Whilst the funding agreement had the incidental benefits to B of enabling it to take on cases and so earn fees, and of protecting it against potential default by its clients, and could loosely be described as a “service”, that was not the essential purpose of the agreement, nor was it a service comparable in any way to the supply of goods or services for use in the practice.

Comment

This is a helpful decision for Insurers. Until the Court of Appeal's judgment, the ambit of the debts and trading liabilities exclusion in the MTCs was relatively uncontroversial, and it is helpful that the majority of the Justices have affirmed what was the traditional view. The effect of the judgment is that pure funders are likely to see any claims against solicitors be treated as uninsured losses. As such funders are treated as providing a service to firms, a distinction may therefore be drawn between funders and ATE insurers.

The extent of the application of the case and the exclusion clause in question may be reasonably limited, but there are occasions where the claim that is made originates from the firm's business arrangements rather than client services. Whilst Insured firms may query the benefits in the decision for them (and perhaps for some the relevance of the decision), any decision which may threaten to widen the scope of cover in the MTCs as understood by the insurance market might carry the risk of affecting insurers' appetite or premium levels. There is also inevitably of course the value of the proper construction of the clause being now settled, with the handing down of the last of three judgments.

Authors

Parminder Badhan
London - Walbrook
pbadhan@dacbeachcroft.com

Philip Murrin
London - Walbrook
pmurrin@dacbeachcroft.com

Clare Hughes-Williams
Newport
chugheswilliams@dacbeachcroft.com

DAC BEACHCROFT