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Supreme Court rules professional indemnity insurer has no liability to funder of insolvent solicitor's firm

Impact Funding Solutions Limited v. AIG Europe Insurance Ltd (formerly known as Chartis Insurance (UK) Limited
[2016] UKSC 57

Article by David Bowden

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Supreme Court rules PII insurer has no liability to funder of insolvent solicitor's firm
Impact Funding Solutions Limited v. AIG Europe Insurance Ltd - [2016] UKSC 57

In claims for industrial deafness, Impact provided funding to a solicitor's firms' clients to cover disbursements in their personal injury claims. That solicitor's firm had professional indemnity insurance from AIG. The solicitor's firm went into liquidation. The funder, Impact, sought to recover its losses from AIG under the insolvency provisions in the Third Parties (Rights against Insurers) Act 1930.

In the Mercantile Court, HHJ Waksman QC ruled [2013] EWHC 4005 (QB) that whilst Impact's claim was within the scope of the PII policy, AIG did not have to pay Impact because a provision in the PII policy excluded trade debts of the firm. This decision was reversed by the Court of Appeal on 3rd February 2015 [2015] EWCA Civ 31 when it decided that the funding arrangements here were inherently part of the solicitor's practice and were covered by AIG's PII policy. By a 4-1 majority ruling, the Supreme Court has restored the judgment of HHJ Waksman. This means that Impact cannot recover its losses from AIG under the PII policy.

Impact Funding Solutions Limited v. AIG Europe Insurance Ltd (formerly Chartis Insurance (UK) Limited
[2016] UKSC 57 26 October 2016
Supreme Court of the UK (Lords Mance, Sumption, Carnwath, Toulson and Lord Hodge JJSC)

What is background to this case?
Impact Funding Solutions Limited (Impact) provided funding to a solicitors firm called Lawyers at Work Limited. This law firm changed its name to Barrington Support Services Limited (Barrington) on 7 April 2011. Barrington was operated by a solicitor called Graham Hughes. Barrington specialised in industrial deafness cases. Barrington took on clients on the basis of a 'no win, no fee' conditional fee agreement (CFA). As an incorporated solicitor's practice Barrington had professional indemnity insurance (PII) from AIG Europe Limited (AIG). AIG's former name was Chartis Europe Limited.

Impact provided funding to Barrington for disbursements such as court fees. Impact provided loans to Barrington for these disbursements. Impact had funding by way of a line of credit of £5million from the Manchester Building Society and £750,000 from its shareholders. Impact operated a claims database called Veracity. Data was put on Veracity by various claims management companies (CMCs).

Barrington had entered into two separate Disbursement Funding Master Agreements (DFMA) with Impact. Under condition 6 of the DFMA Barrington agreed it would comply with all applicable laws, regulations and codes of practice and would indemnity Impact against all loss, damages, claims, costs and expenses. Under condition 13 of the DFMA Barrington warranted to Impact that the services to be provided to its clients would be in accordance with the client CFA.

Barrington was meant to verify information on Veracity before taking on a new client. Impact's instructions were that Barrington was not to take on a claim unless it had prospects of success of either 51% or 55%. Barrington's clients signed a loan agreement with Impact for the disbursement funding and a proposal form for the legal expenses insurance. The Barrington claims did not go to plan. 174 cases were abandoned by Barrington. Two cases went to trial, Barrington lost both and adverse costs orders were made. Impact suffered losses of £581,353.80. Barrington was placed in liquidation on 11 July 2011.

What was the issue under the 1930 Act?
Under section 1 of the Third Parties (Rights against Insurers) Act 1930 (the 1930 Act) where under any contract of insurance a person is insured against liabilities to third parties which he may incur, in the case of a resolution for voluntary winding up being passed, his rights against the insurer shall be transferred to and vest in the third party. Impact accordingly sought to recover its losses from Barrington's PII insurer, AIG. Before Judge Waksman, AIG denied liability to Impact on two bases:

- Barrington's PII did not cover this situation at all, and
- Even if it did, AIG's liability was excluded because this was a '*trade debt'* of Barrington.

What did HHJ Waksman QC in the Mercantile Court decide?
On 30 May 2013 following a trial between Impact and Barrington, HHJ Waksman QC gave judgment in favour of Impact for £581,353.80. There was then a second trial to determine what, if any liability, AIG had to Impact under the 1930 Act. Impact was able to prove in Barrington's liquidation and it could also pursue individual clients of Barrington for unpaid disbursements under the client loan agreements with Impact.

Under Barrington's PII policy, AIG agreed that it '*will pay on behalf of the insured all loss resulting from any claim for any civil liability of the insured which* ***arises from*** *the performance or failure to perform legal services*'. Clause 6 of the PII policy excluded liability for trade debts by providing that AIG would not cover any claim or loss '*arising out of, based upon or attributable to any trading or personal debt incurred by an insured*'. The trial between Impact and Barrington proceeded on the basis of agreed facts.

On the first issue, HHJ Waksman had to determine if Impact's loss '*arises from'* Barrington's performance or failure to provide legal services. There is a careful analysis of a number of authorities by HHJ Waksman in his judgment. In *Omega Proteins v Aspen Insurance* **[2011] Lloyd's Rep IR 183**, Christopher Clark J set out how a court should determine the proximate cause in an insurance dispute. He held that:

- An insured must establish it has suffered a loss,
- The loss must be within the scope of the policy, and
- It is open to an insurer to dispute that an insured was in fact liable.

In *Goddard & Smith v Frew* **(1939) 65 LILR 83**, rent collected by an estate agent was stolen by its employee. A claim against its PII failed because it was held to be outside the scope of the cover provided. Similarly in *West Wake Pine & Co v. Ching* **[1956] 2 Lloyd's Rep 618** a claim against an accountant's PII insurer was dismissed because it depended upon dishonesty and the PII covered only unmixed claims in negligence.

HHJ Waksman found that the proximate cause of the loss was Barrington:

- Failing to scrutinise the claims,
- Wrongly using the disbursements provided by Impact, and
- Failing to obtain valid after the event (ATE) insurance on behalf of its clients.

In *Sutherland Professional Funding Ltd v Bakewells (A Firm)* **[2013] Lloyd's Rep IR 93** ('*Sutherland*') HHJ Hegarty QC sitting in the Manchester Mercantile Court had to decide a similar claim against a PII insurer to that which Impact was making here. Judge Hegarty ruled on the hearing of a preliminary issue that a firm of solicitors could not claim an indemnity against its PII insurers for a claim made against it by a finance company which provided interim funding for personal injury litigation. This was because the claim did not '*arise from'* any neglect, omission or error of a solicitor and so was not within the scope of the PII policy.

Although HHJ Waksman distinguished *Sutherland* on its facts, he did rule that the proximate cause of Impact's losses was Barrington's breach of conditions 6 and 13 of Impact's DFMA with Barrington. Impact accordingly succeeded on the first issue before HHJ Waksman.

However, Impact failed on the second issue. In *Sutherland*, HHJ Hegarty had ruled that the claim against the PII insurer fell squarely within the '*debts and trading liabilities'* exclusion in the PII policy. AIG submitted this was correct and that Impact's claim here was also excluded by a trade debts exclusion clause in very similar terms. HHJ Waksman agreed and said that looked at realistically and commercially, Impact was providing a financial service to Barrington. Accordingly HHJ Waksman dismissed Impact's claim against AIG under the 1930 Act.

What did the Court of Appeal decide on the first appeal?
The Court of Appeal over ruled HHJ Waksman in a judgement handed down on 3 February 2015: **[2015] EWCA Civ 31**. In a short ruling which was disappointingly quite thin on analysis, Lord Justice Longmore said simply that you stand back from all the detail of the scheme and ask what is the essential purpose of clause 6 of AIG's PII policy.

Longmore LJ ruled that obligations arising out of loans made to cover disbursements in intended litigation were essentially part and parcel of the obligations assumed by a solicitor in respect of his professional duties to his client, rather than obligations personal to the solicitor. As an example of an excluded personal debt Longmore LJ said that if a solicitor incurred a liability to the supplier of a photocopier, then PII insurers would not cover that liability.

However Longmore LJ said the Impact loans to Barrington's clients were inherently part of its professional practice and were assumed, as an essential part of its duty to advise the client as to the likelihood of success in the intended litigation. Liabilities incurred by reason of the DFMA were liabilities professionally incurred to which the exception in the insurance policy did not apply. Accordingly, judgment would be

entered against AIG insurer for the sum for which Barringtons firm had been found liable together with interest.

What was the issue on this final appeal?
There was only 1 issue for the Supreme Court:

> '*What is the true construction of the words "in a series of related matters or transactions" within the aggregation clause of a professional indemnity insurance policy?*'

To answer this, the Supreme Court also had to look at the scope of the '*debts and trading liabilities'* exclusion contained in the Minimum Terms and Conditions of PII for Solicitors and Registered European Lawyers in England and Wales. The Supreme Court had to decide whether:

- the Court of Appeal's broad brush approach was correct, or
- whether the rulings of HHJ Waksman in this case and HHJ Hegarty in *Sutherland* were correct instead.

What ruling did Lord Hodge JSC make?
Lord Hodge giving the majority judgement was clear that the Court of Appeal were wrong and that the '*admirable*' and '*impressive*' judgement of Judge Waksman should be restored. Lord Hodge said to determine the appeal, the court had to construe only 2 things:

- the relevant terms of the PII policy, and
- the relevant terms of the DFMA against its factual matrix.

He said that the approach to construction is well established and that following *Rainy Sky SA v Kookmin Bank* **[2011] UKSC 50, [2011] 1 WLR 2900** a court merely '*looks to the meaning of the relevant words in their documentary, factual and commercial context*'. He said there was '*no ambiguity'* in the way the PII policy defined its cover and that there was '*no role in this case for the interpretation* contra preferentum'. Instead Lord Hodge said 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*'.

Interestingly Lord Hodge said that *Photo Production v Securicor* **[1980] UKHL 2, [1980] AC 827** had no application to construction here either because the AIG exclusion clause was '*not of that nature'* in that it did not seek to '*exclude or limit a legal liability which arises by operation of law'*. Lord Hodge noted the rules which the Law Society had promulgated on PII in 2009 which set the minimum limits for PII. When he compared AIG's term with the Law Society's minimum terms he found only '*minor differences in drafting*' which he said were '*of no significance'*. However he said AIG's terms had to be construed '*against the regulatory background which aimed to make sure that protection was afforded to clients of solicitors'*.

Lord Hodge said the DMFA had to be understood in '*its commercial context'* noting that it allowed clients who did not qualify for legal aid the opportunity to litigate their deafness claims noting that a failure of a claim '*is a serious financial risk'* and that Impact had provided funding for disbursements under the DFMA. Where Impact advanced sums to a Barrington's client, Barringtons then had to pay an administration fee to Impact on the execution of each credit agreement with that client and also a quarterly monitoring fee. Lord Hodge noted that Judge Waksman had found that Barringtons '*by failing to give advice properly to assess the merits of the compensation claims*' had breach the DFMA and that this finding of fact had not been appealed.

As to the nature of what Impact provided, Lord Hodge said this was a financial service and that the resulting loans to Barrington's clients were also a service Impact provided to Barrington because:

- Barrington contracted as principal with Impact and not as agent for its clients,
- Barrington obtained a benefit from the funding of its disbursements,
- This was not an incidental or collateral benefit to Barrington, and
- It was a service for which Barringtons paid the administration fee to Impact.

Lord Hodge's conclusion on the construction of the DFMA was:

> *'I therefore conclude that the DFMA was a contract for the supply of services to Barrington. Impact contracted to supply those services to Barrington in the course of Barrington's provision of legal services. Impact's claim against Barrington arose out of the latter's breach of that contract. Prima facie, therefore, the exclusion which I have set out in para 10 above applies to defeat Impact's claim against AIG, unless there is a basis for implying a restriction into that exclusion*.'

As to whether there was a valid restriction, Lord Hodge was he could '*see no basis or implying additional words into the exclusion in order to limit its scope*'. He said PII policy would not '*lack commercial or practical coherence if a term restricting the scope of the exclusion were not implied*'. He said Impact's claim was 'not a claim which is derived from the clients' claims' and that defences that Barrington 'might be able to plead against its clients cannot be advanced against Impact'. Concluding his judgment for allowing the appeal, Lord Hodge said:

> '*In short, Impact's cause of action under the DFMA is an independent cause of action. Excluding such a claim creates no incoherence in the Policy, as it is the combination of the opening clause and the exclusions that delimits AIG's contractual liability.*'

What else did Lord Toulson JSC add?
Lord Toulson delivered a judgment of his own which all judges in the majority agreed with. He ran through the history of business-to-business unfair contract terms including:

- Law Commission report number 69 from 1975 of 'Exemption clauses',
- Draft Bill, and
- Unfair Contract Terms Act 1977 itself.

He noted correctly that the Schedule 1 paragraph 1 of the 1977 Act provided that it did not apply to insurance contracts but he said it was '*nonetheless instructive to note the types of "*exemption clause*" which the Law Commissions saw as potentially suspect in consumer contracts'*.

His starting point was *Photo Productions* being '*authority that business people capable of looking after their own affairs should be free between themselves to apportion risks as they choose'*. On Law Society minimum cover he emphasised:

- AIG's terms replicated the Law Society's ones on minimum cover, and
- It was described as a '*professional liability policy'*.

On what were these '*professional*' liabilities, Lord Toulson felt these liabilities fell into 3 categories:

- Those which solicitors may incur to their clients *as a result of their professional retainer'*,
- Those which solicitors incurred as a result of undertakings given to third parties, and
- Liabilities to quasi-clients such as disappointed beneficiaries under a Will.

When Lord Toulson applied these to Impact's arrangements he concluded that what Impact was seeking to claim did not fall within the cover AIG provided to Barrington under the PII policy. He said that the '*essential purpose'* of the PII clauses had to be '*seen in the context of the essential purpose of the policy'* and that the Court of Appeal '*failed to grapple with the language of the clause'*. Lord Toulson also agreed that the judgment of the Court of Appeal had to be overturned and that the '*impressive judgment'* of Judge Waksman had to be restored.

What reasons did Lord Carnwath JSC give for dissenting?
At the 30 June hearing Lord Carnwath made only a few interventions. He initially queried what '*trade debts*' were. He then queried what the payments made to Impact were for and asked about claims that clients may have against AIG. On VAT he said at the hearing that this did not help at all and was merely a 'further complication for our purposes'.

His dissenting judgment came as a surprise moreover as its contents were not previewed in any way by these interventions. Whilst criticising Longmore LJ in the Court of Appeal for his 'stand back' approach, noting that having done this he 'never returned to the words of the actual words of the exclusion clause' but Lord Carnwarth felt the PII wording in context did in his view '*support a narrower approach than that taken by the judge'*.

He endorses the approach taken by the Court of Appeal in *Tektrol Ltd v. International Insurance of Hanover* **[2005] EWCA Civ 845** in which it interpreted an exclusion clause referring to erasure or loss of data on computer systems caused deliberately by malicious persons. The Court of Appeal held that this did not cover loss of data as a result of theft. He strained *Tektrol* and the use of '*goods*' and '*services*' together with the terms '*supply*' and '*use*' in AIG's policy to come to a narrow interpretation that favoured Impact. His was the sole dissent and no other judge agreed with his analysis.

What will be the implications for costs recovery in civil litigation?
The wording of funding schemes inevitably differs. Here it was clear that Impact had relied on assurances from Barrington as to what it was doing on individual cases. It did not seem that Impact

audited what had been done even when its exposure became high. It is worth noting that no defects were found in any of the scheme documentation. This is reassuring for solicitors who are using similar schemes to fund other cases on a CFA basis.

What are the implications of this ruling?
From a PII insurer's perspective there is a line to be drawn as to which liabilities are attributable to trade or personal debts of the practice of a solicitor or other insured professional and thus excluded from PII cover. As Impact has failed in its challenge, then this is unlikely to mean higher PII premiums for solicitors and other insured professionals. Standard PII policy wording used by insures should be reviewed in the light of this ruling.

Whether Impact tries to pursue its losses from Barrington's clients will depend on a few things. Firstly whether it is economic to pursue them and whether it will recover anything. Secondly whether this is a wise thing to do from a PR perspective. Finally whether the credit agreements that Impact got Barringtons to sign up on their behalf with the clients are enforceable noting here as Lord Hodge JSC does at paragraph 22 of his judgment that '*a solicitors' agent took a package of documents for the lay client to sign'*. If Barringtons were as sloppy at this as they were in dealing with the claims from Veracity, then there is no guarantee that Impact have enforceable loans at all.

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