THE SOCIETY OF LLOYD'S

AND

DAVID WALTER WILKINSON AND OTHERS

NO.2

Judgment of Mr Justice Colman
given on Wednesday, 23rd April 1997

Mr A Grabiner QC, Mr R Jacobs and Mr D Foxton instructed by Messrs Freshfields on behalf of the Plaintiffs.

Mr R Tager QC and Ms I Newman instructed by Messrs Epstein Grower on behalf of the Defendants.

Introduction

This is the second phase of the applications by Lloyd's for judgment under Order 14 against the defendants upon the claim by Lloyd's for the defendants' respective portions of the amount payable to Lloyd's in respect of the reinsurance premium originally due to Equitas under the R&R regime. The facts relating to R&R, and the circumstances in which the defendants, who did not accept R&R, became bound to pay the Equitas reinsurance premium to Lloyd's, as assignee of the premium from Equitas, have already been set out in detail in my judgment in the first phase of these applications which I delivered on 20th February 1997.

The issues raised by the second phase of these applications raise points of fundamental importance in the law of rescission of contracts for fraudulent misrepresentation and of the principles of set-off as between the principal debtor and the assignee of a chose in action.

There are three issues before the court. These can be described as

(i) "the Rescission Issue";
(ii) "the Set-Off Issue"; and
(iii) "the Stay of Execution Issue".

The Rescission Issue is based, for present purposes only and entirely without any factual admission by Lloyd's, on the assumption that the defendants were each induced to become members of Lloyd's by signing the 1986 General Undertaking, or subsequently to remain members of Lloyd's by misrepresentations fraudulently made by Lloyd's or its agents. The defendants contend that by reason of such misrepresentations each of them was entitled to rescind and has rescinded his membership contract with Lloyd's and thereby effectively avoided his membership ab initio. Each contends that in consequence he is not liable to pay the Equitas premium because, having avoided his membership ab initio, he is not bound by any of the R&R arrangements.

The Set-Off Issue arises only if the defendants have not been entitled to rescind their contracts of membership with Lloyd's. In essence the question is whether, assuming, which Lloyd's strongly denies, that each of them has a cross-claim against Lloyd's for damages for fraudulent misrepresentation inducing them to become members, they are entitled to set off that cross-claim against Lloyd's claim for Equitas premium. The main issues here are whether Lloyd's, as assignee of the premium from Equitas, is entitled to the benefit of an anti-set-off or "pay now sue later" clause in the reinsurance contract between Equitas and the defendants. If Lloyd's are right on this point, the defendants have no more than a counterclaim for damages for fraud for the purposes of Order 14.

The Stay of Execution Issue arises only if the defendants are wrong on the Set-Off Issue. It raises the question whether, in view of the defendants' cross claim for damages for fraudulent misrepresentation, the court should order a stay of execution of

judgment under Order 14. The main issue here is whether the express provision in clause 5.5 of the Equitas reinsurance contract whereby the defendants each waived any claim to any stay of execution can be relied upon by Lloyd's or should in any event be given effect to by the court.

I must now consider each of those issues. It is common ground that in so far as these three issues raise questions of law, I should give judgment under Order 14A.

It is right to add that the defendants have raised in the course of these proceedings the argument that they have a cross claim, set-off or counterclaim by reason of Article 85 of the Rome Treaty. I indicated in the course of this hearing that if and to the extent that the issues raised by that submission were indistinguishable from those determined by Cresswell J. in Society of Lloyd's v. Clementson (No.2) [1996] CLC 1590, I would not be prepared to re-visit those issues in these proceedings. In the event, the defendants advanced no argument on this basis and this judgment does not therefore deal with any possible defence under Article 85.

The Rescission Issue

The defendants, Mr Wilkinson and Mr Leighs, submit that they have effectively rescinded their respective contracts of membership of Lloyd's. Mr Wilkinson wrote to Lloyd's Members Agency Services Ltd on 5th June 1995 giving notice of rescission of membership of Lloyd's on the grounds of fraudulent misrepresentation by Lloyd's. He had become an underwriting member with effect from 1st January 1980. He signed the revised form of General Undertaking in October 1986 and continued to underwrite until the 1991 year of account, in the course of which he resigned his membership, that is to say he ceased to underwrite after 31st December 1991. Mr Leighs does not appear to have asserted an entitlement to rescind for fraudulent misrepresentation until he did so in his affidavit in these

proceedings served in December 1996. He began as an underwriting member with effect from 1st January 1981 and signed the 1986 General Undertaking in October 1986. He resigned in July 1988 and therefore ceased to underwrite after 31st December 1988. Mr Lyon has suffered from serious ill health which has incapacitated him for many months. For this reason he has been unable to retrieve his Lloyd's documents relating to his becoming a member of Lloyd's and to his signature of the 1986 General Undertaking from his house in Spain. It is unclear whether he could establish any factual basis for his allegation of being induced to become or continue as a member of Lloyd's by fraudulent misrepresentation. However, for present purposes, I assume that he could adduce such evidence of sufficient strength for Order 14 purposes. There is no evidence of his having given express notice of rescission, but Mr Michael Freeman, his solicitor, has sworn an affidavit in these proceedings indicating that it is Mr Lyon's intention to serve a supplementary affidavit alleging that he was induced to become a member of Lloyd's by fraudulent misrepresentation. I assume that such allegations will form the basis of a claim to be entitled to rescind the contract of membership. It is therefore appropriate in the interests of the efficient management of these proceedings that Mr Lyon should be bound by the determination of this court on the issues now before it which are bound eventually to arise in the proceedings against him. He became an underwriting member with effect from 1st January 1977 and ceased to underwrite at the end of the 1990 year of account, following his resignation in that year.

Lloyd's strongly challenges the defendants' claim to be entitled as of right to rescind their contracts of membership of Lloyd's. The following is a broad outline of its main submissions.

(a) Rescission at common law is only available to a party to a contract who can make <u>precise</u> restitutio in integrum to the misrepresentor party. Otherwise the only way in which rescission can be obtained is by applying to the court for an order for rescission pursuant to its equitable

jurisdiction, for that jurisdiction enables the court to make special orders by way of indemnities, adjustments or the taking of accounts, designed to achieve a redistribution of benefits derived by either party from the contract to be rescinded.

(b) In the present case the defendants cannot rescind at common law and are obliged to apply to the court for the exercise of its equitable jurisdiction to order rescission. For this there are several reasons.

(i) The defendants require an indemnity in respect of the losses sustained by them on their underwriting commitments, for these policies with third parties, as is common ground, cannot be avoided.

(ii) Contributions by the defendants to Lloyd's Central Fund and payments out of that Fund in respect of the defendants' underwriting liabilities would have to be the subject of an equitable account.

(iii) The court would have to make special orders to accommodate the rights of policy-holders under the security trust deeds at Lloyd's in view of the retrospective termination of the defendants' membership of Lloyd's.

(c) Third parties' rights would be affected detrimentally. The defendants have been underwriting members of Lloyd's for many years and have participated in syndicates under contracts with their underwriting agents and managing agents and they have also become parties to contracts of insurance and reinsurance. The defendants' participation in these contracts with third parties has been subject to the Lloyd's regulatory regime, in particular the system of

Lloyd's byelaws and regulations. Accordingly, avoidance of membership ab initio will prejudicially impinge on accrued third party contractual rights. Notably, policy-holders would lose the benefit of access to monies in Lloyd's Central Fund and of Lloyd's administration of policies through Lloyd's Policy Signing Office and of claims collection and payment through Lloyd's Underwriters Claims and Recoveries Office. If, as accepted by the defendants, all contracts of insurance and reinsurance entered into on behalf of the defendants would remain unaffected by rescission, there can be no basis for detaching the defendant names from the Lloyd's system of securing and administering those contracts.

(d) In summary, the conduct of the defendants' business at Lloyd's over the years has given rise to a complex network of contractual obligations owed by the defendants to third parties, some of whom, such as other syndicates, or agents or other underwriting years under the reinsurance to close which are also subject to the Lloyd's regulatory regime, that contractual network being under-pinned by the Lloyd's system of security under the premium trusts fund and the Central Fund. Now to extract the defendants from any of the essential features of this system would be to go far beyond any concept of rescission hitherto accepted.

(e) If rescission were otherwise an appropriate remedy, the court could not order it in this case because to do would render the contracts of insurance written by the defendants illegal under section 2(1) of the Insurance Companies Act 1982. By having written and/or carried out such contracts when not members of Lloyd's the defendants would have committed criminal offences and in so far as the defendants continued to carry out such contracts they would continue to commit such offences, for example by meeting their obligations to pay claims on policies.

Furthermore, contravention of the Insurance Companies Act would engage the powers of intervention of the Secretary of State under sections 37 to 45, designed to protect policyholders. These would include the power to require the defendants to maintain in the European Community assets equal to the amount of that defendant's European Community Liabilities (section 39), to require such assets to be transferred to a trustee (section 40), and generally to take such action as was appropriate for the purpose of protecting policyholders. Lloyd's argues that the amount of any such deposit could hardly be less than the name's Equitas premium and might well be more.

(f) The rescission of the defendants' membership contracts would lead to syndicate fragmentation and acute problems of administration of the 1992 and prior years run-off. This stemmed from the nature of the Lloyd's system under which the syndicate is the standard trading unit and not the individual underwriting name (cf my judgment in the first phase of these proceedings at pages 29-30). Just as it was administratively impossible and unprecedented to treat a minority of names within a syndicate differently from the syndicate as a whole with regard to ordinary inward and outward contracts of insurance and reinsurance, so too as a logical consequence it would be administratively impossible to detach a name or names from a syndicate already reinsured by Equitas and treat them as if they had never participated in the syndicate at all. Two possible consequences might flow from rescission. First and more probably the liabilities of the rescinding names would continue to be run-off by Equitas as part of its administration of the syndicate run-off. This would be an inequitable result because it would mean that Equitas would be reinsuring the defendants yet receiving from them no premium. Secondly, the responsibility for each name's run-off would be taken over by the names themselves or by their own underwriting or run-off agents. That would involve the

imposition of a multiplicity of administrative regimes in respect of the same syndicate's run-off of the same risks including recoveries under syndicate outward reinsurances. It would involve an unacceptable dislocation of the whole R&R regime.

(g) Further, it could not be conclusively determined whether the defendants were entitled to rescind until it had been determined whether Lloyd's made fraudulent misrepresentations which induced the defendants to enter into the 1986 General Undertaking and thereafter to remain underwriting members in respect of subsequent years of account. That issue could not practicably be tried for many months. A full trial would be necessary. Even if prepared with urgent expedition it was difficult to envisage a judgment much before 1998. In the meantime, administration of the defendants' run-off would have to be conducted by Equitas under the R&R regime and the defendants' liabilities would have to be discharged using the assets of Equitas. These assets included syndicate assets as well as monies contributed by other parties to the R&R settlement, including Lloyd's itself, many of the agents, brokers, errors and omissions underwriters and syndicate auditors. There would also have been recoveries by Equitas from syndicate reinsurance protections and those monies would have become part of the assets of Equitas. If rescission were to take effect retrospectively from the date of the court's determination of the issue of fraudulent misrepresentation inducing membership, the whole administration of the defendants' syndicates' run-off for more than a year (since October 1996) would have to be dismantled to detach the individual positions of separate names from the position of the syndicates as a whole and separate run-off accounting would have to be established to cope with each rescinding name and with the remainder of the syndicate separately.

(h) Having regard to the fact that the R&R settlement involved all names paying the Equitas premium, regardless of whether they were accepting names, it would be unconscionable for certain of the names now to be entitled to withdraw from Equitas, leaving the remaining accepting names (some 94 per cent of the total) bound to a regime which they had accepted on the basis of the S.O.D.

(j) In all the circumstances damages was the appropriate remedy and not rescission. Common Law rescission was unavailable because precise restitutio in integrum was impossible and the assistance of the court was needed in order to effect major financial and administrative adjustments. In any event the impact on the rights of third parties would be so substantial that rescission should not in any event be ordered.

On behalf of the defendants Mr Romie Tager QC submits that the defendants have been and are indeed entitled to rescind without recourse to the courts because in this case they need no discretionary remedy in addition to the exercise of their common law right of dissolution of the contract of membership ab initio. Their claim for damages for deceit against Lloyd's would have to give credit for any benefits received during the course of their membership. Additionally, they would be entitled to recover as an indemnity or money had and received payments to Lloyd's, such as the entrance fee, annual subscription and annual and special levies for the Central Fund assessed on premium income. The analysis which underpins this submission involves the drawing of a clear distinction between the contract of membership with Lloyd's on the one hand and contracts which the defendant members have entered into in consequence of that contract on the other hand. In essence, Mr Tager's submission is that losses under such other contracts must be the subject of compensation by damages for deceit. He submits that damages for deceit would be calculated by taking in relation to the years of account down to the date of trial the difference between underwriting losses in

unprofitable years and underwriting gains in profitable years and adding to that the court's estimate of an amount representing the name's total outstanding liability for claims on policies binding on the name which, if commercially reinsurable, would probably be the run-off premium.

Application of this analysis leads, according to the defendants, to the following results.

In relation to the Central fund, there is no need for the taking of an account because the names had no beneficial interest in the amount of their payments to that "old" Fund and Lloyd's has already paid it over to Equitas as part of the R&R financing arrangements. Payments into that Fund would be recoverable as money had and received. The 'new' Central Fund applicable in respect of years of account subsequent to 1992 is of no relevance because the defendants had ceased to underwrite long before it was brought into existence.

In relation to the security trusts fund, since Lloyd's is not a party to those trusts, no equitable remedy is required. The trust funds have now all been paid over to Equitas under the R&R regime and have therefore been exhausted in or towards the discharge of the underwriting liabilities of the defendant names.

Mr Tager emphasises that the existence of the names' third party contracts is immaterial to the question whether restitutio in integrum is still possible. He submits that a distinction is to be drawn between the impact of rescission on third party contracts or interests acquired from the party against whom rescission is sought on the one hand and the third party contracts or interests acquired from the rescinding party on the other hand. He relies on the robust approach of the courts to rescission in cases of fraud, such as <u>Spence v. Crawford</u> [1939] 3 All ER 271 and <u>Hulton v. Hulton</u> [1917] 1 KB 813, where rescission of contracts has been permitted when complete restitutio in integrum could not be accomplished. Mr Tager

submits that, if one leaves out of consideration all contracts between the defendants and third parties there is no question in this case of property which cannot be restored upon rescission because, as between the defendants and Lloyd's, only money has been transferred by the defendants and that is recoverable as money had and received.

The defendants challenge the case advanced by Lloyd's as to the impact of rescission on third party interests. They contend that the basis of the bar to rescission on account of third party rights is nothing less than the protection of the bona fide purchaser for value without notice of property amounting to the subject matter of the contract sought to be rescinded and rely on Babcock v. Lawson (1880) 5 QBD 284.

The defendants argue that even if it is necessary to investigate the impact of rescission on policyholders to see whether it would be prejudicial to their interest in the policies, the result would be that there would be no substantial prejudice because, although they would not be reinsured by Equitas, the latter would in practice, pay claims on a syndicate basis without deduction in respect of names who had rescinded. The defendants would be entitled to recover as part of their damages an amount in respect of the premium which they would need to pay to obtain run-off reinsurance protection against the inability of Equitas to satisfy claims on the defendants. Accordingly, third party policy-holders would not be left in the position of having worthless claims against unreinsured insurers.

As to the Lloyd's argument that one consequence of rescission whereby the defendants' membership was set aside ab initio would be that the defendants would have been carrying on the business of insurance without authority contrary to the Insurance Companies Act 1982, the defendants contend that their underwriting activities were all carried out before the contract was rescinded and that, although rescission has retrospective effect, they were not at the material time acting unlawfully.

They rely by way of analogy on the cases on section 143(1) of the Road Traffic Act 1972 (using a vehicle without a valid insurance policy being in force) which have held that where at the relevant time there is in force a policy which is subsequently avoided for material non-disclosure or misrepresentation, no offence is committed: see Goodbourne v. Buck [1939] 4 All ER 107 and [1940] 1 All ER 613 and Adams v. Dunn [1978] CLR 365.

Restitutio in Integrum: The Law

Before answering this question it is necessary to investigate the function of restitutio in relation to rescission of a contract for fraudulent misrepresentation.

At common law, before the Judicature Acts, a party induced by fraud to enter into a contract had available three remedies: (i) he could rescind the contract by giving notice of rescission; (ii) he could recover from the other party payments which he had made to that party under the contract as money had and received; (iii) he could recover damages for deceit. The function of each of these three remedies is shown by the judgments in Clarke v. Dickson (1858) E B & L 148. From those judgments it is clear that the function of rescission was dissolutive and not compensatory: the contract having been induced by fraud, the misrepresentatee had a right to avoid the contract ab initio by giving notice to that effect. He was entitled to treat the contract as a nullity if he chose to do so. If the contract were wholly executory, that presented no particular problem: no money or property had passed and no material benefit had been enjoyed. If the contract had been wholly or partly performed, the avoidance of the contact ab initio involved, as a matter of principle, restoration of the status quo. Whether that was possible depended upon the nature of the contract and what prior performance had entailed. Unless property, including a chose in action, could be restored to the misrepresentor in substantially the same condition as when delivered or transferred under the contract, rescission was not available. Thus, in Clarke v.

Dickson, supra where the plaintiff sought to rescind for fraud a contract for the purchase of shares in a mining partnership operated on the cost book principle after he had agreed to their being converted into shares in a joint stock company and at a time when the company was already in the process of being wound up, it was held that, because he had changed the nature of the interest, he could not re-transfer that which had originally been delivered to him, and rescission was therefore impermissible.

A second reason why the plaintiff in that case could not rescind was that he had enjoyed the benefit of his participation in the partnership for three years before, having discovered the fraud, he had purported to rescind. He had during that period enjoyed the benefit of a chance of profit and had received dividends in respect of his shares. In other words, he had received a substantial part of the benefit which the contract was designed to confer upon him. As Lord Campbell CJ graphically observed in argument at page 153:

> "For three years the plaintiff has had a chance of profit. Do you say that in the case put, of the lottery ticket, you could return it after it had turned up a blank?"

The answer to that question could only be No, because a contract for the purchase of a right to participate in a speculative venture is one thing before the venture has been entered upon and a fundamentally different thing after participation in the venture and when the outcome is known. The benefit or subject-matter of the contract could not at that stage be retransferred because, although the contract remained partly to be performed, the subject-matter that remained was materially different from that when the contract commenced.

That case also shows that the remedy of recovery of money paid to the misrepresentOr as money had and received, is ancillary to the remedy of rescission and is therefore also subject to

complete restitutio being possible if only with the help of such ancillary remedy.

The action for damages for deceit was available both in addition to and as an alternative to rescission. Its function was to compensate the misrepresentee for losses caused by the fraud which might be sustained either if there were rescission or if rescission were unavailable.

The requirement at common law that precise restitutio of property or subject-matter should be possible in order for rescission to be available was emphasised by Lord Blackburn in Emile Erlanger v. The New Sombrero Phosphate Company (1878) 3 App Case 1218 at pages 1278-1279:

> "It would be obviously unjust that a person who has been in possession of property under the contract which he seeks to repudiate should be allowed to throw that back on the other party's hands without accounting for any benefit he may have derived from the use of the property, or if the property, though not destroyed, has been in the interval deteriorated, without making compensation for that deterioration. But as a Court of Law has no machinery at its command for taking an account of such matters, the defrauded party, if he sought his remedy at law, must in such cases keep the property and sue in an action for deceit, in which the jury, if properly directed, can do complete justice by giving as damages a full indemnity for all that the party has lost: see Clarke v. Dixon, and the cases there cited.
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> But a Court of Equity could not give damages, and unless it can rescind the contract, can give no relief. And, on the other hand, it can take accounts of profits, and make allowance for deterioration. And I think the practice has always been for a Court of Equity to give this relief whenever, by the exercise of its powers, it can do what is

practically just, though it cannot restore the parties precisely to the state they were in before the contract. And a Court of Equity requires that those who come to it to ask its active interposition to give them relief, should use due diligence, after there has been such notice or knowledge as to make it inequitable to lie by. And any change which occurs in the position of the parties or the state of the property after such notice or knowledge should tell much more against the party in mora, than a similar change before he was in mora should do."

The defendants have submitted that, particularly in cases of fraud, rescission is available notwithstanding that restitutio cannot be precisely accomplished. Mr Tager relied in support of this proposition on the decision of the House of Lords in the Scottish appeal, Spence v. Crawford [1939] 3 All ER 271. Lord Wright, having, at page 288, observed that the law of rescission was the same in Scotland as in England, stated that the remedy was equitable. That is because, although the appellant alleged fraud, he had applied to the court for an order for rescission of his contract to sell shares to the respondent, claiming restitution of the shares. Because the appellant had invoked the court's jurisdiction to order restitution, the equitable principles applicable to rescission were brought into play. The speeches have therefore to be understood against that background.

Lord Wright, having referred to the passage from Lord Blackburn's speech in Erlanger v. New Sombrero, which I have already cited, continued:

"In this case, Lord Blackburn is careful not to seek to tie the hands of the court by attempting to form any rigid rules. The court must fix its eyes on the goal of doing "what is practically just". How that goal may be reached must depend on the circumstances of the case, but the court will be more drastic in exercising its discretionary powers in a case of fraud than in a case of innocent

misrepresentation. This is clearly recognised by Lindley MR, in the Lagunas case. There is no doubt good reason for the distinction. A case of innocent misrepresentation may be regarded rather as one of misfortune than as one of moral obliquity. There is no deceit or intention to defraud. The court will be less ready to pull a transaction to pieces where the defendant is innocent, whereas in the case of fraud the court will exercise its jurisdiction to the full in order, if possible, to prevent the defendant from enjoying the benefit of his fraud at the expense of the innocent plaintiff. Restoration, however, is essential to the idea of restitution. To take the simplest case, if a plaintiff who has been defrauded seeks to have the contract annulled and his money or property restored to him, it would be inequitable if he did not also restore what he had got under the contract from the defendant. Though the defendant has been fraudulent, he must not be robbed, nor must the plaintiff be unjustly enriched, as he would be if he both got back what he had parted with and kept what he had received in return. The purpose of the relief is not punishment, but compensation. The rule is stated as requiring the restoration of both parties to the status quo ante, but it is generally the defendant who complains that restitution is impossible. The plaintiff who seeks to set aside the contract will generally be reasonable in the standard of restitution which he requires. However, the court can go a long way in ordering restitution if the substantial identity of the subject-matter of the contract remains. Thus, in the Lagunas case, though the mine had been largely worked under the contract, the court held that, at least if the case had been one of fraud, it could have ordered an account of profits or compensation to make good the change in the position. In Adam v. Newbigging, where the transaction related to the sale of shares in a partnership, which had become insolvent since the contract, the court ordered the rescission and mutual restitution, though the

misrepresentation was not fraudulent, and gave ancillary directions so as to work out the equities. These are merely instances. Certainly in a case of fraud the court will do its best to unravel the complexities of any particular case, which may in some cases involve adjustments on both sides."

Lord Thankerton referred with approval (at page 279-280) to a passage in the judgment of Rigby LJ. in Lagunas Nitrate Co v. Lagunas Syndicate [1899] 2 Ch 392 at pages 456 to 457. The passage begins thus:

> "No doubt it is a general rule that in order to entitle beneficiaries to rescind a voidable contract of purchase against the vendor, they must be a position to offer back the subject-matter of the contract. But this rule has no application to the case of the subject-matter having been reduced by the mere fault of the vendors themselves; and the rule itself is, in equity, modified by another rule, that where compensation can be made for any deterioration of the property, such deterioration shall be no bar to rescission, but only a ground for compensation."

Then, having referred to Lord Blackburn's speech in Erlanger v. New Sombrero, he continued:

> "This important passage is, in my opinion, fully supported by the allowance for deterioration and permanent improvements made by Lord Eldon and other great equity judges in similar cases.... The obligation of the vendors to take back the property in a deteriorated condition is not imposed by way of punishment for wrongdoing, whether fraudulent or not, but because on equitable principles it is thought more fair that they should be compelled to accept compensation than that they should go off with the full profit of their wrongdoing. Properly speaking, it is not now in the discretion of the court to say whether

compensation ought to be taken or not. If substantially compensation can be made, rescission with compensation is ex debito justitiae."

Founding upon this approach Lord Thankerton then considered whether, in a case of fraudulent as distinct from innocent misrepresentation, changes in the subject-matter of the contract (in Spence v. Crawford the value of the shares) while in the hands of the misrepresentor would operate as a bar to rescission. He concluded:

"While the decision in any case must turn on the terms of the contract under reduction and the facts of the particular case, I may say broadly that, in my opinion, the defender who, as purchaser, has been guilty of fraudulent misrepresentation is not entitled in bar of restitution to found on dealings with the subject purchased, which he has been enabled by his fraud to carry out."

The order for rescission in Spence v. Crawford, discussed by Lord Thankerton at pages 283 to 284, shows clearly that rescission was ordered on the basis of monetary adjustments to take account of losses, dividends and interest, as well as repayment of the price of the shares by the vendor appellant.

This case can, therefore, be treated as authority for the proposition that where the party seeking rescission for fraud invokes the jurisdiction of the courts to effectuate rescission, the court will, if necessary, in the interests of justice, be prepared to order rescission in a case where restoration of the exact equivalent of the original subject-matter of the contract is impossible, provided that a broadly just result can be obtained by ancillary orders for monetary adjustments to reflect benefits and detriments which have already accrued under the contract, as well as changes in the subject-matter. It is, however, not authority for the proposition that in a case, even where fraud is involved, where the court is not invited to make

any order for rescission which involves the exercise of its equitable jurisdiction to make ancillary orders in aid of restitutio, rescission will be available to a misrepresentee who cannot give substantial restitutio. In other words, it does not support the proposition that in a case of self-help rescission, even where fraud is alleged, anything less than substantial restitutio will be required. It follows as a matter of logic that if it is just and equitable to order rescission only if partial restitutio can be supplemented by ancillary equitable orders for adjustment, rescission will not be available if the equitable jurisdiction of the court to make such orders is not invoked by the party seeking rescission and is not otherwise engaged.

The decision in Hulton v. Hulton [1917] 1 KB 813, strongly relied upon by the defendants, does not disturb this analysis. The wife applied for rescission of a deed of separation for fraudulent misrepresentation by her husband. Although the husband and wife had performed the contract for five years, including annual payments by the husband and the destruction of letters passing between them, as well as the release of a debt due from the wife to the husband of £375, the court ordered the deed to be rescinded. The reasoning was that, in the exercise of its equitable jurisdiction, the absence of complete restitutio should not bar the remedy because, as Scrutton LJ. put it at page 826, if the deed were discharged ab initio "the benefits on the one side and the other (were) commensurate." He explained the court's refusal to order repayment of the annual payments in these words:

> "While it is true that the wife has received 500 l a year for some years, the husband has received during those years freedom from molestation, freedom from proceedings by the wife for restitution of conjugal rights, and other very considerable advantages. Taking all that into account, I see no reason for ordering the return of the 500 l a year,

a sufficient quid pro quo having been given to the husband."

It is to be noted, however, that, as appears from the judgment of Swinfen Eady LJ. at page 522, the court did make a monetary adjustment by requiring the wife to give credit against her costs for the £375 loan.

This case is another example of the extremely flexible approach to restitutio where the equitable jurisdiction of the court is invoked in case of fraud and of the willingness of the courts to make monetary adjustments in furtherance of flexibility in such cases.

In the present case the defendants assert that they have already effected rescission and deploy that by way of defence to Lloyd's claim for the Equitas premium. They do not suggest that it is necessary or appropriate in the interests of justice for the court to exercise any ancillary power of monetary or other adjustment, because they assert that substantial restitutio is indeed available without any such ancillary orders.

In such a case, however, it is not correct in principle that, as submitted on behalf of Lloyd's, the defendants must necessarily fail to sustain their self-help rescission as a defence unless they can give precise restitutio as if they were advancing the rescission by way of defence in a court of common law before the Judicature Acts. If upon an application to the court for rescission the court could conclude in the exercise of its equitable jurisdiction that, even if substantial restitutio were impossible, the justice of the case required that rescission should be ordered without ancillary orders for adjustment or otherwise, there can be no reason in principle why the party who would be entitled to rescission should not anticipate the making of such an order by a self-help notice of rescission. When that party subsequently comes to rely on his rescission by way of defence to a claim under the contract, he

is entitled to adopt the position that if he had applied to the court for such an order, it would have been made. If it transpires that the order would have been made only subject to ancillary orders for adjustment his defence must fail unless, perhaps, he is prepared to be put on terms as to acceptance of the appropriate adjustments.

Accordingly, I approach the issue of rescission in this case on the basis of the following questions:

(a) Is precise restitutio in integrum possible?

(b) If not, is the extent to which restitutio can be achieved, taking into account the defendants' claims for money had and received and for damages for deceit, sufficient to create a just and equitable dissolution of the contract?

No question of the exercise of the court's equitable jurisdiction to make ancillary orders for adjustment can arise in these proceedings because:

(i) Lloyd's submit that no such adjustment could accomplish any precise or sufficient restitutio;

(ii) the defendants submit that restitutio is sufficiently available without any such adjustment;

(iii) neither party advances any arguable basis upon which such adjustment could be made.

Restitutio in Integrum: the Facts

The subject-matter of the contracts of membership of Lloyd's now sought to be avoided ab initio may be described as the admission of the underwriting name to the facilities of the sole

administrative and regulatory institution within which a private individual is permitted to underwrite policies and carry on the business of insurance in Britain under English Law.

Each of the defendants has been an underwriting member of Lloyd's for a substantial number of years. During the period of membership, each has enjoyed the benefits of Lloyd's administrative facilities without which underwriting could not have been carried out and each has by the fact of membership enjoyed the benefit of being able legally to conduct the business of insurance under the Insurance Companies Act 1982 and its predecessors.

The chief administrative facilities involved include the very fundamental availability of Lloyd's Policy Signing Office, without which no contract of insurance could be entered into by the name, Lloyd's Central accounting system under which premium payments and claims settlements are effected, Lloyd's Underwriters Claims and Recoveries Office, which is essential for the processing of inward and outwards claims, and the Lloyd's administrative control or supervision by means of internal legislation and monitoring of all participants in the Lloyd's market who are essential to a name's underwriting business, amongst whom are included underwriting and managing agents, syndicate auditors and brokers. All these administrative facilities are part of the complex and interlocking network of the Lloyd's system without which no underwriting member can carry on business. In addition, Lloyd's Central Fund provides an important source of ancillary funding which plays a significant part in the preparedness of the British, American and other national regulatory authorities to permit Lloyd's members to underwrite insurance business in Britain, North America and elsewhere.

If one poses the question whether the benefit of this subject-matter can be returned to Lloyd's on the basis that the contract of membership is avoided ab initio, the answer can only be that,

because of its very nature, it is incapable of being returned. The subject-matter has been irretrievably consumed in the course of the defendants' conduct of their underwriting business over the years. There can therefore be no precise or substantial restitutio.

But can restitutio be partially achieved to the extent where it would be possible to create a just and equitable dissolution of the contract of membership? Is this a case in which like Hulton v. Hulton, supra, although the contract is avoided ab initio, the benefits and detriments and the subject-matter of the contract can be left where they lie, without re-transfer or adjustment and in substance the contract can simply cease to have any effect in future?

An argument can be advanced (although the defendants have not advanced it) that, in as much as the defendants have over the years of their membership paid to Lloyd's their membership fees, their annual payments and their contributions to the Central Fund, they have paid for the benefits of membership for as long as they were underwriting insurance business and now that they have ceased to do so and the administration of their syndicates' run-off has been taken over by Equitas which has reinsured their liabilities as underwriting members, substantial justice can be done if the membership contracts are now avoided ab initio, leaving all such payments in the hands of Lloyd's but permitting the defendants to pursue their claims for damages for deceit in respect only of their net underwriting losses. The argument would then be that the benefits on either side were "commensurate", to use the phrase of Scrutton LJ. in Hulton v. Hulton, and restitutio was therefore unnecessary.

Self-help rescission is said to have the effect of avoiding ab initio the defendants' contracts of membership. If that rescission were effected prior to the date when the Equitas contract of reinsurance was entered into (3rd September 1996) the defendants could not be parties to that contract, for they could

not at the date properly be designated as Names or Close Year Names within the definitions of those terms in the contract, which provides:

> "THIS AGREEMENT is made on 3rd September 1996 Between....
>
> THE UNDERWRITING MEMBERS OF LLOYD'S comprising the syndicates specified in schedule 1 as constituted for the years of account specified in schedule 1 (the Syndicates and each a Syndicate) in their capacity as members of one or more of the Syndicates (the Names) acting through the Substitute Agent;
>
> THE UNDERWRITING MEMBERS OF LLOYD'S comprising syndicates reinsured to close whether directly or indirectly into the Syndicates or Centrewrite (the Closed Year Syndicates and each a Closed Year Syndicate) in their capacity as members of one or more of the Closed Year Syndicates (the Closed Year Names) acting through the Substitute Agent;"

Since a name which has already effectively avoided membership _ab initio_ cannot be described as a member of Lloyd's at any relevant time, such a name would not be included within the definition of any of the parties to the Equitas reinsurance contract. The position would then arise where that person, although continuing to be a party bound by all inward and outward insurance and reinsurance written by the syndicate underwriters in years for which that person was a syndicate member, would not be reinsured by Equitas and would not in future be entitled to the administrative facilities otherwise to be provided by Equitas. Nor would such a person be subject to any regulatory control by Lloyd's.

This position gives rise to major problems as regards such person's run-off. Firstly, because the syndicate and not the syndicate member is and for long has been the market trading unit at Lloyd's, the administration of the run-off by Equitas would

be materially impeded by the accounting difficulties arising from the need to separate out for the purposes of both liabilities on inward policies and the recoveries from reinsurers the position of individual participants from that of the rest of the syndicate. This administrative fragmentation would be seriously detrimental, not only to Equitas as party to the contract of reinsurance, but to Lloyd's as a whole, for it would be entirely inconsistent with any uniform global run-off system as established by R&R and might well endanger the effective administration of that system to the detriment of the other members of Lloyd's who had accepted R&R and of Lloyd's a whole.

Even if one tests the position by reference to the Lloyd's system which prevailed before R&R was offered to the names by the Settlement Offer Document, the detachment of a rescinding name from the administration of a syndicate run-off would be highly detrimental to Lloyd's itself because it would bring about the fragmentation of claims administration on Lloyd's policies which would place the name outside any Lloyd's system of regulatory control. It would make claims accounting difficult if not impossible and it would render the distribution of the benefits of syndicate reinsurance protection extremely complex, if it were operable at all. In other words, if a rescinding name were permitted to withdraw the administration of its run-off from that of the Syndicate as a unit the effect would be so disruptive as to be prejudicial to the administration of Lloyd's as a whole.

Secondly, for a name to conduct its run-off otherwise than as a member of Lloyd's would involve the unlawful conduct of the business of insurance, contrary to section 2(1) of the Insurance Companies Act 1982. That would be because the business which the Act prohibits includes carrying out contracts of insurance as held in Bedford Insurance v. IRB [1985] QB 966 at page 981-2 per Parker J. in relation to the Insurance Companies Act 1974 and, also in relation to that earlier Act, in Stewart v. Oriental Fire and Marine Insurance Company [1985] QB 988 at pages 1000-1007, per Leggatt J. Even if it is accepted, as Mr Tager submits, by

analogy with the Road Traffic Act cases Goodbourne v. Buck, supra, and Adams V. Dunn, supra, no criminal offence could have been committed by the rescinding names underwriting insurance business as members of Lloyd's prior to their rescinding their membership contracts, it is not possible to extend that analysis to render lawful the conduct of insurance business after rescission. The fact that prior to rescission a contract of insurance would, by reason of the name's so far unavoided membership of Lloyd's, have been lawfully underwritten does not lead to the conclusion that the effecting of that contract by running it off after the name has rescinded his membership is lawfully to conduct the business of insurance. In my judgment, a name cannot lawfully perform a contract of insurance underwritten by him as a member of Lloyd's unless either he is still a member of Lloyd's or his liability has been reinsured under the Equitas contract and he has been permitted to resign from Lloyd's pursuant to paragraph 40 of the Membership Byelaw or paragraph 14(5) of the R&R Renewal Byelaw.

The resignation facility became available to names only because the DTI approved Equitas as an acceptable vehicle for the reinsurance to close in respect of 1992 and prior years of account. If, however, one takes away the Equitas protection, the names are left exposed except in so far as they arrange their own personal run-off reinsurance in the market. Mr Tager says that they can use the damages they recover from Lloyd's to pay the premium for this protection. But there is absolutely no evidence at all that any such alternative cover would be available in the market or that, if it were, the DTI would have power to authorise the name to continue to operate its run-off or, if it had such power, that it would be likely to exercise it. Indeed, under sections 37 to 45 of the Act, the Secretary of State is given powers of intervention to protect policy holders in the event of contravention of the requirements of authorisation under the Act.

Accordingly, in deciding whether the defendants were entitled to rescind when they purported to do so and, in particular whether,

in spite of the impossibility of substantial restitutio in integrum, the court would set aside the contract without adjustment because the benefits on either side were "commensurate", there would have to be taken into account the detriment to Lloyd's of administrative disruption and also, in my judgment, the further consideration that avoidance of the contract would lead to unlawful contravention of the Insurance Companies Act 1982 by the rescinding name and the consequent intervention by the Secretary of State in the exercise of his powers of enforcement upon contravention of the Act. The latter is a relevant factor because, in determining how the equitable jurisdiction of the court ought to be exercised, the fact that the consequences of its being exercised in one particular way will inevitably involve unlawful conduct must lead as a matter of principle to its being so exercised as to avoid that consequence. It is difficult to envisage that the conscience of the court could be moved otherwise than against unlawful conduct.

As regards Mr Wilkinson, who gave notice of rescission on 5th June 1995, long before the Equitas reinsurance contract was entered into, I have no doubt that these considerations lead to the conclusion that, since substantial restitutio in integrum was at that time impossible, rescission was not then or at any material time an available remedy. In no sense could it be argued that the court would at that time have exercised its equitable jurisdiction to rescind the membership contract in spite of the impossibility of substantial restitutio in integrum.

As regards Mr Leighs, who did not give notice of rescission until December 1996 after the Equitas contract had begun to operate, the position is rather different.

In spite of the fact that he never accepted, indeed expressly rejected R&R, he became bound as a party to the Equitas contract, and liable to pay the Equitas premium as from 3rd September 1996. As a party to that contract he has become entitled to the benefits of reinsurance protection and claims administration in

relation to his run-off. Indeed, since October 1996 his run-off claims have been administered and paid by Equitas. That is a contract which Equitas has no right to terminate for non-payment of premium by the name, as expressly provided by clause 3.10:

> "ERL expressly acknowledges that it shall have no right to terminate this Agreement, in whole or in party, following the Effective Date, as a result of non-payment of any Name's Premium or any other failure of the consideration to be provided to ERL pursuant to clause 5."

Consequently, the assertion by Mr Leighs that in December 1996 he was entitled to rescind his membership contract with Lloyd's ab initio involved not only that he was unable to give substantial restitutio in integrum, for the reasons which I have already discussed, but that he had become bound to a contract of reinsurance by Equitas under which Equitas was locked into its obligation to pay that defendant's losses regardless of whether that defendant paid the premium. Accordingly, if he were to be entitled to rescind his membership of Lloyd's ab initio and if the consequence of that was that he was entitled to be no longer bound by the Equitas contract, he would:

(i) already have received the benefit of the Equitas reinsurance and administration of claims and reinsurances for the period since October 1996 when Equitas went on risk;

2 (ii) be obliged to pay no premium in respect of that cover and those services;

(iii) cause the fragmentation of administration of the future run-off of the syndicate and the disruption of the conduct by Equitas of Lloyd's business to the detriment of other names and of Lloyd's itself, as I have already explained;

(iv) in future be obliged to accomplish the run-off of his outstanding claims outside Lloyd's by unlawfully conducting the business of insurance, as I have already explained.

Here again, therefore, the position, when in December 1996 Mr Leighs first claimed to be entitled to rescind, was that he was unable to give substantial restitutio in integrum and there were considerations weighing conclusively against the court's exercise of its equitable jurisdiction to avoid the contract of membership ab initio without adjustment, leaving the parties to keep their respective benefits and detriments already caused by their part operation of the contract. In this connection, the payment of claims and provision of administrative services by Equitas for the benefit of the defendant without his having to pay premium would be prejudicial to Lloyd's because it would diminish the assets of Equitas and therefore its ability to satisfy all claims that would require to be paid in future. All those considerations would very heavily tip the balance against rescission.

For these reasons, in December 1996 Mr Leighs would not have obtained an order for rescission of his membership contract from a court of equity. It follows that he was not then entitled to the self-help remedy of rescission.

Mr Lyon's position cannot be any better and is probably worse in as much as he has benefitted from the discharge of his liabilities in respect of losses for a longer period than Mr Leighs.

I would therefore hold that none of the three defendants is entitled to rescind his membership contract.

Third Party Rights and Rescission

Before leaving this issue, I must mention an argument advanced by Mr Anthony Grabiner QC, on behalf of Lloyd's, to the effect that it was now too late to rescind because of the impact of rescission on third party rights.

The third parties who, for the purposes of this argument, are said to have acquired rights which preclude rescission are the policy-holders. It is submitted that in contracting with the names as participants in their syndicates and as members of Lloyd's those policy holders had purchased, not merely insurance cover, but also the Lloyd's administrative, security and regulatory system ordinarily supporting a Lloyd's policy, such as the availability of Lloyd's Policy Signing Office, the Lloyd's central accounting system and the administrative facility of dealing with a syndicate managing agent as distinct from individual policy holders. They had also purchased the benefits in terms of security for claims of regulatory control by Lloyd's of those who had underwritten the risk and of the availability of the Central Fund as a source of long-stop protection for claims.

The relevant principle is summarised in Chitty on Contracts, 27th Edition para 6-080:

> "**Third-party rights.** The intervention of a third party may prevent rescission. This is one of the risks run by the injured party if he delays in taking action, for if a third party acquires an interest in the subject-matter of the contract before the contract has been avoided a claim for rescission will not lie, provided that the third party acted in good faith and gave consideration. Thus, although there may be no duty to act within a prescribed time, it is in the representee's interest to act promptly, for the longer the delay, the greater the possibility of a third

party acquiring rights in the subject-matter of the contract."

In Morison v. The Universal Marine Insurance Co (1873) LR 8 Ex 197 at page 204 the Court of Exchequer Chamber approved a passage in the judgment of Bramwell B in Croft v. Lumley 27 LJ (QB) at page 330 as follows:

"In such cases the question is, has the person on whom the fraud was practised, having notice of the fraud, elected not to avoid the contract? or has he elected to avoid it? or has he made no election? We think that so long as he has made no election, he retains the right to determine it either way, subject to this, that if, in the interval whilst he is deliberating, an innocent third party has acquired an interest in the property, or if, in consequence of his delay, the position even of the wrongdoer is affected, it will preclude him from exercising his right to rescind.'

Although the obvious application of this principle is in a case where the transfer of tangible property has been the subject-matter of the contract sought to be rescinded and where that property has been sold on to a bona fide purchaser without notice of the voidability of the title of the seller, the underlying reason for such a principle must, as Mr Tager submits, be that the rights of the bona fide purchaser must be protected and that avoidance of a contract induced even by a fraudulent misrepresentation will not be permitted to disturb the title of an innocent purchaser. But does this principle extend to a case where the misrepresentee has entered into a contract with an innocent third party to be performed in a certain way and subject to the benefit of certain security where rescission of the other contract induced by misrepresentation will prevent performance in that way and will deprive the third party of that security?

Lloyd's relies on the line of authority which has held that where a winding-up petition has been presented in respect of a company it is too late for a shareholder to rescind the contract under which he was allocated shares in the company. Rescission in such a case would deprive the creditors of the company of the right to sue the shareholders in respect of the outstanding debts. Thus, in Oakes v. Turquand (1867) LR 2 HL 325 Lord Chelmsford said this at page 350:

> "It was said by the counsel for the Appellant that the Companies Act, 1862, was to be regarded merely as adjusting the rights of the shareholders inter se, and that, as the liquidators represented the company, the liability of the Appellant must be determined as between himself and the company, and not as respects creditors with whom he never contracted. It is true that there was no contract between the creditor and the shareholders, and that the creditor probably never thought of the shareholders in his dealings with the company. But he must be taken to have known what his rights were under the Act, and that he had the security of all the persons whose names were to be found upon the register, and who had agreed to become shareholders. The liability of the shareholders is not under a contract with the creditors, but it is a statutable liability under which the creditors have a right which attaches upon the shareholders to compel them to contribute to the extent of their shares towards the payment of the debts of the company."

The same approach is to be found in the Scottish case of Tennent v. The City of Glasgow Bank (1879) 4 App Case 615 in which Lord Cairns LC commented upon Oakes v. Turquard thus at page 621:

> "The case of Oakes v. Turquand in this House has established that it is too late, after winding-up has commenced, to rescind a contract for shares on the ground of fraud. This, no doubt, is on the grounds stated by the

Lord President, that innocent third parties have acquired rights which would be defeated by the rescission."

and then continued

"In an ordinary partnership, not formed on the joint stock principle, it is impossible, as a general rule, for a partner at any time to retire from or repudiate the partnership without satisfying, or remaining bound to satisfy, the liabilities of the partnership. He may have been induced by his co-partners by fraud to enter into the partnership, and that may be a ground for relief against them, but it is no ground for getting rid of a liability to creditors. This is the case whether the partnership is a going concern, or whether it has stopped payment or become insolvent. In the case of a joint stock company, however, the shares are in their nature and creation transferable, and transferable without the consent of creditors, and a shareholder, so long as the company is a going concern, can, by transferring his shares, get rid of his liability to creditors, either immediately or after a certain interval. The assumption is that, while the company is a going concern, no creditor has any specific right to retain the individual liability of any particular shareholders.

It is on the same or on a similar principle that, so long as the company is a going concern, a shareholder who has been induced to take up shares by the fraud of the company has a right to throw back his shares upon the company without reference to any claims or creditors. He would have a right to transfer his shares without reference to creditors. The company, as a going concern, is assumed to be solvent, and able to meet its engagements, and to have a surplus, and the company being solvent, its duty to pay the repudiating shareholder what is due to him, and to take the shares off his hands, is an affair of the company and not of its creditors.

> But if the company has become insolvent, and has stopped payment, then, even irrespective of winding-up, a wholly different state of things appears to me to arise. The assumption of new liabilities under such circumstances is an affair not of the company but of its creditors. The repudiation of shares which, while the company was solvent, would not or need not have inflicted any injury upon creditors must now of necessity inflict a serious injury on creditors. I should, therefore, be disposed in any case to hesitate before admitting that, after a company has become insolvent and stopped payment, whether a winding-up has commenced or not, a rescission of a contract to take shares could be permitted as against creditors."

The reasoning in these cases suggests that if rescission of the contract would deprive an innocent third party of some accrued right of action against one of the parties to the contract sought to be avoided, the remedy will not be available even in a case of fraud. Thus, a creditor deprived of his statutory right to sue a shareholder once the company has become insolvent is in substance in much the same position as the third party purchaser of property from a buyer who, having been induced to purchase the property by fraud, seeks to rescind after he has resold it to a bona fide purchaser.

Although enforcement of his policy rights by a policy-holder against a name who has rescinded membership would be significantly more difficult than against a name who had not rescinded, there can be no question of the rescission depriving the policy holder of his right to enforce the policy against the rescinding name. Although enforcement outside the Lloyd's environment may be extremely complicated and involve complex calculations of liability, it is in my judgment quite impossible to conclude that the policy holder would necessarily thereby be deprived of the whole subject matter of the policy. It is still open to him to sue the name on the policy in spite of rescission.

As regards Mr Wilkinson, therefore, who rescinded before the Equitas contract came into effect, I am unable to accept the submission of Lloyd's that such rescission, if otherwise valid, would be impossible due to its impact on the position of the policy holders.

The position in relation to Mr Leighs is different. He waited to rescind until after the Equitas contract had become binding on him. If he were to be held entitled to rescind when he did so, that would not deprive the policy holders of their right to sue for the amounts due from the policy holder in respect of his proportion of the contract of insurance or reinsurance but, if rescission of his membership contract involved his not being bound by the Equitas contract (a consequence which he has to assert in order to avoid liability to pay the premium) the effect of rescission would be to deprive Equitas of its accrued right to the premium under that contract which Equitas has already been partly performed. This is therefore a striking example of the detrimental impact of rescission on the accrued rights of a third party (Equitas). To permit Mr Leighs both to rescind his membership with the effect of entitling him no longer to be bound to pay the Equitas premium and at the same time to enjoy the benefit of the settlement of claims by Equitas under that contract before he rescinded it would be entirely inconsistent with the principle of preventing rescission from damaging or destroying third party rights.

For this reason, also, therefore, I would hold that neither Mr Leighs not Mr Lyon can be entitled to rescind their contracts of membership.

<u>The Set-Off Issue</u>

Clause 5.5 of the Equitas Contract provides as follows:

'5.5 Each Name shall be obliged to and shall pay his Names' Premium in all respects free and clear

from any set-off, counterclaim or other deduction on any account whatsoever including in each case, without prejudice to the generality of the foregoing, in respect of any claim against ERL, the Substitute Agent, any Managing Agent, his Members' Agent, Lloyd's or any other person whatsoever, and:

(a) in connection with any proceedings which may be brought to enforce the names' obligation to pay his Name's Premium, the Name hereby waives any claim to any stay of execution and consents to the immediate enforcement of any judgment obtained;

(b) the Name shall not be entitled to issue proceedings and no cause of action shall arise or accrue in connection with his obligation to pay his Name's Premium unless the liability for his Name's Premium has been discharged in full; and

(c) the Name shall not seek injunctive or any other relief for the purpose, or which would have the result, of preventing ERL, or any assignee of ERL from enforcing the Name's obligation to pay his Name's Premium."

The defendants submit that they have a counterclaim against Lloyd's for fraud which they are entitled to set off against its claim as statutory assignee of the Equitas premium. The nature of that set-off is such as to operate by way of defence to the claim for the premium. There should therefore be leave to defend. The defendants submit that clause 5.5 does not preclude reliance on that set-off for the following reasons.

(i) Clause 5.5 operates in favour of Equitas alone. It prevents the reinsured relying as against Equitas upon cross-claims which it may have against third parties, such as AUA9, any managing agent, members Agent or Lloyds.

(ii) When Equitas assigned the premium to Lloyd's, the latter could not rely on clause 5.5 to prevent cross-claims being set off against its claim because those cross-claims were made against Lloyd's and not against Equitas.

(iii) Even if Lloyd's could rely on clause 5.5 to prevent cross-claims against it, as distinct from cross-claims against Equitas, clause 5.5 does not cover claims in fraud.

(iv) Alternatively, if clause 5.5 covers cross-claims in fraud, it would be a term which fell within section 3 of the Misrepresentation Act 1967. That section provides as follows:

"If a contract contains a term which would exclude or restrict:

(a) any liability to which a party to a contract may be subject by reason of any misrepresentation made by him before the contract was made; or

(b) any remedy available to another party to the contract by reason of such a misrepresentation

that term shall be of no effect except in so far as it satisfies the requirement of reasonableness as stated in section 11(1) of the Unfair Contract

> Terms Act 1977; and it is for those claiming that the term satisfies that requirement to show that it does."

It is argued that clause 5.5 excludes or restricts a remedy available to the reinsured defendants by reason of the misrepresentations made by Lloyd's before they entered into their membership contracts and therefore before they entered into the Equitas contract.

There can be no doubt that, at least as between Equitas and the defendants, clause 5.5 operated effectively to exclude all counterclaims and set-offs. The clause defined the extent of the defendants obligation to pay, there being in general freedom to contract out of the right of set-off. In Coco-cola Financial Corporation v. Finsat Ltd [1996] 3 WLR 849, Neill LJ, with whose judgment Morritt and Huchison LJJ. agreed, said this at page 857:

> "I have come to the clear conclusion that the right of set-off can be excluded by agreement. In general English law permits the parties to a contract to include in it such terms as they consider to be appropriate. This freedom of contract is subject to a measure of control based on grounds of public policy and to some statutory restrictions such as those contained in the Unfair Contract Terms Act 1977. But I am unable to accept that a party is prevented from excluding the right of set-off by section 49(2) of the Supreme Court Act 1981 or by any ground of public policy. There are many circumstances in which the general admonition in section 49(2) cannot be observed. The court itself can order separate trials of different parts of an action where it is convenient to do so: see, for example, RSC Ord 15 r 5. Moreover, I can see no reason in principle why parties who are in a general contractual relationship cannot isolate one contract or one aspect of their dealing and provide that their rights in relation thereto are to be treated separately from their other dealings."

That which Lloyd's received as assignee was therefore the defendants' obligation to pay the Equitas premium subject to the definition of the extent of that obligation in clause 5.5. That definition is not confined to excluding any set-off or counter claim against Equitas itself, but excludes the reinsured's set-off or counterclaim in respect of any claim against Lloyd's and other third parties. Such rights could not in any event be asserted against a claim by Equitas for the premium because there would be no mutuality: a cross-claim against a third party cannot ordinarily be set-off against a claim by another party unless the claimant sues as agent or trustee for the third party. Accordingly, the exclusion of the right of set-off in respect of claims against third parties such as Lloyd's must relate to set-off against claims for the premium brought by those third parties since a claim by Equitas for the premium could never be brought otherwise than in its own right as the party beneficially entitled to the premium. In this connection, it is to be noted that clause 5.5 does not confine the name's obligation to payment of the premium to Equitas. Further, clause 5.5(c) expressly excludes the Name from seeking injunctive or any other relief for the purpose, or which would have the result, of preventing ... any assignee of (Equitas), from enforcing the Name's obligation to pay his Name's premium". So that the contract expressly contemplated the assignment by Equitas of the right to sue for the premium and expressly prevented the Name from preventing enforcement of that obligation by the assignee.

It is therefore absolutely clear that the exclusion of set-off in clause 5.5 on its proper construction precludes the set-off of claims against an assignee, such as Lloyd's who is endeavouring to recover the premium. Accordingly, the assignee can rely on that clause to avoid what would otherwise be the procedural consequences of the reinsured name asserting such counterclaim or set-off.

Does clause 5.5 cover cross-claims in fraud? Mr Tager argues on behalf of the defendants that it is in substance an exclusion

clause and that exclusion clauses will not be construed or enforced in so far as they exclude liability for fraud. Thus, in Chitty on Contracts, para 14-120, it is stated that no exemption clause can protect a person from liability for his own fraud. That proposition is supported by the speeches in the House of Lords in the Irish appeal S Pearson & Son Ltd v. Lord Mayor of Dublin [1907] AC 351, per the Earl of Halsbury at page 356, Lord James at page 362 and Lord Atkinson at page 365. Alternatively, it is submitted that clause 5.5 should not be construed as covering claims in fraud.

Clause 5.5 does not exclude or limit liability for fraud or on any other basis. Its effect is and only is to insulate, as a matter of procedure, claims for the premium from counterclaims or set-offs asserted by the reinsured. It neither excludes nor necessarily postpones such cross-claims. Nor does it make satisfaction of a claim for the premium a condition precedent to the pursuit to judgment of a cross-claim. There is, in my judgment, no reason in principle why a clause directed to nothing more than the procedural insulation of one class of claim from all cross-claims should be construed as inapplicable to cross-claims in fraud, provided that clear words are used. Since under section 14 of the Lloyd's Act 1982 the exclusion of liability of the society is expressly stated not to apply if:

> "the act or omission complained of:
>
> (i) was done or omitted to be done in bad faith; or
> (ii) was that of an employee of the Society and occurred in the course of the employee carrying out routine or clerical duties, that is to say duties which do not involve the exercise of any discretion."

the parties must be taken to have contemplated that cross-claims against Lloyd's could arise only in the two circumstances identified in (i) and (ii). There is no reason in principle why clause 5.5 should be subject to the rule of construction laid

down in relation to the exclusion of liability for negligence by Canada Steamship Lines v. The King [1952] AC 192, to the effect that clause 5.5 applies only to category (ii) cross-claims.

Although this approach to construction has been approved by the House of Lords in Smith v. South Wales Switchgear Ltd [1978] 1 WLR 165 and (in that case) has been applied to indemnity clauses which by general words of indemnity may be said to make one party to a contract liable to indemnify the other in respect of the consequences of the latter's negligence, there is no general principle of construction which requires that it should be extended to other types of clauses, such as an anti-set-off clause. Indeed, there is every reason why it should not be so extended. It imputes a mutual intention to the parties artificially to restrict the ordinary meaning of the words used. It is derived from the bailment and common carrier cases, as is clear from the judgments of the Court of Appeal in Rutter v. Palmer [1922] 2 KB 87, and is a cannon of construction originally designed to protect consumers under standard contracts issued by carriers and other bailees. The availability of statutory means of consumer protection, such as the Unfair Contract Terms Act 1977, which did not exist at the time when this principle was being developed, make it entirely unnecessary now to widen the scope of application of this principle beyond exemption from liability clauses and indemnity clauses. Since clause 5.5 is neither an exemption clause nor an indemnity clause and its wording is wide enough to cover cross-claims for fraud, it should be construed as insulating claims for premium from such cross claims.

Even if that is not the correct approach, and Lord Morton's analysis in Canada Steamship Lines v. The King, supra, at page 208 should analogously apply, it is necessary to have in mind the approach to the application of that principle adopted by the Court of Appeal in Lamport & Holt Lines Ltd v. Coubro & Scrutton (M&I) Ltd [1982] 2 Lloyd's Rep 42. In that case there are some

particularly relevant passages in the judgment of May LJ. Thus at pages 48-49 he observed.

> "Before I turn to the third of Lord Morton's tests, I should refer to the point which Lord Justice Donaldson has also mentioned. Underlying Counsel for the respondents' particular submissions on the respective tests there was a more general one. This was to emphasise that although they are described as tests, this is really a misdescription. They are and were only intended to be guidelines, not words in a statute, and at the end of the day the duty of the Court is just to construe the relevant clause. With Lord Justice Donaldson, I agree with this approach.
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> Further, although Lord Morton's use of the words "so fanciful or remote" could lead one to suppose that an exemption clause would only pass test three if one could discard all possible other grounds of potential liability other than those which were unreal and speculative I do not think that this is a correct interpretation of this passage from his opinion. The words "so fanciful or remote" in the third test are followed by the phrase "that the proferens cannot be supposed to have desired protection against it." Secondly, when on pp 9 and 210 of the reports the learned Law Lord turned to consider the actual construction of the clauses which were in issue in the Canada Steamship case, he considered and dismissed the likelihood not only of a colloquey between the contracting parties about the meaning of the clauses before the lease in that case had been executed, but also that in such a discussion the proferee would have accepted a clause exempting the Crown's liability for the negligence of its servants.
>
> In my opinion, all that one may properly read Lord Morton as saying is that where, under his third test, the Court considers whether the head of damage may be based on some ground other than that of negligence, it should discard any

ground to which, on a reasonable assessment of all the circumstances at the time the underlying contract was made, it is unlikely that the parties would have addressed their mind.

Such an approach indeed underlines the fact that the exercise upon which the Court is engaged in these cases is one of construction, that it is one of deciding what the parties meant or must be deemed to have meant by the words they used; the guidelines or tests which are referred to in the many authorities are only to be used by the Courts as aids to the successful and correct solution of such exercise."

Then at page 50 he said this:

"In seeking to apply Lord Morton's third test, we should not ask now whether there is or might be a technical alternative head of legal liability which the relevant exemption clause might cover and, if there is, immediately construe the clause as inapplicable to negligence. We should look at the facts and realities of the situation as they did not must be deemed to have presented the contract themselves to the contracting parties at the time the contract was made, and ask what potential liabilities the one to the other did the parties apply their minds, or must they be deemed to have done so."

If one looks at "the facts and realities of the situation" in this case there can be no serious doubt that the words of clause 5.5, in as much as they referred to cross-claims and set-offs against Lloyd's, could not possibly have been intended to be confined to those derived from acts or omissions within category (ii) of section 14(3) of the Lloyd's Act 1982. At the time when R&R was put forward there were in existence all manner of threatened or outstanding claims by names against Lloyd's which on one basis or another raised bad faith on its part. All this

would have been common knowledge at the time and the suggestion that any party to the Equitas contract could possibly have understood clause 5.5 as not applying to such claims is far-fetched in the extreme.

I have considered whether clause 5.5 is wide enough to exclude a set-off operating by way of equitable defence, as distinct from one which can be expressed only as a counterclaim which could be set-off against the claim for the premium.

In my judgment, the wording of clause 5.5 is sufficiently wide to cover a set-off of that kind. It is clear that, provided clear words are used even a plea in abatement as in Mondel v. Steel (1841) 8 M& 858 can be contractually excluded: see Modern Engineering v. Gilbert Ash [1974] AC 689 per Lord Diplock at p.718. Since such a plea operates as a substantive defence, at least in sale of goods and building cases, an equitable set-off by way of defence must equally be excludable. That it is appears to be implicit in the judgment of the Court of Appeal in Coca-Cola Financial Corporation v. Finsat Ltd, supra. I refer in particular to that passage at page 857 in the judgment of Neill LJ. which I have already cited in this judgment with which the other members of the court agreed, where he stated the general principles applicable to anti-set-off clause.

In my judgment, the words "in all respects free and clear from any set-off, counterclaim or other deduction on any account whatsoever" are wide enough to include set-off by way of equitable defence to the claim. The notion that the parties to this contract of reinsurance are to be taken by these words to have distinguished that kind of set-off not amounting to an equitable defence by references to the practice of the Court of Chancery prior to the Judicature Acts is unreal, to say the least.

Even if equitable set off by way of defence is excluded from the scope of clause 5.5, the defendant's claim for fraud in this case

is not such a set-off. In Government of Newfoundland v. Newfoundland Railway Co (1888) 13 App Case 199 Lord Hobhouse, who delivered the judgment of the Privy Council referred at page 213 to the set-off of unliquidated damages claims "as between the original parties, and also against an assignee if flowing out of and inseparably connected with the dealings and transactions which also give rise to the subject of the assignment". In The Dominique [1989] 1 Lloyd's Re 431 Lord Brandon, with whose speech all other members of the House of Lords agreed, treated this as "the test for an equitable set-off": see pages 438L and 440 R.

In the present case the claim is for a debt assigned to Lloyd's by Equitas. The debt arose from the reinsurance contract under which Equitas was entitled to receive payment of the premium as reinsurer of the Names. The defendants' claims for fraud are not against Equitas as appertaining to or in connection with the Equitas contract, but against the assignee, Lloyd's, in respect of the inducement of a quite different contract and one to which Equitas was never a party. Whereas it is certainly true that, if the defendants had not become members of Lloyd's, they would not have become involved in R&R or with Equitas, that is far more remote a connection between claim and cross-claim than that which is exemplified or suggested by any of the authorities at that time on defences of equitable set-off. In Rawson v. Samuel (1841) Cr & Ph 161 Lord Cottenham LC. comprehensively reviewed the authorities on equitable set-off and all of them suggest not merely that Equity would intervene to permit set-off only if the cross-claim arose out of the same contract between the same parties as that which gave rise to the claim but that there must be at least a close internal nexus between cross-claim and claim. The concept of "inseparable connection" (see Lord Hobhouse in Government of Newfoundland v. Newfoundland Railway Co at page 438) permeates all the authorities.

The defendants further contend that clause 5.5 is a term which excludes or restricts a remedy available to another party to the contract by reason of a misrepresentation made to that party by

the party before the contract was made and that by reason of section 3 of the Misrepresentation Act 1967 it is therefore of no effect except in so far as it satisfies the requirement of reasonableness as stated in section 11(1) of the Unfair Contract Terms Act 1977. It is argued that the question of reasonableness, the burden of proving which lies on Lloyd's, has not been supported by any evidence at this stage and it is therefore appropriate that, if for no other reason, leave to defend should be given to resolve this issue.

A number of questions arise in relation to this submission.

First does clause 5.5 exclude or restrict any remedy "by reason of such misrepresentation"?

In my judgment, it does no such thing. As I have already held, it insulates recovery of the Equitas premium from recovery of damages for other claims, including claims in deceit for fraudulent misrepresentation, but that insulation does nothing to exclude or restrict that remedy. It is as open to a Name to claim and recover such damages in the face of clause 5.5 as it would be without it. All that he is prevented from doing is declining to satisfy the premium debt until his claim for damages has been determined and then setting-off the damages against the premium due. In no sense can that be described as excluding or restricting the remedy by way of damages for fraudulent misrepresentation.

Secondly, the remedy in question must clearly be a remedy in respect of entering into the contract containing the term of exclusion or restriction or possibly a contract to which the exclusion term applies. The purpose of the section was to prevent, except where reasonable, exclusion clauses being used to block or restrict liability or the application of the remedies for misrepresentation inducing the <u>contract in question</u>. Accordingly, if the misrepresentation in relation to which the liability is asserted or the remedy is sought is not a

misrepresentation in reliance upon which that contract containing the term under attack, or perhaps another contract referred to by the term, was entered into, section 3 has no application.

Since in the present case it cannot be suggested that the alleged fraud induced the Equitas contract, which contained clause 5.5, there can be no basis for the application of section 3. True it is that the misrepresentation was made in this case before the Equitas contract was entered into, but it is the contract of membership in respect of which the clause is said to exclude or restrict the remedy and clause 5.5 does not apply in terms so as to exclude any remedy in relation to misrepresentation which induced _that_ contract.

The Stay of Execution Issue

The defendants submit that if they are not entitled to rescind their contracts of membership at Lloyd's and further if clause 5.5 of the Equitas contract prevents them from relying on their claim for damages for fraudulent misrepresentation by way of set-off to justify non-payment of their Equitas premium, nonetheless, the court ought to exercise its jurisdiction to grant a stay of execution of any judgment for the premium pending determination of the counterclaim.

By clause 5.5(a) the Names waived any claim to any stay of execution and consented to the immediate enforcement of any judgment in respect of the unpaid premium.

Where an anti-set-off clause is inserted in a contract, its purpose is to prevent one of the parties delaying payment of debts accruing due under the contract while cross-claims are investigated and determined. The insulation of the set-off or counterclaim does not have the purpose of achieving severance for its own sake, but merely as a means of achieving the speedy discharge of indebtedness. If that effect could be avoided by applying for a stay of execution in the face of such a clause its

whole function would be subverted. This was recognised by Parker LJ. in Continental Illinois National Bank & Trust Company of Chicago v. John Paul Papanicolaou [1986] 2 Lloyd's Rep 441 at page 445.

> "The purpose of both guarantees was to ensure immediate payment if the principal debtor did not pay. Indeed the present cases make it the more necessary that the Court should not interfere, for here the parties have specifically provided both in the loan agreement and the guarantees that payment should be made free of any set off or counterclaim. It would defeat the whole commercial purpose of the transaction, would be out of touch with business realities and would keep the bank waiting for a payment, which both the borrowers and the guarantors intended that it should have, whilst protracted proceedings on the alleged counterclaims were litigated. We do not doubt that the Court has a discretion to grant a stay but it should in our view be "rarely if ever" exercised, as Lord Dilhorne said in relation to claims on bills of exchange (in Nova (Jersey) Knit Ltd v. Kammgarn Spinnerei [1977] 1 WLR 713 at page 722) Guarantees such as these are the equivalent of letters of credit and only in exceptional circumstances should the Court exercise its power to stay execution. The fact that a counterclaim which was likely to succeed existed would not by itself be enough, as Lord Justice Buckley pointed out. It might be that the existence of such a counterclaim coupled with cogent evidence that the bank would, if paid, be unable to meet a judgment on the counterclaim would suffice, but nothing of that nature arises here."

Further in Coca-Cola Financial Corporation v. Finsat Ltd, supra, at pages 858-859 the Court of Appeal held that it was inappropriate by a stay of execution to deprive the plaintiffs "of the right which (the anti-set-off clause in that case) was inserted in the loan agreement to serve".

It is not suggested and could not plausibly be suggested that Lloyd's might not be in a position to satisfy a judgment on the counterclaim for fraud. Accordingly, whatever strength the counterclaim may be assumed to have, there should be no stay of execution in this case. The presence of clause 5.5(a) does not affect the matter. In the face of clause 5.5 an order for a stay would have been entirely inappropriate, even in the absence of sub-clause(a).

Conclusion

The defendants are not entitled to rescind their contracts of membership with Lloyd's.

The defendants are by clause 5.5 of the Equitas contract precluded from setting off their counterclaim for damages for fraud against Lloyd's claim for the Equitas premium.

The defendants are not entitled to a stay of execution of a judgment against them for the Equitas premium.