

Postmaster Litigation

CONFIDENTIAL AND SUBJECT TO LEGAL PROFESSIONAL PRIVILEGE

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Executive Summary

Context

There are now 522 applicants to the litigation. These include both current (103) and former (346) postmasters; DMB employees (3), and postmaster assistants (29). Some of them have criminal convictions; some have been the subject of debt collection proceedings; some of them have previously signed settlement agreements with Post Office (c115 - eg on exit as a result of network transformation), and Post Office would argue that the claims of many are time barred (193). As a result, the range of claims against Post Office arise from very different factual circumstances.

The High Court determined in January 2017 that the best way to manage this variety of claims was via the Group Litigation Order. The next procedural step in the Postmaster Litigation is the Case Management Conference ('CMC') to be held on 19 October 2017. At this hearing, a Judge will decide on the strategic direction of the Group Litigation for the next 6 – 24 months following representations from both parties.

There are therefore a series of strategic decisions to be made as to how Post Office should approach the CMC. These are set out below.

Questions addressed in this report

1. What are the options regarding the ongoing management of the case?
2. What are the risks of the various options and how would we mitigate them?
3. What is our recommendation and why?

Conclusion

1. Post Office has various options as to the approach it takes at the CMC. These are not without risk. In essence there are 2 key themes emerging from the documents filed by Freeths:
 - whether Horizon is robust and accurately records branch transactions, and
 - whether the postmaster contract is fair and supports Post Office's current operating practices. Of particular concern is the question as whether any terms should be implied into the postmaster contract over and above those which are explicitly set out. Freeths argue that there are a large number of terms which should be implied, and that Post Office has been in breach of some or all of these as regards the applicants.

There is a strategic choice as to the sequence in which these arguments are addressed.

2. It is the recommendation of Post Office's legal team (and in particular of our QC Anthony de Garr Robinson) that we should seek to have the issue of the postmaster contract addressed first.
3. The rationale for this is that although alleged issues with Horizon have to date caused the most publicity, the question as to whether Horizon is robust and accurately records branch transactions is a factual one. Even if Horizon is found to be robust, it is only possible for the applicants to succeed if they can also show that the contract contains additional implied terms regarding Horizon.
4. Accordingly, addressing the question of the scope of the implied terms first, allows the Court to determine whether Post Office has in fact breached those terms. If Post Office is successful in limiting the scope of the proposed implied terms, then many of the Applicants' claims will fail.

Input Sought

The Board is asked to endorse the recommended strategy and the risks inherent in it.

The Report

What are the options regarding the ongoing management of the case?

5. There are 3 major strategic questions that will be addressed through the litigation, together with a number of smaller issues. The sequence in which the following questions are addressed is critical:
 - whether Horizon is robust and accurately records branch transactions;
 - whether the postmaster contract is fair and supports Post Office's current operating practices; and
 - whether all of the applicants should in fact be party to the litigation or whether there are legitimate legal reasons for excluding them.
6. In addition, it may be possible to defer the court's determination of the key issues for some time; and of course it would be possible for Post Office to seek to settle the litigation outside of the Court process.
7. Set out in Appendix 1 is a high level summary of these options, together with initial thoughts on the risks and benefits of each option. The legal team recommend addressing the issues relating to the Postmaster contract as a priority. In parallel we will seek to address the issue as to whether all the applicants should properly be parties to the litigation.

What are the issues relating to the postmaster contract?

8. Freeths have argued that some 20 separate terms should be implied into the postmaster contract. These are set out in Appendix [2] and for convenience we have grouped like terms together, although this is not how they are set out in the pleadings.

9. We believe that the most damaging group of terms sought to be implied are those that seek to reverse the burden of proof so as to make Post Office responsible for investigating shortfalls. Post Office's contention is that only the Postmaster can know what happens in branch, such that the Postmaster is best placed to deal with a shortfall. This is particularly the case where postmasters actively seek to conceal losses.
10. The Post Office position is that we should agree that only the following 2 duties are implied into the contract:
 - Each party would refrain from taking steps that would inhibit or prevent the other party from complying with its obligations under or by virtue of the contract.
 - Each party would provide the other with such reasonable cooperation as was necessary to the performance of that other's obligations under or by virtue of the contract.

What is our recommendation and why?

11. Post Office's legal team believe that resolution of the issues regarding the proper interpretation of the contract and whether these terms should be implied is critical to the effective management of the case. The question as to whether Horizon is robust and accurately records branch transactions is a factual one. However even if Horizon is found to be robust, it is only possible for the applicants to succeed if they can also show that the contract contains additional implied terms regarding Horizon, and that Post Office has breached those implied terms.
12. Accordingly, if the contractual issue could be resolved first, it would make it significantly more difficult for the Claimants to sustain their claims, as those claims are founded on the basis of the additional implied terms.
13. Even if the court's determination of the contract issues is delayed for a period, these issues will remain and have an increasing impact on Post Office's ability to continue to operate the business pending resolution. Already there is an increasing number of postmasters who have challenged Post Office's ability to exercise normal 'BAU' remedies where shortfalls have arisen, and these 'BAU' processes are now having to be supervised on a day-to-day basis by the legal team.

What are the risks and mitigations of the various options?

14. Although a finding that the other duties should be implied into the contract would potentially impose significant cost and burden onto Post Office, the reversal of the burden of proof would make it almost impossible for Post Office to ever determine the cause of a shortfall, and therefore be able to recover that shortfall from the agent.
15. Post Office's whole framework is built on the notion of the postmaster as 'agent' who therefore owes fiduciary duties to Post Office to account for cash provided by Post Office and held in branch. A reversal of the burden of proof would therefore have a substantial impact on the current operating model for the agency network and require on or more of the following:
 - substantial changes to the design and operation of Horizon;

- the restructure of the legal relationship between Post Office and agent, which would impact the whole agency network;
 - a completely different approach and legal basis for the provision of cash and risk allocation in the network;
 - a review and likely change to the commercial and remuneration model for postmasters to balance the shift of risk to Post Office; and / or
 - a substantial increase in the numbers of support staff so that discrepancies may be investigated by Post Office.
16. This may also trigger further claims from other postmasters looking to recover shortfalls they have paid to Post Office over the last decade.
17. It is unlikely that any decision on the key legal questions would be made before late 2018, and given the significance of the matter and that this is a question of law, it is highly likely that Post Office would seek to appeal an adverse finding, such that the impact may not crystallise for 12-24 months. Even then the Court's decision will only be directly binding on those postmasters in the Group Action and so Post Office will have options as to how to translate the judgment into operational and commercial change. This creates the opportunity to further mitigate some of the effects of an adverse judgment.
18. Included in Appendix 2 under each group of implied duties is a non-exhaustive list of possible responses which we have identified to date should Freeths be successful in arguing that one or more of the specific terms should be implied into the contract. Many of these possible responses will be unacceptable. Over the next 6-12 months further work will be undertaken to develop and cost appropriate plans and we will brief the Board on these ahead of the hearings on the substantive issues.

Appendix 1

TACTICAL OPTIONS FOR THE CONDUCT OF THE LITIGATION

OPTION	BENEFITS	RISKS
<p>1. Focus on Horizon</p> <p>Push the Court to address at an early stage whether Horizon is robust and accurately records branch transactions.</p> <p>Recommendation: We do not believe it is possible to address this issue without first establishing Post Office's legal obligations in relation to Horizon (see Option 2).</p>	<ul style="list-style-type: none"> • A successful Court decision on this issue would lessen the strength of all Claimants' claims (though not as much as Option 2 – see below). • Horizon is the high profile issue that attracts the media attention – a successful result would reduce media noise / chatter in the network. • Losing this point is not fatal to Post Office's overall legal case as it may still be successful on the contractual issues (Option 2) and / or on the facts of any individual case. • Losing this point is unlikely to cause an existential problem for Post Office. It will however create the need to rapidly fix any identified problems in Horizon (or migrate to a new system) and that will come with a significant cost and create major short-term commercial problems. 	<ul style="list-style-type: none"> • The Claimants cannot just point the finger at Horizon with no legal basis for their complaints. They need to ground their claims in the postmaster contracts by showing that there was some legal obligation on Post Office to maintain Horizon to a certain standard. Without clear legal obligations, a Court cannot determine whether Horizon meets those obligations. We therefore do not believe that a Court will be attracted to tackling this issue at an early stage. • The above issue also means that we do not know exactly what disclosure and evidence is required, which could lead to very wide disclosure being given at a very high, and potentially wasted, cost. Expert evidence on Horizon will also be very expensive. This lends weight to tackling another issue first.
<p>2. Focus on contractual issues</p> <p>Push the Court to address at an early stage whether the postmaster contract is fair and whether it supports Post Office's current operating practices.</p>	<ul style="list-style-type: none"> • A successful Court decision on this issue would seriously undermine all Claimants' claims. • Moreover, it would establish the principle that Post Office's contracts are fair and support the way Post Office has been operating for the last 20+ years. • Having established this principle, it will be easier to settle the claims without opening the 	<ul style="list-style-type: none"> • The Claimants' arguments on the postmaster contracts are not without merit. There is a chance that they might be successful, in which case Post Office would be left in a very difficult commercial position. • On Post Office's best case it accepts that it had some responsibilities to support

<p>Recommendation: This is our recommended approach in conjunction with Option 3.</p>	<ul style="list-style-type: none"> • floodgates to claims / complaints from other postmasters. 	<ul style="list-style-type: none"> • postmasters, albeit to a lower standard than that sought by the Claimants. Winning the contractual arguments will therefore not determine the whole litigation but will leave the Claimants with much more difficult claims. • There are dozens of sub-issues that are connected to the postmaster contracts. There is therefore unlikely to be a binary win/lose outcome, with Post Office being successful on some points and losing others.
<p>3. Focus on weak claims</p> <p>Ask the Court to strike out Claimants who are facing legal and procedural problems, such as their claims being out of time, having previously signed settlement agreements or generally having very weak claims on their own facts.</p> <p>Recommendation: We do not believe that a Court would focus on these satellite issues in isolation as this would not tackle the major issues at the heart of litigation. They could however be addressed in conjunction with Option 2.</p>	<ul style="list-style-type: none"> • A successful result on these satellite points could see over 200 of the 522 Claimants being struck out. This would make settlement easier / cheaper. • It sends a message to the Claimants that Post Office will not allow weak and poorly presented claims to survive in this litigation. • Some early victories might shake the confidence of the Claimants and their litigation funder. • The Claimants are trying to portray themselves as having been oppressed by Post Office. Getting some of the weakest and most unattractive claims in front of the Court at an early stage, especially those where there is clear theft or dishonesty, might re-balance the Court's views on the general fairness of Post Office's position. 	<ul style="list-style-type: none"> • The downside with this approach is that it is piecemeal. It will require lots of satellite issues to be run in parallel. The Court may not want to do this as it may see it being very burdensome for the Court to manage (and Judges are very conscientious about the use of Court resources). • It may also cause Post Office to incur costs on matters that only have a micro effect on the overall dynamic of the litigation. • It will not give Post Office a victory on a key point of principle and so may not quell media noise or complaints from other postmasters.
<p>4. Settle now</p> <p>Try to agree a settlement now that closes down the litigation at an early stage.</p>	<ul style="list-style-type: none"> • An immediate settlement avoids the possibility of an adverse Court decision under Options 1 and / or 2. • A settlement avoids further legal costs (though 	<ul style="list-style-type: none"> • The claims have not yet been fully valued but early indications suggest the total claims made by the applicants could be as high as £100m. This figure is however open to a

<p>Recommendation: This option is not recommended as it would result in Post Office having to pay significantly over the odds.</p>	<ul style="list-style-type: none"> these are anticipated to be considerably less than the amount of a settlement at this stage). 	<ul style="list-style-type: none"> large margin of error and we believe it to be highly inflated. A settlement now, without proper challenge to these figures, would lead to a much higher settlement number. A settlement now would undoubtedly cost more than £21m as that is the litigation funder's share of the winnings. The settlement would need to be more than this for the Claimants to receive any money. Drawing the above two strands together, we cannot see a viable settlement being reached in the short-term without Post Office paying out at least £40m. Settling now without any Court decision in Post Office's favour may give the impression that Post Office has a weak legal position. This may encourage new claims against Post Office or give postmasters an excuse to run up losses in branches. A number of the Claimants have been prosecuted and are looking for their convictions to be overturned. A settlement with these Claimants would cause their convictions to become unsafe. Not settling with these Claimants may make settlement as a whole impossible.
<p>5. Attrition</p> <p>Stretch out the litigation process so to increase costs in the hope that the Claimants, and more particularly their litigation funder, decide that it is too costly to pursue the litigation and give up.</p>	<ul style="list-style-type: none"> This approach avoids tackling at an early stage the issues in Options 1 and 2 and therefore delays (but does not avoid) the risk of an adverse Court decision. In effect, this approach would mean agreeing with the Claimants' current case management proposals which set the litigation on a long course with no objective in mind. This would 	<ul style="list-style-type: none"> The Claimants' litigation funder, Therium, is an experienced funder with deep pockets. It will be prepared for a long piece of litigation. So long as it believes the merits of the case are favourable, it can be expected to fund the litigation. Over time the litigation will become more disruptive to Post Office's business as more

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<p>Recommendation: This option is not recommended as we believe the pressure on, and cost to, Post Office would become unbearable before the Claimants gave up.</p>	<ul style="list-style-type: none">• limit arguments at the CMC.	<ul style="list-style-type: none">• operating practices are put under the spotlight and then have to be overseen by lawyers in order to avoid problems in the litigation process.• Although media reporting on this matter is presently low key, there is increasing chatter in the network and a feeling that the litigation may start to dissuade individuals from being postmasters. This will increase as the litigation continues without a result in Post Office's favour.
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Appendix 2

TERMS SOUGHT TO BE IMPLIED INTO THE POSTMASTER CONTRACT

The following are the terms which Freeths argue should be implied in to the contract as duties on Post Office:

Implied Duty: Burden of proof to discover and investigate errors

- properly and accurately to effect, record, maintain and keep records of all transactions effected using Horizon;
- properly and accurately to produce all relevant records and/or to explain all relevant transactions and/or any alleged or apparent shortfalls attributed to Claimants;
- to co-operate in seeking to identify the possible or likely causes of any apparent or alleged shortfalls and/or whether or not there was indeed any shortfall at all;
- to seek to identify such causes itself, in any event;
- to disclose possible causes of apparent or alleged shortfalls (and the cause thereof) to Claimants candidly, fully and frankly;
- to make reasonable enquiry, undertake reasonable analysis and even-handed investigation, and give fair consideration to the facts and information available as to the possible causes of the appearance of alleged or apparent shortfalls (and the cause thereof);
- properly, fully and fairly to investigate any alleged or apparent shortfalls; not to seek recovery from Claimants unless and until:
 - (a) the Defendant had complied with its duties above (or some of them);
 - (b) the Defendant has established that the alleged shortfall represented a genuine loss to the Defendant; and
 - (c) the Defendant had carried out a reasonable and fair investigation as to the cause and reason for the alleged shortfall and whether it was properly attributed to the Claimant under the terms of the Subpostmaster contract (construed as aforesaid).

Possible responses

- *substantial changes to the design and operation of Horizon to capture and retain transaction records so as to address the perceived deficiencies;*
- *enhanced procedures to detect discrepancies;*
- *increase in size of network support team to perform weekly cash and stock balances, network wide and investigative staff to investigate discrepancies;*
- *re-contract all operators on to new "agency" contracts that expressly exclude the implied terms ordered by the Court;*
- *move to a more commonly used franchise model where operators provide their own cash and stock and therefore directly bear the risk of losses;*
- *review current products and services to identify those with greatest risk of causing losses, and discontinue these, moving to those products with lesser risk;*

- *develop a branch portal to enable postmasters to access their own data so that they can interrogate their own transactions as part of their own investigation to any discrepancies*
- *require postmasters to provide a bond in advance to offset losses;*
- *take out insurance against losses;*
- *operate a zero-tolerance policy towards operators who suffer losses;*
- *change to the remuneration model for postmasters to balance the shift of risk to Post Office;*
- *retain/increase the number of DMBs to enable more direct control of branch operations;*
- *renegotiate client contracts to share with our trading partners the risks of irrecoverable branch losses;*
- *introduce a more stringent recruitment and appointment process for Postmasters and assistants;*
- *introduce a competency based assessment for postmasters and their assistants to mitigate risk of errors being made;*
- *adopt a zero tolerance for vetting and training prior to providing access to Horizon – this would cover process and systems (mainly Horizon) as well as compliance and product knowledge.*

Implied Duty: Horizon

- *to provide a system which was reasonably fit for purpose, including any or adequate error repellency;*
- *to communicate, alternatively, not to conceal known problems, bugs or errors in or generated by Horizon that might have financial (and other resulting) implications for Claimants;*
- *to communicate, alternatively, not to conceal the extent to which other Subpostmasters were experiencing relating to Horizon and the generation of discrepancies and alleged shortfalls;*
- *not to conceal from Claimants the Defendant's ability to alter remotely data or transactions upon which the calculation of the branch accounts (and any discrepancy, or alleged shortfalls) depended;*

Possible responses:

- *substantial changes to the design and operation of Horizon to address the perceived deficiencies – particularly as regards 'error repellency'; this would need to be an almost fool proof system with minimal risk of human error and no ability to override the system.*
- *move to customer self-service estate*
- *introduce screen sharing capability at NBSC and for PO investigation team*
- *take legal action against Fujitsu for providing a defective system;*
- *pro-active communications to postmasters of all 'bugs' or 'errors' and operational issues experienced by other postmasters which could result in*

postmasters relying on issues to account for any trading errors, with the consequential increase in losses required to be borne by Post Office.

Implied Duty: Training

- to provide adequate training and support (particularly if and when the Defendant imposed new working practices or systems or required the provision of new services);

Possible responses:

- *review and change the design and delivery of induction training for new postmasters and for new products or changes, and ongoing/refresher training to address any issues or perceived shortfalls identified;*
- *introduce periodic assessments for postmaster and their assistants. Failure to reach the required level would instantly restrict access to Horizon system*
- *enhance Horizon so as to become intuitive with a Google type search engine enabling quick answers to product and process questions*
- *introduce web chat functionality for NBSC to better support branches where language/accent is a barrier to providing accurate support*
- *Post Office takes on direct responsibility for recruiting and training assistants;*
- *Post Office provides new contract terms that exclude or limit liability for training.*

Implied Duty: Suspension or Termination of Postmasters

- not to suspend Claimants:
 - (a) arbitrarily, irrationally or capriciously;
 - (b) without reasonable and proper cause; and/or
 - (c) in circumstances where the Defendant was itself in material breach of duty;
- not to terminate Claimants' contracts:
 - (a) arbitrarily, irrationally or capriciously;
 - (b) without reasonable and proper cause; and/or
 - (c) in circumstances where the Defendant was itself in material breach of duty;

Possible responses:

- *Update the Post Office standard contracts to specifically exclude the above termination rights;*
- *Enhanced collation and retention of evidence and audit trails to explain the rationale for any action taken against postmasters to demonstrate that it was not arbitrary, irrational or capricious; was for due cause and that Post Office was not itself in breach of a relevant duty.*

Implied Duty: General

- not to take steps which would undermine the relationship of trust and confidence between Claimants and the Defendant;
- to exercise any contractual, or other power, honestly and in good faith for the purpose for which it was conferred;
- not to exercise any discretion arbitrarily, capriciously or unreasonably;
- to exercise any such discretion in accordance with the obligations of good faith, fair dealing, transparency, co-operation, and trust and confidence;
- to take reasonable care in performing its functions and/or exercising its functions within the relationship, particularly those which could affect the accounts (and therefore liability to alleged shortfalls), business, health and reputation of Claimants

Possible responses:

- *introduce account management for all branches;*
- *increase level of in-branch and remote (helpline and on-line) support for operators to increase "trust and confidence";*
- *Introduce more controls and governance on ensuring Post Office standards are consistently applied.*