

The recession's impact on litigation

Mazars' Litigation and Arbitration Survey 2010

This report compiled by the Forensic and Investigation Services team presents the results of a wide-ranging survey of top litigators into the impact of the global recession on the volume of litigation. Has there been a wave of new disputes, as expected? Or has the recession to date had no real impact on litigation at all?

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KEY FINDINGS

Two years ago, the global financial crisis was expected to be the catalyst for a new wave of disputes. As the UK emerges from recession, the impact on the volume of litigation remains unclear, and the market is still uncertain. It is clear from the responses received to this survey that the anticipated wave of new disputes is still to come.

Volume of litigation

When considering the overall impact of the recession on the number of new litigation and arbitration cases, the respondents were clearly split into two camps – those who felt there had been either a reduction or no change in volume, and those who felt there had been an increase.

It appears that whilst there have been small increases in certain types of dispute, notably business interruption and breach of contract cases, the wave of litigation expected in the wake of the financial crisis is yet to arrive. Potential Claimants are perhaps waiting for the economic recovery to be assured, conscious of the cost of litigation. Defendants may therefore be breaching contracts or committing tortious acts, but are being reprieved by the recession, albeit temporarily. Claimants may also not yet have experienced the full extent of a breach of contract or tortious act. Given the length of time following a breach or tortious act that a claim can be made, it is possible to bring such a claim a significant period of time after events occur.

Are claims being settled earlier?

Over half of survey responses suggest that claims are being settled at the same stage of the litigation process as they were prior to the recession. This is surprising, as it could be widely expected that, given a higher awareness of the costs of litigation and a greater level of risk aversion, Defendants and Claimants might have been prepared to compromise more readily and come to a quicker conclusion.

Revisiting past potential losses

A significant number of those surveyed have experienced Claimants reviewing past activity, looking for potential claims to replace lost income. It would appear that entities are searching for new, creative ways in which to improve their profits during a period of economic downturn. Considering the often significant cost of litigation, this represents a brave move by Claimants.

What does the future hold?

Responses to this survey clearly demonstrate that a peak in forensic accountancy is expected between 2011 and 2012. While this represents the peak for expert witnesses and advisers, we would expect this to generally follow the various stages in the litigation process. Litigators involved in the early stages of litigation could therefore expect their peak of activity to occur in late 2010 / early 2011.

Our 2009 predictions

Serious financial reporting mistakes are likely to be exposed over the forthcoming months. As trading conditions deteriorate and asset values diminish, making estimates and judgements, or establishing whether it is appropriate to presume that an entity will continue to operate, becomes more risky. Misrepresentation and fraud risks will escalate, leading to an increase in professional negligence claims.

Ian Mayes QC is a commercial litigator at Littleton Chambers, who cut his teeth as an advocate on the secondary banking crisis of the Seventies.

He was, for ten years before he took silk, Treasury Counsel to the Revenue so he has seen it all before. Nowadays, as well as practising at the Bar, he is a director of a highly successful hedge fund.

The survey comes as no surprise to him. It reflects what he has been hearing for months and what is now working its way through to his Chambers.

“There is”, he says, “a real head of steam behind the litigation recovery. I expect to be seeing much more of my favourite forensic accountants over the rest of this year and into 2011.”

“From both a UK perspective, and through interactions with colleagues around the world, it is clear that the surge of litigation that was expected following the credit crunch is proving slower to materialise than first thought, and that the wave of disputes following the global recession has yet to hit us.”

Nigel Grummitt, Global Head of Forensic and Investigation Services, Mazars

1. GENERAL IMPACT OF THE RECESSION

In late 2008 / early 2009, many reporters and legal specialists were forecasting what they termed the “credit crunch fallout”, predicting that the global financial crisis would lead to a surge in litigation. Speaking to The Times’ Law Panel, former Lord Chancellor Lord Falconer of Thoroton believed that many companies would look at where to point the finger of blame when trying to resolve their financial crises. He warned that the government and Financial Services Authority needed to be prepared to conduct the enquiries people demanded and that “lawsuits were sure to follow”.

Alex Novarese, Editor of Legal Week, believed that the restructuring of companies would prove a lucrative business for litigators. He said, “the Lehman deal may end up producing the most expensive legal mandate in European legal history, with more examples likely to follow.”

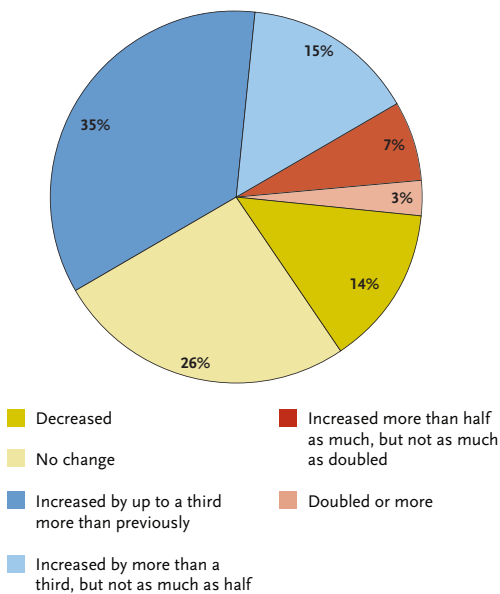
Likewise, Lord Falconer felt that the “explosion” in Court proceedings had not yet arisen as the market was still in turmoil. Once the economy began to settle, the rise in legal action would become more apparent. He added that it was “inconceivable” that this would not happen. (Source: Times Law Panel, December 2008)

As was expected, 60% of the respondents have experienced an increase in the number of litigation and arbitration cases (see Figure 1). However, this increase was not as large as might be assumed given the severity and global nature of the recession; most of those who indicated they have seen a rise in the number of cases qualified that it was only up to one-third more than before the recession.

Interestingly, 40% of those surveyed have either not yet seen an increase in the number of cases or have actually experienced a decrease. It is possible that this latter group are experiencing “the calm before the storm”. It would therefore be advisable for them to remain vigilant and be prepared to deal with any sudden increase in the coming months.

Figure 1 General impact of the recession

Generally, how has the recession impacted on the number of litigation and arbitration cases experienced?



Source: Mazars

Our 2009 predictions

Incentives to commit financial crime and fraud abound as the global crisis intensifies. Management may come under pressure to achieve results, to secure or extend borrowing facilities. Employees may be motivated to defraud their employer to resolve their own personal problems.

2. PROFESSIONAL NEGLIGENCE

It is a widely accepted fact that an economic recession often leads to a significant increase in professional negligence claims brought against professionals such as surveyors, solicitors, accountants, real estate agents and Independent Financial Advisers (IFAs).

There are a number of possible causes for this increase:

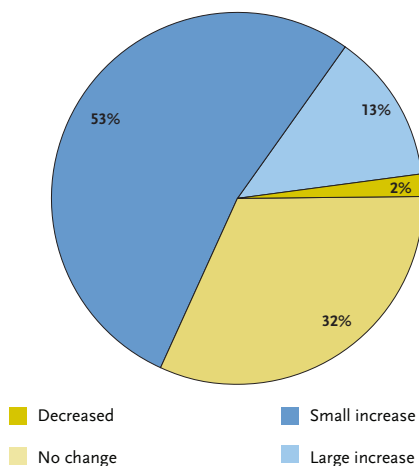
- In a booming property market, delays or errors by professionals can be obscured by increasing property values and profits. During an economic downturn however, such negligence (as well as the financial losses it causes) is revealed.
- As more companies enter administration, the work performed by auditors comes under greater scrutiny, as shareholders seek a way to recoup some of their lost investments.
- Valuations of companies will typically be more volatile in a recessionary environment. Where an individual suffers as a result of such a fluctuation, they may seek to mitigate any losses by claiming against the valuer.
- As financial markets collapse and interest rates fall, investors often lose value in their investments. They invariably turn to and blame IFAs for the advice provided.
- Whilst there is often little scope for obtaining large settlements from many potential Defendants as they too have suffered financially as a result of the downturn, professional advisers are typically insured and Claimants see them as a worthwhile target.

The survey responses appear to confirm the assumption that the recession is a catalyst for exposing a greater proportion of negligent acts and in turn prompting an increased volume of claims. 66% of respondents have experienced an increase (see Figure 2), however, when looking in greater detail at the breakdown of responses, only 13% have seen a large increase, whilst 53% considered it a small increase.

Therefore, while there has been an increase in claims for professional negligence, it does not yet appear to have been as great as anticipated. As we have only just come out of recession, it is likely that a larger increase is yet to come.

Figure 2 Professional negligence

What impact has the recession had on the number of litigation and arbitration cases for professional negligence claims?



Source: Mazars

“I am routinely appointed as an expert witness in professional negligence cases, but this has been balanced to some degree by clients deciding not to proceed. We have also certainly experienced clients asking for work to be completed within unrealistic budgets.”

Nigel Grummitt
Global Head of Forensic and Investigation Services, Mazars

3. BREACH OF CONTRACT

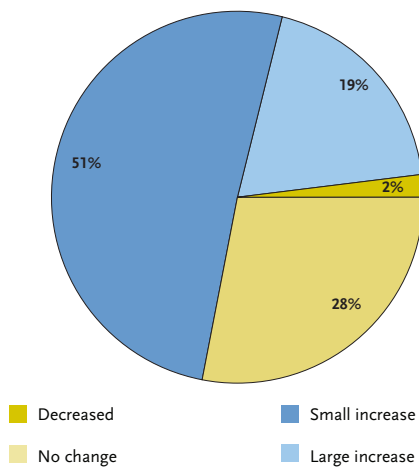
The UK has just witnessed some of the toughest trading conditions for a decade and when finances are tight everyone looks for ways to save money and this can include trying to exit contracts that now appear onerous.

Further, some contracts are being breached because of reduced demands for products or services, others because the pricing is no longer sustainable, and others simply because one party cannot pay.

As was expected, 70% of the respondents have seen an increase in the number of business interruption or breach of contract claims - with 51% regarding this as a small increase (see Figure 3). Once again, it would seem that the majority of claims are yet to come, as many Claimants may have been holding off due to the complexity of such claims, the lack of funds to fight a claim, or the risk that the Defendant does not have the ability to pay damages. Further, when a company loses a major contract, its first focus is usually to replace that contract by going out to the market and looking for alternatives. More often than not this takes precedence over initiating a claim for lost profits.

Figure 3 Breach of contract

What impact has the recession had on the number of litigation and arbitration cases for business interruption / breach of contract claims?



Source: Mazars

“I am often engaged as an expert in breach of contract and business interruption cases. We have already experienced many cases where a contract has been breached as a result of the credit crunch and parties are seeking to recover lost profits. However, we are also experiencing an increase in the number of negotiated settlements. We have prepared an increased number of financial models for clients, aimed at a quick resolution, rather than long-term litigation.”

Mark Taylor, Forensic and Investigation Services, Mazars

4. TRANSACTION AND VALUATION DISPUTES

There has been a clear drop in transactions as a result of the recession, with the result that there are fewer transactions to be disputed.

However, it is likely that a higher proportion of the transactions completed as the UK was going into recession will give rise to disputes, as the change in trading conditions will have exposed inaccuracies and miscategorisations.

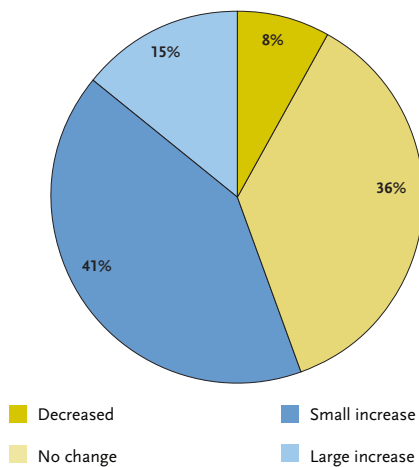
Typically, a purchaser has two years to claim under the warranties and it might be that this causes a spike around two years after the collapse of the economy.

In respect of valuations, we would again expect the change in trading conditions to produce lower valuations and this might give rise to concerns that valuations conducted at the time of the downturn were over-optimistic.

There are clearly many factors affecting transactional valuation disputes which may compensate or reinforce each other. The survey results show that the vast majority of respondents have seen only a small increase or no change at all which suggests the factors are currently compensatory (see Figure 4).

Figure 4 Transaction and valuation disputes

What impact has the recession had on the number of litigation and arbitration cases for transaction and valuation disputes?



Source: Mazars

“The financial stress of the past two years has shown quite clearly that companies need to pay particular attention to the specific warranties and indemnities put into sale documentation.

- *From a seller's perspective, making sure that any issues lurking in the accounts are adequately disclosed pre-sale is essential if future claims are to be avoided.*
- *From a buyer's perspective, making sure that “belt and braces” protection is enshrined in the deal documentation is vital to covering off the same risk.*
- *From both sides' perspective it is obvious that deferred payment terms based on actual performance have become a larger proportion of the consideration.”*

Stephen Skeels, Corporate Finance, Mazars

Our 2009 predictions

In the current economic climate, purchasers will inevitably be looking at the valuations placed on acquisitions, particularly where there have been significant write-downs. Underperforming acquisitions will give rise to a scrutiny of the financial warranties.

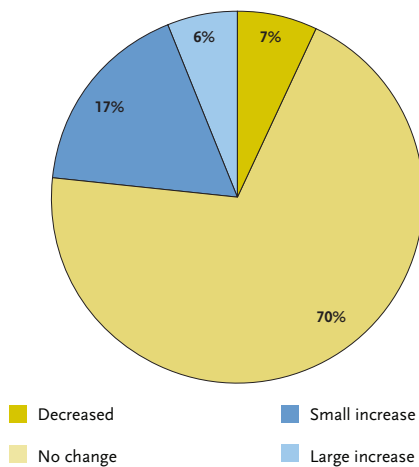
5. INTELLECTUAL PROPERTY AND LICENSE DISPUTES

It might be expected that we would see a clear link between economic conditions and the defence of intellectual property (IP), on the basis that protecting market share and IP rights become much more important when the economy is perceived to be on unstable ground; IP counts as a significant proportion of litigation. However, most IP rights (and particularly patents and design rights) are very time-limited. Litigation may therefore be driven more by this than by the broader economy, rendering litigation in this field more acyclical than countercyclical.

This theory has been reflected in our survey. Only 23% of respondents have experienced an increase of any kind in IP claims (see Figure 5), whereas a significant number (69%) of respondents said they had experienced no change at all.

Figure 5 Intellectual property and license disputes

What impact has the recession had on the number of litigation and arbitration cases for intellectual property and license disputes?



Source: Mazars

“These results are unlikely to come as a great surprise to most intellectual property owners and litigators. Other than trade mark rights, most IP rights are time-limited, so there is a limited timeframe in which they can be enforced. It is therefore understandable that IP owners will continue to enforce their rights in bad times as in good. It should also be borne in mind that significant IP litigation is relatively sporadic and so its distribution among law firms’ will always be “lumpy”. It is therefore difficult to assess short-term variations in volume of litigation at the level of individual law firms’ as statistically significant, and equally law firms reporting are likely to attribute variations in work flow to standard variation rather than systemic change in the rate of litigation.”

Counsel, leading IP practice, London

6. OTHER COMMERCIAL DISPUTES

The modern world has become increasingly competitive and regulated – everyone accepts that commercial disputes have become a way of daily business life. This situation can only be aggravated by recession; economic pressures will inevitably lead to the breakdown of certain business relations, forcing contentious issues to the surface. Money is tight, liquidity is scarce, and difficult decisions need to be made as to whether or not to pursue or maintain business ventures and relationships.

Not surprisingly, therefore, an overwhelming majority of survey respondents (73%) have experienced an increase in the number of other commercial disputes (see Figure 6).

Tim Constable and Justine Ash of Matthew Arnold & Baldwin note that this is further supported by recent figures which have revealed that caseloads involving business disputes at leading London tribunals jumped sharply in 2009. Some experts see this as the first signs of the volume of litigation expected in the wake of the economic crisis.

They consider that many cases are still in their early stages and are yet to go public whilst the parties attempt to settle their scores in private. However, many disputes are heading straight for the Courts.

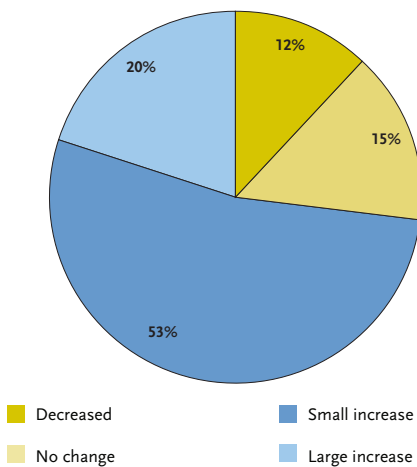
The Judge in charge of the London Commercial Court said in a recent interview that he was still trying to work out why new lawsuits had spiked from 1,002 in 2008 to an eight-year high of 1,225 in 2009. He said that, having discussed the matter extensively in the City and with arbitrators and UK lawyers, “no one has encountered what I call a tidal wave of credit crunch litigation...but we have also heard of a pending increase in disputes between investors and banks and are watching that with interest...” (Source: www.smeweb.com)

“From our work with insurers and solicitors, it is apparent that we are now witnessing a steady increase in the volume of commercial disputes including overhead disputes, account manipulation, and insurance claims.”

Stephen Lewis, Forensic and Investigation Services, Mazars

Figure 6 Other commercial disputes

What impact has the recession had on the number of litigation and arbitration cases for all other commercial disputes?



Source: Mazars

Our 2009 predictions

As the global financial crisis worsens, we can be sure that this will be a catalyst for an increase in insurance claims, with questions arising around fraud and financial motive.

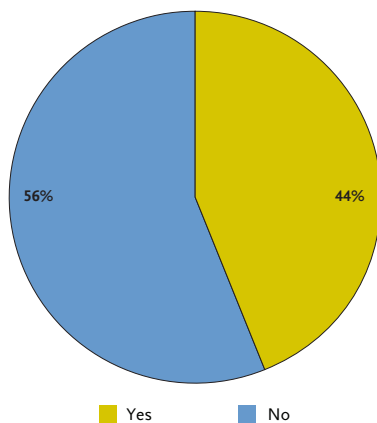
7. ARE CLAIMS BEING SETTLED EARLIER?

During a recession, it could be expected that claims settle at an early stage in the litigation cycle (for example, at the mediation stage or prior to claims being filed with the Courts). It would be in the interests of both Claimants and Defendants to try to keep costs as low as possible. Both parties might also be more open to compromise in the hope of gaining a satisfactory outcome, rather than risk coming away with nothing and still have considerable costs to pay out.

Interestingly, our survey does not reflect this theory. Just over half of our respondents (see Figure 7) indicated that claims are being settled at the same stage they would have prior to the recession. What is not clear is exactly what stage this is. For example, are the majority of claims being settled at mediation stage or prior to Court? If so, this may be an indication that all parties are increasingly aware of the cost of litigation. Even if they have a greater need to obtain a positive outcome, their determination to see the case “through to the bitter end” may be affected by this awareness and a greater aversion to risk than they held in the past.

Figure 7 Are claims being settled earlier?

Are disputes now settling at an earlier stage than before the recession (e.g. at mediation or prior to Court)?



Source: Mazars

“As the recession bit, we saw a reduction in the number of instructions and expected more of these to settle early, with parties unwilling or unable to incur significant costs. Instead of seeing parties trying to preserve their funds by settling earlier, we have noticed that parties are actually being much more cautious when instructing experts and it is often taking twice or even three times as long to agree a new instruction.”

Graham Platts, Forensic and Investigation Services, Mazars

8. REVISITING PAST POTENTIAL LOSSES

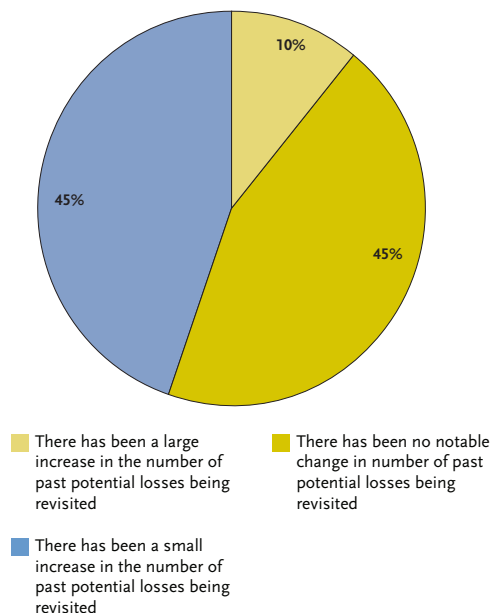
In a recession, cash is king. Most companies will look for ways to save and recover cash, in addition to competing for it, in an effort to manage their budgets for the current year and beyond.

A majority of those surveyed have experienced companies reviewing past activity, looking for potential claims to replace lost income (see Figure 8). When one considers the fact that 44% of cases are now settling earlier, it appears that this might be perceived by certain parties as a new way to improve profits in a period of recession. Considering the often significant costs of litigation, this represents a brave move by Claimants.

Mazars is increasingly instructed by companies to carry out reviews and analyses of their cost base to identify savings, for example identifying over-payments or duplicate payments to suppliers or in some cases to review underperforming divisions to identify and develop remedial plans.

Figure 8 Revisiting past potential losses

Some commentators have suggested that entities unable to generate sufficient income in the current economic climate have been reviewing past activity looking for potential claims to replace lost income. To what extent do you believe that this is happening?



Source: Mazars

“Frequently in such reviews we are also asked to explore or search for dormant or unpursued claims which may be related to poor controls, duplicate payments and/or underperforming elements of the business.”

Paul Forrest, Head of Transaction and Consulting Services, Mazars

9. THE FUTURE

A large majority (76%) of the respondents believe that a peak would occur after the end of this year. Of those, the largest proportion believe that the peak is still over 18 months away. It would therefore appear that predictions of a tsunami of litigation as we came out of the recession were incorrect. The greatest impact is likely to be felt in a year or more.

The majority of respondents (66%) believe that the peak of forensic accountants' work will be in 2011 to 2012 (see Figure 9). We would expect this peak in demand for expert witnesses and advisers to generally follow the level of litigation.

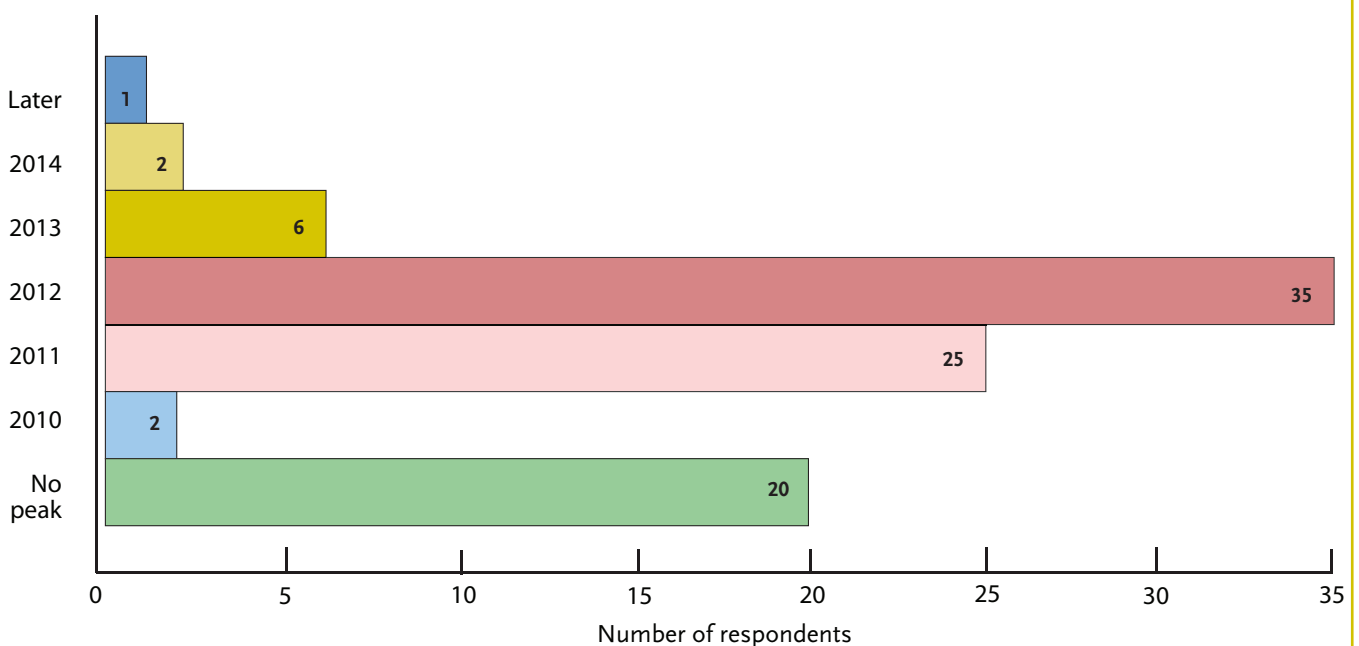
Surprisingly, 22% of those surveyed believed that there would be no peak. This may mean they expect a general increase in activity over the next few years, or that they anticipate no increase at all.

“Although the Scottish litigation market has lagged England in the use of forensic accountants, we are expecting to see a significant increase in assignments in the coming years. Conversations with local lawyers support this belief and we anticipate that Scotland will see a similar peak profile as England although the level attained may continue once the local market becomes more comfortable instructing forensic accountants.”

Dr. Tom Mitchell, Forensic and Investigation Services, Mazars

Figure 9 Future peak in forensic accountancy

When do you, as a litigator or arbitration lawyer, believe forensic accountants' work will peak following the recession?



Source: Mazars

10. METHODOLOGY

Mazars' Litigation and Arbitration Survey 2010 was designed to provide an insight into the impact of the global recession on the volume of litigation, and to gain an idea of how these trends would continue into the future.

Mazars therefore contacted over 1,000 of the top litigation lawyers in the UK, including the leading individuals as listed in the Legal 500. The sample comprised litigators from magic circle and other large City firms, alongside litigators from leading regional firms, obtaining coverage of the whole of England and Scotland.

The analysis is based on 110 respondents, which represents a 10% return on the total sample, being a sound representation.

As the nature of the survey was subjective, we selected questions that allowed respondents to provide answers that gave an overview of broad categories. The nine categories chosen represent how many firms structure their departments and the categories used by publications such as Chambers and the Legal 500.

We also focused on categories in which Mazars actively provides dispute resolution services.

Finally, we included the questions on revisiting past losses and the future trends because these are topics that are repeatedly raised in our conversations with our broad lawyer client base.

11. OUR EXPERTISE

Mazars is an integrated international business advisory firm specialising in audit, tax and advisory services.

Mazars is an international firm with a European heart and local roots. With our global reach, we have an appropriate understanding of local regulations and legislation around the world. We are an integrated organisation in 56 countries with over 12,500 professionals. We also have co-operative agreements in an additional 13 countries and are a member of the Praxity alliance which brings together 25,000 professionals in 72 countries.

Mazars has considerable experience of dealing with:

Banking and financial disputes

Mazars has extensive banking and financial markets expertise. We work with a wide range of clients across the sector, including major international banking groups, providing insight and advice in understanding complex regulatory requirements. We have strong relationships with banking regulators and standard setters both at the national and European level. Mazars is the only accountancy firm outside of the Big Four to be an associate member of the Council of Mortgage Lenders. We are currently acting as monitoring trustee for the European Commission for two banks, including one in the UK.

Financial reporting disputes

We have acted in many professional negligence matters relating to technical accounting issues, including auditor negligence, valuation disputes and accounting advice in relation to financial reporting. We have also performed many GAAP investigations to identify how accounting transactions should be recorded in financial statements and assignments to opine on the fair value of assets.

Professional negligence disputes

Mazars advises on both liability and quantum in relation to professional negligence disputes. We are ideally placed to opine on the best practice and hence on liability issues where the professional judgement or the actions of an auditor or accountant is at issue. We have acted on many professional negligence matters, including cases relating to accountants, actuaries, auditors, tax and financial advisers and solicitors, whether in relation to corporate transactions, audits, valuations or other advice.

Transaction disputes

We have considerable expertise of dealing with transaction disputes in the UK and globally. This expertise includes pre-completion advice on the negotiation of the sale and purchase agreements, advising on the negotiation of the completion accounts, expert determination, breach of warranty claims and rectification claims.

Fraud investigation and asset recovery

Mazars investigates many different types of fraud and has undertaken asset tracing and recovery assignments across a wide range of sectors, both nationally and internationally. We have extensive experience of working with the Serious Fraud Office, both in assisting them with their inquiries into companies and seconding team members for specific assignments. We also have experience acting for Defendants. We have experience of both criminal and civil trials and are familiar with injunctive reliefs.

Our clients include large public interest organisations, entrepreneurs and owner-managed businesses as well as private individuals. Mazars acts for 17% of the FTSEurofirst 100 and audits more FT Global 500 companies than any non-Big Four firm.

12. OUR TEAM



Stephen Lewis – Partner, Birmingham

Stephen has acted in a wide range of civil litigation and investigation cases, and criminal cases as both expert witness and adviser. He has extensive experience of alternative dispute resolution, including mediation and expert determination. Stephen's experience includes insurance claim disputes, loss of profit, breach of contract, post transaction disputes, business and share valuation disputes, asset tracing and fraud investigations.



Dr. Tom Mitchell – Director, Edinburgh

Tom has acted in a wide range of expert witness and investigation assignments, including fraud investigations, serious governance failures, loss of profits claims, transaction disputes and professional negligence cases.



Nigel Grummitt – Partner, London

Nigel heads up Mazars' Forensic and Investigation Services in the UK and is chairman of the group coordinating the provision of these services within Mazars worldwide. He has worked on numerous civil litigation and investigation cases both as expert and adviser accountant in connection with professional negligence, financial valuations, breach of contract, loss of profits, fraud, asset tracing and post transaction disputes.



Graham Platts – Partner, The South

Graham has many years of experience acting as an expert accounting witness. He has acted as adviser and party appointed expert for both Claimants and Defendants, and also as a single joint expert on numerous occasions. His expertise includes commercial and contractual disputes, share and business valuations, partnership disputes, accountants' professional negligence, matrimonial claims, personal injury and fatal accident claims, medical negligence, fraud and theft.



Mark Taylor – Partner, London

Mark has considerable experience in the dispute resolution arena, having specialised as a forensic accountant over 15 years ago. Mark has acted as an expert accountant and adviser on a broad range of civil and criminal disputes in the UK, Europe, the USA and SE Asia, involving complex accounting and valuation issues. Mark's arbitration and Court work includes post transaction disputes, breach of contract, account manipulation, fraud, asset tracing and loss of profits assignments.



Warwick Sabey – Director, London

Warwick has extensive civil litigation and regulatory experience. He completed over eight years as one of the Secretaries to the investigation into the flotation of Mirror Group Newspapers plc and the abuse of its pension schemes. He has conducted other investigations for the DTI and in connection with Lloyd's matters. He has acted on many other disputes including cases of professional negligence.

Industry sector experts

Where a dispute requires sector or specialist expertise, it is our practise to propose such an expert from within Mazars and to support that expert with our Forensic and Investigation Services team to produce a robust and reliable product. We have worked with over 30 such Mazars experts.

International team

Frauds and disputes are not constrained by national boundaries. Mazars is well placed to undertake complex investigations and disputes resolution assignments throughout the world and facilitate positive resolutions. We operate on a regional basis with Forensic and Investigation Services hubs in Europe, the Americas, Asia, Africa and the Middle East, and with further teams within the regions.

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In March 2009, the Mazars Forensic and Investigation Services team published a series of leaflets under the banner “Dealing with conflict: the credit crunch”.

The publications reported that whilst the fallout from the global financial crisis was then uncertain, we could be sure that it would be the catalyst for a wave of disputes. In the post credit crunch era, it was anticipated that we would be working to a new set of rules. This wave of disputes and new set of rules would also trigger a new way of thinking, leading to innovative resolutions in the arena of litigation and arbitration.

In May 2010, with the worst of the financial crisis seemingly at an end, the team then conducted a survey in order to determine whether or not, as predicted, the global recession had led to a significant rise in litigation.

