PROFESSIONAL NEGLIGENCE – GETTING CREATIVE

Pushing the boundaries from a Chancery Perspective

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INTRODUCTION

On 11th April 2017, the Supreme Court handed down its decision in *Swynson v Lowick Rose* [2018] AC 313, a case that sought to push the boundaries of equitable subrogation beyond breaking point. The Claimants were very firmly knocked back and it was made entirely clear that equity cannot be used as a modern day palm tree. Equity is based on legal principle, not discretion, or an amorphous concept of fairness. However, that does not mean there is *no* scope to get creative – provided you work out what the rules are and stick to them.

We tend to think of professional negligence in terms of contract or tort, but the Chancery concepts of trust and proprietary claims can expand the boundaries – or get both claimants and defendants out of tricky corners. Equally, a Chancery perspective can lead to avenues of recovery that tort and contract will not touch – such as unjust enrichment. This talk will look at a few of the concepts in the context of potential claims against solicitors.

TRUSTS

Target – the starting point

It used to be thought the last word on breach of trust claims against solicitors was set down in stone in *Target Holdings v Redferns* 1996 AC 421 – and defendants regularly wrote letters stating that a breach of trust claim against a solicitor could not succeed. That was a misreading of the case, and far too simplistic.

The basic point to take from the case: "moneys held by solicitors on client account are trust moneys" and "the basic equitable principles apply to any breach of such trust by solicitors".

That raises the obvious point that any claim that involves money passing through a client account will raise the possibility of a trust claim.

The basic questions are always, since the monies are held on trust, who are they held for, and what are the terms of the trust?

The law has moved on and there have been a number of important cases since 2010 which, at their root, look at those questions.

Markandan – the modern law gets started

Lloyds v Markandan & Uddin [2012] PNLR 20 – a fraudulent conveyancing case in the Court of Appeal, and the first since *Target*. Lloyds remitted mortgage monies to M&U for the completion of a property purchase, intending to take a first legal charge over the property. M&U remitted the monies to a fake firm of solicitors, whereupon they disappeared. The property purchase never completed – the owners knowing nothing about it. M&U admitted that they held the money on trust, but claimed there was no breach of the trust. That engages the basic questions –

Who was the money held on trust for? The Court of Appeal confirmed M&U held the monies for Lloyds until completion.

And what were the terms of the trust? To hold the monies unless and until there was completion and, on completion, to pay the monies to the vendor in exchange for the property. If there was no completion, the monies had to go back to Lloyds.

So the big question was, what is completion? If there had been completion, no breach. If there was no completion, there was a breach of trust.

The Court of Appeal (Rimer LJ, Para 50) concluded that completion means genuine completion – the exchange of real money for real documents of title. This is the King Lear "nothing comes from nothing" quotation. Without genuine completion, there is a breach of trust.

Easy in cases where there is no genuine completion of whatever the trust transaction is – and it is not limited to conveyancing. Remember, **all** client account money is trust money – so any payment out **could** be a breach of trust. But what happens when there is some form of completion? When the purchaser gets a property but it is not what they were expecting? The basic questions provide the answer.

Target re-visited – the modern approach

AIB v Redler [2015] AC 1503 – another conveyancing case, this time in the Supreme Court. Here, there was a remortgage so the "completion" was completion of the remortgage. AIB did in fact get a charge over the property, so what was the problem? AIB had instructed Redler to get a *first* legal charge, but Redler failed to clear off a pre-existing Barclays charge, so AIB only got a *second* charge, behind Barclays.

Redler started by alleging there was no breach of trust – because AIB asked for and got a charge. That, they alleged, was completion.

That got short shrift – a second charge is not a first legal charge. Redler did not complete the transaction they were asked to complete. The basic questions show there is a breach of trust – the terms of the trust were to get a first legal charge, Redler failed to do it. 1-0 to the Bank.

The big question, however, is what loss flowed? Following the answers to the basic questions in *Markandan*, surely the trust monies, namely the whole advance, had to go back to AIB?

There was an apparent tension between common law and equity on this point. Redler, taking the common law position, stated that AIB wanted a charge over the property and they got it, subject to the Barclays charge. The only loss was the value of the Barclays charge – which just happened to be the basic negligence loss which was admitted. AIB, taking the apparent Chancery position, argued that AIB wanted a first legal charge and didn't get it, so the remedy was to return the trust monies to AIB – meaning the whole advance.

It mattered because in fact the property had been sold at a huge shortfall. On the Redler position, the loss was about £300,000 – the Barclays redemption figure – as AIB got the rest of the value of the property at the date of sale - which *was* what they had asked for. On AIB's case, the loss was the entire shortfall on the sale (over £2.5m), as they were prepared to give credit for the monies recovered on the sale - even though that gave them money, not the property they had asked for.

The Court concluded that the loss was the Barclays redemption figure. But they achieved that result by applying a trust analysis, not importing common law rules into trust. The Court concluded that the real loss was only the loss which would not have been suffered in any event had the trustee not acted in breach of trust. This was a case where AIB wanted the first legal charge. If they had got the first legal charge, they would have suffered the same loss, less the Barclays redemption figure. The loss flowing from the breach of trust was limited to that sum. 2-1 to Redler.

The reasoning in the judgment is convoluted and does not do a very clear job of explaining, as a matter of trust law, how there can be no completion of the mortgage and yet no requirement for Redler to account to AIB for the whole advance. In fact, there is a simple way of analysing the case applying the basic questions – by going back to the simple question, what were the terms of the trust?

Reading between the lines, the Supreme Court was using conventional trust accounting to determine the proper level of compensation. In assessing compensation, you take an account of the trust and you identify the loss suffered as a result of the breach. In the left hand column of the account, you have the asset that would have been there but for the breach – what the trustee was required to get under the terms of the trust. In the right hand column you have what is actually there – the result of the breach. The correct compensation is the difference between the two.

But to say, as AIB did, that because there was no completion of the first legal mortgage the asset in the left hand column is the full advance is a flawed analysis of this situation – and far too creative.

So what should have been in the left hand column? What was Redler required to do by the Bank under the terms of the trust?

In fraud cases, the bank requires the solicitor to perform by returning the advance. The left hand column contains the full advance, the right hand column contains nothing - which is why the compensation in *Markandan* was the full advance, since the fraudsters had disappeared with the money. That is conventional, and it is what *Target* says.

However, that is not the *Redler* case. As the judge found, what AIB wanted was a first legal charge – and it was available. AIB did not want its money back – had Redler sent the money back, there would have been howls of protest. AIB wanted the first legal charge. That was the performance that was required.

So, when you take the trust account, the asset in the left hand column is not the full advance but the first legal charge – the required property. In the right hand column is the second charge that was in fact obtained. The difference is the £300,000 odd figure paid to Barclays, which just happens to be what every judge has considered to be the right result, regardless of their different reasoning. While breach of trust claims put defendants on the back foot, creative trust accounting can redress the balance – in the right case.

<u>Getting more creative</u>

The Court in *Redler* did something else quite useful – and clever – which gets overlooked. Lord Toulson said the following at Para 74 –

"The solicitors did not "complete" the transaction in compliance with the requirements of the CML Handbook. But as a commercial matter the transaction was executed or "completed" when the loan moneys were released to the borrowers. At that moment the relationship between the borrowers and the bank became one of contractual borrower and lender, and that was a fait accompli."

He has picked up that completion in this context can mean several different things. He is referring to two different transactions – the completion of the mortgage security in accordance with the terms of the trust and the CMLH, which did not happen, and completion of the loan which, in that case, did happen.

When he says the mortgage did not complete, that is consistent with the modern Court of Appeal authorities on conveyancing completion, starting with *Markandan*. Lord Toulson's comments neither undermine nor change that. But AIB was not a fraud case, so there were two relevant transactions – the mortgage and the loan. And the loan did complete – the borrowers got the money.

Recognising that one is complete when the other is not actually helps both claimants and defendants while getting to what feels like the just result. It means that where the borrower has had the money, but the security has gone awry, the borrower can be pursued on the loan contract, but the lender can also claim a proprietary interest in the monies paid out in breach of trust. Which means that both lenders and insurers have the best chance of recovering the money and limiting the insurance payout.

Against the borrower, there is no need to resort to unjust enrichment, money had and received, or mistake. There is no need to deal with change of position defences. Contractual limitation applies – including acknowledgement and part payments. If the borrower has had the benefit, he cannot wriggle away free. Indeed, he can be obliged to execute a proper mortgage if the property exists.

On the other side of the equation, however, since the mortgage did not in fact complete so there was a breach of trust, the lender retains proprietary claims. Lenders *and* insurers can trace, they can claim equitable remedies including charges, subrogation and vendors' liens. They can protect their interests on the Land Register. They can rely on accessory liability. In the rare cases where the police actually find assets, they can reclaim them without having to rely on the criminal compensation regime.

It gives us the best of both worlds – which is what equity is really all about. The right solution to fit the problem, and consistent with trust and land law principles. It is a win for modern trust law – and the Chancery perspective.

But it raises those other Chancery wild cards - proprietary remedies, tracing, subrogation and, if all else fails, unjust enrichment claims. So what are the basics to bear in mind?

PROPRIETARY CLAIMS

Proprietary claims are useful – they can open up avenues of recovery for claimants and defendants, and even opportunities for co-operative recovery action. However, the plethora of unjust enrichment claims in recent years has pushed them to the sidelines, even to the extent that the majority in the Supreme Court in *Bank of Cyprus v Menelaou* [2016] AC 176 did not even acknowledge that such a claim existed – and was more straightforward.

The premise is simple, until property passes through a completed transaction it remains the property of the original owner who can reclaim it from whoever is holding it. Where property passes from A to B under a completed contract, property passes even if the contract is voidable. However, where the contract is void or - more relevant in this context – the transaction is a breach of trust, property remains with the original owner – subject to equity's darling. The claim is as simple as "that is mine, you must give it back".

So, whenever there is a breach of trust underlying a negligence claim, the question is, what has happened to the property and why hasn't it been claimed back? After all, if it still exists and is recoverable, there is no loss because it still belongs to the claimant – a point for defendants to remember even when the claim is framed as conventional negligence.

The Chancery concepts of tracing and following are used to establish where the property is, what the property is and whether it can be recovered.

So - when assets are disbursed in breach of trust, property in those assets does not pass to the recipient unless he is equity's darling – a bona fide purchaser for value without notice – see *Lewin on Trusts*, 19th Ed, 41-004. Of course, if there is a bona fide purchaser, then the trustee will have received the purchase price from him. So, the claim will either be to the original property in the hands of the recipient, or to the purchase price exchanged for it – and this is where tracing and following come in.

Where trust assets are disbursed in breach of trust they are *followed* into the hands of the recipient from the trustee – *Lewin*, 41-003. If they remain in the same form in which they were disbursed, they can be reclaimed from any recipient who is not equity's darling – no matter how long the chain of transactions. If they do not remain in the same form, the assets can be *traced* into any replacement property which has been substituted for the original (subject to any barriers which may have arisen) – *Lewin*, 41-005. They may be in a different form either because the recipient has converted them – eg spent money on a diamond necklace – or because they have been converted into the purchase price received from equity's darling. Traced assets are therefore claimed *either* from the recipient of the property *or* the recipient of the price from equity's darling. It is simply a matter of identifying what asset represents the trust property.

This gives proprietary rights not just to chattels or to land, but also to more amorphous property such as charges, liens, or even covenants to pay, contractual debts and other assignable rights – which is where subrogation can come in and takes us full circle to *Swynson*, and unjust enrichment – the last line of defence when the proprietary claim has gone.

EQUITABLE SUBROGATION AND UNJUST ENRICHMENT

Equitable subrogation at its most basic means stepping into the shoes of a third party to enforce the third party's rights against a defendant. It applies where the claimant intended to get rights but failed, and a third party had those rights but no longer needs them, as a result of something the claimant did. For example, A has mortgaged his property to B. A wants to remortgage and C offers to lend him the money in exchange for a mortgage. C pays the money to B, which clears the existing mortgage, but A doesn't sign the mortgage. C can subrogate to B's mortgage and enforce it against A.

There are 2 possible bases for equitable subrogation:

- A proprietary remedy to vindicate the type of proprietary rights already discussed; and
- A restitutionary remedy to reverse unjust enrichment.

Simply, unjust enrichment only applies where there is **no** proprietary claim. Unjust enrichment occurs where a proprietary interest has unjustly transferred from claimant to defendant.

As already discussed, when a claimant can show a subsisting proprietary interest in property, he can follow that property into rights to which he can be subrogated in place of his property. It turns out that is the easy basis!

Unjust Enrichment

The second basis is newer, and comes from *Banque Financiere de la Cite v Parc (Battersea) Ltd* [1999] AC 221, which introduced equitable subrogation as a remedy for unjust enrichment, and gave us the modern test for unjust enrichment:

- Has the defendant been enriched?
- Was the enrichment at the expense of the claimant?
- Was that enrichment unjust?

It ***should*** be obvious that those questions can only be answered affirmatively if the claimant has lost something which has ended up in the defendant's hands. Some form of direct transfer was required – the "direct providers" rule.

However, a raft of recent cases have shown that a lack of analysis has led to some serious confusion about when unjust enrichment arises – and when it doesn't. Even the Supreme Court got lost – as can be seen from a quick glance at *Menelaou*.

The convoluted reasoning of the majority led to some strange attempts to create exceptions to the direct providers rule, and direct attacks on the basic principles underlying unjust enrichment and equitable subrogation. *Menelaou* has been roundly criticized – not for the result but for the route followed to get there.

It directly led to this kind of thinking:

*"Following **ITC** and **Menelaou** it could not be clearer that there is no longer a 'direct providers only' rule in unjust enrichment claims, and that the exceptions to the general principle will be based on economic and commercial realities rather than predetermined classes of exceptional cases. Claims may in appropriate circumstances be brought not simply by indirect recipients of money but also cases where there is the indirect provision of 'value' in the wider sense of the term. This can include both the loss of security by the transferor, and cases where the ultimate transferee does not actually receive money or money's worth."*

Hugh Sims QC and James Wibberley

"Unjust Enrichment: the evolving treatment of indirect benefits"

It was clear that some re-assessment was required. Unjust enrichment was losing its usefulness and becoming entirely unpredictable.

The appeal in *Investment Trust Companies v Revenue & Customs Commissioners* [2018] AC 275 ("ITC") required the Supreme Court to address the real meaning of the *Banque Financiere* test and fix the muddle created by *Menelaou*. Lord Reed did not shrink from the task or spare Lord Neuberger's blushes:

- The existing tests for whether enrichment was at the expense of the claimant – "sufficient nexus" or "proximity" - were too vague and failed to answer the critical question;
- The Court had a responsibility to establish more precise criteria, given the uncertainty resulting from the use of "vague and generalized language".

Lord Reed set out the new criteria in [38]-[66] - including a few timely reminders:

- Unjust enrichment is dealing with personal not proprietary claims;
- It is based on legal principle not discretion or an amorphous concept of "fairness";
- The rules must be easily ascertainable and consistently applied;
- The *Banque Financiere* test provides a structured approach which should underpin, not dispense with, a careful legal analysis;
- The purpose of "unjust enrichment" is to correct normatively defective transfers of value – restitution is the most common remedy precisely because it restores the disrupted balance;
- The Court is searching for a defect recognized by law which has resulted in a gain to the defendant at the cost of the claimant;
- Incidental benefits do not count.

The sense of the *ITC* criteria was immediately illustrated by their application to the unconventional equitable subrogation claim in *Swynson* – albeit only the Court had the benefit of Lord Reed's reasoning!

The facts of *Swynson* are convoluted. Swynson was a company ultimately owned by a Mr Hunt. In 2006, Swynson lent £15m to another company, EMSL, to finance EMSL's acquisition of a US medical devices business known as Evo. The loan was made in reliance on a due diligence report provided by the accountants, HMT (now Lowick Rose), which had been negligently prepared. EMSL defaulted on this loan. In 2007 and 2008, Swynson made further loans to EMSL to support its liquidity; again EMSL defaulted on the loans. At the same time as the last of these loans was made, Mr Hunt also became the controlling shareholder in EMSL, resulting in Swynson and EMSL being treated as connected companies for tax purposes.

At the end of 2008, Mr Hunt decided that he did not want a large bad debt sitting on Swynson's books; he also wanted to alleviate the adverse tax consequences of the connection between Swynson and EMSL. He therefore personally made a large loan to EMSL which was used to pay down the sums owing to Swynson, leaving a balance of just £3m outstanding.

EMSL went into liquidation in 2011. After realisation of various securities, Mr Hunt and Swynson sued HMT for losses totalling £16m. Mr Hunt's personal claim failed at first instance, on the basis that he was not owed a duty of care by the accountants. However, the judge held that the repayment made at the end of 2008 was '*res inter alios acta*' (in short, irrelevant to the quantification of the accountants' liability), on the basis that Mr Hunt had – for purely private reasons – effectively stepped into Swynson's shoes. The judge therefore concluded that the repayment did not reduce the sums recoverable by Swynson and entered judgment for £15m (the amount of a contractual cap agreed between Swynson and the accountants), plus interest. A majority of the Court of Appeal upheld the judge's decision, holding that a different result would represent a triumph of form over substance and that it was appropriate to disregard technicalities.

The relevance for today is the secondary claim made by Mr Hunt – namely that if all else failed he was subrogated to Swynson's negligence claim against HMT and could sue on Swynson's cause of action.

The basis of the claim was never clearly set out but appeared to be:

- Mr Hunt made a mistake in lending money to EMSL to enable EMSL to repay Swynson without considering the impact on any claim against HMT;
- The result of that mistake was that HMT was unjustly enriched at Mr Hunt's expense, because he was left with a bad debt and HMT was relieved from liability;
- The unjust enrichment could and should be remedied by allowing Mr Hunt to step into Swynson's shoes and pursue Swynson's claim against HMT – equitable subrogation to Swynson's rights. The lack of any direct transfer of benefit was irrelevant.

This did not so much push boundaries as remove them completely. Had the claim succeeded, the result would have been to rip up all those carefully built up tortious and contractual negligence principles – and replace them with that oft heard refrain "But it's not fair!"

Properly analysed, as it was by the Supreme Court, the claim betrayed the fundamental heresies and misunderstandings that Lord Reed was seeking to correct in ITC:

- It was "rather contrived" to treat HMT as enriched simply because no loss flowed from its breach;
- It was an "odd assumption" that HMT's enrichment was at Mr Hunt's expense, since his loss was not attributable to HMT's benefit, which was purely incidental to the loan to EMSL;
- However, even if one assumed there was enrichment of HMT at Mr Hunt's expense, that was not unjust (Lord Sumption, [20]).

None of the three fundamental questions could really be answered positively, after careful legal analysis.

Equitable Subrogation – the Supreme Court's last word

Lord Sumption concluded that an analysis of why equitable subrogation was not available also explained why there was no injustice. Relying heavily on Lord Reed he said at Para 22:

- The law of unjust enrichment is part of the law of obligations. It is not a matter of judicial discretion;
- There is no judicial licence to meet the perceived requirements of fairness on a case-by-case basis. Legal rights must be determined by ascertainable and consistently applied rules of law;
- The cases are not random illustrations of the Court's indulgence to litigants - they have the common feature that some legal norm or some legally recognized expectation has been disrupted or disappointed;

The purpose of the law of unjust enrichment is to correct normatively defective transfers of value by restoring the parties to their pre-transfer position.

Focusing on equitable subrogation, he said:

- Subrogation is available where C bargains for a benefit which fails and D obtains a resulting windfall for which he has not bargained - all the modern subrogation cases are cases of defective transactions in this sense;

- The windfall character of the benefit means, uniquely in subrogation cases, that it is not unjust to give effect to the failed unilateral expectation of C – even if D had no part in that expectation;

- Subrogation is also unique in that it does not restore the parties to their position prior – it operates to specifically enforce (so far as possible) the defeated expectation;

- The real basis of the rule is the defeat of an expectation of benefit which formed the basis of C's payment – and its real purpose is to rectify that defect.

Two things are clear:

- The role of unjust enrichment in such cases is to characterise the enrichment of D as unjust ***because*** the absence of the stipulated for benefit disrupted a relevant expectation under which the money was paid; and

- The role of equitable subrogation is to replicate as far as possible that element of the transaction whose absence made it defective.

It is therefore clear why Mr Hunt's case was hopeless, neither establishing injustice nor a defeated expectation:

- The December 2008 refinancing was not a defective transaction;

- Mr Hunt received from it the whole benefit for which he had stipulated;

- Non-repayment by EMSL was a commercial risk inherent in the transaction and not what enriched HMT.

The *ITC* criteria make this clear – lifting the *Menelaou* fog. Mr Hunt had no right to subrogate because he had not bargained for any claim against HMT – his mistake was to think that he already had such a right personally. He had no proprietary claim to subrogate and his unjust enrichment claim was smoke and mirrors.

As the final nail in the coffin, and reminding us there are limits to creativity, Lord Sumption said at Para 34:

> *"This was an error, but it does not follow that its consequences constitute an injustice which falls to be corrected by the law of equitable subrogation. Unless the claimant has been defeated in his expectation of some feature of the transaction for which he may be said to have bargained, he does not suffer an injustice recognised by law simply because in law he has no right. Failure to recognise these limitations would transform the law of equitable subrogation into a general escape route from any principle of law which the claimant overlooked or misunderstood when he arranged his affairs as he did."*

It is a timely reminder that while we can use equitable principles creatively to push boundaries, it is not an excuse to throw out firmly established negligence principles.

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Nicole's practice in recent years has focused heavily on financial, property and mortgage law, civil fraud, trusts and equitable remedies alongside Chambers' mainstream professional indemnity work. She has significant experience of unjust enrichment, subrogation, breach of trust and fiduciary duty claims. She is never happier than when finding novel answers to tricky problems.

Nicole is described as **'*a master tactician who is exceptionally bright and has a fantastic ability to condense significant evidential information*'** (Legal 500). Her practice has given her the opportunity to argue a number of 'interesting' legal points in the Court of Appeal – such as *MAS(No 2) Ltd v. Chater* (undue influence), *Mortgage Express v Filby* (subrogation, unjust enrichment, restitution), *Bradford & Bingley v Rashid* (also House of Lords, limitation, acknowledgment), *Bank of Scotland v Joseph* (land registration, priority, unilateral notices), *Lloyds TSB Bank plc v Markandan & Uddin* (breach of trust, completion of conveyancing transactions), *Re North East Property Buyers* (overriding interests, trusts), *Mortgage Express v Lambert* (overriding interests, overreaching, subrogation), *NRAM v Evans* (mistake, rectification and land registration) and *Swynson v Lowick Rose* (the subrogation and unjust enrichment elements). She enjoyed two successful trips to the Supreme Court in 2014, *Re North East Property Buyers* and *AIB v Redler,* followed by *Swynson v Lowick Rose* in 2016.