Briefing

BURGES SALMON

Professional Negligence

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Re-financing debt and the effect of lender claims – avoiding getting bogged down in technicalities

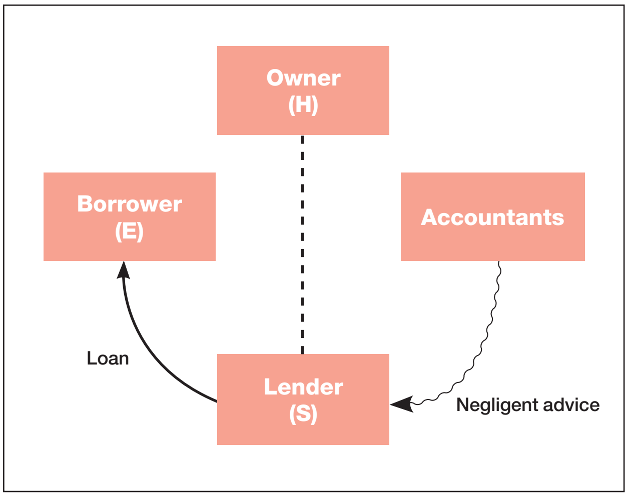
Where a loan has been re-financed by a party related to the original lender the Court of Appeal has confirmed that the original lender was not prevented from seeking recovery actions against negligent advisors.

This case will be of interest to lenders, who are commonly faced with issues relating to preserving negligence claims against advisors while at the same time seeking to re-structure or sell distressed debt.

It is also of interest to professional advisers in general, as a reminder that the Court is prepared to side step the strict application of legal principles if they lead to an unjust end result.

Swynson Ltd v Lowick Rose LLP

Mr Hunt ("**H**") was the owner of Swynson ("**S**"), which he used as an investment vehicle. H decided to invest in a company ("**E**"), to enable it to facilitate a management buyout of a company called Evo. H made his investment by way of loans from S to E.



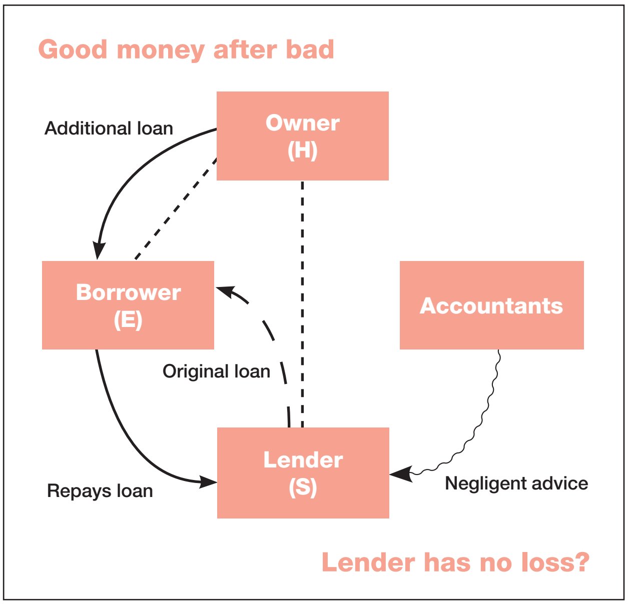
S engaged the defendant accountants to prepare a due diligence report on, among other things, Evo's financial strength, which S relied on when it made the loan to E. The report was negligently prepared and misstated Evo's working capital, which had a material impact on Evo's cash flow (E's primary source of funds with which to repay the Loan to S).

Saving a sinking ship

Within a short period of time, Evo began to experience financial difficulties and S was faced with a stark choice – either make further investment into Evo or it would collapse and the existing investment (i.e. the loan from S to E) would be lost.

H therefore opted to refinance E in the hope of saving his investment and realising a profit. However, by this point H had become the majority owner of E and, therefore, E and S (which he also owned) were now connected entities for tax purposes. If H opted to continue financing E through loans from S, tax would be due on the loan repayment amounts.

Therefore, H decided to lend further funds in his own name to E. That money was used by E to pay off the loan to S. The practical effect of the refinancing, therefore, was to substitute H for S, as the person to whom E was indebted. The overall amount of money H had lent (whether from his own pocket or from that of the company he controlled, S) was not diminished.



Unfortunately, the refinancing did not save Evo and eventually it was dissolved with virtually no assets. The refinancing loan was never repaid.

Suing the accountants

S then brought proceedings against the accountants for professional negligence. S alleged that if the due diligence report had been prepared competently, H would not have caused S to make the original loan to E and, as a result, H would not have had to subsequently advance the further loan in his own name to refinance E.

The accountants' resisted the claim arguing, among other things, that S's losses had been extinguished when E repaid S's loan using the money lent to it by H. Therefore, so the argument went, S had suffered no loss.

The Court of Appeal rejected the accountants' argument and held that repayment of S's loan by E did not extinguish S's losses for the purposes of the litigation.

Collateral events

When calculating damages, it is a well-established principle that a claimant must give credit for any funds it has received that reduced the losses caused by the defendant. These may be the result of deliberate acts of mitigation by the claimant or from unexpected third party sources. For example, a negligently structured transaction may give rise to unanticipated tax efficiencies.

But this is not an absolute rule – the claimant only needs to give credit where the avoided part of the loss arises from collateral events or circumstances and not consequences of the breach of contract / tort by the defendant.

This is sometimes referred to as the *res inter alios acta* principle or 'things between others'. The most common example is how insurance proceeds are treated. The fact that a claimant has received an insurance payment in respect of a particular risk (say the cost of fire damage to a building) does not prevent the claimant suing the builder who accidentally burnt the building down.

The principle will only apply where the collateral event: (i) does not arise out of the consequences of the breach of contract; or (ii) is not in the ordinary course of business.

The Court of Appeal held that the refinancing of E by H may have arisen out of the consequences of the accountants' negligence but it could not be said to be in the ordinary course of business. The loan in question was on uncommercial terms and was clearly driven by necessity rather than commerciality.

Basic justice – form or substance?

It is clear that the Court of Appeal was aware of the fact that if the accountants' argument succeeded they would escape liability altogether on technical grounds, even though H would have suffered a substantial loss that clearly resulted from their negligence.

The Court of Appeal referred to the House of Lords decision in Parry v Cleaver which allows the Court, when assessing loss, to *'focus on the substance of the matter, as against the technical form'*. This allows the Court to *'disregard technicalities'* so that justice can be done in the practical reality of the parties' relationships.

In the present case, the practical reality of the refinancing by H was that no losses had been extinguished whatsoever, they had simply been transferred from S (who H owned and controlled) to H. There was no reason why that should benefit the negligent accountants to let them off the hook while leaving H with a loss of over £16m.

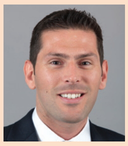
A victory of common sense

The end result in Swynson seems to be intuitively correct and is by no means the only instance of the Court disregarding technicalities or placing substance over form in order that basic justice is achieved. For example, in complex multiparty transactions the Court will sometimes 'find' a claimant for a loss to ensure that it does not disappear down a 'legal black hole'.

This type of issue can often arise when professional advisers are engaged on a complex transaction by SPVs or wholly owned/controlled companies but the 'real' client, who is likely to suffer losses as a result of negligent advice, is the person(s) sitting behind them.

Swynson underlines the importance of standing back from a case and looking at the practical outcome of applying strict legal principles. Where the end result appears to be unjust, and would see an otherwise culpable party walk away leaving an injured party uncompensated, one has to consider very carefully whether the Court will try to find a way around this before committing to a litigation strategy.

Contacts



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