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Unjust Enrichment and Adjusting Relationships on a Fictionalised Basis:

Lowick Rose LLP (in liquidation) v Swynson Ltd [2017] UKSC 32

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Introduction:

In *Lowick Rose* the Supreme Court examined three principles (mitigation and *res inter alios acta*: transferred loss; and unjust enrichment and equitable subrogation) which had been ingeniously raised by the claimants in the context of a damages claim against accountants where a company had made a loan relying on the accountants' advice but which had been paid off by the controlling shareholder thereby avoiding the first claimant's loss. The first instance judge and the Court of Appeal by a majority had upheld the claim on the sole ground that the payment was *res inter alios acta* but in three complex judgments delivered by Lords Sumption, Mance and Neuberger the litigation wheel spun in favour of the defendant and the appeal was allowed essentially because the shareholder had deliberately chosen to repay the loan directly.

Facts:

H, the second claimant, had incorporated the first claimant, S Ltd, as a special purpose vehicle to make loans to 'riskier' companies in return for substantial arrangement fees and relatively high interest rates. H caused S Ltd to lend £15m to Evo Ltd to finance a management buy-out of an American corporation, Medical Industries Inc ("Medical"). Prior to the loan, the defendant firm had carried out due diligence on Medical which negligently failed to show a deficiency of working capital; had H and S Ltd been aware of the deficiency the loan to Evo Ltd would not have been made. Medical started to fail and Evo Ltd was unable to make any interest payments to S Ltd. H had become the majority shareholder in Evo Ltd which resulted in HMRC treating S Ltd as receiving the interest payments which Evo Ltd was not in fact making. To avoid this charge, and on the advice of his accountant, H made a loan to Evo which was used by Evo to pay off the loan made by S Ltd; H chose not to lend the money to S Ltd to shore up its financial position following Evo's defaults. When H and S Ltd raised a claim against the defendant for breach of contract, the defendant admitted negligence but successfully argued that it owed no duty to H (there was no appeal from this finding). In relation to S Ltd it argued that the effect of H's loan to Evo was that S Ltd's loss had been avoided since the loans had been repaid; the real loser was of course H. In response S Ltd argued that the loan was res inter alios acta and so did not affect the loss; that it was entitled to recover under the transferred loss principle; and that the defendant was unjustly enriched by H's loan to Evo.

The first instance judge and the Court of Appeal (by a majority) upheld S Ltd's claim on the sole ground that the payment was *res inter alios acta*.

The Law:

Mitigation and res inter alios acta: loss which has been avoided is not recoverable as damages although expense reasonably incurred in avoiding loss may be recoverable as a cost of mitigation; as an exception, collateral payments which arise independently of the circumstances giving rise to the loss are excluded, examples being contributory pension payment or proceeds of insurance since the law treats the receipt of those benefits as tantamount to the claimant making good the loss from his own resources. The principle was derived from considerations of 'justice, reasonableness and public policy' (Lord Reid, Parry v Cleaver [1970] AC 1 at p.13) and the critical factor is not the source of the benefit but its character, i.e., arising independently.

Transferred Loss: the 'anomalous' principle of transferred loss applies where there is a contract between A and B relating to A's property which is acquired by C; the principle enables A to recover damages for B's breach of contract which injures the property even though the injury is suffered by C thereby avoiding a 'legal black hole'. It provides a limited exception to the general rule that a claimant can recover only loss which he himself had suffered and an essential feature is that the right in the contracting party to recover the third party's loss should be necessary to give effect to the object of the transaction as well as avoiding the black hole. Further, in any contract a contracting party might have a performance interest which enabled it to claim damages without proving actual loss.

Unjust Enrichment and Equitable Subrogation: 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' (Commissioners of HMRC v Investment Trust Companies [2017] UKSC 29, Lord Reed at [42]). It reflects an Aristotelian conception of justice as the restoration of a balance or equilibrium which has been disrupted. Four sequential questions have to be answered: has the defendant benefitted in the sense of being enriched; was the enrichment at the claimant's expense; was the enrichment unjust; and are there any defences. The critical question will be whether the enrichment was unjust and, in this case, whether subrogation was the right route. The reality, rather than formal shape, of a transaction can show that the claimant had conferred a benefit on the defendant even if there was no direct relationship between them. Subrogation by virtue of unjust enrichment is an equitable remedy which operates by adjusting relationships on a fictionalised basis and belongs to an established category where the claimant discharges the defendant's debt on the basis of some agreement or expectation of benefit which fails.

The Supreme Court:

On *res inter alios acta* Lord Sumption held that the repayment by H of the loan by S Ltd to Evo 'could not possibly be regarded as collateral' because it discharged the very liability which represented S Ltd's loss, since the loan by S Ltd to Evo and the loan by H to Evo were distinct transactions between different parties and because the repayment loan was not an act of S Ltd and was not attributable to the defendant's breach of duty [13]. Lord Mance accepted that if H had simply given the sum to S Ltd the payment would not have been relevant and noted that the Court of Appeal was motivated by 'justice, reasonableness and public policy' since the defendant's negligence had put H and S Ltd in an invidious position. However, he held that H's loan to Evo was not the equivalent of a benevolent act benefitting S Ltd. Lord Neuberger considered that the types of payments which were not to be taken into account were either paid out of the claimant's pocket or the result of benevolence; as H's loan to Evo was not a gift it was not collateral. He accepted that the money could have been provided to S Ltd in a way which would not have resulted in S Ltd's loss being avoided but that did not allow the conclusion that the payment should be treated as though it had that effect [100].

On transferred loss, Lord Sumption held that the principle could not apply because it was no part of the object of the engagement of the defendant to benefit H; his loss had arisen out of the loan to Evo 'which had nothing to do with' the defendant [17]. Lord Mance held that S Ltd's performance interest was solely in being indemnified for its loss in lending to Evo which had been satisfied by H's payment; that performance interest could not be expanded to H's loss. Lord Neuberger held that the transferred loss argument suffered from two defects: firstly, H's loss of the loan to Evo was not the same as S Ltd's loss of its loan to Evo (which was avoided by H's loan) and, secondly, S Ltd could not demonstrate that it was reasonably foreseeable that H would provide the loan to Evo so it would be an intended beneficiary of S Ltd's contractual rights against the defendant [107-108].

On unjust enrichment, S Ltd argued that H had effectively enriched the defendant by repaying the sums due by Evo to S Ltd. Lords Mance and Neuberger agreed that the defendant had been enriched but the latter was unconvinced that it was at H's expense because the payment was indirect (via Evo). For Lord Neuberger, 'unjustness in the context of unjust enrichment is not…of the palm tree variety' and there was no defect in the transaction because H got precisely what he intended, namely repayment to S Ltd of the original loan and a right to recover against Evo [119]. For Lord Mance the crux of the appeal was that H's loan to Evo and Evo's discharge of S Ltd's loan were exactly as H had intended; the indirect consequence of avoiding S Ltd's loss did not establish any 'normative or basic defect' in H's loan [87]. As a result H could not be subrogated to any claim S Ltd would have had against the defendant if its loss had not been avoided, even though it was an injustice to S Ltd and a windfall for the defendant arising out of H's mistake. It was not the role of unjust enrichment 'to provide persons finding to their cost that they have made a mistake with recourse by way of subrogation against those who may indirectly have benefitted by such a mistake under separate relationships which those making the mistake were not addressing' [89]. For Lord Sumption, equitable subrogation applied where a transaction was defective because the claimant had paid money on the basis of an expectation which had failed and it operated to specifically enforce a defeated expectation [30]. As the relevant transaction was not defective, H had not suffered an injustice recognised by law; to fail to recognise that limitation would transform the law of equitable subrogation into a general escape route from any principle of law which the claimant misunderstood [34].

Conclusion:

Rather unfairly, perhaps, Lord Sumption regarded the case as illustrating the tendency of businessmen to treat their companies as indistinguishable from themselves notwithstanding the fact that the distinct legal personality of companies had been a fundamental feature of English commercial law for 150 years. Like Lord Mance, it is difficult not to have sympathy for H since the grounds of distinction with the court below are extremely fine. The glacial pace of the development of the law of unjust enrichment means that litigators will need to analyse the general principles intently before relying on the principle where transactional mistakes have been made.