

In the wrong hands

Can solicitors escape liability when lenders claim for breach of trust?

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In the wrong hands

When transactions go wrong and lenders claim for breach of trust, can solicitors escape liability? **Christopher Stone** and **Alison Padfield** discuss how judges may be merciful

The last boom and bust in the housing market was marked by a flurry of cases in which lenders and solicitors tried to ensure that losses resulting from fraud or from the fall in the housing market fell on someone other than themselves. This time around, the situation is no different.

Although there has perhaps not been the flood of lenders' claims that some expected, several recent decisions, including three in the Court of Appeal, highlight that the legal arguments in claims by lenders against solicitors are picking up where they left off. We will consider recent cases concerning claims by lenders for breach of trust in conveyancing transactions, and applications by solicitors for relief from liability under section 61 of the Trustee Act 1925 in these and similar cases.

In *Target Holdings Ltd v Redferns* [1996] 1 AC 421, the House of Lords acknowledged that a solicitor could be required to restore to a client account monies paid away before an underlying conveyancing transaction had completed, but that the client had no right to have the solicitor's client account reconstituted as a 'trust fund'. The CML handbook requires that the solicitor hold the loan on trust for the lender until completion, and the focus of recent cases has been on whether completion has taken place and, where it has not, whether the defendant solicitors should be relieved from liability pursuant to section 61 of the Trustee Act 1925, on the grounds that it appears to the court that the trustee "has acted honestly and reasonably, and ought fairly to be excused for the breach of trust...".

In *Lloyds TSB Bank Plc v Markandan & Uddin* [2012] EWCA Civ 65, the defendant solicitors were an innocent party in a fraud in which they paid money for the purchase of residential property to what they believed to be the Holland Park office of a firm of solicitors. The firm was genuine, but the Holland Park office was not; the property had never been for sale and the undertakings that had been given by the

bogus office were worthless. The Court of Appeal found the defendant solicitors in breach of trust as they had paid monies away when they had neither received documents necessary to register title nor received a solicitor's undertaking to provide such documents, holding that, in these circumstances, there had been no completion.

There was no appeal from the judge's finding under section 61 that the solicitors had not acted reasonably in conducting the transaction: they had not established that the firm (which did in fact exist) actually had an office in Holland Park (which it did not), and they had parted with the completion monies a second time when they knew that the 'firm' had breached earlier undertakings. Rimer LJ remarked that a "careful, conscientious and thorough solicitor, who conducts the transaction by the book and acts honestly and reasonably in relation to it in all respects but still does not discover the fraud, may still be held to have been in breach of trust for innocently parting with the loan money to a fraudster. He is, however, likely to be treated mercifully by the court on his section 61 application."

The claimants were also successful in establishing liability for breach of trust in *Cherney v Neuman* [2011] EWHC 2156 (Ch), in which the defendant conveyancing solicitors had paid out money from one of the claimants' client accounts to a party acting as agent for the claimant, without his authority. The firm obtained advice from counsel, but this did not provide either a defence to the claim for alleged breach of duty of care or the benefit of section 61 because of deficiencies in counsel's instructions and the failure by the firm to give proper and independent consideration to his advice, although, on the facts, no loss was suffered. More recently, in *Challinor v Juliet Bellis & Co* [2013] EWHC 347 (Ch), Hildyard J said, having found that the solicitor had acted in breach of trust in



paying monies out of a client account in a complex property development transaction, that it was well established that section 61 was to be 'narrowly construed and strictly applied'. He refused to exercise his discretion in favour of the solicitor on the basis that she had not acted reasonably, and that her conduct fell short of the high standards expected of her position; put another way, he said, she failed to act in a "commercially acceptable" way.

In *Mortgage Express v Iqbal Hafeez Solicitors* [2011] EWHC 3037 (Ch), a case of mortgage fraud involving a bogus firm of solicitors similar to *Markandan*, the defendant solicitors paid out completion monies in return for undertakings from a bogus firm of solicitors, and this was held to constitute a breach of trust. A claim by the solicitors under section 61 also failed, the judge remarking that "[the solicitor's] honesty has been vindicated at the expense of his knowledge and understanding of the law and its practice in the very field of law in which he was attempting to practise, and on the basis of his consequent naivety".

The section 61 application was rejected on the basis that the defendant had not satisfied the court that it would be fair for it to be relieved of liability, in particular because it was a trustee employed as such because of its professional skill, and paid for its services in performing its duties, and because it had been guilty of wide-ranging



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and highly culpable negligence in its handling of the relevant transactions.

Although the question of whether or not a trustee is being paid for his or her services is a factor which the courts will take into account in deciding whether to grant relief under section 61, it is clear from other cases that it is not a bar to relief. In *Davisons Solicitors v Nationwide Building Society* [2012] EWCA Civ 1626, the second of the three recent Court of Appeal decisions in this area, the Court of Appeal applied *Markandan* and decided that, in paying away completion monies on the strength of undertakings from a bogus firm of solicitors, there had been no completion and that therefore the solicitors

were in breach of trust. However, the appeal in relation to section 61 succeeded, as the solicitors were found to have acted reasonably in the checks that they made to establish that the vendor's solicitors existed, as the Law Society and SRA websites both wrongly confirmed that the firm existed and operated from the address quoted on correspondence. The defendant solicitors had therefore received undertakings from a purported firm of solicitors which they reasonably believed to be acting for the vendor.

The chancellor said that section 61 only required the trustee to have acted reasonably, not that he had necessarily complied with best practice in all respects, as “the requisite standard is that of reasonableness not of perfection”, and reiterated the fact-sensitive nature of the exercise of the discretion under section 61. The Court of Appeal also allowed the solicitors' appeal in respect of the construction and effect of the requirement of the CML handbook that the solicitors obtain a fully enforceable first legal charge over the property, holding that this was not an absolute obligation and that it went no further than an obligation to exercise reasonable skill and care.

AIB Group (UK) Plc v Mark Redler & Co [2013] EWCA Civ 45 completes the trio of recent Court of Appeal decisions in this area. The solicitors had failed to obtain a first legal charge as only one of two mortgage accounts was redeemed during a remortgage, with the surplus being paid to the borrowers, leaving the existing lender with a first legal charge securing borrowing on a second mortgage account of about £300,000. The contractual measure of damages was limited to this sum. However, the borrowers defaulted, the property was sold at a substantial loss, and the lender sought damages for breach of trust calculated as the entire loss that it had suffered as a result of entering into the transaction.

The Court of Appeal referred to *Markandan* and *Davisons* and said that they could see no material difference between the need for the lender's solicitor on a remortgage to ensure that the advance would be used to discharge the existing mortgage, and the requirement that the solicitors should have been in receipt of

relevant documents of title, including a certificate of discharge of the existing mortgage or a solicitor's undertaking to produce such documents once the existing mortgage was redeemed. They found that the breach was not limited to paying away the £300,000, but said that had the remortgage been properly completed and the charge of the earlier lender redeemed, the remortgage lender would still have been exposed to the losses caused by the borrowers' default but would have had security for an additional £300,000 of its loan.

The case was therefore fundamentally different from the position in *Markandan* and *Davisons*, where, had the solicitors not released the monies in advance of completion, there could have been no transaction and no loss would have been suffered at all. Applying equitable rules of compensation, the Court of Appeal upheld the decision at first instance that damages should be limited to the £300,000. The solicitors accepted that their failure to pay the £300,000 to the remortgage lender was both negligent and unreasonable, and their application for relief from liability under section 61 was limited to the additional losses claimed by the lender. However, as the appeal on quantum succeeded in respect of the losses over £300,000, it was unnecessary for the Court of Appeal to consider the application under section 61.

The bar for completion of a conveyancing transaction having been set high by these decisions, solicitors should not take too much comfort from the chancellor's remark in *Davisons* that the requirement under section 61 is reasonableness, not perfection. The exercise of the court's power under section 61 is discretionary, and it is only the solicitor described by Rimer LJ in *Markandan*, who is careful, conscientious and thorough, who conducts the transaction by the book and acts honestly and reasonably in relation to it in all respects, who has reason to think that the court may be merciful.



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