CLIENT ALERT

English Court of Appeal Sets Sights on Post-Breach Windfalls, Demonstrates It's Not Always So Straightforward

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Last year, we reported on the judgment of the High Court in the case of *Fulton Shipping v Globalia Business Travel* [2014] EWHC 1547 (Comm). In that case, the charterers of a vessel had, in breach of contract, returned her to the owners two years early. The owners then sold the vessel at a price far higher than they would have achieved at the end of the charterparty. An arbitrator had determined that the level of damages awarded to the owners for the charterers' repudiation of the charterparty should be reduced to account for this unexpected windfall. The Court upheld the owner's appeal against the arbitration award on the basis that the arbitrator had erred in law.

In June 2015, in the case of *Swynson Ltd v Lowick Rose LLP* [2015] EWCA Civ 629, the Court of Appeal considered what recourse a lender had against a negligent firm of accountants, which had failed to perform sufficient due diligence on a borrower. The position was complicated because the ultimate owner of the lender eventually provided the borrower with funds, which were then used to pay off part of the loan. The negligent accountants argued their liability should be lowered to reflect the reduction in the lender's actual loss.

The Facts

In 2006, an accountancy firm (HMT), which later became Lowick Rose LLP, prepared a due diligence report. Relying on that report, the appellant (Swynson) loaned Evo Medical Solutions Limited (EMSL) £15 million, to facilitate a management buyout of an American medical supplies company.

HMT initially contested, but ultimately conceded, that it had been negligent in the preparation of its report, having failed to identify a discrepancy in the American medical supplies company's actual and forecast working capital of around $4 million.

By the spring of 2007, the American medical supplies company was experiencing significant financial difficulties and required a cash injection to avoid financial collapse. Swynson therefore granted EMSL an additional short-term facility totaling £1.75 million. This loan, plus the initial £15 million loan, were to be repaid in full in October 2007. EMSL was unable to make any repayments, and this deadline passed.

The ultimate owner of the lender, Swynson, a Mr. Michael Hunt, took the view that he needed to keep the American medical supplies company solvent either until it could be floated, or a private buyer could be found. In June 2008, he therefore injected funds through the loan of an additional £3 million from Swynson to EMSL. At the same time, Mr. Hunt's indirect 25 percent shareholding in EMSL was converted into 85 percent preference ordinary shares, giving him majority control of the company.

On 31 December 2008, all of the loans were restructured. Mr. Hunt personally made £18.6 million available to EMSL. This sum was used to pay off EMSL's debts to Swynson, with the exception of the latest loan of £3 million. In part, the restructuring was undertaken to reduce the total tax liability of the companies and to improve the balance sheet of Swynson.

The various attempts to improve the fortune of EMSL were unsuccessful and, in late 2011, it was wound down, owing £3 million plus interest and fees to Swynson and £18.6 million to Mr. Hunt.

The Issues

Having relied on HMT's negligently prepared report, Swynson sought to recoup losses from HMT. Swynson's claim was for damages equal to the total of all the loans it granted to EMSL.

HMT's position was that it could only be held liable for repayment of the £3 million loan from 2008, because EMSL had repaid the earlier loans with funds received from Mr. Hunt. At first instance, Mrs. Justice Rose held that that repayment was collateral to the loss caused by HMT's breach of duty. As a result, it had no effect on HMT's liability for Swynson's losses in respect of the earlier loans.

Where an innocent party has suffered loss, it typically has a duty to mitigate its loss, where possible. In determining whether any such "avoided loss" should be taken into account in the assessment of damages, the usual position is that if the avoided loss is brought about by circumstances which are collateral to the contract, it does not factor into the calculation of losses. If, however, the circumstances bringing about the avoided loss arise as a consequence of the breach, and in the ordinary course of business, that will be taken into account.

Here, EMSL's repayment of the loans granted in 2006 and 2007 was made with funds provided by Mr. Hunt. The question for the Court of Appeal was whether, in these circumstances, the repayment extinguished HMT's liability in relation to those loans.

The Decision

Indicating the complexity of this area of law, the Court did not reach a unanimous decision. Indeed, although Lord Justices Longmore and Sales were in the majority and permitted the appeal, they reached their conclusions by quite different routes.

Lord Justice Longmore gave the lead judgment. He took the view that Swynson was in no position to mitigate its loss, either by exerting influence on EMSL to repay the loan, or by seeking to sell the loan on the open market. In those circumstances, he held, if:

> "Mr Hunt had given the amounts of the 2006 and 2007 loans to Swynson (so that Swynson could balance its books) from Swynson's point of view that would be an act of benevolence and no one could sensibly suggest that any such payment should enure to the benefit of the negligent advisor […] To hold that a different result should occur merely because the payment is made through EMSL would be a triumph of form over substance."

He concluded that, in reality, the repayment had come from Mr. Hunt himself, and should not be taken into account in calculating the damages owed by HMT.

Lord Justice Sales agreed, finding that the governing principles in this area:

> "are intended to reflect the practical reality and basic justice as between the three persons involved: the person who has suffered the loss, the person who is in law responsible for causing the loss and the third party who had

> made a payment which reduces that loss […] To my mind, this approach requires a court to focus on the substance of the matter, as against the technical form which may have been adopted by the third party in choosing how to benefit the person who has suffered the loss."

However, Lord Justice Davis took a different view finding that, the loans having been repaid by EMSL "it is evident that, in the circumstances of this case, Swynson has suffered no loss." In relatively strong judicial language, he concluded that:

> "One cannot simply disregard the actual form which the transaction took, with a view to achieving what perhaps may appear (to some) to be a 'just' result. In fact, as I see it, the form here is the substance."

Commentary

The lack of consensus demonstrates the Court's difficulties in reconciling perceived equities of a case with apparently sound, but technical, legal arguments.

It is helpful to have Court of Appeal authority to provide guidance on the calculation of damages where an innocent party is unable to mitigate its loss. In Lord Justice Longmore's view, the position is the same irrespective of whether the innocent party is able to avoid loss through mitigation. In either case, where a loss is avoided as a consequence of the breach and in the ordinary course of business, this avoided loss should form part of the damages calculation. However, where the loss is avoided in circumstances unrelated to the breach, or outside the ordinary course of business, they should not feature in the calculation.

Commercial parties will want to be aware of this case, to ensure they avoid any unintended consequences of financing group debtors. Had the Court taken the view that Mr. Hunt's loan to EMSL formed part of the ordinary course of business, Swynson's damages claim against HMT would have been severely reduced.

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