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The search for redemption: surveyors' liability for refinance loans

KEY POINTS

- Where a first loan is refinanced by a second, and the surveyors have negligently undervalued the security, any claim against the first surveyor is extinguished when the first loan is refinanced.
- The second surveyor can, however, be held liable for the entirety of the lender's loss, including the portion of the second loan used to discharge the borrower's existing indebtedness.
- The onus is on surveyors to limit their liability in order to avoid this rule.
- If the bank has chosen to arrange the second loan as a redemption of the first, the court will not usually deviate from that arrangement.

On 1 July 2016, the Court of Appeal gave a landmark judgment on the scope of surveyors' liability in *Tiuta International Ltd v De Villiers Surveyors Ltd* [2016] EWCA Civ 661. The effect of that judgment was to broaden the potential scope of such liability enormously. This article examines how the court arrived at that decision, and its wider implications.

In 1996, Lord Hoffman subjected the issue of surveyors' liability to detailed examination in *South Australia Asset Management Corpn v York Montague Ltd* [1996] UKHL 10 (SAAMCO). Put simply, surveyors' obligations are usually to offer information, as opposed to advice. In those circumstances, their liability is narrower than that owed by a negligent advisor; the surveyor will be responsible only for the foreseeable consequences of his or her valuation being wrong.

Since then, the relevant principles have become a well-trodden path for those of us who practise regularly in this area. However, earlier this year, a novel question arose. Can a surveyor who has negligently undervalued a security be liable to a lender for all its losses as a result, including for the value of earlier borrowing redeemed by the loan advanced on the basis of the negligent valuation? The Court of Appeal has held – surprisingly – that it can.

THE CASES

The decision in *Preferred Mortgages*

To understand how the court arrived at this conclusion, we must go back to 2002 and the case of *Preferred Mortgages Ltd v Bradford & Bingley Estate Agencies Ltd* [2002] EWCA Civ 336. In that case, the claimant bank had lent £49,500 to a borrower on the basis of a valuation report which had negligently overvalued the relevant security. The borrower later sought a further advance, and the bank obtained a second valuation from a different surveyor, who also negligently overvalued the security. The bank advanced the additional sum sought in reliance on the second valuation, choosing to structure the transaction as a new loan which refinanced the previous borrowing.

The bank then sought to recover its losses by way of a negligence claim against the *first* surveyor only. The Judge at first instance found that the first transaction had been fully discharged by the second, and accordingly the bank suffered no loss as a result of the first negligent valuation.

An appeal by the bank was unsuccessful. The Court of Appeal referred to the dicta in *Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd (No 2)* [1997] 1 WLR 1627, which adopted SAAMCO principles and defined the measure of loss as:

> 'the comparison between (a) what the plaintiff's position would have been if the defendant had fulfilled his duty of care and (b) the plaintiff's actual position … the surveyor is liable for the adverse consequences, flowing from entering into the transaction, which are attributable to the deficiency in the valuation'.

It concluded that the transaction in question was the first advance, since that was the practical result of the allegedly negligent valuation. That transaction caused no loss to the bank because it was fully redeemed. Accordingly, the bank had no good claim against the first surveyor.

The case provided authority for the proposition that any cause of action in negligence against a surveyor is, essentially, extinguished when the loan advanced on the basis of the negligent valuation is redeemed. But the position of the second surveyor, which had necessarily been overlooked by the Court of Appeal since there was no material before the court which was pertinent to that subject, remained a mystery. Could he or she be held responsible for the entirety of the loss suffered, even though there was no good claim against the first surveyor whose negligence might also have caused loss? With that question left open, the stage was set for *Tiuta*.

Tiuta: the facts

The dispute arose out of the claimant bank's decision to lend against a residential development which was under construction. The bank obtained a valuation report from the defendant in February 2011, and advanced sums to the borrower in reliance on that report.

The bank obtained two further valuation reports from the defendant in November 2011. On the basis of those reports, it agreed to make a further advance to the borrower. Just as in *Preferred Mortgages*, the bank said that the second transaction had been structured as a new loan which refinanced the existing debt.

The borrower then defaulted on the loan. The bank sought to realise its security, but the sale of the development site was not expected to meet the bank's losses. The bank accordingly brought a claim against the surveyor.

However, its pleaded case only alleged that the November valuations were negligent. No similar allegation was made in respect of the earlier February valuation. The bank later explained that this was because it understood that any such claim would have been extinguished when the first loan was redeemed, following *Preferred Mortgages*.

The surveyor sought summary judgment on the issue of the extent of its potential liability. It argued that it could not be held responsible for the entirety of the bank's loss. The borrower was already indebted to the bank at the time of the November valuations. The loss attributable to that indebtedness did not pass the "but for" causation test and accordingly the defendant could not be liable for that portion of the bank's loss.

The judge at first instance accepted those arguments and granted summary judgment in favour of the surveyor. The bank appealed.

The appeal

The bank relied heavily on the decision in *Preferred Mortgages*, arguing that:

- The effect of the decision in *Preferred Mortgages* was that the bank had lost any opportunity to bring a claim in respect of the first valuation when it refinanced the loan. The bank's remedies were therefore limited to claims in respect of the second valuation.
- However, if the "but for" test was applied strictly to such claims, it inevitably limited the bank's recoverable loss to the difference in value between the second loan and the existing indebtedness, as the defendant had argued. Any claim for sums lost under the first loan "disappeared down a black hole".
- Such a result was unjust in circumstances where the second valuation was provided negligently (such facts being assumed for the purposes of the summary judgment application).
- Instead, the second loan had to be treated as a separate transaction, quite unrelated to the first, and dealt with on its own without reference to the first.

The surveyor's response was to emphasise that the second transaction was, in essence, simply an extension of the first loan. Its substance, rather than its form, ought to dictate the court's approach, and its substance militated against viewing the second loan separately. In any event, that it had been arranged as a full redemption of the first loan was a matter for the bank, which could not now complain of the consequences which flowed from its own decision to organise its business in that manner.

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The Court of Appeal found in the bank's favour by a majority. Moore-Bick LJ, with whom King LJ agreed, said that the "but for" causation test needed to be adjusted to take into account the structure of the transaction. He cited specific dicta in *Nykredit* which defined the measure of damages in an over-valuation case as the difference between the amount of money lent by the claimant and the value of the rights acquired (namely, the borrower's covenant and the true value of the property) and concluded that that test could be applied to the second loan.

Curiously, given that there was no allegation of negligence in respect of the February valuation, the fact that the second loan had discharged any potential liability relating to the first was a key factor in the reasoning of the court:

> 'the loan made under the second transaction was the means by which the borrower was enabled to pay off the first and it was the fact that the second loan was used to repay the first in full that released the respondent from any potential liability in respect of the first valuation. The second loan therefore stands apart from the first and the basic comparison for ascertaining the appellant's loss is between the amount of that second loan and the value of the security.'

The other points cited in support of that conclusion were:

- If the first loan had been advanced by a different lender, it would have been "obvious" that the defendant should be liable for the entirety of the claimant's loss.
- The effect of that approach was not unfair for the defendant. Even if the first valuation report had been completed by a different surveyor, the defendant's liability did not stem from the first transaction, but from the defendant's own negligent valuation which supported the second.
- Conversely, it was unfair to allow a negligent surveyor to use an attack on the legitimate commercial practice of the bank (in structuring its loans in this way) as a means of escaping the consequences of its negligence.
- In any event, criticism of such business practices cut both ways; it was similarly within the surveyor's gift to choose to limit its liability accordingly if it felt this was necessary or appropriate.

ANALYSIS

To say that this judgment is surprising is something of an understatement. There are a number of issues it raises which need to be considered in more depth.

The different tests for causation

The biggest hurdle the bank faced in this case was that, as its Counsel frankly admitted (and as McCombe LJ noted in his dissenting judgment), the application of an orthodox "but for" test was fatal to its case. It is clear that the indebtedness which already existed at the time of the November valuations could not have been caused by any negligence in respect

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of those valuations; it would have existed regardless of such negligence. The claimant needed to get away from the standard "but for" test to have any hope of winning the appeal.

Happily for the claimant, the court seems to have been strongly influenced by the perceived unfairness the bank would suffer, as a result of *Preferred Mortgages*, if the "but for" test was applied in the usual way. That such an outcome might be unfair was widely accepted; all members of the court commented on this aspect, as did the Judge below.

However, unfairness alone cannot be a basis on which to displace the "but for" test (and again, as McCombe LJ noted in his dissenting judgment, 'the law tampers with the "but for" test of causation at its peril.') Instead, the court seized upon the dicta in *Nykredit* defining the measure of loss as the value of the loan, less the real value of the property and the borrower's covenant. On that attractively simple analysis, the court essentially discarded the fact of the first loan altogether and applied the "but for" test in relation to the second loan as if it were the only transaction that had taken place.

The trouble with that approach is that the relevant dicta in *Nykredit* were not about causation at all, but about calculating the amount of recoverable loss. To use that calculation to answer the question of whether any loss has in fact been caused is to put the cart before the horse.

That is because the usual approach is to apply the "but for" test to establish whether factual causation can be made out. Only after that step would the court go on to consider legal causation. The purpose of the latter stage is to impose proper limits on the otherwise potentially very wide scope of the "but for" test. Accordingly, determining legal causation will often involve applying limiting factors (of which the SAAMCO "cap" is one example). What is extraordinary in this case is that, not only did the Court of Appeal rely (at least in part) on the legal causation test in *Nykredit* in support of its conclusion that factual causation could be made out, but the result appears to have been a broadening of the scope of the "but for" test – precisely the opposite of what applying legal causation principles is supposed to achieve.

The importance of internal processes

A consistent theme of the case law surrounding this issue is the integrity of banks' internal processes. A large part of the surveyor's argument in *Tiuta* was predicated on the idea that the substance, rather than the form, of a transaction ought to define the courts' approach. In truth, it was perhaps unwise of the surveyor to deploy that line of reasoning; the Court of Appeal gave short shrift to a similar argument in *Preferred Mortgages* when the lender had tried to argue that its own decision to refinance the first loan was nothing more than an internal bookkeeping exercise which had no practical effect. Once the lender in that case accepted that the legal effect of the second transaction was to discharge the borrower's liabilities under the first, 'one would have to find amongst the facts some startlingly clear answers that that was not to be the true consequence'. Although the possibility was not dismissed outright, it is clear that the court intended to set a very high bar which would only rarely, if ever, be surmounted. There is nothing in the reported judgment in *Tiuta* which suggests it could have been one of those rare cases.

It appears, then, that rather than seeking to intervene, the courts will allow lenders to choose how to structure their transactions, and will usually honour those choices. This might be interpreted as a *laissez-faire* approach which benefits financial institutions. However, in some cases it can prove something of a strait jacket. Take the case of *Capital Home Loans Ltd v Countrywide Surveyors Ltd* [2011] 3 EGLR 153, which concerned two concurrent loans to a borrower, each of which was made in reliance on a valuation by the defendant surveyor. After a default, the claimant bank repossessed and sold the charged property, but there remained a shortfall. The bank claimed in negligence only in respect of the second valuation. However, its automated computer system had applied the proceeds of sale to the second loan and extinguished it. The bank argued that was a mistake which had occurred in the name of convenient record keeping, but that argument was unsuccessful; essentially, the bank was compelled to bear the strict consequences of its own internal processes and its claim could not proceed.

CONCLUSION

Tiuta represents an important milestone in surveyors' negligence cases. The attribution of liability for the entirety of a refinance loan to a second surveyor is a noteworthy development in the law, which will have a significant impact on the financial and surveying industries. The knock-on effects will be numerous; surveyors' professional indemnity insurers will need to review their cover, premiums are likely to rise, and surveyors may wish to re-draft their standard terms to limit their liability as King LJ suggested.

However, whether those will constitute lasting impacts remains to be seen. Perhaps unsurprisingly, it is said that the defendant surveyors are seeking to appeal the decision to the Supreme Court. If they are granted permission, they will be on fertile ground; arguably the Court of Appeal judgment raises many more questions than it answers. The writer would go as far as to suggest that the decision is unlikely to survive in its current form.

In *Nykredit*, Lord Nicholls said:

> 'I can see no necessity for the law to travel the commercially unrealistic road'.

The irony of *Tiuta* is that, by applying Lord Nicholls' own dicta in the way it has done, the Court of Appeal has arguably caused the law to do exactly that. ■

Further Reading:

- Expert evidence to support or challenge loss calculations: how credible is it? [2015] 9 JIBFL 583B.
- Filling black holes: do the courts want to and can they? [2010] 11 JIBFL 652.
- LexisNexis Loan Ranger blog: recovering the loss – assessing the scope of the SAAMCO principle.