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Undue influence – court rejects new category of "hybrid" transactions

The recent Appeal Court decision in *One Savings Bank plc v Waller-Edwards* [2024] EWCA Civ 302 ("**OSB**") has provided helpful clarification for lenders as to when they will be deemed to be put "on inquiry" and required to comply with the steps set out in *Royal Bank of Scotland plc v Etridge (No 2)* [2002] 2 AC 773 ("**Etridge**").

Undue influence and its relevance to lenders

A lender may find itself unable to enforce a guarantee or third-party security granted in its favour by an individual in support of facilities which it has made available to another customer if:

- the individual was induced to grant the guarantee or third-party security because of the other customer's "undue influence"; and
- the lender was aware of the undue influence at the time, or was deemed to have notice of the undue influence by being "put on inquiry".

Consequently, a lender will want to take steps to satisfy itself that a guarantor or third-party security provider was not induced to enter into the guarantee or security document by the undue influence of the principal debtor.

RBS v Etridge

Etridge is the leading case on undue influence. Etridge built on and clarified earlier case law in this area, and the House of Lords laid down detailed guidance and a series of steps for lenders to follow, such that if a lender followed the steps, it should be able to rebut any arguments of undue influence.

According to the House of Lords in Etridge, a lender is put "on inquiry" of the risk of undue influence whenever the relationship between the guarantor/provider of third-party security and the principal debtor is "non-commercial". The meaning of "non-commercial" can extend beyond the obvious non-commercial relationships, such as those between spouses or

cohabitees, posing challenges for lenders in identifying such relationships. In ambiguous cases, lenders often err on the side of caution and follow the Etridge steps in full.

Etridge did, however, make it clear that a bank **will not** be put on inquiry in cases of joint lending in non-commercial scenarios, unless it knows the loan is being made for the sole purposes of one of the joint borrowers. In this respect it was confirming the position in the earlier case of *CIBC Mortgages v Pitt* [1994] 1 AC 200 ("**Pitt**") which involved a joint loan for non-commercial purposes being taken out by two parties in a relationship.

The distinction between these two scenarios of joint-lending vs a surety relationship is exactly what the court had to grapple with in the OSB case.

OSB case - Background

In the OSB case, the defendant/appellant, Catherine Waller-Edwards (the "**Appellant**"), had become involved with a Mr Bishop in 2011. She had used the proceeds of the sale of a property which she owned, along with her savings of around £150,000, to assist with the purchase of a property in joint names with Mr Bishop.

While the property was held in joint names, there was a declaration of trust put in place whereby the property was owned 1% by Mr Bishop and 99% by the Appellant.

In 2013 Mr Bishop and the Appellant approached the claimant/respondent, One Savings Bank plc (the "**Respondent**"), with a view to obtaining a loan secured by a mortgage over this property.

As far as the Respondent was aware, the proceeds of the loan were to be used for the following purposes:

1. repay existing debt which was secured by a mortgage over the property (approximately £200,000);

2. repay Mr Bishop's credit card debt (approximately £16,000);
3. repay Mr Bishop's car finance debt (approximately £24,000); and
4. purchase another property (for approximately £142,000).

However, the Respondent was not aware that the £142,000 was not in fact going to be used to buy another property, but was instead to be given to Mr Bishop's ex-wife under the terms of their divorce settlement. The Respondent was also not aware of the terms of the declaration of trust under which the property was only 1% owned by Mr Bishop.

From the Respondent's perspective, the transaction was simply a joint application to consolidate debts from parties who were in a relationship and who had joint expenditure. During the court proceedings, the Respondent made clear its view that, in its experience, it was not unusual for existing debts to be refinanced to be in one party's name or for a greater debt to be attributable to one party.

After the Respondent had made available the loan, the relationship between Mr Bishop and the Appellant broke down. Mr Bishop moved out of the house and eventually stopped making mortgage payments.

In 2021 the Respondent looked to start proceedings to seek possession of the property and enforce its security.

The Appellant sought to have the transaction overturned on the basis that her agreement to enter into the loan and grant the security was secured as a result of undue influence and that the Respondent should have been put on inquiry.

OSB case - Decision

The trial judge held that Mr Bishop had exerted undue influence over the Appellant in obtaining the loan and getting her to consent to providing security over the property. The Respondent, however, was not put on inquiry or required to follow the steps set out in *Etridge* because it was not a transaction that could be called a "surety-type" case.

As the Respondent was not aware of the amounts being paid to Mr Bishop's ex-wife, as far as the Respondent was concerned only a small amount of the overall loan proceeds were for the sole benefit of Mr Bishop. In the view of the trial judge, this small element of benefit to be derived by Mr Bishop was not sufficient to turn this from a case similar to *Pitt* (where there was a non-commercial relationship, but the parties were joint-borrowers) into a case similar to *Etridge* (where there

was a non-commercial relationship and one party stood surety for the other).

This decision was upheld at appeal in the High Court, with the appeal judge also rejecting the claim that the Respondent was put on inquiry.

The case was finally brought to the Court of Appeal in March 2024. The Appellant's main argument was that the lower courts were wrong to take the transaction as a whole and determine whether it was a surety or joint-borrowing scenario. Instead, the Appellant argued there existed a category of "hybrid" transaction involving joint borrowers that puts a lender on inquiry as to undue influence where one of the parties in the non-commercial relationship obtains a sole benefit. In these scenarios a bank should be put on inquiry unless the sole benefit derived by that other party is trivial.

The Court of Appeal rejected this distinction, finding nothing in the *Etridge* decision which would imply that there was a third type of "hybrid" scenario which puts a bank on inquiry. The Court of Appeal noted that (per *Etridge*) a bank could only be put on inquiry if it is aware that a loan is being made for the sole purpose of one party rather than on a joint basis. Therefore, for joint-borrowing cases, there is a far higher threshold before a bank is put on inquiry. It requires the joint-borrowing case to, as a matter of fact, operate essentially the same as a surety one.

For those reasons, the Court of Appeal held that the trial and appeal judge acted correctly in viewing the transaction as a whole and deciding, based on the evidence available to the Respondent, whether this "hybrid" transaction was in fact a surety or joint-borrowing scenario.

Conclusion

As the judgments of both the High Court and the Court of Appeal highlighted, this was a particularly sad case where the Appellant lost her savings and went from living mortgage free to being deeply in debt and risking losing the property she was living in.

In the wider context of bank lending, however, a decision that there was indeed a new category of "hybrid" transaction whereby a bank would be put on inquiry could potentially have damaging consequences on the wider market. As the Court of Appeal flagged:

- if there were to be a hybrid test in cases other than where the sole benefit to one party is "trivial", this would then raise the question of what would constitute triviality; and
- it is often difficult for a bank to know which debts are truly for the sole benefit of a party.

If the court had held that there was a new "hybrid" category, banks would have to act extra cautiously when lending in joint-borrowing cases and, in an effort to mitigate risk, would likely require any joint-borrower to go through the entire Etridge process as a matter of course. This outcome would seem to be an act of overkill given that most joint-borrowing cases are straightforward and should not otherwise put a bank on inquiry.

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We hope that you find this update both useful and interesting. If you have any comments or would like to learn more about this topic, please get in touch with either your usual SH contact or any member of our team.



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