

LENDING DECISIONS – IMPACT ON PROFESSIONAL NEGLIGENCE CLAIMS

In this article, Stephanie Tozer explores the judge's criticisms of a lending decision in the recent case of *Governors and Company of the Bank of Ireland v Watts Group plc [2017] EWHC 1667*, and the effect of the decision.

The Facts

The Bank of Ireland ("the Bank") was asked to lend £1.4 million to assist an SPV to purchase a site in York city centre, and to construct 11 apartments on it. It approved the application in September 2007, and allowed the draw down of the sum necessary to enable the purchase of the site to proceed.

Thereafter, it instructed the defendant quantity surveyors to advise as to whether the borrower's estimate for construction costs was a realistic estimate, to agree a schedule of drawdowns against identified staged completions, and to certify that those stages had been met.

The development was not a success. The borrower went into liquidation, and the Bank was left with a loss of about £750,000. It sued the defendant in the hopes of recovering some or all of those losses.

The decision

The matter came before Coulson J in May 2017. The judge held that the defendant had not been negligent. But, the interesting part of the case is what the judge had to say on causation, and in particular his finding (at paragraph 156) that "the cause of the entirety of the Bank's pleaded loss was the Bank's botched consideration of the loan application and the fundamentally flawed decision to lend to the Borrower." As a result, even if the defendants had been negligent, he would not have required them to make any payment to the Bank.

He considered the question of causation to be separate from contributory negligence, which he concluded he would have (had he not rejected the claim) put at 75% being "about the maximum that can be deducted in circumstances such as this" (paragraph 180).

The Effect of the Decision

Generally, a defendant will be liable if breach was "an effective cause" of the loss. The judge's rejection of the claim on causation grounds therefore amounts to saying that the only effective cause of the loss was the decision to lend in the first place. But, in a sense, the decision to lend is always the real cause of the Bank's loss when the borrower does not repay the loan, whether the decision to lend was good or bad. Does this decision mean that a bank will always struggle to establish that a professional's negligence was an effective cause of the loss, even if the lending decision was good?

It is clear from the judgment that the Judge considered that the argument on causation only arose because he was satisfied that the lending decision was bad. The reasoning does not appear from the

judgment, and is not easy to ascertain. Certainly a professional who sought to argue that he should not be liable for any losses resulting from his negligence because those losses were really caused by the decision to lend in the first place would have to persuade a Court that this was not a relevant point of distinction.

A further point to note is that, unusually, the professional's advice was not a factor in the lending decision. The professional here was retained after the lending decision was made, so it was easier than it would be in many cases to draw a distinction between the professional's acts and the lending decision. Where the professional's advice was one of the factors taken into account by the bank in making its lending decision, it might be far more difficult for the professional to argue that it was the decision to lend in the first place, and not its advice, which caused the loss.

The Criticisms of the Lending Decision

This was not a case where the Bank's lending policies themselves were being criticised. The problem was that the Bank had failed to follow their own guidelines. The loan failed to comply with 3 of the 4 guidelines relating to loan to value and so on. As the judge said, this was "a very unpromising start for a credit application" (paragraph 162). However, the judgment does not appear to suggest that failing to follow the bank's own guidelines by itself meant that the lending decision was bad. Rather this was one factor to be taken into account when considering the lending decision.

In addition, due to internal failings, the area credit department's conditions were not properly implemented, in 2 separate respects:

- (i) The decision memorandum stipulated that the loan should be capable of being repaid on or before 70% of the units had sold assuming the cheapest sold first, but this was missed. No steps were taken to ascertain if this condition would be met or not, but staff had information to show that it would not have been met.
- (ii) They required a valuation to confirm the current value and GDV of the site, and also to confirm that the absence of on-site car parking will not detract from marketability. The valuer did provide appropriate valuations, but commented that the absence of car parking would deter some purchasers, who would generally expect a car parking space at this price point.

To compound the problems, the bank also failed to follow the advice in a valuation report (provided to the bank by Savills prior to its lending decision being made) that the borrower's costs estimates should be checked by a quantity surveyor before any draw down was made. The bank appears to have decided to ignore that advice, allow the draw down necessary for the purchase of the property, and then retained the defendants afterwards.

Additional factors which "should have sent sufficient alarm bells ringing" (paragraph 157) were that even on the borrower's own figures the margins for the development were tight, and the guarantee which the bank had accepted as additional security had no intrinsic value.

It seems that the Bank placed far too much weight on its existing relationship with one of the entities behind the SPV, and, as a result they failed to scrutinise the application with the care they

would have done if the borrower had been unknown to them. However, as the judge pointed out, the existing relationship provided 2 further reasons why the Bank should have had concerns about the loan:

- (i) The Bank should have known that this project, a speculative residential development, was entirely different than those on which the Bank had lent previously.
- (ii) The existing exposure

Advice to Lenders

The case serves as a helpful reminder of the importance of ensuring that staff:

- comply with the lending guidelines;
- operate systems designed to ensure that conditions imposed by underwriters are imposed and policed; and
- take care to follow professional advice as to steps which should be taken before a lending decision is made.

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