KEY POINTS

- The policy underlying the decision in *Woodeson v Credit Suisse* protecting the security rights of the lender applies equally whatever the nature of the security.
- A free-standing cross-claim may be statute-barred under the Limitation Act 1980 and thus unenforceable if the lender has recovered the mortgage debt from the proceeds of sale of the security, although no time bar would apply to the claim if it were raised by way of equitable set-off in defence to a money claim.
- The views of members of the Court of Appeal appear to differ as respects the availability of set-off where the borrower seeks not only damages but also rescission of the mortgage transaction (which, if successful, would have the effect that the lender is not in the position of a secured lender and so not *prima facie* entitled to receive the proceeds of sale of the security).

Feature

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Secured indebtedness, set-off and enforcement: the law after *Woodeson v Credit Suisse*

It has long been recognised by practitioners in the mortgage field that the existence of a cross-claim for unliquidated damages will not give the borrower a defence to the lender's claim for possession. This article explores the policy underlying that principle and its recent application by the Court of Appeal in *Woodeson v Credit Suisse* and examines its scope and consequences, particularly in relation to other forms of secured lending, issues of limitation and a possible exception where the cross-claim is based on an allegation of deceit.

INTRODUCTION

It is a common feature of secured lending that when the lender wishes to enforce the security the borrower resists on the ground that he or she has a claim against the lender which should be set off against the lender's claim. It is also a common feature of secured lending that the lender seeks to protect itself against that eventuality by including in the documentation an exclusion of the right of set-off. That was the background to the recent decision of the Court of Appeal in *Woodeson v Credit Suisse (UK) Limited* [2018] EWCA Civ 1101. In that case, however, Leggatt LJ referred to "a long line of binding decisions of the Court of Appeal" which had the effect that mis-selling claims of the kind asserted in *Woodeson* "cannot, as a matter of law, be set off against the mortgage debt (irrespective of whether the claimant's contract with the bank contains a 'no set-off' clause)".

Like all judicial statements, this one must be read in the context of the case before the Court of Appeal. It nevertheless prompts an examination of the scope of the principle to which Leggatt LJ referred and in particular its impact in relation to:

- secured lending other than lending on a mortgage of land;
- the availability of a limitation defence to the borrower's cross-claim;
- cases in which the cross-claim is based on deceit.

THE *WOODESON* CASE

The facts

The essential facts of the case were simple. Mr and Mrs Woodeson owned a property subject to a fixed rate mortgage. In 2007, as the fixed rate period approached its end, a friend suggested remortgaging in a foreign currency with a lower interest rate and introduced them to an employee of Credit Suisse. In the event, in January 2008 they remortgaged the property with Credit Suisse for a sum in Swiss francs which was substantially greater than was required to redeem the previous mortgage and invested the surplus in sterling deposits with a view to benefiting from the interest rate difference between indebtedness in Swiss francs and sterling deposits. The mortgage was for a five-year term. The transaction proved disastrous when sterling interest rates fell sharply as a result of the 2008 financial crisis and the exchange rate of sterling to the Swiss franc also fell sharply. The borrowers did not repay the mortgage debt either in 2013, or after extensions to the mortgage term. Receivers were appointed in September 2015.

Mr and Mrs Woodeson alleged that they had claims against the bank for negligence and breach of statutory duty (based on failure to comply with conduct of business rules made by the Financial Services Authority), on the footing that the bank had positively recommended a transaction in Swiss francs, had given advice which discouraged hedging and failed to warn adequately of the exchange rate risk. They also alleged that they had a claim in deceit based on a document disclosed in December 2014 which was contended to support inferences that a bank employee had either given dishonest advice about hedging and the exchange rate risk or that, having come to a proper appreciation of the risks of the transaction, he dishonestly failed to correct his earlier advice.

The stage was thus set for a classic case of a claim by the receivers to enforce the mortgage and a cross-claim by the borrowers for mis-selling the mortgage product.

The proceedings

The first shot was fired by the receivers, who issued possession proceedings in November 2015. For reasons which do not emerge from

the Court of Appeal judgments, Mr and Mrs Woodeson did not assert their cross-claim by way of set-off and counterclaim in the possession proceedings but issued separate proceedings in February 2016 claiming a declaration to the effect that they were entitled to set off in equity the amount of their damages claim and further consequential declaratory relief.

As a tactic to defeat the possession proceedings, the borrowers' action was, in a legal sense, unsuccessful. By the time of the Court of Appeal decision in that case, a possession order had been made (in March 2016) and unsuccessfully appealed at various judicial levels. In a practical sense, however, whatever the legal merits of the approach taken, it had enabled Mr and Mrs Woodeson to remain in possession of the property at least until 17 May 2018.

The bank's own response to the borrowers' proceedings was to apply for summary judgment on the grounds that:

- the claims of negligence, breach of statutory duty and deceit were statute-barred;
- in any case, the claims could not be set off against the mortgage debt because the borrowers had contracted out of the right of set-off.

At first instance, the judge held that the claims for negligence and breach of statutory duty were statute-barred, but the claim in deceit was arguably not, since s 32 of the Limitation Act 1980 postpones the start of the limitation period in cases of fraud until the claimant has discovered the fraud or could with reasonable diligence have discovered it. He accepted that Mr and Mrs Woodeson might not have been able to appreciate that they had a claim in deceit until they obtained the 2014 document.

The question whether the claim could be set off therefore arose only in relation to the claim in deceit. It was argued for Mr and Mrs Woodeson that reliance on the contractual exclusion in such circumstances was unreasonable for the purposes of the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations 1999 and the judge accepted that that was arguable. He therefore declined to order summary judgment in favour of the bank on the deceit claim, but made such an order on the negligence and breach of statutory duty claims.

Mr and Mrs Woodeson then appealed to the Court of Appeal against the judge's order in so far as it granted summary judgment. It is readily understandable that they would have preferred not to be restricted to a claim which would require them to surmount the high hurdle of establishing dishonesty on the part of a bank employee.

The appeal

It is clear from Leggatt LJ's judgment that the "long line of binding decisions" to which he referred, which culminated in *Spencer Day v Tiuta International Limited* [2014] EWCA Civ 1246, did not feature in the submissions before the first instance judge. The essence of those decisions, as explained by the Court of Appeal, is that a cross-claim for damages cannot be relied on as reducing or extinguishing the mortgage debt in such a way as to prevent the lender from obtaining possession in accordance with the terms of the mortgage or from retaining out of the proceeds of any sale the amount of the unreduced mortgage debt. It follows that the borrowers' claims to declaratory relief were doomed to failure, in so far as the borrowers sought to reduce the amount of their indebtedness by reference to their cross-claim. Their proceedings could only proceed as free-standing claims for damages, subject to any limitation defence.

This was, of course, the result ultimately achieved at first instance and the appeal was accordingly dismissed. *Spencer Day*, however, provided a means of sidestepping many of the arguments raised by Mr and Mrs Woodeson, It may therefore be important for both lenders and borrowers to understand the scope of the *Spencer Day* principle and the circumstances in which it can be relied upon.

THE PREVIOUS DECISIONS

The starting point

The first of the line of cases is the decision of the Court of Appeal in *Samuel Keller (Holdings) Limited v Martins Bank Limited* [1971] 1 W.L.R. 43. The facts were that Martins Bank as second mortgagee of certain property, having obtained possession and sold, was faced with conflicting claims by Samuel Keller as third mortgage and Henry W Lawton Limited as mortgagor to the balance of the proceeds of sale. The bank issued an interpleader summons in the Chancery Division to deal with the conflicting claims. The third mortgage was granted in connection with a share sale and purchase by Henry Lawton from Samuel Keller under which, in substance, part of the purchase price was left outstanding and secured by the mortgage, although in legal terms a loan was made and the proceeds of the loan were applied in discharge of the purchase price. In separate proceedings in the Queen's Bench Division Samuel Keller claimed sums owing under the mortgage and Henry Lawton (by now in liquidation) counterclaimed for damages for breach of various warranties in the share sale agreement. The issue before the Court of Appeal in the interpleader proceedings was whether payment of the balance of the proceeds of sale to Samuel Lawton, up to the amount of the mortgage debt, should be stayed pending the determination of the proceedings in the Queen's Bench Division.

The effect of such a stay would have been to prevent Samuel Keller as mortgagee from receiving the proceeds of sale of the security which it had been granted and to which it was *prima facie* entitled. The argument for Henry Lawton was that its counterclaim, if established, would operate to reduce or even extinguish the mortgage debt. As explained at 47C-D by Megarry J, who heard the case at first instance, it was argued that the debt was discharged by appropriation to it of the counterclaim, the discharge operating conditionally until the counterclaim was established (or not). It was accepted that this approach would only apply where the counterclaim arose out of the same transaction as the mortgage.

This argument was firmly rejected by Megarry J, who described the concept as "both novel and awkward" and said that a doctrine of the discharge of a mortgage

debt by the unilateral appropriation of an unliquidated counterclaim was "neither convenient nor just". He went on to state that even where there was a liquidated and admitted claim exceeding the mortgage debt it might be to the advantage of one party or the other or both to keep the mortgage and the mortgage debt alive and that he had heard no reason why the mortgagor alone should have a unilateral power of appropriation. Russell LJ, with whom the other members of the Court of Appeal agreed, expressed his agreement with what had been said by Megarry J.

It was also argued that, even if the mortgage debt did still exist, it would be unfair to allow the mortgagee to receive and deal with the full amount of the debt when the counterclaim arose from the same transaction as that which led to the mortgage. This argument was summarised by Russell LJ as follows:

> "Put as a matter of equity in terms of fairness it was explicitly, or implicitly perhaps, argued that when the mortgage was part of the purchase price which would not have been paid at all had the matters of complaint (if established) been known at the time of the contract, some check should be put on the full exercise of the mortgagee's rights until the issue has been determined." (51B)

The argument was rejected by Russell LJ on the ground that it could lead to abuse if the mortgagee was kept out of his undoubted rights, expressly provided for, by allegations of some connected cross-claim, which might prove without foundation.

A similar point had been made, albeit in a slightly different way, by Megarry J, who said:

> "… I bear in mind the consideration that, so far as any claim against the [surplus proceeds of sale] is concerned, the mortgagee has a secured claim to what is due under the mortgage and the mortgagor has a secured claim as to any surplus. The mortgagor's counterclaim for unliquidated damages was never a claim which was secured on the mortgaged properties or the proceeds of sale thereof, and I do not see why the court should strain to give it what in effect would be a secured position. The counterclaim may fail or it may succeed; to the extent of its success the mortgagor will have the ordinary rights of a judgment creditor against the mortgagee: and I see no injustice in saying that the mortgagor must be content with that." (48D)

> … the *Samuel Keller* principle [provides] that a mortgage debt cannot be discharged by a unilateral appropriation of an unliquidated counterclaim.

Subsequent applications of the principle

Possession was not in issue in the *Samuel Keller* case because possession had been taken by a prior mortgagee. It was, however, part of the relief claimed in three subsequent cases, discussed by Leggatt LJ in *Woodeson*. They are:

- *Mobil Oil Co Limited v Rawlinson* (1982) 43 P&C.R. 221.
- *Barclays Bank Plc v Tennet* (unreported, 6 June 1984).
- *National Westminster Bank Plc v Skelton* [1993] 1 W.L.R. 72.

In all three cases, the court emphasised both the general common law rule that a mortgagee has an unqualified right to possession and the applicability of the *Samuel Keller* principle that a mortgage debt cannot be discharged by a unilateral appropriation of an unliquidated counterclaim.

The *Spencer Day* case

Unlike the previous three cases, the claimant was not the lender but the borrower. He had remortgaged a property to obtain funds for development, but failed to make repayment of the loan. Receivers were appointed, but the claimant ousted them from possession. In the proceedings he asserted a claim for unliquidated damages which he claimed to be able to set off against the mortgage debt to release the property from the charge and thereby invalidate the appointment of the receivers. The lenders counterclaimed the amount of the mortgage debt and declarations that the charge was valid and enforceable and the receivers had been validly appointed.

In response, Mr Day raised a new allegation, that he had been induced to enter the mortgage by fraudulent misrepresentation. The lender, which was itself by now in liquidation, contended that even if Mr Day was able to rescind the mortgage, as he contended, it was subrogated to a prior mortgage paid off with the proceeds of its loan. In the Court of Appeal, the case was primarily concerned with the effect of the subrogation claim, since it was accepted that the Court of Appeal itself was bound by the line of authorities culminating in *Skelton*.

The claim to subrogation was resisted on a number of grounds, one being that it was an equitable remedy and it would be unjust to leave Mr Day to a remedy in damages against an insolvent lender while allowing the lender to enjoy the status of a secured creditor. Gloster LJ, who delivered the leading judgment, therefore examined the question whether the *Samuel Keller* line of authorities went so far as to entitle an insolvent chargee to apply the proceeds of the realisation of the security in the discharge of the charged debt without providing for payment of the possible counterclaim. She concluded that it did and that the lender's insolvency was no answer to the subrogation claim. Similarly, a claim that the money paid in discharge of the previous mortgage was obtained by fraudulent misrepresentation to third parties would not prevent subrogation.

The Court of Appeal's decision that the attack on the lender's claim to subrogated rights failed had the effect that the appeal was dismissed. There remains an unanswered question about what the position would have been if there had been no previous mortgage and thus no claim to subrogation. The lender contended that Mr Day could only rescind its mortgage if he could make counter-restitution

Feature

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by returning the money lent, which he could not do. The question arises, however, whether he could have claimed to set off his unliquidated damages claim against the lender's money claim for restitution, given that a successful claim for rescission would have the effect that the lender, in the absence of subrogated rights, was not in the position of a secured lender.

The judgments of the members of the Court of Appeal point in different directions on this issue. Gloster LJ, at para 70, considered that it would be unlikely that the court would rule out the possibility of such a set off. Vos LJ, on the other hand, at para 77, regarded the *Samuel Keller* line of authority as conclusive against such an argument in the absence of success on the damages claim, at least unless the Supreme Court could be persuaded that there should be an exception in such cases. Moses LJ agreed with both the other judgments.

CONCLUSIONS

From this examination of the authorities, it seems that the underlying policy is that a secured creditor should be entitled to the benefit of the security for which it has contracted and should not be deprived of the benefit of that security by a pure money claim, *a fortiori* if the claim is unliquidated. This leads to the following conclusions:

- Given that policy rationale, there is no reason why the same line of authorities should not apply in relation to all secured lending. There is nothing particular about the fact that in the cases themselves the security consisted of land.
- Conversely, where the lender has obtained the full benefit of the security it has contracted for, or where it is seeking a money judgment unconnected with the existence of the security, there is no policy reason for excluding a claim to a set-off. It was treated as available by way of defence to a shortfall claim in *TSB Bank Plc v Platts* [1998] N.P.C. 23. Accordingly, it may still serve a useful purpose to include a clause excluding the right of set-off in security documentation, although the effectiveness of the clause may be a matter of dispute under the Unfair Contract Terms Act or the Unfair Terms in Consumer Contracts Regulations, as in *Woodeson* itself, or, now, under the Consumer Rights Act 2015. An excessively wide exclusion clause was successfully challenged under the 1977 Act in *Stewart Gill Limited v Horatio Myer & Co Limited* [1992] 1 Q.B. 600.
- Where the *Samuel Keller* principle applies, cross-claims have to be brought as free-standing claims and so are subject to the usual limitation defences. That is not the case where the cross-claim is advanced by way of defence to a money claim, such as a shortfall claim. This was decided by Hobhouse J in *Westdeutsche Landesbank v Islington Borough Council* [1994] 4 All E.R. 890, a decision followed in the context of a pure money claim in *National Westminster Bank Plc v Frankham* [2013] EWHC 1199 (QB). The result of this appears to be that the more deficient the lender's security, the more effectively the borrower can rely on a cross-claim which would be statute-barred if brought as a free-standing claim.

  It is to be noted, however, that the assertion of a right of equitable set-off, and the existence of such a right, do not of themselves extinguish or reduce either the mortgage debt or the cross-claim. That can only be done by agreement or judgment: see the *Woodeson* case at para 63, citing *Fearns v Anglo-Dutch Paint & Chemical Co Limited* [2011] 1 W.L.R. 366 and *Equitas Limited v Walsham Bros & Co Limited* [2013] EWHC 3264 (Comm).
- So far as can be seen from the judgments, although there was a claim in deceit in *Woodeson* there was no claim to rescind the mortgage. The problem posed by *Spencer Day* in this respect remains unresolved. It is suggested, however, that the policy rationale for the *Samuel Keller* line of cases does not apply, or does not apply with full force, where the effect of the cross-claim is to impugn the existence of the security on which those cases depend. It clearly would not apply if the borrower alleges that the mortgage is void on the ground of forgery or *non est factum* or is not binding on the beneficial interest of one of a number of mortgagors. The factual issues raised in such a case have to be dealt with before enforcement is possible.

A claim that the mortgage has been obtained by the fraudulent misrepresentation of the lender is in a different category, in that the mortgage contract is voidable rather than void and in all probability the borrower will have obtained some financial benefit from the transaction, as in *Spencer Day*. Restitution is the usual counterpart to rescission. If, however, the borrower has suffered substantial damage which would reduce or extinguish a money claim for restitution, it is not clear why that claim should not be taken into account by way of set-off in determining what is required by way of restitution. If restitution is possible, whether or not it is effected by way of set-off, and a claim to rescission is thereby established, it takes effect from the date of the rescinded transaction. The lender not only is not, but is shown never to have been, a secured creditor. If the borrower is able to demonstrate a reasonably arguable case that the mortgage was obtained by deceit, it is not clear why the lender should nevertheless obtain the benefits associated with being a secured creditor. That is all the more the case if, as in *Spencer Day* itself, the creditor is insolvent and there is no prospect of a damages claim being met in full. ■

Further Reading:

- Can equitable set-off apply to a situation where set-off has been excluded by the terms of the contract between the parties? (2016) 7 JIBFL 438.
- Challenging debt claims: pay later and litigate now? (2014) 1 JIBFL 30.
- LexisPSL: Banking & Finance: News: Limitation – declarations and concealment (*Woodeson and another v Credit Suisse*).