UNDUE INFLUENCE AND SUBSTITUTE MORTGAGES

One of the most litigated property law issues over the past decade has been the equitable jurisdiction to set aside a mortgage transaction procured by undue influence or some other vitiating conduct.

The most common scenario is where the complainant has executed a mortgage as co-mortgagor with the principal mortgagor or has otherwise postponed his or her interest in the mortgaged property in order to secure the debts of the principal mortgagor; and, by way of a defence to an action for possession by the mortgagee, the complainant seeks to have the transaction set aside on the ground that it was procured by vitiating conduct on the part of the principal mortgagor. *Barclays Bank plc* v. *O'Brien* [1994] A.C. 180 established the structure of the defence. The complainant must establish that there was some vitiating conduct on the part of the principal mortgagor such that a transaction between those parties would be set aside; and that the mortgagee had sufficient notice of the vitiating conduct and should therefore prima facie be subject to the complainant's right to set aside the mortgage. However, the mortgagee may establish that it took appropriate steps to ensure that the complainant's execution of the mortgage was not procured by vitiating conduct, in which case the mortgage will not be set aside. In *Royal Bank of Scotland plc* v. *Etridge (No. 2)* [2001] UKHL 44, [2002] 2 A.C. 773 the House of Lords endorsed the basic *O'Brien* structure but sought to refine the principles and to address a number of practical issues that had been identified in a series of subsequent cases.

Yorkshire Bank plc v. *Tinsley* [2004] EWCA Civ 816, [2004] 1 W.L.R. 2380 raised a related issue that had not previously been considered, namely whether a substitute mortgage could be set aside where the original mortgage was voidable in accordance with the principles in *O'Brien* and *Etridge*.

Mr. and Mrs. Tinsley were co-owners of their matrimonial home. In 1988, and again in 1991, they mortgaged the property to the claimant bank in order to secure the present and future business debts of Mr. Tinsley. In 1994 Mr. and Mrs. Tinsley separated. The matrimonial home was sold and another property was purchased for Mrs. Tinsley. As a condition of discharging the mortgage over the former matrimonial home, the bank required Mrs. Tinsley to execute a replacement mortgage over her new property.

When Mr. Tinsley failed to repay his debts, the bank brought possession proceedings against Mrs. Tinsley. The county court

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judge held that Mrs. Tinsley had executed the 1988 and 1991 mortgages under the undue influence of Mr. Tinsley; that the bank had been put on inquiry as to that undue influence; and that the bank had failed to take appropriate steps to satisfy itself that Mrs. Tinsley had freely entered into both transactions. It followed that both mortgages had been voidable as against the bank and liable to be set aside at the instance of Mrs. Tinsley. However, the judge held that the undue influence in relation to the earlier mortgages could not be transferred to the 1994 mortgage ("which was on a different property altogether"); and, since the 1994 mortgage was otherwise unimpeachable, he made an order for possession.

Mrs. Tinsley appealed to the Court of Appeal. A range of arguments was pursued but, since the bank did not seek to challenge the voidability of the 1988 and 1991 mortgages, the principal issue was whether the 1994 mortgage was voidable and liable to be set aside *because it was a substitute for the earlier voidable mortgages*.

Longmore L.J. gave the leading judgment. Considering the issue as a matter of principle, he stated that "[i]t would be natural to expect that if, without more, an obligation incurred between two or three parties is legally ineffective in any way, any new obligation arising out of the release of such earlier obligation would be legally ineffective in a similar way". Applying that principle to the present case, the 1994 mortgage was a substitute for the earlier mortgages; it was granted as a condition of the discharge of the earlier mortgages (and on the assumption of both parties that the earlier mortgages were valid); but the voidability in fact attaching to those earlier mortgages continued to operate so as to render the 1994 mortgage voidable, *even though there was no operative undue influence at the time of the 1994 mortgage*. Since the reasoning was based on the continuation of the constructive notice of the undue influence that affected the conscience of the mortgagee, Longmore L.J. rejected the argument of the bank that the decision involved an unjustifiable over-extension of equitable principles.

Moreover, Longmore L.J. accepted that there was some authority for the principle—in two cases found by counsel for Mrs. Tinsley. *Crowe* v. *Ballard* (1790) 1 Ves. Jun. 214 and *Kempson* v. *Ashbee* (1874) L.R. 10 Ch. App. 15 both concerned the enforceability of substitute bonds (rather than mortgages); but both appeared to hold that a later bond, unimpeachable in itself, was unenforceable by reason of the fraud or undue influence that attached to an earlier bond with which it was "inseparably connected".

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Longmore L.J. sought to define, both positively and negatively, the scope of the decision and the otherwise broad principle underlying the decision. First, the principle applies only where the substitute mortgage is granted to the same mortgagee, although it is irrelevant whether the substitute mortgage is a remortgage on the same property or relates to a different property. There is no question that a substitute mortgagee should be adversely affected by a voidable mortgage to which it was not a party since the principle is based on the continuation of the constructive notice of the vitiating conduct that affected the conscience of the original mortgagee. Secondly, the principle applies only where the substitute mortgage is "inseparably connected" with the earlier mortgage, for example where, as in the present case, the discharge of the earlier mortgage is conditional upon the grant of the substitute mortgage. Thirdly, the principle applies even though the vitiating conduct affecting the earlier mortgage is no longer operative and even though the substitute mortgage is not affected by any new vitiating conduct and would thus be unimpeachable in the absence of the history of the earlier mortgage. (Rix L.J. appears to have stated that the undue influence of Mr. Tinsley had *not* ceased to be operative. However, on that basis, the present case raised no new issue: it could have been decided simply by reference to the undue influence *ex hypothesi* affecting the substitute mortgage and without reference to the earlier mortgages.) Fourthly, although the vitiating conduct affecting the earlier mortgage need no longer be operative, it must not have been cured or negated, for example by the informed affirmation of the mortgage(s) by the complainant.

Peter Gibson L.J. and (subject to the point noted above) Rix L.J. agreed with the judgment of Longmore L.J. In addition, Peter Gibson L.J. expressed the view that, contrary to the argument advanced on behalf of the bank, the decision did not cause any significant practical difficulties for lending mortgagees. In accordance with the principles established in *O'Brien* and *Etridge,* the mortgagee should take steps to ensure that the co-mortgagor receives independent advice on the particular transaction. In the case of a substitute mortgage, the transaction involves the discharge of an earlier mortgage; and proper advice should necessarily extend to that aspect of the transaction.

Yorkshire Bank plc v. *Tinsley* raised a previously undecided point in a much litigated context. It is submitted that the Court of Appeal was correct in deciding that the voidability of the earlier mortgages was transferable to the substitute mortgage. It is further submitted that the limitations on the broad principle underlying the decision should ensure the proper balance between the parties in

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such circumstances; but it remains to be seen whether the principle and its practical implications will generate yet more litigation.

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CONTESTS BETWEEN RIVAL TRUST BENEFICIARIES

HAVING been promised 15% *per annum* returns on their investments, hundreds of investors paid a total of over £6m to Mr. Prentis' firm of solicitors, to be invested in short term, high interest mortgages. The payments were held on trust in a client account pending investment. Only some of the payments received were in fact invested in mortgages. For those that were, the documentation was woefully inadequate; frequently it did not identify which investor's money had been applied towards each mortgage or in what amount. There were substantial shortfalls, both in capital and in income. The Law Society intervened and Mr. Prentis was struck off, preventing the firm from continuing to act as trustee. In *Russell-Cooke Trust Co.* v. *Prentis* [2002] EWHC 2227 (Ch), [2003] 2 All E.R. 478 the replacement trustee sought directions as to how it should distribute between the various investors the investments which had been made and the surplus funds remaining in the client account.

There was no contest between the trustee and the beneficiaries. The true contest was between the various beneficiaries, regarding whose claims would prevail over the investments and the remaining funds. In five instances, the documents made clear whose money had been used to invest in each mortgage *and* in what amounts. Those investors could assert a beneficial interest in the relevant mortgages as separate trusts existed for each of them: at [40].

This left the question how the remaining mortgage investments and the funds remaining in the client account were to be distributed. As the client account was a current account, the received wisdom in England is that *Devaynes* v. *Noble; Clayton's Case* (1816) 1 Mer. 572; 35 E.R. 781 provides the starting point, requiring that the beneficiary whose money was first placed in the current account be treated as the person whose money was first taken out of the account. No-one argued in *Prentis* that this rule applied to the mortgage investments where specific investors were identified *but* it had not been made clear in what amounts each identified investor's money had been used. The reason is that it is clear from *Clayton's Case* itself, as well as from later decisions (*In re Hallett's Estate* (1880) 13 Ch.D. 696, 728, 738–739; *Cory Bros. &*

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