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Third party duress and undue influence: pitfalls for the IP

KEY POINTS

- Insolvency practitioners need to be alert to the possibility of duress and undue influence by third parties on those with whom they are negotiating settlement agreements.
- Negotiations with parties who are husband and wife, or parent and child, or others in a known relationship of trust and confidence, may require a special approach akin to that in *Etridge*.
- The 'rule' in *ex p James* preventing an insolvency practitioner from relying on his or her strict legal rights to retain monies remains a potent weapon in contemporary insolvency disputes.

INTRODUCTION

This article discusses the recent case of *Hieber v Duckworth* (liquidator of *Hieber Ltd*) LTL 28/6/2017 in which a Tomlin order between a liquidator and a company secretary, who was also the wife of the sole director, was set aside on the grounds of duress and undue influence, and in the alternative by reason of the 'rule' in *ex p James*. Albeit a first instance decision of a deputy registrar, it has the potential for significant ramifications.

A brief summary of the law on duress, undue influence and the 'rule' in *ex p James* is considered first. The facts of *Hieber* are then set out in detail because some point to possible grounds for distinction of the decision whilst others are likely to arise in many other cases. They should therefore be of interest to insolvency practitioners (IPs) and those dealing with IPs.

THE LAW ON DURESS EXERTED BY A THIRD PARTY

A contract entered into as the result of threats to a victim's person *by the other party* to the transaction may be set aside by the person under the duress. Such threats are seen by the law as illegitimate pressure. Whether a contract entered into as the result of threats *by a third party* can be set aside has been much less clear.

Chitty at para 8-053 opines that duress can apply to avoid a contract in third party cases provided that it is proven that the other party:

'... knew of the duress, or had *constructive notice* of it or had procured the making of the contract through the agency of the party who exercised the duress'.

No case is cited in support of this proposition. Rather, it is based upon an analogy with the position said to apply to third party misrepresentation and undue influence cases.

THE LAW ON UNDUPLICATE INFLUENCE EXERTED BY A THIRD PARTY

Traditionally undue influence has been divided into two sub-categories: 'actual' undue influence where a party must prove that the other party had influence over him, in fact exercised that influence, and that the exercise was undue and resulted in the transaction, and 'presumed' undue influence where the parties were in a type of relationship where it is presumed that one party has influence over the other and where a transaction between them was not readily explicable by the relationship. The presumption in the latter case can be rebutted. Typically this is done by showing that the other party took independent and competent advice.

Its application to tripartite situations is more controversial. Chitty at para 8-108 opines that:

'Where one party seeks to avoid a contract on the ground of undue influence by a third person, it must

appear either that the third person was acting as the other party's agent, or that the other party had actual or *constructive notice* of the undue influence.'

Notwithstanding that general statement of the law, the courts have rarely permitted a party to impugn a transaction based on the undue influence of a third party where the other party only had constructive notice. The notable exception is the well-known banking surety line of cases.

The leading House of Lords case of *Royal Bank of Scotland Plc v Etridge (No 2)* [2001] UKHL 44 laid down the principle that a bank is put on inquiry of the possibility of undue influence when an offer to stand as surety is made by a wife in respect of debts which are her husband's debts and not hers. The relationship is one where influence may be exercised and such a transaction is not readily explicable by ordinary motives.

In such cases, a lender can avoid being fixed with notice of the undue influence only if it takes reasonable steps to minimise the risk of undue influence. In *Etridge* that required the lender to insist that the wife attend a private meeting with a bank representative where the extent of her liability as surety is discussed, where she is warned of the risk she is running and where she is told to take independent legal advice.

THE RULE IN EX PARTE JAMES

In *re Condon, ex parte James* (1874) 9 Ch App 609 a trustee demanded payment from a debtor of the bankrupt who paid. As a result of a subsequent Court of Appeal decision it became apparent that the trustee had not had any entitlement to the debt. The trustee was not permitted to rely on his strict legal rights to retain the monies and was ordered to repay the money.

In *Re Clark (A Bankrupt) ex parte the Trustee v Texaco Ltd* [1975] 1 WLR 559 it

was held that four criteria must be met before the 'rule' in *ex p James* can apply:

1. There must be some form of enrichment.
2. Except in the most unusual cases, the claimant must not be in a position to submit a proof of debt.
3. If, in all the circumstances of the case, an honest man who would be personally affected by the result would nevertheless be bound to admit: 'It's not fair that I should keep the money; my claim has no merits.'
4. When the rule does apply, it applies only to the extent necessary to nullify the enrichment.

FACTS

Mr and Mrs H had been the sole director and company secretary respectively of Hieber Ltd (In Liquidation) ('the company') and had each held one of the two issued shares. The company's liquidator applied to court for the following:

- Repayment of a debt of £39,325 by Mr H to the company, or alternatively an account of the same figure; and
- a declaration that Mr and Mrs H were accountable to the company for £85,984.79 received into their joint account by way of unlawful dividends.

Mrs H's evidence in response to the application was that she had never received any of the 'unlawful dividends' because the joint account was controlled and accessed solely by Mr H. In any event she asserted that all but £11,800 was statute barred.

At various stages the liquidator's solicitor was contacted by people purporting to act on behalf of Mrs H including JK, direct access counsel (who advised that Mr H would be separately represented) and BM.

Purporting to act for both Mr and Mrs H, BM offered that Mr H would pay £30,000 in instalments and Mrs H would grant a charge over her property as security limited in amount to £11,800. In other words, Mrs H would stand as a limited surety to her husband. The liquidator was minded to accept that offer.

For reasons which were not clear to the registrar, the Tomlin order subsequently

drafted and signed enshrined a slightly different agreement. It provided that Mr and Mrs H would be *jointly liable* for £30,000, that Mrs H's liability would be capped at £11,800 and that Mrs H would grant a charge over her property as security limited in amount to £11,800 plus any enforcement costs.

A draft of the Tomlin order was sent under cover of a single letter addressed jointly to Mr and Mrs H. That resulted in a number of queries sent from an email address which appeared from its name to be Mrs H's email address. The liquidator's solicitor responded to the queries and later received a copy of the Tomlin order signed by Mr and Mrs H.

Mr H subsequently died and Mrs H sought to set aside the Tomlin order on the grounds that her agreement to it had been procured by the undue influence of Mr H.

In support of her position, Mrs H's evidence was that:

- she knew nothing about her husband's business and had not been aware of her appointment as secretary or her shareholding in the company;
- she had never had contact with JK or BM;
- she had no knowledge of the email address in her name and had not seen either the questions or the responses about the Tomlin order sent to and from that address; and
- she had signed the Tomlin order because Mr H had been a violent and abusive alcoholic who had told her to, and she had feared that she would be beaten if she had refused.

THE DECISION ON DURESS AND UNDUE INFLUENCE

The Deputy Registrar was completely satisfied on the evidence that Mrs H did not give her willing and informed consent to the terms of the Tomlin order because she was subject to the undue influence and very significant duress of Mr H. Thus there was actual duress and actual undue influence. However, the court also accepted that the liquidator had no actual knowledge of this. The Deputy Registrar turned to constructive notice and the *Etridge* line of arguments.

The Deputy Registrar accepted that, by analogy with *Etridge*, the questions to ask were the following:

1. Whether the liquidator was put on inquiry as to the possibility that Mrs H had been subject to undue influence and duress by Mr H.
2. Having been put on inquiry, whether the liquidator failed to take reasonable steps in relation to that possibility.

As to the first question, while the Registrar did not address the matter specifically, he presumably accepted that as Mr and Mrs H were husband and wife, they were in a relationship where presumed undue influence was a risk. The Deputy Registrar held that there was an absence of financial benefit to Mrs H in entering into the Tomlin order. In doing so, the court placed great weight upon the original offer from BM which represented the 'substance' of the agreement as opposed to the Tomlin order which was drafted on the basis of joint liability. Pursuant to BM's offer, Mrs H's liability was limited to that of a surety for Mr H by way of a charge over her property.

In addition, it appears that the Deputy Registrar placed weight on the following:

- The merits of the liquidator's claim against Mrs H were doubted in circumstances where she had not received the money and had no knowledge that such money would have amounted to unlawful dividend.
- Counsel's submission, repeated without adverse comment, was that the liquidator was put on notice of a conflict of interest between Mr and Mrs H when contacted by direct access counsel, and that 'alarm bells' should have rung when subsequently contacted by BM purporting to act for both Mr and Mrs H and offering Mrs H as a surety.

As to the second question, the liquidator had not taken reasonable steps to satisfy himself that Mrs H fully understood the transaction. The liquidator had not tried to establish that BM was authorised by Mrs H. Mrs H had not seen any of the liquidator's correspondence sent to Mr and Mrs H jointly

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and had not seen any of the emails explaining the Tomlin order.

THE DECISION ON EX P JAMES

The court held that, in the alternative, the Tomlin order should be set aside by application of the rule in *ex parte James*. Applying the *Re Clark* criteria:

1. There was unjust enrichment. The liquidator had secured an advantage in the Tomlin order which had been procured by duress and undue influence.
2. Settlement of the claim and thereby the loss of Mrs H's ability to challenge the claim could not have been the subject matter of a proof.
3. It cannot be regarded as fair to enforce an agreement procured by duress and undue influence.
4. The rule in *ex p James* applied to nullify the Tomlin order but the liquidator was permitted to resurrect and pursue his original claim against Mrs H.

COMMENTARY

There are a plethora of issues in or arising from this short, first instance judgment. The main points are listed below:

1. The *Etridge* category of cases may not be confined to its banking context as hitherto widely thought. Certainly IPs now need to be aware that they may be fixed with constructive notice of the undue influence by a third party (although there is no reason in principle why this rule would be limited to IPs).
2. This case concerned actual duress and actual undue influence, which is relatively rare. However, to a large extent this is a red herring because the liquidator did not have actual knowledge of this. Thus the case proceeded as if it were a presumed undue influence case of which the liquidator had constructive notice.
3. Surety cases have often been caught by *Etridge* as these transactions are presumed to be of little financial benefit to the surety. However, this case was not a strict surety case and, irrespective of the court's doubts about the merits of the liquidator's claim or the previous negotiations, the wife settled her own

liability in the Tomlin order (and thus received good consideration). The case thus suggests that *Etridge* is not confined to surety case.

4. The court did not say what the liquidator ought to have done to satisfy the requirement that he took all reasonable steps to minimise the possibility of undue influence. The best guidance is therefore likely to remain that set out in *Etridge*.
5. The law on duress has arguably been elided with the law on undue influence insofar as the duress or undue influence is exercised by a third party to the transaction.
6. *Ex p James* is likely to apply so as to set aside any settlement agreement negotiated between an insolvency practitioner and a party influenced by duress or undue influence where that IP has not taken reasonable steps to ensure that the other is entering the transaction freely.
7. It is possible that *ex p James* may apply even where the IP *has* taken reasonable steps to ensure that the other is entering the transaction freely. That will depend upon the court's view on whether an honest man would, upon learning that his reasonable steps had been insufficient, would nevertheless feel it was unfair to bind the other party to the agreement.

PRACTICAL IMPACT

Assuming this decision is not successfully appealed, it introduces worrying uncertainty into settlements entered into by IPs. Whilst the duress and actual undue influence element in the case is likely to arise rarely, the possibility of presumed undue influence in agreements involving a husband and wife and the spectre of *ex p James* have the potential to arise frequently.

It may be that insolvency practitioners need to consider carefully introducing a standard procedure which would apply to settlements with spouses (or others potentially in a relationship of trust and confidence such as parent and child), where the financial benefit to one is uncertain, akin

to the procedure applied by banks following *Etridge*. This will undoubtedly increase costs and the complexity of settlement negotiations but should reduce the risk of relying and enforcing the resulting settlement agreements.

Solicitors acting for couples in negotiating an agreement whereby one partner accepts a liability with no obvious financial benefit may also need to consider their role carefully and whether the guidance in *Etridge* should be followed.

All those working in the field of insolvency should also be aware of the recent resurgence of the rule in *ex p James*. The 'rule' was recently applied successfully in *Allen (Trustee in Bankruptcy) v Michelle Young LTL 25/4/2017*, a decision by the Chief Registrar. In both cases the 'rule' was raised by the Registrar rather than the parties and ultimately was found to apply. This too creates uncertainty by rendering the enforcement of settlements and the exercise of other legal rights subject to sensitivities of the notional 'honest man'. This author also questions the relevance to modern times of a 'rule' which makes insolvency practitioners subject to a different standard of behaviour to other contracting parties. ■

Further reading

- LexisPSL Restructuring and Insolvency: Practice notes: Roles, powers, functions and duties of a trustee in bankruptcy
- RANDI blog, 21 May 2015: Independent legal advice – the pitfalls for lenders (*HSBC Bank Plc v Brown*)
- LexisPSL Restructuring and Insolvency: Practice notes: *Etridge* – checklists for a lender taking third-party security from an individual and for a solicitor advising an individual in relation to granting third-party security