BERMANS
Asset Finance

Briefing

Winter 2023

Consumer Duty Countdown

Exchange Station
Tithebarn Street
Liverpool
L2 2QP
Tel: 0151 224 0500

3rd Floor
1 King Street
Manchester
M2 6AW
Tel: 0161 827 4600

www.bermans.co.uk

Published by Bermans

The announcement by the FCA in late July last year of its final decisions on implementing the new Consumer Duty has led to a range of responses within the leasing and consumer credit industries.

The aim of the FCA is said to be to fundamentally improve how regulated firms serve consumers, by setting higher and clearer standards of consumer protection across financial services and explicitly requiring regulated firms to put their customers' needs first.

The Duty is made up of an overarching principle and new rules regulated firms will have to follow. It will mean that consumers should receive communications they can understand, products and services that meet their needs and offer fair value, and they get the customer support they need, when they need it.

The FCA explained its aspirations as follows:

"Clarity on our expectations and firms focusing on what their customers need should lead to more flexibility for firms to compete and innovate in the interests of consumers.

The Duty forms part of the FCA's transformation to becoming a more assertive and data-led regulator. With firms assessing how they're meeting their customers' needs, the FCA will be able to quickly identify practices that don't deliver the right outcomes for consumers and take action before practices become entrenched as market norms...

The Consumer Duty will lead to a major shift in financial services and will promote competition and growth based on high standards. As the Duty raises the bar for the firms we regulate, it will prevent some harm from happening and will make it easier for us to act quickly and assertively when we spot new problems."

In response to industry concerns about the speed of implementation, the FCA has now dictated a two-phase implementation period:

- From the end of July 2023, the consumer duty will apply to all new products and services, and all existing products and services that remain on sale or open for renewal.
- From the end of July 2024, the consumer duty will come fully into force and apply to all closed products and services.

The FCA stresses the importance of regulated firms making full and effective use of the longer implementation period to make the necessary changes to policies, process, governance and culture.

No application to business customers

For asset financiers involved primarily in the business market, the unwelcome news is that the revised made rules appear to in effect extend beyond the usual definition of a "retail customer" as *"an individual who is acting for purposes which are outside his trade, business or profession,"* so that regulation will also now extend to **any** customer in a regulated activity, in other words encompassing sole trader and partnerships of 2 or 3 who are business customers.

However, the FCA's jurisdiction essentially remains limited to those firms which it regulates, so the Consumer Duty will not apply to unregulated business. It will not, for example, apply to credit products outside the FCA's remit, such as unregulated business lending. However, it will apply to unregulated activities that are ancillary to regulated activities. For example, the design of a product or service, and ongoing customer support services, are not themselves regulated activities. They are, however, necessary activities linked to regulated activities.

There is an interesting and positive perspective on the new Consumer Duty in a recent blog by Julian Rose, a much respected expert and commentator on the asset finance industry:

"For many, implementation of the FCA's Consumer Duty rules may be a concern. It really shouldn't be: This is an example of smart new regulation and we should welcome it…

But behind all of this, the regulation is simple and good. The FCA is saying, in effect, put aside for a moment everything else in the thousands of pages of Handbook rules, and just be certain that your customers get a fair deal. Fairness is, of course, a matter of judgement, but the guidance gives plenty of useful indicators of what to look for.

…the FCA is clear that what is expected of firms should be interpreted 'in light of what is reasonable' given the nature of the product, the characteristics of customers, and the firm's role in the distribution chain. These factors point to asset finance being low risk, suggesting a lighter-touch implementation. So if Consumer Duty is becoming a very large project, I suggest take a step back and ask whether that's necessary and what the FCA intends".

You can read Julian's blog in its entirety at:

https://www.assetfinancepolicy.co.uk/post/smarter-regulation-in-2023-consumer-duty-runs-rings-around-fred-82

Foreign assets traced in the Arena fraud

Asset financiers have not had much comfort from the sorry tale of the Arena TV fraud, but we did notice with interest a passage in a recent judgment against the main perpetrator individuals behind the fraud which illustrates the principle that in certain circumstances victims of fraud can trace assets such as foreign property which the fraudsters have obtained with the proceeds of the fraud.

The judgment was in a case brought by the Arena TV administrators against the two individuals behind the Arena group of companies, and whilst the description of the fraud and the issues relating to assessing financial loss are of limited interest given the obvious impecuniosity of those individuals, there was at least some solace in the court's approach to a claim to recover foreign assets:

"The claimants say that in addition they caused the claimants to trade whilst insolvent and they point to certain specific misappropriations that they say were made by the defendants in breach of their fiduciary duties to the company.

In particular they seek a declaration that the defendants jointly hold the property in Sitges Barcelona on trust for Arena Aviation. The plea at paragraph 23(5) of the amended particulars of claim is that between the 25th of November 2019 and the 26th of November 2019 the defendants wrongfully caused Arena Aviation to pay at least Euros 1.814 million to the client account of Eshkeri and Grau which they used to jointly purchase the Sitges property at a time when the claimant companies were insolvent. The evidence is that those payments were all misappropriated at a time when Arena Aviation was indeed insolvent.

The claimants say that the payments and now the Sitges property are therefore held by the defendants on trust for the claimants as company property. Further the payments could not have been made for a proper purpose. The defendants could not possibly have considered in good faith that they would promote the success of the company for the benefit of its members as a whole and the defendants did not act faithfully in the interests of the claimants but they acted for their own interests in breach of s.175 of the Companies Act 2006 and their duty of fidelity. I am satisfied that these were indeed misappropriations for which the defendants are liable as acting in breach of their fiduciary duties to the company".

HM Treasury consults on reform of Consumer Credit Act

On 9 December 2022 HM Treasury published a consultation paper on reform of the Consumer Credit Act 1974 ("CCA").

The Government announced its intention to reform the CCA in June 2022, with the ambition of moving most of the CCA from statute to FCA rules. Given the scale and complexity of this work, it is expected to take a number of years. The consultation paper is the first step in this process. In it, HM Treasury seeks views on the objectives, principles and overall direction of the proposed reform.

HM Treasury considers that it is the right time to further align consumer credit regulation with the wider financial services framework. However, in doing so, it recognises there are specificities of consumer credit regulation that potentially warrant a different approach to ensure adequate consumer protection.

The Government's overall objective is to modernise and streamline regulation for the benefit of consumers and business. In practice, this aims to create a simpler, more focused regulatory regime for consumer credit and to modernise consumer credit regulation so it follows more closely the approaches in other areas of financial services regulation. It does not envision provisions being purely replicated in FCA rules, but being recast (potentially not mirroring their current composition).

This means that rules, guidance and principles in the FCA Handbook will provide effective and high levels of consumer protections that achieve similar ends to existing legislation. HM Treasury recognises that there may be some provisions that will stay in legislation, subject to any modifications or refinements considered appropriate.

In chapter 4, HM Treasury has categorised the CCA provisions to understand specific issues and sets out its proposed approach to reform. Chapter 5 sets out further questions about how this reform can help increase access to credit and financial inclusion. It also explores how the consumer credit market can become fairer and take account of inequality.

Comments can be made on the consultation paper until 17 March 2023. HM Treasury intends to develop more detailed policy proposals, which it expects to put to stakeholders through a second stage consultation. Implementation of the final approach will likely require primary legislation, which will be brought forward when parliamentary time allows.

The FCA will consult on its approach to any new rules in due course.

Link to Consumer Credit Act consultation

Taking Security from "Protected Persons"

As long ago as 2001 in the landmark case of *Royal Bank of Scotland Plc v Etridge* [2001] UKHL 44 the House of Lords (since renamed the UK Supreme Court) significantly extended the circumstances in which a financier will be put on constructive notice of misrepresentation or undue influence committed against an individual executing a Guarantee or other security, but there remains a great deal of misunderstanding of the relevant principles.

The mischief addressed over 20 years ago by the House of Lords arose from wives regularly being misled or unduly pressured by husbands into signing Guarantees or executing Charges in favour of creditors, but the protection afforded by the law extends much further.

For example in *Credit Lyonnais Bank Nederland BV v Burch* [1997] 1 All ER 144 Ms Burch, a junior employee of the borrowing company, in her early 20s, was persuaded by her employer (who was the alter ego of the company) to give a mortgage over her flat (then worth about £100K with an equity of £70K) as security for the increased borrowings of the company on an overdraft facility with the bank. She was not told of the amount of the overdraft (£270K) nor of the extent of the company's existing indebtedness (£250K) however, the bank's Solicitor wrote to her not once but twice, pointing out that the Charge was unlimited in time and amount and encouraging her to take independent legal advice, which she failed to do. Indeed she wrote a letter to the bank in which she specifically refused such advice.

The Court of Appeal held that the steps taken by the bank were insufficient in the circumstances to displace constructive notice of undue influence. The bank was put on enquiry because it knew that the relationship was one of junior employee and employer working together in a small business, and that Ms Burch had no incentive to enter into the transaction. The receipt by the bank of Ms Burch's letter declining to take legal advice should have put the bank on notice she was being unduly pressured by the company. In addition, it was important that no attempt had been made to inform Ms Burch of the level of borrowings involved, so she was not in a position to make an informed decision as to entering into the Charge.

Partly as a result of cases such as this the protection afforded to individuals granting security was very substantially extended by the House of Lords in *Etridge* to an extent which is still not fully appreciated by many asset financiers. There is a common assumption that the doctrine of "protected person status" applies only to wives or co-habitees, and that it is automatically displaced where the individual concerned is a shareholder or a Director in the client company. Thus while some creditors apply the rather nebulous test of whether an individual is a "fully involved director", over the years there seems to have been something of a relaxation of this test and many creditors simply assume that an individual with any sort of shareholding or any registered role as an office holder in a company does not require any special consideration before entering into security.

In fact this far from the case, as Lord Nicholls said expressly at paras 48-49 and 84 of the judgement in *Etridge*:-

"As to the type of transactions where a bank is put on enquiry, the case where a wife becomes surety for her husband's debts is, in this context, a straightforward case…less clear cut is the case where the wife becomes surety for the debts of a company whose shares are held by her and her husband. Her shareholding may be nominal, or she may have a minority shareholding or an equal shareholding with her husband. In my view the bank is put on enquiry in such cases, even when the wife is a director or secretary of the company. Such cases cannot be equated with joint loans. The shareholding interest, and the identity of the directors, are not a reliable guide to the identity of the persons who will actually have the conduct of the company's business…if a bank is not to be required to evaluate the extent to which its customer has influence over a proposed guarantor, the only practical way forward is to regard banks as "put on enquiry" in every case where the relationship between the surety and the debtor is non-commercial. The creditor must always take reasonable steps to bring home to the individual guarantor the risks he is running by standing as surety. As a measure of protection, this is valuable. But, in all conscience, it is a modest burden for banks and other lenders. It is no more than is reasonably to be expected of a creditor who is taking a guarantee from an individual. If the bank or other creditor does not take these steps, it is deemed to have notice of any claim the guarantor may have that the transaction was procured by undue influence or misrepresentation on the part of the debtor.

Different considerations apply where the relationship between a debtor and guarantor is commercial, as where a guarantor is being paid a fee, or a company is guaranteeing the debts for another company in the same group. Those engaged in business can be regarded as capable of looking after themselves and understanding the risks involved in the giving of guarantees."

There have been important comments in two relevant cases on this issue in the past few years. In *Mahon & Anor v FBN Bank (UK) Ltd* [2011] EWHC 1432 (Ch) after analysing the relevant passages from *Etridge* HHJ Simon Barker QC said this at paragraph 51:

"Thus, and by way of example (1) where the loan is to or for the benefit of the husband or his business, as distinct from a joint loan to or for the benefit of both the husband and the wife, the bank is "put on inquiry". That is so even where the wife is a shareholder and/or an officer (director or secretary); (2) where the wife's interest and/or involvement is substantive rather than titular, if she is an active participant in managing the Company's affairs and is rewarded by remuneration for her work and/or dividends or interest for her investment, the loan may well be equated with a joint loan; but, (3) where the financial arrangements with the bank are negotiated by the husband and the wife plays no part in those negotiations but is asked to become surety for the debts of her husband or the business, the bank should be aware of the vulnerability of the wife and of the risk that her agreement might be procured by undue influence or misrepresentation on the part of the husband, and is "put on inquiry".

In the more recent case of *YS GM Marfin II LLC & Ors v Lakhani & Ors* [2020] EWHC 2629 (Comm) the court referred to this passage and expressed the following view at paragraph 71:

"Particular reliance was placed on the decision of HHJ Simon Barker QC, sitting as a High Court Judge, in Mahon v FBN Bank. This case showed that even if the potential guarantor is a shareholder and/or director in the debtor Company, the lender is "put on inquiry" unless they have substantive involvement in the Company and are rewarded by remuneration or dividends for their role. But even if a potential guarantor did have a substantive involvement, a bank would be put on inquiry where the financial

arrangements to be Guaranteed were negotiated by a husband.., and the wife .. played no part in those negotiations but is asked to become surety for the debts of the Company.".

The upshot is that asset financiers need to be aware when dealing with any individual potentially granting security that, unless that individual truly has a substantial involvement in operation of the client together with a shareholding which is not nominal and a directorship which is not cosmetic, special measures need to be taken to ensure the protection of that individual against the risk of misrepresentation or undue influence.

What Steps need to be Taken?

One option is for the creditor to have a private meeting with the individual Guarantor, but in practice this is seen as an unsatisfactory approach because of scope for future disputes about the nature and extent of the information imparted at the meeting.

In the absence of such a meeting the House of Lords in *Etridge* directed that the creditor should:-

- inform the Guarantor directly that for its own protection the creditor will require written confirmation from a Solicitor acting for the Guarantor, to the effect that the Solicitor has fully explained the nature of the document and the practical implications they will have for the Guarantor;

- inform the Guarantor that the purpose of the Solicitor's written confirmation is that, once the transaction has been entered into, the Guarantor should not be able to dispute that they are legally bound by the documents they have signed;

- ask the Guarantor to nominate a Solicitor whom they are willing to instruct to advise them, separately from the client, and to act in giving the necessary confirmation to the creditor; and

- tell the Guarantor that if they wish, the Solicitor may be the same Solicitor as the one acting for the client in connection with the transaction, but that they may prefer to instruct a different Solicitor.

The House of Lords expressly state that in their view the creditor should not proceed further with the transaction until there is received an appropriate response to the above directly from the Guarantor.

Once the Guarantor has nominated and instructed a Solicitor, the creditor should get the client's consent to send all the necessary information to the Solicitor to enable him to advise properly. This will depend on the circumstances, but will ordinarily include:

- an explanation of the purpose for which the facility is required;

- a note of the amount of any current indebtedness;

- a note of the amount and terms of the proposed new facility; and

- a copy of any written Application by the client for a facility.

Once the Solicitor has advised the Guarantor, the creditor should ask the Solicitor to certify that he has acted for the Guarantor, has explained the transaction, the documents, the implications for the Guarantor of signing the documents, the nature and extent of the potential liability that the Guarantor is taking on and the risks involved.

If the creditor fails to observe these guidelines and the Guarantor subsequently proves that either misrepresentation or undue influence by the client or another Guarantor has induced him to enter into the security, then the creditor will be affixed with constructive notice of the wrongdoing and the Guarantee or other security will be unenforceable.

Is it Sufficient to Give an Opportunity to Take Independent Legal advice?

In our experience a number of asset financiers are still under the impression that the comprehensive requirements set out in *Etridge* are optional and that they can be replaced by the simple device of including a statement at the end of a Guarantee or other security to the effect that the individual has been afforded the opportunity of taking independent legal advice. Unfortunately this is not the case: in the words of a leading textbook on the subject:-

"A written statement from the wife to the effect that she understood the transaction perfectly and had no wish to take independent legal advice could now be regarded as something of a poisoned chalice."

In practice Operations people seem often to accept the protestations of new business that in a highly competitive market sales would be lost by going through the procedures of advising individuals as to the procedure to be adopted and requiring a Solicitor's Certificate, but this point was expressly dealt with by the House of Lords when Lord Nicholls pointed out that everyone is subject to the same playing field:-

"[it is]…a principle which imposes no more than a modest obligation on banks and other creditors. The existence of this obligation in all non-commercial cases does not go beyond the reasonable requirements of the present time. In future, banks and other creditors should regulate their affairs accordingly."

However, we recognise that in the real world a balance has to be struck between the practicalities of signing up new business and the relatively minimal risk of a Guarantee or other security subsequently being challenged on the basis of misrepresentation or undue influence by the client (as opposed to alleged misrepresentation by new business, which is an entirely different matter).

Nevertheless we do continue to come across such situations, sometimes in contexts involving individuals way outside the classic relationship of co-habitees. One case we are dealing with moving towards a trial shortly for a substantial claim involves allegations of undue influence by a wife who was a shareholder drawing dividends and a director of the client, and the allegation that she was subject to undue influence by her husband (which he supports) was not made until 12 years after the Guarantee was signed.

Bermans Key Contacts

Alex Chapman, Partner
t: 0151 224 0554
m: 07779 118254
e: alex.chapman@bermans.co.uk

Dave Gledhill, Partner
t: 0161 827 4611
m: 07976 805724
e: david.gledhill@bermans.co.uk

Andrew Henderson, Partner
t: 0161 827 4607
m: 07745 885955
e: andrew.henderson@bermans.co.uk

Alissa Marsh, Senior Associate
t: 0161 827 4601
m: 07584904817
e: alissa.marsh@bermans.co.uk

Ian Munford, Consultant
t: 0161 827 4606
m: 07976 832966
e: ian.munford@bermans.co.uk

Claire McDonnel, Senior Associate
t: 0161 827 4603
m: 07796 531735
e: claire.mcdonnell@bermans.co.uk