

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION

CRAWLEY BOROUGH COUNCIL

- v -

BRADFORD AND BINGLEY BUILDING SOCIETY

and

ALLEN AND OVERY (Third Party)

MR JUSTICE LLOYD:

Introduction

In 1988, the Leamington Spa Building Society (LSBS) wished to increase its assets and activities. In the new regime of prudential supervision introduced by the Building Societies Act 1986 it needed to ensure that its capital base was adequate for this purpose. Early in 1988 the way was opened for building societies to add to their capital by borrowing for at least 5 years on terms that the principal would not be repaid until after all ordinary creditors and shareholders had been paid in full - subordinated debt. In October and November 1988 LSBS sought to take advantage of this new possibility, and was able to do so by three transactions, one with a foreign bank as lender and the other two with English local authorities. This action arises from one of the latter two transactions, the lender being Crawley Borough Council. It is now clear that Crawley and LSBS ought never to have entered into the transaction. The true effect on it of the then tax legislation meant that it was bound to be uncommercial for one party or the other, but both parties were mistaken as to the tax regime that would apply and therefore both failed to realise this. After the end of the second year of the loan (which was terminated after five years under a borrower's break clause) the tax legislation changed, so as to bring the economic effect of the transaction into line with the parties' prior understanding. However for the four interest periods which had expired before that change LSBS has paid Crawley less than the latter claims is due to it, and by this action Crawley seeks payment of the difference, amounting to £253,794.99.

The deal was negotiated on 10th November 1988 through money brokers in the City and was confirmed by what has been called the Term Sheet. The loan was made on

15th November 1988. After the agreement had been made LSBS instructed Allen & Overy to prepare the formal agreement which both parties knew would be necessary (and which the Term Sheet provides for) so as to ensure that the subordination was dealt with appropriately, and that the debt would qualify as capital for LSBS' purposes. The Loan Agreement was drawn up and entered into on 30th November 1988. Crawley contends either that this agreement entitles it to be paid the full amount which it claims, or that if it does not it ought to be rectified so that it does, and contends incidentally that the Term Sheet on its own would have that effect. Bradford & Bingley Building Society (which, in 1991, took a transfer of the engagements of LSBS, and therefore succeeded to LSBS' liabilities) denies both these claims. In case it is wrong, however, (and for certain purposes even if it is right) Bradford & Bingley Building Society claims damages against Allen & Overy in third party proceedings.

Summary of conclusions

For the reasons which I will set out, I have come to the following conclusions:

- (1) Crawley is not entitled to the sum claimed on the terms of the Loan Agreement as it stands.
- (2) However, Crawley is entitled to have the Loan Agreement rectified to provide for an obligation on the part of LSBS to pay 11.6% interest, and to recover the sum claimed on that footing.
- (3) Allen & Overy were not negligent in any of the respects pleaded, nor in the various respects alleged though not pleaded, and are not liable in the third party proceedings.

The facts

I will first set out the facts in such detail as seems to me necessary for the purposes both of the main action and of the third party proceedings.

In 1988 LSBS was a medium sized building society, about the 21st largest of the building societies, and wished to grow. Consistently with the prudential supervision operated by the Building Societies Commission (BSC) under the Building Societies Act 1986, it could only do so if it had adequate capital. Historically the capital of a building society had only been its reserves. However in 1988 an additional form of capital was authorised by statutory instrument, namely subordinated debt. This first became possible in February 1988 as a result of the Building Societies (Designated Capital Resources) Order 1988, but this was replaced (for reasons which are not here relevant) by the Building Societies (Supplementary Capital) Order 1988 with effect from 18th May 1988. At the same time the BSC issued one of its series of Prudential Notes, 1988/1, about Subordinated Debt.

LSBS was not one of the first societies to take advantage of this new freedom. Some of the largest societies were earlier borrowers by way of subordinated debt. However by July 1988 LSBS had identified a need to increase its capital base, and wished to

explore the availability of subordinated debt in the market. Mr. Ken Clark, LSBS' Treasurer, accordingly spoke to at least two brokers in the City with a view to seeing what might be available and on what terms. The brokers eventually came up with four possibilities, though one did not proceed. This seems to have been the very first to be proposed, a loan from the Bank of Ireland.

LSBS realised that the documentation of such a transaction would not be straightforward, and knew that it would need to produce to the BSC an opinion from external lawyers advising that the transaction fell within the terms of the legislation, if it was to qualify as capital. Mr. Clark therefore instructed Allen & Overy (A&O) to advise on this first transaction. Mr. Morley, a partner in the banking department of A&O, had already acted for LSBS on another quite different transaction, and it was no doubt for this reason that Mr. Clark asked Mr. Morley to act on this proposal. He saw that there might be a tax problem, because of the status of the lender, and consulted one of his tax partners, Mr. Mears, who confirmed that there was a problem, and what it was. This seems to have been the cause of the transaction not proceeding. It had been proposed and abandoned by early October 1988.

The next offer emanating from a broker also involved a foreign bank, referred to by the parties as the First Austrian Bank, and in fact called Die Erste Osterreichische Spar-Casse-Bank. Mr. Clark again instructed Mr. Morley who again referred to Mr. Mears. In this case, however, the bank also instructed solicitors, Lovell White Durrant, and did not give up in the face of the tax issue. Eventually, indeed, this issue was resolved, and the loan proceeded in late December 1988. However it was recognised that, unless this point was sorted out, the matter could not proceed, and accordingly no detailed work was done on the documentation until a solution had been achieved, nor was any money lent in advance of the formal agreement being executed. For this reason, although this was the first of the three effective transactions to be introduced, it was the last to go through.

At the end of October LSBS received and accepted an offer through a broker called City Deposit Brokers of a subordinated loan of £5 million from Harlow District Council for 10 years at LIBOR plus 9/16%. This was confirmed by the brokers in a letter of 31st October and drawn down on 2nd November. Mr. Clark spoke to Mr. Morley again, probably on 31st October, to instruct A&O to handle the documentation and the necessary advice. Mr. Morley took the view that he should not himself handle this transaction, because of pressure of other commitments (though he did continue to deal with the First Austrian Bank transaction through to the end) and therefore handed the file to his partner Mr. Monk, in the international capital markets department, who already had experience of subordinated debt transactions for building societies. He in turn delegated the work, under his supervision, to one of his assistants, Mr. Dan Lauder. The documents in evidence include a manuscript note made by Mr. Monk of his conversation with Mr. Morley about the matter (Bundle 4/4), as well as a note by Mr. Monk's other assistant of the time, Jonathan Mellor (who did not in the end work on the case) of some of the principal features of the transaction (Bundle 4/5), and a short note by Mr. Lauder (Bundle 4/3) of a few of the features. Mr. Monk's note includes the phrase "deduct at source", and Mr. Mellor's note also includes the germ of a formula intended to make sure that LSBS would not have to pay more than the agreed rate of LIBOR plus 9/16, taking into account its

obligations to the Inland Revenue.

Mr. Lauder spoke direct to Mr. Clark at LSBS about the Harlow transaction. Mr. Clark told him when they first spoke that he did not want to be troubled with legal technicalities, and expected the firm just to get the job done. This did not of course affect the scope of the firm's duties to their client but it did affect, perhaps materially, their approach to reporting. Mr. Clark had said much the same to Mr. Morley when instructing him on the earlier transactions, although in the case of the First Austrian proposal, A&O did in fact report to him from time to time, as the discussions with the bank's solicitors proceeded. Mr. Clark confirmed the details of the transaction to Mr. Lauder, in particular the LIBOR plus margin rate, and gave Mr. Lauder to understand that this was to be the total cost of the transaction to LSBS, though he said nothing about tax and did not ask for any specific advice, other than the opinion letter which would be needed to be produced to the BSC, as distinct from the drafting of the necessary agreement.

Mr. Morley, with his banking department background, seems to have had a less clear appreciation of the special tax regime applying to payments of interest by building societies than Mr. Monk did, the latter having undertaken a number of capital market transactions for building societies and having therefore become aware of the position. It may be that, since all bank loans to building societies were dealt with differently, Mr. Morley had no occasion to be aware of the rules about the so-called composite rate tax (CRT) regime. Thus, whereas Mr. Morley seems to have used the phrase "deduct at source" in handing the Harlow transaction over to Mr. Monk, the latter understood as soon as he thought about it that this was likely to be a case not of deducting tax at the basic rate and accounting for it to the Revenue but of accounting to the Revenue, under the CRT regime, for a sum at the so-called reduced rate by reference to the interest paid to the lender (known as "sideways accounting"), which would not be a deduction of tax out of something payable to the lender and would not be recoverable by the lender from the Revenue as deducted tax. I will deal with this difference in more detail later but it is this that made the transaction unfavourable for one party or the other: if LSBS had to pay over interest to Crawley at 11.6%, it would also have to account to the Revenue for an additional amount calculated by reference to that payment, so that the total cost to LSBS would be significantly in excess of 11.6%; if on the other hand the aggregate of LSBS' payments in respect of the loan amounted to 11.6%, this would have given about 8.9% to Crawley, and the balance to the Revenue, but in circumstances in which Crawley, though being exempt from income tax as a local authority, could not reclaim from the Revenue the amount so deducted, so that its return on the loan would be that much less than 11.6%.

Mr. Morley had suggested that Mr. Monk should refer to Mr. Mears on the Harlow deal, because of his prior involvement with the client's other transactions, and Mr. Monk followed this suggestion. He appreciated the tax position, but was not an expert, and wished to check it in any event. By the time Mr. Mellor was making notes of the principal features of the Harlow transaction, he had already got to the stage of recording the interest provision as "pay such rate as after satisfying IR would equal LIBOR + 9/16", and his page of notes also includes the note "careful rev[iew] re w/h [i.e. withholding] tax".

Mr. Monk provided Mr. Lauder, by way of a precedent, with a document he had

prepared for use for a subordinated debt issue for the Abbey National Building Society (as it then was), but interest on this had been paid gross because it was a listed bond, so it was necessary to start from scratch on the interest rate provision for the Harlow loan. Mr. Monk therefore prepared some working drafting for the interest rate provision, which he saw as unusual because of the application of CRT. He may have done this in co-operation with Mr. Mears; if not he obtained his comments afterwards. Both Mr. Monk's and Mr. Lauder's drafting notes are in the bundle, at 4/6-7 and 4/9-10 respectively. The discussion between Mr. Monk and Mr. Mears, at which Mr. Lauder was also present, produced a formula which was used in the first draft for Harlow, and was only slightly varied thereafter, due to further thoughts by Mr. Mears. Their discussion led them to wonder why Harlow was prepared to agree to the transaction, since they realised that LSBS would have (on their formula) to pay Harlow less than LIBOR + 9/16%, in order to account sideways to the Revenue at the reduced rate and end up paying out overall no more than the agreed rate of interest, whereas Harlow, though a non-taxpayer, would not get a refund of the amount accounted for to the Revenue.

Both men were puzzled by this, but were satisfied that their drafting accorded with their client's instructions and best interests. Mr. Mears would have liked to speak (with Mr. Clark's permission) to Harlow or its advisers, first to see whether there was some way of which he was unaware in which they expected to be able to get the full benefit of the agreed rate of interest, and secondly, if not, to be sure that there was no misunderstanding. Mr. Monk, however, was the partner in charge of the file and of direct dealings with the client, and did not agree that it was for them to alert Harlow to any commercial deficiencies of the transaction from its point of view. He was convinced that Mr. Clark must realise that it was a CRT case, since he was the Treasurer of a medium-sized building society, and felt, partly because of what he called Mr. Clark's robust attitude (as reported to him by Mr. Morley and Mr. Lauder), that the latter would not take kindly to having this pointed out to him, still less to a suggestion that, if LSBS had an advantageous deal, the nature of the disadvantage for the other side should be pointed out to them.

In fact, this was a misjudgment of Mr. Clark. First, for reasons which are wholly unclear, he believed, wrongly, that CRT did not apply to such a transaction as this and that it only applied to retail funds, i.e. those raised by way of deposits or shares from individuals. Secondly, he said in evidence, and I accept, that he would have wished to have known that the transaction was bound to work to the significant disadvantage of the counterparty, if only to avoid future problems such as this litigation. He said that such a transaction might have had adverse consequences for LSBS in the marketplace, but that was a small risk and not one which in my judgment was material.

Nevertheless, Mr. Monk decided that it was not appropriate to raise the question with Mr. Clark, and so it was not done. Mr. Monk felt that, if there was a misunderstanding on the Harlow transaction, it would become apparent when the draft agreement was examined by or on behalf of Harlow, though he did not seek to go out of his way to point it out. He did, for example, include a fairly standard gross-up clause, clause 5(2), even though this would not apply, in his view, to the amount accounted for to the Revenue under the CRT system. The draft agreement was therefore prepared and sent to Mr. Clark by Mr. Lauder on 8th November. Later the same day he sent a revised version of the definition in clause 4(3), following further thoughts by Mr.

Mears on the point. I do not know what scrutiny was given to the document by Harlow, but it was found acceptable and executed on 10th November.

On or shortly before the same day, other brokers, Sterling Brokers Ltd., offered LSBS another subordinated loan of £5 million, this time from Crawley, at 11.6% fixed for 5 years and thereafter at LIBOR plus 2% for the following 5 years, but with a borrower's prepayment option at 5 years. Mr. Clark's note of the transaction as put to him by the broker is in the bundle at 4/14; Mr. Cornwell's internal note, for Crawley, is at 4/72A, which specifically states that interest would be paid net of standard (i.e. basic) rate income tax. This offer was accepted, and was confirmed by the Term Sheet on 10th November (which refers to "interest payable net") and the loan was drawn down on 15th November. On 10th November, Mr. Clark spoke to Mr. Lauder to instruct A&O to deal with the transaction as had also been done for the Harlow loan. Mr. Lauder's note of the instructions is in evidence (Bundle 4/11). Mr. Lauder worked under Mr. Monk's supervision in this transaction as he had also in relation to the Harlow loan. Apart from the different interest provisions and the prepayment option, this transaction was essentially the same as the Harlow loan, so that A&O took the view that it could be documented by essentially the same form of agreement.

By 15th November Mr. Lauder had adapted the Harlow agreement to fit the Crawley transaction, both in respect of the interest rate formula and by inserting a prepayment option for the borrower, and he then sent it to Mr. Clark (drawing attention to these two changes) and direct to Mr. Cornwell of Crawley at Mr. Clark's request. Mr. Cornwell is and was Treasury Services Manager for Crawley, and was responsible within the Council's organisation for this transaction.

Mr. Clark read the draft and understood it to provide for interest at 11.6%: see Day 2, page 158, lines 23-26. Mr. Cornwell looked at the draft and noted certain points on it. His copy is in evidence, at 4/131 and following pages. He ticked certain clauses, including all the definitions in clause 4(3), and noted "see 5(2)" against the formula in clause 4(3)(i). Although Mr. Cornwell read and checked the draft he thought that it fitted with his understanding that tax would be deducted at the basic rate and accounted for to the Revenue, from whom he would recover it in due course. Like Mr. Clark, he thought that the draft was to the same effect as the prior agreement, in providing for interest at 11.6%.

From the outset Mr. Cornwell had been cautious in relation to the proposal, as it would be the first time his Council had undertaken a transaction of this kind. He knew about CRT and that there could be no recovery of tax by the Council under that regime. He therefore wished to be reassured that it was a case of deduction of tax at source. He said that he asked the brokers to check with the counterparty that this was the case, and said that he got such an assurance, together with details of a contact in the Revenue at Somerset House with whom to check. Mr. Clark certainly did believe that it was a deduction of tax case, not a CRT case, and it seems to me likely (and I hold) that Mr. Cornwell's request was passed to him through the brokers, and that he did say that he understood it to be a deduction of tax case, but also said that the lender should check up for itself. I think it unlikely that Mr. Clark volunteered the Somerset House contact, which came instead from the brokers. Mr. Cornwell did in fact pursue this contact, though he cannot now remember the name of the person. The result of the enquiry, however, was seriously misleading, because it led Mr. Cornwell to an

Inland Revenue Guidance Note which applied to interest paid by local authorities on loans made to them, not to interest paid to them on loans made by them to building societies. He seems to have been referred to a particular passage in the document so that he did not have occasion to realise, from the wider context, how inappropriate this answer was. Whether this was due to his asking the wrong question, or not making himself plain, or for some other reason, I cannot tell. But the result was that he thought he had (albeit not in writing specific to the transaction) independent confirmation of what he had been told was the counterparty's belief. He did also check with his local Revenue office, but that was only on the speed of the tax refund, not the basic question of the tax regime applicable. He also checked with another local authority Treasurer, whose name was given to him by the brokers, who had entered into a similar transaction with a building society and was satisfied with it as regards recovery of tax. All this was done before he committed the Council to the transaction. His belief, derived in this way, about deduction of tax at source, seemed to be confirmed by what he read in the draft agreement. Thus, despite Mr. Monk's expectations, the drafting of the agreement did not lead the counterparty in this case, any more than on the Harlow loan, to query the provisions as regards the interaction between interest and tax.

Thus while A&O, through Mr. Monk, Mr. Mears and Mr. Lauder (on the Harlow and Crawley transactions) realised the correct tax position, and prepared their documents accordingly, both Mr. Clark and Mr. Cornwell, and thus LSBS and Crawley, continued in their shared misapprehension.

In the Loan Agreement, the formula used to express the interest obligation is set out in clause 4. Clause 4(1) provides that "interest shall be payable by the Society on the Loan in accordance with this clause" and clause 4(2) then provides for interest periods of 6 months each. Clause 4(3) contains two formulae, one for each of the 5 year periods. I need only consider the first, which is as follows:

"the amount of interest payable by the Society to the Lender in respect of each Interest Period [in the first 5 years] shall be calculated by the Society as follows:

$$A + T = 11.60 \times I \times L / 365$$

where

'A' = the amount of interest payable to the Lender by the Society in respect of such Interest Period;

'T' = the amount for which the Society is required to account to any taxing authority in the United Kingdom in respect of the payment of and calculated by reference to A;

'I' = the number of days in the Interest Period concerned;

'L' = the amount of the Loan for the time being outstanding."

It is common ground that this is to be read as if there were a percentage sign after the

11.60 figure.

I shall also have occasion to consider the effect of another clause in the agreement, clause 5(2), the gross-up provision, which is relied on by Crawley, and I set the material part of that out here for convenience.

"All payments to be made by the Society hereunder shall be made without set-off or counterclaim and free and clear of and without deduction for or on account of any present or future UK Taxes unless the Society is compelled by law to make payment subject to any such UK Tax. Should any such payment be subject to any UK Tax, the Society shall pay to the Lender such additional amounts as may be necessary to ensure that the Lender receives an amount free of all liability for UK Taxes equal to the full amount which it would have received had payment not been made subject to such UK Tax."

The Crawley agreement was agreed without material alteration, and was executed on 30th November. A&O delivered their opinion letter and the BSC agreed that the loan could be treated as Tier 2 capital. Eventually, the issue affecting the First Austrian Bank transaction was also cleared up, and it too proceeded but in that case on the footing that interest would be paid gross, it being a bank loan. The interest formula used was, however, essentially the same as for Harlow and Crawley, with the practical difference that no sum would be required to be paid to the Revenue, so that "T" would be nil and "A" would be the full agreed interest rate. On 22nd December, when the First Austrian Bank loan was finalised, A&O submitted their account to LSBS for the three subordinated debt transactions (and the abortive work on the fourth proposal) which LSBS duly paid. The recital of the work done in relation to each of the three effective transactions included "advising on the tax implications".

On the first three interest payment days under the Crawley loan, matters proceeded as both Mr. Clark and Mr. Cornwell had expected. LSBS sent to Crawley a remittance for 75% of the interest for 6 months at 11.6% on £5 million, and a certificate of deduction of tax for the balance of 25%, then the basic rate of income tax. Crawley then obtained a refund of the tax from its local Revenue office. However in November 1990 the Revenue woke up to the fact that this was not the correct treatment. In November 1990 LSBS again paid Crawley 75% and provided a tax deduction certificate, but this time the Revenue refused to refund the tax, and in due course obtained the repayment from Crawley of the tax which it had refunded on the previous three payments. Crawley then claimed payment of the 25% from LSBS. The latter made a payment to Crawley but this was only enough to bring the amount withheld down from 25%, the basic rate of tax, to the reduced rate relevant for CRT (21.75% and 22% in the relevant years), for which, on this basis, the building society would have to account to the Revenue. This was therefore the result, as LSBS saw it, of the application in this new situation of the formula in clause 4(3)(i). The difference, for which LSBS eventually accounted to the Revenue, is £253,749.99. Of course, if LSBS should have paid Crawley 11.6%, its sideways accounting obligation will involve a correspondingly higher figure.

As from 5th April 1991 the tax regime changed, and after that LSBS was able to pay the 11.6% to Crawley gross, so no issue arises except as regards the first four interest payments. I understand that the borrower's prepayment option was exercised at the

end of the first five years of the loan, following the merger with Bradford & Bingley Building Society.

The tax regime applicable to building societies

The tax treatment of interest paid by building societies at this time was specific to them. Ordinarily, under sections 349 and 350 of the Income and Corporation Taxes Act 1988 (ICTA) the payer of interest was obliged to deduct out of the interest a sum representing income tax on it at the basic rate for the current year, and to account to the Revenue for that amount, so that the recipient of the interest was thereby discharged of any liability to pay basic rate tax on it but could also claim a refund if it was not liable to pay tax. However if the payer was a building society, sections 476 and 477 of ICTA, and the Income Tax (Building Societies) Regulations 1986, applied instead. The result of this regime was that in certain cases a building society paid interest gross, for example on bank loans and in respect of qualifying certificates of deposit or qualifying time deposits or quoted Eurobonds, or to non-residents, but that in all other cases a building society paid interest to the lender and separately accounted to the Revenue for an amount calculated by reference to, but not deducted out of, the interest. The obligation to account is set out in regulation 3 and refers to so-called reduced rate and basic rate amounts. Regulation 4 prescribes the cases where the reduced rate amount applies, which include investments (other than marketable securities) owned beneficially by individuals, by personal representatives where the deceased had been the beneficial owner, by trustees holding on trusts only for individuals, and by persons (with certain exceptions including companies) entitled to exemption from income tax under Schedule D: see reg. 4(2)(a) to (d). Investments owned by local authorities are within reg. 4(2)(d). Regulation 5 deals with the basic rate amount and applies, among other things, to interest on investments owned by companies. Regulation 6 sets out the cases of gross payment. By virtue of section 476(5), no deduction is to be made for income tax from interest paid by a building society, and no repayment of income tax is to be made to the person receiving the interest, though section 476(3)(b) makes an exception to the latter rule in the case of companies. Leaving aside this exception, and the cases of gross payment, therefore, building society interest was paid at a rate from which tax was not deducted, although the recipient was not assessable to basic rate income tax in respect of the income so received. Correspondingly a non-taxpayer could not obtain repayment of income tax, because none had been deducted. This was known as the composite rate tax regime, and the process of accounting to the Revenue was sometimes described as sideways accounting. It was different in principle from the system applicable under section 349, which might properly be called a withholding tax system, or deduction of tax at source. Because of the irrecoverability of tax, an advertising code had been agreed, under which building society investment interest rates were only quoted as gross if the interest was to be paid gross (and was therefore subject to tax in the hands of the recipient, depending on the latter's circumstances). Ordinary investment rates were quoted as "net", meaning the rate payable to the lender, basic rate tax being deemed to have been paid but not being recoverable, though a "Gross equivalent" rate might also be quoted, showing the net rate grossed up to take account of the discharge of liability to income tax at the basic rate.

Construction

I will consider first the arguments as to the true interpretation of the agreement as it stands.

For the Defendant, Mr. Peacock (supported in this by Mr. Simmonds for A&O) submits that the formula and the definitions in clause 4(3) are perfectly clear and that it is only the item "A" which is interest payable to Crawley: that is "the amount of interest payable to the Lender by the Society", and it is the only amount which is identified as interest. You have to know the amount (if any) of item "T" before you can work out the interest payable, but this does not mean that tax ("T") is deducted from an overall amount of interest. It seems to me that this is correct and unanswerable. Mr. Goldberg for Crawley says that it would be clearer if the element "T" were on the other side of the equation as a subtracted item, but I cannot see that the effect of the equation is altered by a neutral feature of presentation such as that.

Mr. Goldberg prayed in aid various matters as part of the matrix of fact relevant to the construction of the contract. There was a good deal of divergence between all three Counsel as to what was or was not permissible to be taken into account as part of the matrix. If it were necessary to rule on that, I would favour the narrowest submission of the three, put forward by Mr. Simmonds; both Mr. Peacock and Mr. Goldberg seemed to me to rely on matters altogether outside the scope of what Lord Wilberforce indicated as acceptable in *Prenn v. Simmonds* [1971] 1 WLR 1381. It is not necessary to rule on this because it seems to me that the wording of clause 4(3) is entirely clear and unambiguous, in relation to what is now agreed to be the correct position, namely that CRT applied. I can see how a non-lawyer not familiar with the peculiarities of the CRT regime would not necessarily appreciate that it was drafted to give effect to that system of taxation. But on no basis does it seem to me to be possible to read the clause as obliging LSBS to pay A + T to Crawley by way of interest, rather than A alone.

Mr. Goldberg placed more emphasis on clause 5(2). He says that a payment of A is a payment made "subject to any UK Tax", so that the second sentence of the clause applies and, he says, obliges LSBS to bring the payment up to the amount which it would have been had it not been subject to such UK Tax. He says that the sideways accounting obligation is a UK Tax within the meaning in clause 1(1)(xv) and (xvi). I cannot accept that argument either. In the second sentence of clause 5(2), the phrase "subject to any UK Tax" is a reference back to the previous sentence. That sentence, however, does not apply, because the payment to be made "hereunder", i.e. to the Lender under the Agreement, is only of item "A", and that payment has indeed been made without set-off or counterclaim and free and clear of and without deduction for or on account of any UK Tax. The fact that, in order to work out what A is, you have to ascertain what if any amount has to be paid to the Revenue by reference to A does not mean that A, which is all that Crawley is entitled to, is paid subject to deduction for tax or otherwise than free and clear of tax.

Thus, Crawley cannot succeed on the terms of the Loan Agreement itself.

Rectification

In that event, Crawley claims that the Loan Agreement fails to give effect to the true accord between the parties and must be rectified to do so, and that if it is so rectified, the full amount of 11.6% was payable by LSBS to Crawley and therefore the outstanding balance of £253,000 odd is still due. Mr. Goldberg's formulation of the rectification is to substitute a different formula in clause 4(3) by deleting, in each subparagraph, the sum "A + T =", as well as the definitions of A and T, and by deleting clauses 5(2) and (consequently) 5(3), and substituting for clause 5(2) words such as "All payments to be made by the Society hereunder shall be made subject to deduction of tax (if appropriate) as required by the Income and Corporation Taxes Act 1988".

Mr. Goldberg submits that the case as regards rectification is simple. The parties agreed a transaction under which LSBS would pay, and Crawley would receive, 11.6% interest, for the first 5 years. True, they did not realise the correct fiscal consequences of that agreement, namely that LSBS would have to account to the Revenue for an additional sum, and they thought that tax would be dealt with differently (and neutrally). But that was no part of the agreed terms: the relevant agreed term is 11.6% interest and, on the basis of what I have said above, the Loan Agreement does not give effect to that accord. There is no evidence that the parties changed their agreement and there is indeed evidence that they executed the Loan Agreement believing that it did give effect to the accord as to the interest rate. Of course, the parties knew what it was that they were signing, but they did not appreciate its true legal effect. It ought therefore to be rectified so that it does fit with and give effect to the prior agreement: see *Joscelyne v. Nissen* [1970] 2 QB 86, the case being indeed even stronger than that because here there was a prior concluded contract to which the Loan Agreement failed, by mistake, to give effect.

It is not in dispute that, if parties know what are the terms of the document they have executed, but are mistaken as to its legal effect, this can be a basis for rectification if the true effect is not the same as what they have previously agreed: see *Jervis v. Howle and Talke Colliery Co Ltd.* [1937] Ch. 67, where, appropriately enough by way of analogy, an agreement that a mineral royalty should be received free of tax, which had been put into the lease in those terms, and was therefore ineffective, was rectified so as to require the tenant to pay such sum as, after deduction of income tax at the relevant rate, left the agreed sum. This was approved by the Court of Appeal in *Whiteside v. Whiteside* [1950] Ch. 65 and applied in *Re Butlin's Settlement* [1976] Ch. 251.

The critical question is what is to be regarded as having been agreed between the parties. Mr. Peacock accepts that an interest rate of 11.6% was agreed but says that from LSBS' point of view it was their intention that that should be the total cost of the borrowing, and that to rectify the Loan Agreement in such a way as to add to the Society's cost of borrowing because of CRT would be to produce a result which does not correspond with the parties' intention. Mr. Goldberg's answer to that, which in my view is correct, is that although each party made various assumptions about the commercial and economic effect of the transaction, including the incorrect assumption as to tax treatment, which led to an assumption by LSBS as to the total

cost of the borrowing for it, none of these assumptions were terms of the agreement which had been reached between the parties. The only relevant matter on which the parties, through the brokers, agreed was as to the interest rate payable.

I therefore regard it as a case in which it is clearly established that there was a common prior accord and intention - reflected in the oral agreement reached on 10th November and recorded in the Term Sheet - that the loan would be made on terms that the Society would pay interest to Crawley at 11.6% for the first 5 years. The Loan Agreement does not give effect to that. The parties thought that it did, and it is therefore by mistake that it does not, because, even though they each knew exactly what was in the document in the relevant respect, they did not understand its effect. Accordingly Crawley is entitled to have the Loan Agreement rectified, in the respects set out above, and on that basis I will order payment by LSBS to Crawley of the sum retained of £253,794.99.

The third party proceedings

That being so, LSBS claims against A&O in its third party proceedings, but only for its costs of the litigation and its liability for costs to the Plaintiff. I will now deal with that claim, but I should first summarise how the third party claim is put generally.

In the Third Party Notice, as amended, LSBS alleges that, if the Loan Agreement were found to have the effect contended for by Crawley, it would have been as a result of negligent drafting by A&O. Alternatively it is said that if Crawley is entitled to rectification so as to be entitled to recover the sums claimed under clause 5(2), then that would be the result of negligent drafting by A&O. Thirdly, whatever the outcome of the action, it is said that the drafting was negligent and opened the way to litigation, even though unsuccessful, so that the unrecovered costs of the main action could be claimed by way of damages against A&O. Lastly, it is said that A&O negligently failed to advise LSBS as to the tax consequences of the transaction. LSBS' loss resulting from these alleged acts of negligence is put as follows: if Crawley won on construction, the sum of £253,000 odd recoverable by Crawley; if Crawley won on rectification, the Defendant's costs incurred in the action, which in submissions Mr. Peacock made clear is also intended to include those it may be ordered to pay to the Plaintiff; if Crawley lost, the costs (so far as not recovered from Crawley) of the main action. No loss is pleaded as resulting from negligent failure to advise as such.

On the basis on which I have dealt with the main action, A&O's drafting was competent and accurate. Even if it had not been correct in the result, it was in any event the result of careful consideration and thought. It put into effect the instructions conveyed by Mr. Clark to Mr. Lauder, namely that the total cost to LSBS should be the agreed interest rate. I would therefore not have been prepared to accede to any claim for damages on the basis of negligent drafting.

As the matter was developed before me, however, Mr. Peacock put the case rather differently. He fastened on the fact, which I have mentioned, that Mr. Monk, the responsible partner, realised that there was an oddity about the transaction, and deliberately decided not to raise it with Mr. Clark, making the assumption that Mr. Clark knew that it was a transaction to which CRT applied. He submitted that a

solicitor is not entitled to make an assumption as to so fundamental a matter, especially having identified that there is something odd about the deal - even if what is odd is not of direct disadvantage to the solicitor's own client.

Mr. Simmonds' first answer to such a case is that it has not been pleaded, even by way of amendment in the face of Mr. Simmonds taking this point in his skeleton argument before trial, and that it is therefore not open to LSBS to abandon its pleaded case in favour of this different approach. Incidentally he also points out that the negligent advice which is alleged is put as a breach of A&O's retainer in relation to the Crawley transaction, whereas in truth, if the duty arose, the advice should have been given in relation to the Harlow transaction, before the Crawley transaction arose, and the consequences would have been different for the Crawley transaction - in all probability it would not have occurred at all. It seems to me that Mr. Simmonds is entitled to take these positions on the pleadings, and that would be sufficient to lead to a finding against the Defendant.

But I will go further and express my view on the substance of the allegation as it stands, since it seems to me inappropriate, where the evidence has been heard, to rest solely on what might be thought to be a technical point where an allegation of professional negligence is made against a firm of solicitors, in circumstances in which I am satisfied that they were not negligent.

It is common ground that Mr. Clark did not ask A&O to advise on tax matters in relation to any of the four transactions on which they were instructed. Mr. Peacock suggested that the reference "deduct at source" in Mr. Monk's note of his conversation with Mr. Morley may show that Mr. Clark had used this phrase to Mr. Morley. I do not accept that. Mr. Clark's evidence does not support it. I hold that he said nothing about tax when instructing anyone at A&O on any of these transactions. It is also common ground that they had to consider the tax aspect of the transactions, and that they duly did so. A&O accepts that, if an unfamiliar point arose, or one which would affect the interests of LSBS, it was necessary for them to advise their client, as they did in relation to the First Austrian Bank loan. However, Mr. Monk's attitude was that the application of the CRT regime was so fundamental to building society operations that Mr. Clark, as the treasurer of a medium sized building society, must have been aware that it applied, and therefore was not in need of advice on the point. In my judgment he was entitled to take that view. In itself the application of CRT to the interest payable by LSBS was not strange - indeed the application of any other tax regime would have been exceptional. Mr. Clark himself was quite unable to account for his misapprehension: see Day 2, page 149, lines 16-22.

Mr. Peacock relied on evidence from the A&O witnesses that the tax position on this transaction was unusual, as explaining why the commercial lawyers were expected to and did check the position with the tax department. That is a misreading of the evidence. The tax position relating to this building society transaction was not in any way unusual for those, such as Mr. Clark, who were accustomed to building society transactions. However the tax treatment of building society transactions generally was unusual for those more accustomed to dealing with companies. Mr. Monk knew about CRT because he had dealt with several building society transactions, but even he did not know chapter and verse; Mr. Lauder and Mr. Morley, and perhaps Mr. Mellor, had a much less clear knowledge of the position, but they all knew they had to check.

It was therefore eminently sensible for the solicitors to ensure that the commercial departments should check with the tax department as a matter of routine in a case involving a building society. Indeed they could not have drafted a formula or form of words for the Loan Agreement without checking precisely what the tax regime was and how it applied.

I should also mention that the A&O witnesses were cross-examined about the references in the firm's bill to "advising on the tax implications" of the Harlow and Crawley transactions. It is clear that no advice as such was given to Mr. Clark on this aspect of these transactions. The reference should have been to "considering the tax implications" for the purpose of drafting the Loan Agreements correctly. Nothing turns on that minor misdescription.

What was strange was therefore not the tax treatment but why Harlow or Crawley should have agreed to the transaction. Mr. Mears did want to raise the issue with Harlow, and therefore first with Mr. Clark. With hindsight Mr. Mears wished that they had decided to do so, since it would have revealed Mr. Clark's inexplicable misapprehension. Although the Harlow loan had been made, that could probably have been unravelled, or it would have proceeded on a different basis, but not one allowing it to count as subordinated debt; in that case the brokers' confirmation of the deal provided for a fall-back position to 6 month time deposits at the same rate of interest, which would have been paid gross. The Crawley transaction would not have happened at all. Whether LSBS would have found another source of subordinated debt before the year-end is a matter of speculation.

None of that happened, however. It seems to me that, although solicitors could (and, as I have said, did) take different views as to whether it was appropriate to raise the point with their client, it cannot be said that no reasonably competent solicitor would have taken the position that Mr. Monk did. Different solicitors differ in their practice as regards reporting to their clients, but I cannot accept that Mr. Monk was under a duty to point out to Mr. Clark that CRT applied to this transaction, given that there was nothing to suggest to A&O that Mr. Clark did not realise that this was the case, and that would be the natural assumption of anyone experienced in building society transactions, such as a building society treasurer must have been. In the end, the highest that Mr. Peacock could put his case was by taking a hypothetical question which I put to Mr. Monk at the end of his evidence as one which he could have put to Mr. Clark, which would in fact have alerted Mr. Clark to the application of CRT by referring to the odd commercial effect of that on Crawley: see Day 4, page 314, lines 7-14. Some solicitors might have put such a question to Mr. Clark, but I cannot hold that it was the duty of A&O to do so, nor that no reasonably competent solicitor would have taken the attitude that Mr. Monk did in the circumstances. Mr. Clark himself said in cross-examination that, if A&O's drafting produced a contract under which the total cost to LSBS was 11.6%, then there was no other advice that they needed to give him: Day 2, page 142, lines 10-24. In re-examination he qualified that somewhat with hindsight but in my view that was an accurate statement of his position and of A&O's duty.

I would therefore have rejected the Defendant's third party claim on the merits even if I had not done so on the basis that the pleaded case has been abandoned and the case as put is not open on the pleadings. It also seems to me difficult to say that the cost

resulting from the Defendant's decision to resist the Plaintiff's rectification action, unsuccessfully and unjustifiedly, amounts to loss caused by anything that A&O did or failed to do, even if, contrary to my view, any negligence on their part had been shown.

Conclusion

Those therefore are the reasons why I find in favour of the Plaintiff in the main action, though only on rectification, and for the Third Party in the third party proceedings.

I will order that the Defendant pay to the Plaintiff the sum of £253,794.99. I will hear submissions as to whether I should order that the Loan Agreement be rectified, and as to interest on the sum ordered to be paid and costs.