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To Mitigate or Not to Mitigate – That is the Question!

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If you suffer loss as a result of negligent advice, do you have a duty to mitigate? If yes, what does that duty look like in practice? How far do you need to go in attempts to reduce the loss you have suffered? This was the subject of a recent decision of the Court of Appeal in *LSREF III Wight Limited –v- Gateley LLP* [2016] All ER (D) 145. The case confirms that mitigation issues are multifaceted questions but that there is a level of reasonableness to be applied. In this article we consider what the decision of the Court of Appeal might mean for real estate investors and their lenders and suggest some practical steps to be taken.

The Facts

The case concerned a development loan facility, provided by a bank which was to be used mainly for the development of a single property, the security for which was a first ranking legal charge over a newly granted 199 year lease of that property in favour of a special purpose vehicle company, the bank's borrower. The transaction completed in September 2007. The defendant solicitors firm, Gateley, had been retained by the bank to provide a report on title. That report, delivered shortly before the loan facility and security was completed, was deficient in that it failed to draw the bank's attention to the existence and serious consequences of a clause in the lease which provided for the lease to be forfeited if the tenant suffered any number of specified insolvency events. The borrower defaulted on the loan and the lenders sought recovery but the effect of the insolvency related forfeiture provision clearly impaired the value of the property significantly to the extent that it was less than the amount owed by the borrower to the bank.

The claimant against Gateley was an assignee of the loan from the original bank, it having taken an assignment of the original bank's rights under the facility agreement, the legal charge and its retainer with Gateley.

The claim against Gateley was for transactional loss allegedly suffered by the claimant (being the amount it was owed by the borrower less the amount it would have recovered had security been over a leasehold interest without the unreported defect).

Gateley on the other hand submitted that while it had been negligent in preparing the report on title, the claimant had failed to mitigate its loss and, on the facts, should have pursued a variation of the lease which had been offered by the freeholder at a cost of £150,000. Doing so would have allowed the claimant to recover the transactional loss as well as the costs of the variation, by increasing the value of the property.

The judge at first instance had found that the claimant had not acted unreasonably in failing to pursue this offer as the obtaining of a variation of the lease was a complicated, risky and uncertain process. He awarded the claimant the transactional loss it suffered based on the diminution in the value of the lease as security for the loan attributable to the existence of the insolvency forfeiture provision which, measured at that time (September 2007), he held to be £240,000.

Gateley appealed to the Court of Appeal. The basis of the appeal was that the judge was wrong to assess the loss at the date of the transaction and should instead have assessed it at the trial date (December 2014). By December 2014 the claimant had failed unreasonably to mitigate its loss by remedying the defect in the marketability of the lease at a cost of £150,000 which, by then, Gateley had offered to lend to the bank.

The Legal Analysis

The first question is did the lender suffer a loss by entering into the transaction based on the negligently prepared report on title? If so, how much of the loss was attributable to the adviser's negligence? The fact that the loss had not been crystallised at the point of the transaction did not mean that the loss could not be identified and quantified at that point, and the judge was correct to note this. However, the Court of Appeal held that the judge made an error in principle in confining the assessment of loss to the transaction date rather than the date of the trial, when the facts could more clearly point to what the real transactional loss might be.

Looking then at the trial date the question also arose as to whether the claimant had unreasonably failed to mitigate its loss.

In this context, it was important to note that the offer from the freeholder to vary the lease to remove the offending forfeiture provision had been there; the cost of £150,000 to secure that variation would increase the value of the underlying lease by two or even threefold that amount; that even without the offer of a loan from Gateley, the funds to do that deal were there and the claimant was a sophisticated investor so negotiating the variation should be considered "ordinary course of business" for it. Therefore it was reasonable to expect the claimants to pursue the variation (which after the first instance trial it in fact did). The loss for which Gateley were liable therefore was the sum of £157,100 (being the cost of securing the variation plus legal costs for that variation and interest).

The Implications

The case points to a number of practical issues relevant to investors in commercial real estate and their lenders:

1. In taking security over long leasehold interests, it is essential, both to an investor and its lenders, to understand the terms of those leases (particularly when the landlord can bring them to an end and the implications of that on the value of the lease); indeed, some terms for certain transactions or properties may be so critical that relying on the report on title only in understanding the lease is an undesirable approach;
2. Here the assignment of rights against the report provider took the form of an assignment of a retainer. Understanding the assignment of rights against the original transactional team is an equally vital part of the due diligence process, particularly for an investor or lender who comes in "after the event";
3. If an investor or a lender decides an adviser is at fault and proposes to take action against it, even where liability for negligent advice is admitted (as was the case here), it is important, at an early stage, to consider what steps can or should be taken to mitigate the loss; and
4. In drafting security documentation, enforcement costs should be widely drawn to include the costs of taking action against third parties and mitigating losses resulting from third-party action.