GOUGH SQUARE CHAMBERS' CONSUMER CREDIT COLUMN: SEPTEMBER 2018

James Ross, Ruth Bala, Thomas Samuels and Lee Finch are all specialist consumer credit counsel at Gough Square Chambers. On a regular basis, they will share their views with Practical Law Financial Services subscribers on topical developments or key issues relating to consumer credit.

In the September 2018 column, Ruth Bala considers validation orders relating to consumer credit agreements in the light of *Plaxedes Chickombe and others v FCA and Clydesdale Fin Services Ltd t/a Barclays Partner Finance [2018] UKUT 0258 (TCC).*

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VALIDATION ORDERS POST-*CHICKOMBE*

Statutory unenforceability

There are various sources of unenforceability of credit agreements in the Financial Services and Markets Act 2000 (FSMA). This column only concerns credit agreements, although it should be noted that the reach of these sections transcends credit agreements.

Firstly, section 26 of FSMA covers agreements made by unauthorised persons, in breach of the general prohibition. This is apt to encompass regulated credit agreements or regulated mortgage contracts entered into by an unauthorised lender who is not exempt.

Secondly, section 26A(1) of FSMA covers agreements made by authorised persons in contravention of a requirement (that is, acting outside the scope of their permission), in the course of carrying on a "credit-related regulated activity". The phrase "credit-related regulated activity" is defined in section 23(1b) of FSMA to mean a regulated activity designated by article 2 of the Financial Services and Markets Act 2000 (Consumer Credit) (Designated Activities) Order 2014 (*SI 2014/334*). This includes entering and administering credit agreements that are not secured on land. Therefore, section 26A is apt to encompass unsecured regulated credit agreements entered into by a lender that is authorised, but lacks permission to enter such agreements (that is, permission to undertake the activity specified by article 60B(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) (*SI 2001/544*)).

Thirdly, section 27 of FSMA covers agreements made through unauthorised persons. This is apt to encompass certain regulated credit agreements or regulated mortgage contracts where the lender is properly authorised, but the broker is unauthorised.

In each of these cases, not only is the credit agreement rendered unenforceable, but the default position is that the borrower is entitled to recover any payments they have already made (*sections 26(2), 26A(2) and 27(2), FSMA*). In this respect, the FSMA sanction is harsher than the various sanctions of unenforceability under the Consumer Credit Act 1974 (CCA), none of which permit the borrower to claw back repayments.

Statutory cure

There are two routes back to enforceability by obtaining what is known as a validation order (V-O). In the context of credit, the appropriate route depends on whether or not the agreement is secured on land. For secured agreements, the creditor must apply to the court, pursuant to section 28 of FSMA. For unsecured agreements, the creditor must apply to the FCA, pursuant to section 28A of FSMA.

In either case, the court or the FCA may permit enforcement "or" retention of sums paid. It is curious that these outcomes are described in the alternative (*sections 28(3) and 28A(3), FSMA*), but in practice it is assumed that they can both be granted.

In reaching its determination, the court or the FCA may only permit enforcement and/or retention of repayments if "it is satisfied that it is just and equitable in the circumstances of the case". The test is the same in either case. Both entities have a residual discretion even once so satisfied (see the word "may").

In applying the "just and equitable" test, one factor is expressly identified as mandatory for the court or the FCA to take into account (Specified Issue).

The Specified Issue

For agreements made unenforceable by section 26 or 26A of FSMA, the Specified Issue is whether the lender reasonably believed that it was not contravening the general prohibition, or acting outside the scope of its permission, by entering into the agreement (*section 28(4)(a) and (5); section 28A(4)(a) and (5), FSMA*).

For agreements made unenforceable by section 27 of FSMA, the Specified Issue is whether the lender knew that the broker was contravening the general prohibition (*section 28(4)(b) and (6); section 28A(4)(b) and (6), FSMA*).

For agreements made unenforceable by section 26 or 26A of FSMA, the Specified Issue is a question of reasonable belief. In the Encyclopaedia of Financial Services Law ed Lomnicka & Powell p2A-116, it states:

> "The test here is part subjective and part objective: the firm must have both (subjectively) believed that it was not contravening ... and have so believed *reasonably*. An honest but unreasonable belief is not enough, so ignorance of the provisions of this Act, for example, would not constitute 'reasonable belief'."

In *Helden v Strathmore Ltd [2011] Bus LR 1592*, the trial judge had found that the creditor had possessed a "reasonable belief" that it was not contravening FSMA, on the grounds that it did not usually enter into mortgages and so was unaware of the FSMA provisions, and its solicitors had failed to alert it to the applicability of FSMA. The Court of Appeal declined (at [52]) to decide the "difficult issue" of whether lack of awareness of FSMA amounted to a "reasonable belief" that one was not contravening it. The Court of Appeal upheld the V-O solely on the basis of the additional factors which were relevant to the "just and equitable" test.

Specific consumer detriment

Factors which might properly be taken into account in deciding whether it is "just and equitable" to permit enforcement and/or retention of sums paid are summarised in *Helden v Strathmore* (at [45]-[46]). One such factor is any "respects in which [the borrower] would have been better placed if [the lender] had been an 'authorised person' for FSMA purposes" (at [45], factor (vii)).

In applying for a V-O, many lenders therefore relied on the absence of any consumer detriment resulting from the regulatory contravention. Lenders sought to demonstrate that the customer experience was not affected by the lack of authorisation, or the insufficient permissions. Such submissions had particular force where the firm was authorised in any event and thus within the FCA's regulatory reach (that is, the unenforceability arose under section 26A or 27 of FSMA).

General consumer detriment

In the recent case of *Plaxedes Chickombe and Others v FCA and Clydesdale Fin Services Ltd t/a Barclays Partner Finance [2018] UKUT 0258 (TCC)*, the Upper Tribunal held (at [58] and [64]) that, in considering whether to grant a V-O, the FCA should take into account "consumer detriment more generally", in addition to specific consumer detriment resulting from the lack of authorisation. Given the materially identical wording of the test under section 28, the decision is also likely to be relied on in V-O applications to the court.

In *Chickombe*, the general consumer detriment encompassed alleged mis-selling of timeshare accommodation that was financed by the relevant credit agreements. Such detriment could not have been caused by the broker's lack of authorisation, since the Upper Tribunal made a finding of fact (see [40] and [54]) that there had been no change in the customer experience following the broker becoming an appointed representative.

This approach is unsatisfactory. In deciding whether to cure a defect, it is appropriate to look at the prejudice caused to consumers by that defect. The extent of that prejudice affects whether it is right to offer a cure (the V-O) and, if so, whether some price for the cure should be exacted (for example, permitting the borrowers to retain some or all of the repayments they have already made). Grant of a V-O is not intended to address all ills arising out of the agreement, but the specific defect of lack of authorisation or adequate permissions.

A useful analogy is with section 127(1) of the CCA (regrettably not considered in *Chickombe*): in deciding whether it is "just" to grant an enforcement order to cure, for example, improper execution, the court must have regard to "prejudice caused to any person *by the contravention in question*" (emphasis added). The court is not invited to have regard to prejudice caused by some other act or omission in relation to the agreement that is quite distinct from the contravention rendering the agreement unenforceable.

If there is prejudice to consumers caused by some other act or omission in relation to the agreement, it will have its own remedy where Parliament has deemed that relief is warranted. If consumers' rights to such remedies are mixed up with the V-O application procedure, the lender will effectively be penalised twice for that act or omission.

If there were acts or omissions by the unauthorised party that would have constituted breaches of the Consumer Credit sourcebook (CONC) or the Mortgages and Home Finance Conduct of Business sourcebook (MCOB) if they had been authorised (only an authorised firm is bound by the FCA Handbook), then the consumer's deprivation of a right of action in damages would be prejudice resulting from the lack of authorisation, and therefore quite properly a relevant factor on the narrow approach.

In the light of *Chickombe*, one can now expect the FCA to seek evidence of all consumer complaints arising out of credit agreements that are the subject of V-O applications, whether or not those complaints bear any relation to the lack of authorisation or adequate permissions.

The Upper Tribunal made no reference to whether the FCA should also have regard to consumer detriment resulting from acts or omissions by a third party (for example, by the lender, where it was the broker which was unauthorised, and vice versa).

One saving is that the Upper Tribunal said that the respective "weight" to be given to general consumer detriment and specific detriment resulting from the lack of authorisation was a matter for the FCA (at [64]). Therefore, while evidence of general consumer detriment is unlikely to be excluded as irrelevant, it remains open to the lender to argue that it should be attributed minimal weight.

For information on the Upper Tribunal decision in *Chickombe*, see *Legal update, FCA directed to reconsider validation order relating to unenforceable regulated credit agreements (Upper Tribunal).*

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For previous consumer credit columns written by barristers at Gough Square Chambers, see *Practice note, Gough Square Chambers' consumer credit columns.*