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ARTICLE

Unjust Enrichment and the Direct Transfer Rule: *Investment Trust Companies v Revenue and Customs Commissioners*

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On 11 April 2017 the Supreme Court handed down judgment in *Investment Trust Companies v Revenue and Customs Commissioners* [2017] UKSC 29 [2017] 2 WLR 1200. This judgment, given by Lord Reed, provides a welcome analysis of the requirement that a defendant must have been unjustly enriched 'at the expense of' a claimant if he is to claim restitution from him.

The basic requirements of a claim in restitution are well established. A claimant must establish that: (1) the defendant has been enriched; (2) at the claimant's expense; and (3) the enrichment was unjust. If these factors can be made out, and the defendant has not been able to rely on any defences, his claim will succeed.[1] Where the claimant directly conferred the benefit on the defendant, the application of this test is, in principle, straightforward.

Complications arise, however, where the claimant has not dealt with the defendant directly. In these circumstances, a question arises as to what it means to say that a defendant's enrichment has been 'at the expense of' the claimant. Recovery in these circumstances was recently allowed by the Supreme Court in *Menelaou v Bank of Cyprus UK Ltd* [2015] UKSC 66.

In that case the defendant bank had lent the appellant's parents money, secured by a charge over their home. They decided to sell and purchase another property, which they wanted to (and in the event did) gift to the appellant (Melissa). The bank agreed to release its charges on their property so that the sale could go through, on the condition (inter alia) that they have a legal charge over the new property. The solicitors confirmed that these conditions would be complied with. A legal charge was drawn up, purportedly signed by the appellant.

The charge had not been signed by Melissa and, so, was not enforceable against her. She was thus better off than she would have been if her parents had complied with the terms of their agreement with the bank. The issue was whether she was required to make restitution to the bank in respect of this gain. The gain was a result of two separate transfers:

– First, from the bank to the appellant's parents. This transfer was defective: the Menelaous subsequently failed to comply with its conditions.
– Second, from Melissa's parents to her. This transfer was not defective. The property was gifted to her, and it was accepted that she had no knowledge of her parents' dealings with their bank.

In these circumstances the Supreme Court found that the bank had been unjustly enriched at her expense.

Commenting on the Supreme Court's judgment in *Menelaou* in an earlier edition of this publication, the present writer noted that the basis upon which the Supreme Court had made this finding was unclear; and lamented the lack of guidance as to what it meant to say that the defendant's enrichment has been '*at the expense of*' a claimant with whom he has had no direct dealing.[2]

Happily, the Supreme Court has since had the opportunity to consider the matter afresh. Lord Reed's judgment in *ITC v Revenue and Customs Commissioners* directly engages with the issue, with a rigour which earlier case law has lacked.

ITC: the facts

Varies investment companies (the 'Managers') had made supplies of investment management services. These supplies were treated as taxable, as a result of the incorrect transposition of an EU VAT directive into UK law Their customers (the 'Companies') paid the amounts charged,

The Managers received these amounts, and in turn accounted to the Commissioners in respect of the same. In carrying out this accounting process, the Managers deducted from the tax chargeable on its supplies (known as 'input tax') the tax which it had itself paid on taxable supplies received for the purposes of its business (known as 'output tax'). It paid to the Commissioners the remaining surplus, if any.

Notes

1 Adopting Lord Clarke's formulation in *Benedetti v Sawiris* [2014] AC 938 at [10].
2 Subrogation based on Unjust Enrichment: *Menelaou v Bank of Cyprus Plc* Int. C.R. 2016, 13(3), 211-214.

Thus, for example, if the Managers made supplies to an ITC, and charged £100 VAT, but had purchased taxable supplies during the relevant period on which the VAT was £25, the Manager would apply the £25 against the £100, and pay the Commissioners the balance (£75).

The Managers' obligation to account for VAT was triggered by the supply of the relevant services, rather than the VAT being charged to, or paid by, the Customer. The Customers' liability was contractual.

The Managers had statutory claims against the Commissioners for repayment of the VAT which they had accounted for, under the Value Added Tax Act 1994. They successfully claimed back the VAT they had accounted for in respect of the amounts paid by them to the Customers, with two exceptions:

- They were unable to claim in respect of accounting periods ending on or after 4 December 1996, which were time-barred under s.80 of the Value Added Tax Act 1994;
- The amounts repaid to the Managers were calculated on the basis that, under s.80(2A), it was necessary to set the amount of input tax which they had deducted against the output tax for which they had accounted. Taking the notional figures set out above, the Managers were entitled to repayment of the £75 which they had actually paid to the Commissioners, but not the £25.

The Managers passed on the amounts they were repaid to the Customers, with the result that they obtained a refund of the amounts they had paid, subject to these two exceptions.

The customers' claims against the commissioners

The Customers brought proceedings against the Commissioners, claiming restitution of the amounts covered by the two sections above – i.e., they claimed:

- the full £100 in respect of payments made during periods which were subject to the statutory time bar; and
- the £25 which they had paid to the Managers, but which the Managers had not paid over the to the Commissioners because of the accounting process referred to above.

The 3 key questions before the Supreme Court were identified by Lord Reed as follows:

- Did the claimants have a common law claim against the Commissions in principle (subject to any statutory exclusion)?
- If so, did s.80 of the 1994 VAT Act bar such a claim?
- If there was no claim, or any such claim was barred, was this result compatible with EU law?

This casenote addresses the first of these questions, which raises the issue outlined above.

Recovery of the £25

It was accepted that the Commissioners were enriched by the notional £75 which they received from the Managers. Both heads of claim required the Court to consider whether they were also enriched by the notional £25. It held that they were not. This conclusion turned on the way in which VAT is accounted for and since the question is unlikely to arise in other cases, it will not be covered here. Suffice to say, the Supreme Court held that any argument that the Commissioners were enriched by moneys which they did not actually receive depending on establishing that the Managers were entitled to factor the VAT received on the relevant supplies into their input and output tax calculations. This was inconsistent with the claim to recover the £75 on the basis that it was not due. If the Commissioners were required to repay the notional £25, they would in fact be £25 worse off.

Recovery of the £75

Of broader interest is the question as to whether the Commissioners' receipt of the £75 enriched them at the expense of the Claimants. The relevant facts were as follows:

The Managers accounted to the Commissioners for their output tax liability in respect of the relevant periods.

When doing so, they took into account the £100 that they had received from the Claimants.

The net result, therefore, was that the Commissioners were better off as a result of the Claimants' payments to the Managers (and the Claimants were, of course worse off).

However, the Claimants had not directly paid anything to the Commissioners.

Moreover, the Managers liability to account for the £100 arose because they had charged the Claimants this amount in respect of the services, not because the Claimants had actually paid it.

Enrichment 'at the expense of' a claimant

When considering whether a defendant has been enriched 'at the expense of' a claimant with whom he has not directly dealt, Lord Clarke, in *Menelaou,* stated that 'the question in each case is whether there is a sufficient causal connection, in the sense of a sufficient nexus or link, between the loss caused and the benefit received by the defendant.' (at [27])

However, this does not tell us what type of nexus or link will be considered sufficient. Lord Reed criticised the 'test' in *Menelaou* as being 'too vague to provide clarity … [it] leaves unanswered the critical question, namely, what connection, nexus, or link is sufficient[to justify such a remedy]?' (at [37])[3]

When considering a claim in unjust enrichment, the Court must determine whether it can justify compelling the defendant to pay his gains over to the claimant. The requirement that the defendant's enrichment be 'at the expense of' the claimant is directed at this question: it is designed to ensure that such disgorgement can be justified.

Further, he noted:

> 'the questions [e.g. whether the enrichment is at the expense of the claimant] are not themselves legal tests, but are signposts towards areas of inquiry involving a number of distinct legal requirements. In particular, the words 'at the expense of' do not express a legal test, and a test cannot be derived by exegesis of those words, as if they were words of a statute.' (at [41])[4]

Lord Reed underlined the necessity for a careful legal analysis of individual cases, by reference to the purpose of the law of unjust enrichment, namely, to correct normatively defective transfers, usually by restoring the parties to their pre-transfer positions (at [42]). To this end, the requirement that the enrichment be 'at the expense of' the claimant is designed to ensure that there is a transfer of value from the claimant to the defendant, with the claimant having suffered a loss, which loss has benefitted the defendant (at [43]).

If the law of restitution is about reversing defective transfers, it is not immediately obvious that the remedy should be allowed in a three party case, especially if only one of the transfers is defective (as in *Menelaou*).

Lord Reed recognised that 'it has often been suggested that there is a general rule, possibly subject to exceptions, that the claimant must have directly provided a benefit to the defendant' if he is to claim that the latter has been unjustly enriched at his expense (at [50]).

He set out the following examples of cases in which a claimant will have a remedy in unjust enrichment, despite not having dealt directly with the defendant:

– Where one or both parties have dealt through an agent. Here, the series of transactions is legally equivalent to a direct transaction between the claimant and defendant. (at [48])
– Where the right to restitution has been assigned, the claimant assignee stands in the shoes of the assignor. He is, therefore, treated as if he had been a party to the relevant transaction, and the transaction is treated as if it were a direct one (at [48]).
– An intervening transaction may be created in order to conceal the connection between the claimant and the defendant. If it is found to be a sham, the arrangements may be treated as 'equivalent to a direct payment' (as in *Relfo Ltd v Varsani (No 2)* [2014] EWCA Civ 360, see that case at [103] and [115]).
– If the property received by the defendant is one into which the claimant can trace an interest, the law will treat the property as if it were the claimant's. Thus 'the defendant is therefore treated as if he had received the claimant's property'. ([48])
– Where a claimant discharges a debt owed by the defendant to a third party, the defendant is directly enriched – not by the payment, but by the discharge of his debt. If the transfer of value is defective, the law reverses it, so far as possible, by subrogating the claimant to the rights formerly held by the third party. ([49])
– There are also cases in which a series of transactions are treated as if they formed a single scheme or transaction, 'on the basis that to consider each individual transaction separately would be unrealistic' ([48])

Taking Lord Reed's 5 categories of case:

– The first three encompass circumstances in which there is in truth a single transfer of value from the claimant to defendant. They are cases which, on analysis, do not fall foul of any general principle that the law of restitution provides a remedy only where the defendant's gain was the direct result of his dealing with the claimant.
– In the fourth, the 'at the expense of' requirement is satisfied by dint of the fact that the claimant's property can be traced directly into the defendant's hands. Lord Reed sees this situation as one which can be reconciled with the 'direct benefit rule' on the basis that the defendant is treated as if he were the recipient of the claimant's property. If the claimant had an interest in the property at the time it was transferred to the defendant, such a transfer is normatively equivalent to a direct transfer from claimant to defendant.

Notes

3 See also F. Wilmot-Smith 'Taxing Questions' (2015) 131 LQR 521, commenting on the Court of Appeal's decision in the ITC case, 'it is a tautology to say the link must be sufficient: the question remains what connection *is* sufficient. Before we can answer that, we need to know what *kind* of connection we seek.'

4 See also F. Wilmot-Smith 'A dream case' (2016) 132 LQR 196, especially comments on *Menelaou* at p. 99.

– In cases where a claimant discharges a defendant's debt owed to a third party creditor, the defendant is directly enriched. Thus, on Lord Reed's analysis, the claimant has directly provided a benefit to the defendant.
– The last, however, is problematic.

Lord Reed acknowledged that, where the defendant has not received a benefit directly from the claimant, and in circumstances falling outwith the first four categories listed above, it is 'generally difficult to maintain that the defendant has been enriched at the claimant's expense.' (at [51]) He clarified that:

– A 'but for' causal connection between the claimant being worse off and the defendant being better off is not sufficient to constitute a transfer of value from one to the other.
– Nor is the 'at the expense of' requirement satisfied by a connection between the benefit and loss that exists merely as a matter of economic or commercial reality. 'Economic reality' is not a criterion that can be applied with any rigour or certainty – especially where there have been chains of suppliers or consumers. As has been recognised in other jurisdictions, it can be extremely difficult to ascertain whether the economic burden of an unjust enrichment has been passed on. Moreover, as Lord Reed highlighted, since unjust enrichment is not concerned with compensation for loss, an approach which seeks to identify the party who ultimately bears a particular loss is not one which accords with the purpose of restitution law (at [60]).

Despite these difficulties, there are cases where the courts have allowed unjust enrichment claims brought by claimants who have not dealt directly with the defendant (whether through agents, or because any intervening transactions were shams), and who cannot trace their property into the defendant's hands.

Lord Reed explains these as cases in which recovery is allowed because the relevant transactions are 'co-ordinated', such that it is 'unrealistic' to consider them individually. They are instead considered to form part of a single scheme or transaction – to which both claimant and defendant are parties.

Unfortunately, he did not provide any guidance as to the circumstances in which the courts will hold that it is 'unrealistic' to treat each individual transaction in a series as separate transactions. This was treated as a separate category of case from those where the intervening transaction is a found to be a sham.

The two examples Lord Reed gave of this category of case were *Banque Financiere de la Cite SA v Parc (Battersea) Ltd* [1991] 1 AC 221, and *Menelaou*.

– *Banque Financiere* is a complicated case, and this case note is not the place to engage in an analysis thereof. Suffice to say, however, that it has been subject to academic criticism – notably by Professor Peter Watts, who described the result as 'problematic'.[5] It is not clear that Lord Reed's 'co-ordinated transactions' test sheds any further light on the analytical basis for the decision in that case.
– Lord Reed's judgment does not help make sense of the result in *Menelaou*. In particular, there was no explanation as to why the transactions in *Menelaou* should be treated differently from those in *ITC*, i.e. why it was 'unrealistic' to treat the transactions in one case as if they were a single transfer, but not in the other.

Without any guidance as to what it means to say that a series of (non-sham) transactions cannot 'realistically' be considered to be separate, the breadth of this exception to a general rule that a claimant must have directly provided a benefit to a defendant if the court is to strip the defendant of his gains is unclear.

This is perhaps unsurprising: Lord Reed thought that it would be 'unwise to attempt in this appeal to arrive at a definitive statement of the circumstances in which the enrichment of a defendant can be said to be at the expense of the claimant' (at [38]) and 'unwise at this stage of the law's development to exclude the possibility of genuine exceptions [to the direct transfer rule], or to rule out other possible approaches.' (at [50])

He was, however, clear that it could not be said that the Commissioners had been enriched at the expense of the Customers. This was based on his rejection of the notion that there had been a transfer of value from the Claimants to the Commissioners.

– There was a transfer of value from the Claimants to the Managers (the notional £100).
– There was a further transfer of value from the Managers to the Commissions (the £75).

Both transfers were defective (the former, because it was made in performance of a contractual obligation which was mistakenly believed to be owed; the latter because it was made in compliance with a statutory obligation which was incompatible with EU law). However, 'These two transfers cannot be collapsed into a single transfer of value.' (at [71])

Given Lord Reed's warning that he was not seeking to lay down a definitive test, this conclusion should perhaps not be understood as requiring a claimant

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5 LQR 1998, 114(Jul) 341-345.

in an indirect transfer case to show that a number of transfers can be 'collapsed' into a single transfer of value from himself to the defendant if he is to recover. Given the lack of clarity as to the circumstances in which transfers can be so collapsed, this is probably good.

The scope of the exception will have to be worked out in later cases. However, Lord Reed's judgment provides valuable guidance to practitioners when considering how to analyse cases involving multiple transfers.

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