Sempra Metals – A simple solution to compound interest

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In a landmark judgment in *Sempra Metals Ltd v Commissioners of Inland Revenue and another* [2007] HL 34 given on 18 July 2007 the House of Lords has found that Sempra Metals Ltd (Sempra) is entitled to claim compound interest from HMRC on payments of advance corporation tax (ACT) which were made by Sempra in respect of dividends paid to its then German parent company. The case follows a string of decisions which have developed the scope for claims against HMRC for monies paid by way of tax pursuant to legislation which it is claimed is unlawful. The judgment is significant to Sempra and to other companies in the same position as Sempra, as well as potentially to all claimants bringing claims in either restitution or damages for loss of use of money, whether against HMRC or any other party.

**Background to the House of Lords’ decision**

The roots of this decision lie in a claim issued on 23 November 1995 by Sempra (at the time known as Metallgesellschaft Ltd). Sempra alleged that ICTA 1988, s 247(4), which permitted a subsidiary to pay dividends to its parent company without accounting for ACT but only if the parent company was resident in the UK, was in breach of the EC Treaty and in particular the principle of freedom of establishment.

In 1998 the claim was referred to the ECJ, together with the claim of Hoechst UK Ltd (Joined Cases C-397/97 *Metallgesellschaft* and Others v Commissioners of Inland Revenue and HM Attorney-General and C-410/98 *Hoechst AG and Hoechst UK Ltd v Commissioners of Inland Revenue and HM Attorney General* [2001] Ch 620). In its judgment, given on 8 March 2001, the ECJ found that s 247(4) was indeed discriminatory and that Sempra was entitled to be granted a remedy by the English courts in the form of interest on the amounts of ACT it had paid. However, the ECJ left a number of matters to be determined by the English courts, including the basis on and rate at which that interest should be calculated.

Following the ECJ’s judgment a significant number of claims were brought in the High Court by companies in a similar position to Sempra. These have, since 2001, been grouped within a Group Litigation Order known as the ACT Group Litigation Order.

On 8 April 2003 Sempra was appointed the test claimant on the question of whether companies bringing claims against HMRC arising from the ECJ decision are entitled to recover compound interest or, as HMRC maintained, the entitlement was only to simple interest on the amounts paid by way of ACT.

Sempra’s case was heard in the High Court by Mr Justice Park and judgment was handed down on 16 June 2004 in favour of Sempra. Mr Justice Park found that Sempra was entitled to compound interest at a conventional rate (as opposed to a rate calculated by reference to Sempra’s own particular commercial circumstances). The Court of Appeal upheld Mr Justice Park’s decision (subject to an amendment to include provision in relation to the rests at which compounding should take place) in its judgment given on 12 April 2005. HMRC then appealed to the House of Lords.

**Other relevant developments**

During the course of Sempra’s claim there has been a further development in English law which expanded the scope of claims against HMRC. In the case of *Deutsche Morgan Grenfell Group plc v HMRC and another* [2006] UKHL 49 the House of Lords found that Deutsche Morgan Grenfell Group plc (DMG) was entitled to reclaim from HMRC payments of ACT which DMG had paid under a mistake of law (the mistake being the belief that the relevant legislation denying DMG and its German parent company the opportunity to enter into a group income election, and thereby avoid the payment of ACT, was lawful), and that the limitation period for DMG’s claim began to run from the point when DMG discovered its mistake (here, the ECJ’s ruling in the *Hoechst/Metallgesellschaft* cases that certain aspects of the relevant tax legislation were unlawful).

The effect of the DMG judgment was that, in addition to a claim in damages for breach of statutory duty and a claim in restitution based on unlawful demand following *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1993] AC 70, Sempra also had a claim in restitution based on a mistake of law. The advantage of this was that, following the decision in DMG, Sempra could pursue claims in respect of ACT payments made as long ago as 1974, which in some cases had remained unutilised for periods of up to ten years.

Sarah Lee and Caroline Edwards report on *Sempra Metals Ltd v Commissioners of Inland Revenue and another*.

This article is not intended to provide legal advice, which should be sought on particular matters. If you would like to discuss the issues raised, please speak to Sarah Lee or your usual contact at Slaughter and May.
The decision in *Sempra*

Following a very detailed examination of previous authorities and of the different remedies claimed by Sempra, the House of Lords found that:

- Sempra is entitled to compound interest from HMRC on the amounts of ACT paid from the date of payment to the date of utilisation or repayment of the ACT in question;
- the applicable rate of interest for Sempra’s restitutionary claim is to be calculated by reference to the rates of interest and other terms applicable to borrowing by the government in the market at the relevant time; and
- the applicable rate of interest for Sempra’s damages claim is to be calculated by reference to commercial borrowing rates and subject to the usual rules regarding recovery of damages in tort.

Their Lordships recognised that the payment of ACT by Sempra was the ‘equivalent of a massive interest-free loan’ and that ‘there can be nothing unjust about requiring the Inland Revenue to pay compound interest ... on the huge interest-free loan constituted by Sempra’s payment of ACT’ (per Lord Nicholls at para 118).

**Wider application**

The case is potentially of wide application. The courts below had found in Sempra’s favour on the basis that the ECJ required the English Court to award Sempra compound interest as its remedy; it was therefore not necessary to consider the position under domestic law. Significantly, however, the House of Lords made its decision based on domestic law. It took the opportunity to conduct a thorough review of 200 years of English authorities on interest and concluded that the English law of interest is deficient in various respects. Historically, interest could only be recovered:

- under statutes expressly permitting interest claims, for example Supreme Court Act 1981, s 35A;
- in equity in specified (but limited) circumstances, for example in cases of fraud or against parties in a fiduciary position in respect of profits improperly made;
- in the exercise of equity’s jurisdiction to come to the aid of rights enforceable at common law; and
- under the common law, only if a claim for interest fell within the second limb in *Hadley v Baxendale* (1854) 9 Ex 341 (constituting special damage within the contemplation of the parties).

Compound interest was available in even more restricted circumstances.

The House of Lords in the *Sempra* judgment has now recognised that this position does not reflect the realities of modern-day life. However, there was a divergence of views between their Lordships as to how, and to what extent, the law on interest should be developed.

**The judgments considered**

Sempra claimed the time value of the money paid prematurely by way of the ACT payments made. How that value is to be measured depends on the nature of the remedy sought. As already identified, Sempra’s claim was advanced in both damages and in restitution.

The leading judgment was given by Lord Hope. Given the significance of Sempra’s claim in restitution based on mistake of law, which allowed Sempra to claim interest in respect of ACT payments made since 1974, the basis upon which interest, and compound interest in particular, could be claimed in restitution was very carefully examined.

Lord Hope found that their Lordships were not bound by the previous authority of *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, which had addressed the question of whether compound interest was available in equity in support of a common law claim in restitution. In *Westdeutsche Landesbank* the question had been answered in the negative. However, the case had proceeded on the assumption that a common law claim for interest in restitution was not available. Accordingly, Lord Hope found that it was open to the House of Lords to consider how restitutionary relief at common law should be assessed in a case such as this.

He considered that the answer lay in the law of unjust enrichment. This was not a claim for damages; the ‘essence of the claim’ was the unjust enrichment gained by HMRC by virtue of the premature payment of corporation tax by Sempra and it was that which should be returned (by a process of ‘subtraction’ from HMRC rather than compensation for Sempra’s loss) to Sempra. However, the measure of that subtraction does not depend on proof of what HMRC actually did with the ACT payments; the enrichment was the opportunity to turn the ACT payments to account and it is that which had to be measured.
That enrichment is to be measured by compound, and not simple, interest since simple interest is an ‘artificial construct which has no relation to the way money is obtained or turned to account in the real world’ and is ‘an imperfect way of measuring the time value of what was received prematurely’ (paragraph 33). By contrast, ‘compound interest is a necessary, and very familiar, fact of commercial life’ and was, in Lord Hope’s view, the appropriate basis of assessment in this case.

As to the appropriate calculation of the enrichment, this was something which should ordinarily be calculated objectively by reference to what a reasonable person would pay for the benefit in question. In this case the parties had agreed that a conventional rate of interest should be adopted and, this being the case, Lord Hope found that the conventional rate should be a rate which is appropriate to the enrichee’s circumstances. Ordinary commercial rates of interest, at ordinary rests, would be appropriate if those rates were relevant to the enrichee’s circumstances but it is open to an enrichee to show that it had been able to borrow money on more favourable terms than those available in the ordinary commercial market. In Sempra’s case, the unusual position of HMRC had been sufficiently demonstrated and it was therefore appropriate to adopt a rate of interest by reference to the rates of interest and the terms applicable to borrowing by the Government in the market during the relevant period.

Lord Hope also considered Sempra’s damages claim and agreed with Lord Nicholls (see below) that the court has jurisdiction to award compound interest as damages (both for breach of contract and in tort) at common law, subject to the claimant pleading and proving his actual interest loss and to the usual rules of recovery of damages, including remoteness.

Lord Nicholls examined the position of interest claims in damages in some detail. He found English law to be wanting in that the common law did not recognise a claim for interest on late payment of a debt; claims for interest by way of damages were only recognised if such damages were pleaded and proved as special damages under the second head in Hadley v Baxendale. However, Sempra’s claim for damages was based on a breach of statutory duty. As such, Lord Nicholls considered that it was not covered by either of these restrictions at common law. Therefore Sempra could claim interest, whether simple or compound, by way of damages, subject to the usual rules for recovery of damages in tort.

Lord Nicholls went further and found that the previously perceived restrictions on the ability to claim interest by way of damages at common law should no longer be observed. He found that it is now open to a claimant to claim interest (whether simple or compound) by way of damages for late payment of a debt, as well as on other claims for breach of contract and tort, subject to the usual rules applicable to damages claims (remoteness, mitigation, etc). The claim to interest does not have to fall within the second limb of Hadley v Baxendale. However, it is still necessary for a claimant to plead and prove interest losses; an unparticularised claim for damages will not suffice and the previous common law position still applies to that extent.

As to Sempra’s claim in restitution, Lord Nicholls, like Lord Hope, found that it was open to their Lordships to reopen the issue, which was assumed but not addressed in Westdeutsche Landesbank, of whether the court has common law jurisdiction to award interest in restitutionary claims. Having done so, he found that there was only one answer to the question in this case, which was that an award of compound interest was necessary to achieve full restitution. Accordingly, he found that the court did have the power to make an award of compound interest in the exercise of its common law jurisdiction in restitutionary claims.

As to measurement, Lord Nicholls also distinguished between the objective measurement of the time value of use of money and the actual benefit derived by the defendants. Having decided that an objective measure was appropriate Lord Nicholls held that the court can depart from an objective measure in appropriate cases in order to avoid an unjust outcome. In the present case, the appropriate rate for the restitutionary claim was the rate at which the UK Government could borrow in the market during the relevant periods.

Lord Scott agreed that interest losses can be claimed for breaches of contract and in tort, subject to proof of loss and relevant rules relating to recoverability of damages in contract or tort, as the case may be. He also agreed with Lords Hope and Nicholls that a restitutionary claim for interest at common law (as opposed to in equity) was prima facie available, subject to change of position defences. However, departing from the approach adopted by Lords Hope and Nicholls, he found that whether or not interest was available in restitution in a particular case depended on proof of the actual benefit derived by the defendant; ‘mere possession of money for a period is not a benefit to be valued and
disgorged’. On the facts of Sempra's case, there was no evidence that the Revenue did derive any benefit from the payments in question.

Lord Walker agreed with the other judgments insofar as they related to interest as damages in claims for breach of contract and in tort. He also agreed that a claim for compound interest in restitution should be recognised. However, he preferred to follow the minority in Westdeutsche Landesbank and find that the court had jurisdiction in equity to allow such a claim; the claim was not available as of right at common law. In practice, however, on the facts of this case, whether the claim was available at common law or in equity produced the same result.

Lord Mance also agreed with the other judgments insofar as they related to interest as damages in claims for breach of contract and in tort. Like Lord Walker, he agreed that compound interest was available in restitution by way of extension of the equitable jurisdiction and not as a matter of right at common law. In terms of measurement, he agreed with Lord Scott that, whether the claim was recognised in common law or in equity, it must be measured by reference to the actual benefit obtained by the recipient and that an objective measurement was not appropriate.

**Conclusions**

The case represents a fundamental change in the English Court’s approach to recovery of interest. It is of obvious relevance to all claims against HMRC for recovery of taxes which can be brought in either restitution or damages and its wider application will be watched with interest.

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