How Much Does Negligent Advice Cost? The Court of Appeal Decides

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It seems that auditors have recently dominated the limelight for the wrong reasons. Negligent advice was at the heart of *Manchester Building Society v Grant Thornton UK LLP* [2019] EWCA 40 (Civ), in which the Court of Appeal confirmed the extent of an auditor's liability for losses caused by that advice.

Background

Between 2004 and 2009, Manchester Building Society (MBS) issued a number of fixed interest lifetime mortgages and between 2006 and 2012, MBS purchased interest rate swaps to hedge against changes in interest rates.

A change in the accounting rules from 2005 meant that MBS was required to prepare its accounts in accordance with the International Financial Reporting Standards and include the fair mark-to-market (MTM) value of the swaps on its balance sheet. This meant that MBS's financial position, as stated in its accounts, would be at the mercy of movement in the fair value of the swaps, which would cause volatility in MBS's reported financial position.

In 2006, MBS's auditor, Grant Thornton (GT), advised MBS that it could apply hedge accounting to the interest rate risk under the mortgages and swaps. This enabled adjustments to be made to the carrying value of the mortgages to partially off-set the changes in the fair value of the swaps, reducing accounting volatility. GT confirmed that advice in its annual audit of MBS's accounts.

In 2013, it became apparent that MBS was not entitled to apply hedge accounting. MBS was exposed to significant volatility on its balance sheet and the decline in variable interest rates caused by the financial crisis meant that its accounts no longer disclosed sufficient regulatory capital. MBS decided to close out the swaps, which were broken at their fair value in June 2013 resulting in an MTM loss of £32.7 million.

GT didn't dispute that it had been negligent by failing to advise MBS in 2006 and on the occasion of each audit that it could not apply hedge accounting, but this case concerned the extent of its liability for the losses sustained by MBS when it broke the swaps. At trial, Teare J held that GT was only liable for the transaction costs of breaking the swaps, and not the MTM losses, as those losses flowed from market forces for which GT had assumed no responsibility. MBS appealed that decision on various grounds, including the legal test for liability used by Teare J.

The Court of Appeal decision

The Court of Appeal unanimously dismissed MBS's appeal. It confirmed the application of the SAAMCO principle from *Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd* [1997] AC 191, as clarified by the Supreme Court in *Hughes-Holland v BPE Solicitors* [2017] 2 WLR 1029, which Teare J had rejected in favour of a more general assumption of responsibility test.

The SAAMCO principle provides a filter in cases where foreseeable losses are suffered as a result of entering into a transaction in reliance on negligent advice or information. In summary:

1. It is first necessary to consider whether the case is an "advice" case or an "information" case. Although the labels are

artificial and have a “descriptive inadequacy”, the distinction is important because the scope of the duty, and therefore the measure of liability, is different in the two cases.

2. It will be an “advice” case if “it has been left to the advisor to consider what matters should be taken into account in deciding whether to enter into the transaction”, that “his duty is to consider all relevant matters and not only specific matters in the decision” and that he is “responsible for guiding the whole decision-making process”.
3. In an “advice” case, the negligent advisor will have assumed responsibility for the decision to enter into the transaction and all the foreseeable financial consequences of entering into the transaction.
4. If it is not an “advice” case, it will be an “information” case and responsibility will not have been assumed for the decision to enter into the transaction. The negligent advisor will only be responsible for the foreseeable financial consequences of the advice/information being wrong.
5. This involves consideration of what losses would have been suffered if the advice or information had been correct. Only losses that would not have been suffered in such circumstances are recoverable. The burden of proof is on the claimant.

The Court held that this was an “information” case. Although GT gave accounting advice, it was not involved in the decision to enter into the swaps. Therefore, GT only assumed responsibility for that advice and not all the reasonably foreseeable consequences of MBS’s decision to enter into the swaps.

MBS’s claim for damages reflected the fair value of the swaps when they were broken. However, receiving fair value does not ordinarily give rise to loss. The fact that the swaps were “out of the money” should make no difference in principle: although MBS incurred a liability to pay their negative MTM value, it also obtained the equal benefit of removing liability from its balance sheet.

To prove that it would not have suffered MTM losses if GT’s advice had been correct, MTS needed to prove the relevant counterfactual, namely that the loss would not have been suffered if they continued to hold the swaps. MBS could not do so. The fact that the swaps were “out of the money” in 2013 was the result of market forces. Closing them at that time crystallised the loss but did not create it.

As such, despite the shifting analysis as to the test for liability, the Court of Appeal confirmed Teare J’s overall conclusion that the MTM losses were not recoverable.

Comment

The decision is significant for a number of reasons.

It confirms the SAAMCO principle as a basis for determining the scope of duty and the measure of liability for negligent advice or information. As we have seen in other interest rate swap cases (in particular, those involving mis-selling), these cases are fundamentally concerned with an assumption of responsibility for reasonably foreseeable consequences. Despite the descriptive inadequacy of the labels, the distinction between “advice” and “information” provides a useful lens for analysing that assumption of responsibility.

In this case, GT’s assumption of responsibility was limited to correctness of the accounting treatment. However, the Court acknowledged that it was possible to envisage circumstances in which a wider damages claim would have succeeded.

Generally, auditors are coming under increasing scrutiny for the accuracy of their advice. It is clear that the courts, alongside regulators, play an important role in ensuring that clients are compensated for professional failings.

Finally, this case demonstrates the complexity of interest rate swap transactions, the number of professionals involved, the significant potential losses and the range of claims that might arise.

Hausfeld routinely acts for claimants in professional negligence claims. If you require more information, please contact John McElroy.