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PROFESSIONAL ADVISERS: SCOPE OF DUTY

Introductory remarks:

HHJ Russen QC

Speakers:

Hugh Sims QC & John Virgo

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Introductory remarks

- HHJ Jonathan Russen QC
- Bristol Circuit Commercial Court

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Outline of this talk

- Analysis of the principles behind a professional adviser's scope of duty as they emerge from *Manchester Building Society v Grant Thornton UK LLP* and *Meadows v Khan*
- Understanding past decisions and the impact of *MBS* on
  - Accountants/auditors
  - Financial Advisors
  - Valuers, solicitors and other professionals

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Manchester Building Society v Grant Thornton UK LLP [2021] 3 WLR 81

Key Facts

- 2004 to 2008 MBS acquired life-time mortgages worth £68m and went on in 2008 to 2010 to acquire £40m of Spanish LTMs serviced by the borrowers at fixed interest rates
- The UK portfolio was hedged by 14 ‘swaps’ with a notional value of £74.2m for 50 year terms; the Spanish portfolio was hedged by 14 swaps with a value of €57m for terms of between 5 and 30 years
- The fixed swap rates were below the LTM rates and so MBS was set to benefit from a sustained profit

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MBS's need for advice

<u>The critical facts</u>

- MBS as an FCA authorised entity had to maintain protective levels of regulatory capital which required a calculation taking into account the MTM value of the swaps
- From 2005 the MTM generated by the swaps fell to be recorded in the Society's accounts by reference to standards set by the IFRS
- GT advised (1) MBS could offset the carrying value of the LTMs against increases in MTM by valuing the future income stream derived from the loans over 50 years netted back to a present day value and (2) MBS could assume that LTM falling in within 50 years would be replaced by substitute LTM at the same rates of interest i.e. "hedging accounting"
- MBS could thereby meet its on-going regulatory capital requirement and thus adopt the business model on which the UK and Spanish LTM business was based

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What went wrong?

- GT's advice was wrong (1) there was no correlation between the 50 year swaps and the length of a LTM and (2) mortgage substitution was not permitted by the hedge accounting rules that applied
- GT advised MBS in 2011 that its advice was incorrect leading to a need to re-state its year-end accounts with the result:
  - A reported profit of £6.35m became a loss of £11.44m
  - Net assets were reduced from £38.4m to £9.7m
  - Regulatory capital stated at £20.4m moved to a deficit of £17.9m
- To remedy the above MBS terminated the swaps at a break cost of c£32.7m and sold its UK LTM portfolio for £68.4m

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MBS's claim and pre-SC twists

The key claim made by MBS was to recover the break cost as damages which:

- failed at first instance as Teare J concluded that (1) GT had not assumed responsibility for the break costs and (2) the break costs were market driven i.e. caused by market volatility not GT's advice;
- failed in the CA as although that court rejected the "assumption of responsibility" approach employed by Teare J, the CA held that (1) GT had given information and not advice and (2) GT could only be liable for the consequences of the information being incorrect: MBS could not show that if the information had been correct (and it had held the swaps to term) that it would have been better off than it was by breaking the swaps early

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MBS in the SC

The SC concluded (1) that Teare J was wrong to adopt an "assumption of responsibility" approach and (2) that the CA was wrong to determine liability according to whether GT could be said to have given advice or information.

<u>The correct approach</u>

This asks: what was the purpose for which the advice was given? i.e. "what risk was the duty supposed to guard against?" and "does the loss suffered represent the fruition of that risk?"

The question: "would the same loss have come about if the advice was correct" should not be used as a starting point to determine the outcome to liability

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Applying the correct approach

"[34]… the purpose of the advice was clear. [GT] advised that [MBS] could employ hedge accounting in order to … keep its regulatory capital at a level it could afford in relation to swaps to be held to term on the basis that they were to be matched against mortgages. … That advice was negligent. It had the effect that [MBS] adopted the business model, entered into further swap transactions and was exposed to the risk of loss from having to break the swaps, when it was realised that hedge accounting could not in fact be used and [MBS] was exposed to the regulatory capital demands which the use of hedge accounting was supposed to avoid. That was a risk which [GT]'s advice was supposed to allow [MBS] to assess, and which their negligence caused [MBS] to fail to understand":

The break costs were therefore a loss connected with and caused by the breach of duty

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Meadows v Khan [2021] 3 WLR 147

The Facts

The claimant sought Dr Khan's advice as to whether she was a carrier of the haemophilia gene which he negligently answered in the negative; C went on to conceive; Yip J found that correctly advised she was a carrier, the claimant would have had her foetus tested which would have detected haemophilia leading to a termination. Following birth, the child was found to be haemophiliac but also to suffer from an unrelated condition of autism. C claimed the cost of care generated by the 2 conditions which Yip J allowed in full assessed at £9m; the Court of Appeal reduced this award to £1.4m being the cost relating solely to the haemophilia

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The purpose approach in the Supreme Court

The Court: "One asks: "what is the risk which the service which the defendant undertook was intended to address?" Where a medical practitioner has not undertaken responsibility for the progression of the pregnancy and has undertaken only to provide information or advice in relation to a particular risk in a pregnancy, the risk of a foreseeable unrelated disability, which could occur in any pregnancy, will not as a general rule be within the scope of the clinician's duty of care."

Here Dr Khan had advised on the risk of haemophilia not autism or any risk in general – so the scope of his duty was limited to the purpose for which his advice was sought

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The new conceptual framework…

The majority view (Lord Hodge and Lord Sales (Reed, Kitchin and Black concurring)) (at [4]): (i) the scope of duty question should be located within a general conceptual framework in the law of the tort of negligence; (ii) the scope of the professional's duty…is governed by the purpose of the duty, judged on an objective basis by reference to the purpose for which the advice is given; (iii) the distinction between "advice" and "information" cases should not be treated as a straight-jacket; (iv) counterfactual analysis should be used as a cross-check to ascertaining the scope of duty under (ii) but subordinate to that analysis

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The conceptual framework…a step further

The majority view (Lord Hodge and Lord Sales (Reed, Kitchin and Black concurring)) (at [6]): (1) Is the harm (loss, injury and damage) which is the subject matter of the claim actionable in negligence? (the actionability question); (2) What are the risks of harm to the claimant against which the law imposes on the defendant a duty to take care? (the scope of duty question); (3) Did the defendant breach his or her duty by his or her act or omission? (the breach question); (4) Is the loss for which the claimant seeks damages the consequence of the defendant's act or omission? (the factual causation question); (5) Is there a sufficient nexus between a particular element of the harm for which the claimant seeks damages and the subject matter of the defendant's duty of care as analysed at stage 2 above? (the duty nexus question); (6) Is a particular element of the harm for which the claimant seeks damages irrecoverable because it is too remote, or because there is a different effective cause (including novus actus interveniens) in relation to it or because the claimant has mitigated his or her loss or has failed to avoid loss which he or she could reasonably have been expected to avoid? (the legal responsibility question)

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The minority view/s

The first minority view (per Lord Leggatt at [124]):

the principle denies liability where an alternate cause that is unrelated to the subject matter of the defendant's negligence is the true source of the injury…

A further minority view (but closer to the majority)(Per Lord Burrows at [179]):

the SAAMCo principle is best understood as focussing on the scope of duty in the context of the provision of professional services

and at [212] – policy driven - a fair and reasonable allocation of risk

and does not like "duty nexus" – duty, SAAMCO kicks in when asking whether factually caused loss is within scope of duty

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Understanding past decisions

- Past decisions need to be viewed in the light of this approach which the SC said was already the basis for the leading cases in which scope of duty and loss had been considered – once those cases were properly understood. So:
  - *Caparo* is explained on the basis that the purpose for which the auditors were retained was to produce accurate audited accounts and not to advise the directors what business decisions to make or to assist potential investors in deciding whether to invest
  - *SAAMCO* is explained on the basis that the purpose of the lender in asking for advice on value is to know the extent of its security not to help it to decide whether to lend at all
  - *Hughes-Holland* is explained on the basis that the purpose of BPE's retainer was to draw up the mortgage not to advise the lender whether to lend
  - *Aneco Reinsurance* is explained on the basis that the purpose of the broker's advice was to know if there was a market for the book of business to be written by him

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Impact on other professional disciplines

Accountants/Auditors

Galoo Ltd v Bright Graham Murray [1994] 1 WLR 1360 saw a claim by the company against its auditors for damages put as trading losses and liabilities incurred struck out in circumstances where the audited accountants negligently overstated the value of stock & WIP. No causal link was alleged between the accounting errors and the losses – merely that if the accounts had correctly shown the company to be insolvent, it would have ceased to trade and not incurred the trading losses and liabilities it did.

Applying a "purpose test" would the case be differently decided today?

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Constructing the case

On the bare facts alleged in *Galoo* it would be decided the same way post MBS but there are indications the claim might have been restructured so as to establish liability. Thus:

- Lord Leggatt "necessary to plead and prove link between the losses and those matters which the auditors negligently failed to detect and which made the accounts inaccurate" and "no attempt was made to disprove the possibility that the losses would have occurred even if the value of stock and [WIP] shown in the accounts had been accurate"

- The possible implication is that if the above had been addressed then liability for the losses *may* have been established

- cf *Barings plc v Coopers & Lyrand (No 7)* [2003] Lloyd's Rep IR 566 where damages were recovered for negligently failing to detect unauthorised trading by the general manager which thus continued – there was a link therefore between the negligent omission to alert the bank to a risk that proper performance of the duty would have detected

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Building the case

Assetco plc v Grant Thornton UK LLP [2021] Bus LR 142 where damages were recovered for negligently failing to detect falsified accounts which showed 2 major contracts as being profitable when they were loss making

Per Lord Leggatt: "…Where an auditor negligently fails to detect and report a cause or potential cause of loss to the audited entity, with the result that losses from that cause occur or continue to occur, there is ex hypothesi a causal link between the subject matter of the auditor's negligence and those losses. Thus, on the facts of *Assetco*, it seems clear that the two contracts which the auditors negligently failed to identify as heavily loss-making were inherently likely to continue to generate further losses, as in fact happened, unless or until they were terminated. The losses on the contracts were in those circumstances losses which the auditors owed a duty of care to protect the claimant against…"

Lesson: Express clearly the purpose of instructing the audit – so – "we need to know if we need to make redundancies or can afford to retain current staffing levels?"

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Financial Advisers?

Per Lord Leggatt: “What determines whether the adviser has a duty to protect the client against the full range of risks associated with a potential transaction, or only against some of those risks, is whether or not the adviser's contribution to the decision-making process is limited. If it is not, either because the adviser is responsible for recommending a course of action (and not just for providing material relevant to the client's decision as to what course of action to take) or because the matters which the adviser is expected to take into account are open-ended and not limited to a particular subject matter, then the adviser's responsibility extends to all the foreseeable risks of entering into the transaction.”

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O'Hare v Coutts [2016] EWHC 2224

As regards that approach, in *MBS* Lord Leggatt noted:

> "The position may be different where, for example, the claimant is a private individual relying on a financial adviser to recommend an investment"

This was the case in *O'Hare* where Coutts persuaded the claimants to make higher risk investments than was consistent with their "unconditioned risk appetite"

In *O'Hare* Kerr J stated: "As I read the authorities and the COBS regulatory scheme, there is nothing intrinsically wrong with a private banker using persuasive techniques to induce a client to take risks the client would not take but for the banker's powers of persuasion, provided the client can afford to take the risks and shows himself willing to take them, and provided the risks are not – avoiding the temptation to use hindsight – so high as to be foolhardy"

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Applying a “purpose test”

Applying a “purpose test” i.e. “I, the investor, am asking about “low risk” investments” would the outcome now be different?

O’Hare poses problems in that:

1.The court “divorced” common law duties from the Bank’s statutory duty under COBS.

2.The COBS duty was to “take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client” but where “suitable” included knowledge of risk imparted by the adviser per Kerr J “In the context of investment advice too, there must be proper dialogue and communication between adviser and client”

3.The court thus used COBS to dictate a result in which what would have been viewed by the claimants according to their “unconditioned risk” appetite as unsuitable.

4.If the *O’Hare* approach to the scope of duty is correct then adopting a “purpose test” is not likely to result in a different outcome – as *O’Hare* provides a route to by-passing the “purpose test”

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Back to the future *Rubenstein v HSBC*

C was wrongly advised to invest in a fund which exposed him to a risk of market loss but where the events resulting in the realisation of the risk were themselves not foreseeable – the Court of Appeal nonetheless held C was entitled to damages for his loss as the adviser had advised on market risk incorrectly so that C was in the wrong fund – it was not permissible to isolate the risk which in fact eventuated and contend that as <u>that</u> risk was not foreseeable the adviser was not liable

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Thus …

Per Rix LJ: “It was the bank's duty to protect Mr Rubenstein from exposure to market forces when he made clear that he wanted an investment which was without any risk (and when the bank told him that his investment was the same as a cash deposit). It is wrong in such a context to say that when the risk from exposure to market forces arises, the bank is free of responsibility because the incidence of market loss was unexpected”

This case would no doubt be decided the same way today and appears an earlier example of adopting a “purpose of advice” approach

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Valuers

- Damages for negligence in surveyor's negligence cases are conventionally assessed by reference to the diminution in value of the property (i.e. a comparison between the value of the property as described in the report and as it ought to have been described)

- The measure of loss is not therefore equated with the cost of remedying unreported defects – unless these equate to the difference in value

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Hart v Large [2021] EGLR 11

- The Harts purchased a cliff top property in Devon for £1.2m which had been extended by works so poorly executed as to generate extensive damp ingress so that the only solution was demolition and re-build
- The Harts had obtained a homebuyer report which pointed out that the property had been newly reconstructed and extended so that it was not possible to assess if adequate damp proofing measures had been installed
- Critically, Mr Large did not recommend that a Professional Consultancy Certificate was obtained which would have revealed the works had not been properly carried out

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The damages awarded

- The trial judge awarded damages assessed as the difference in value between the property with the defects as reported in the homebuyer report and its value with all the defects which in fact existed i.e. even defects which the report could not have been expected to identify
- Applying a "purpose test" to the scope of duty the trial judge and the appellate court concluded "the purpose of obtaining …a [PC] Certificate was precisely to obtain some form of protection against the presence of defects which a competent surveyor could not identify in a newly rebuilt house" from which it followed that "there were no losses attributable to risks other than the risks against which Mr Large had a duty to safeguard the Harts"

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Valuer cases – quantum revisited

- Paras 102-105 Per Lord Leggatt

- Negligent valuation of property at 10m – true value 8m
- SAAMCO "cap" – 2m – extent of overvaluation
- Market value collapse – 10m down to 5m and 8m down to 4m
- Difference – 1m
- A justified "legal rule applied in a robust way" per Lord Sumption in *Hughes Holland* at [46] or need to be revisited?
- Wider lesson – do not use counterfactual as mechanical exercise – focus back on purpose, allocation of risk and where responsibility lies

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Solicitors: Hughes-Holland v BPE [2017] 3 AER 969

The facts

- Mr Gabriel decided to advance £200k to Mr Little in the belief the funds were to be deployed in the development of a disused heating tower at Kemble Airfield in Gloucester – and which he believed L owned. G's assessment was the building was worth £150k but once developed would be worth £400k.
- In truth, L did not intend to use the money to fund the development but rather he was to (and did) use it to repay an outstanding charge over the property for £150k and cover other VAT liabilities.
- BPE took instructions from L and knew of his plans as to the application of the loan; BPE drew up a facility and charge which contained wording that led G to believe the funds were to be applied to development costs; at first instance the court held BPE negligent for not explaining to G that L was not obliged to use the funds for redevelopment and was intending to apply the money to repay a prior loan; the judge also found that had BPE warned G of L's plans G would not have made the advance and so G was entitled to recover substantial damages

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The subsequent course of the case

- The Court of Appeal was persuaded that if BPE had drawn up a charge limiting the use of the advance to redevelopment G would have lost the entire sum of £200k as the venture would never have provided the return expected by G from which it followed the loss was caused by G's misjudgement as to the commercial merits of the investment.
- The SC upheld the decision of the CA. Lord Sumption's reasoning was: "On the footing that BPE was not legally responsible for Mr Gabriel's decision to lend the money, but only for confirming his assumption about one of a number of factors in his assessment of the project, the next question is what if any loss was attributable to that assumption being wrong. The answer is that if it had been right, Mr Gabriel would still have lost his money because the expenditure of £200,000 would not have enhanced the value of the property. The development would have been left incomplete, the loan unpaid and the property substantially worthless when it came to be sold into a depressed market under the chargee's power of sale"

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MBS and Hughes- Holland

MBS did not question the correctness of Hughes-Holland but explained it per Lord Leggatt on the basis: "In accordance with the principles established by SAAMCO and Hughes-Holland and not disputed on this appeal, such an adviser is not… liable for all the foreseeable adverse consequences of decisions taken in reliance on its incorrect advice. It is liable only for consequences of matters which made its advice incorrect"

However: (1) there is a tension between MBS and Hughes-Holland in that the decision in the latter was driven by a conclusion that if BPE had performed its duty correctly, G would have suffered the same loss – this appears to give primacy to the counterfactual analysis that was rejected in MBS as the proper starting point and (2) asking if G would have sustained the same loss by reference to a counterfactual that did not occur overlooks the finding that G would not have lent any money if it was not to be applied to fund development; (3) the posited counterfactual assumes that L would have yielded to a restriction on the use to which the money could be put (which does not appear to have been explored).

MBS will no doubt continue to be fertile ground for argument in all future professional negligence claims.

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Solicitors

Cases where counterfactual case does not work

Per Lord Leggatt at para 105

Eg – solicitor advising lender who negligently fails to discover and report that the borrower is a former bankrupt – had the lender known, it would not have made the loan – if borrower fails to repay then in deciding whether the loss sustained is within the scope of duty does it make sense to ask whether if the (implied) advice that the borrower had not previously been bankrupt had been true the borrower would have repaid the loan so that the loss would not have occurred – better to ask whether reporting on significant credit risk was part of the solicitor's duty – no need for counterfactual analysis here

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Finally ….

Any questions?

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