PLAY IT AGAIN SAAMCO: MANCHESTER BUILDING SOCIETY V GRANT THORNTON

Caytons
Changing Perceptions

Introduction

The suspense is over. Eight months on from the hearing, the Supreme Court's judgment in ***Manchester Building Society v Grant Thornton UK LLP* (2021) UKSC 20** has finally been handed down. This is the first time that the Supreme Court has looked at the application of the *SAAMCO* principle in auditors' claims and was a further opportunity for it to revisit this vexed area of law.

There has been much speculation about what the court might do, from shifting the burden onto the defendant of proving that the same loss would have been suffered in a world with no breach, to doing away with *SAAMCO* altogether. It did neither of those things.

The Supreme Court stressed that it was not departing from *SAAMCO* and would have been reluctant to do so if asked. Yet it is hard to see the decision as no more than a clarification. It is at least a refinement and is already being described by the Society's lawyers as a fundamental realignment.

Therefore, we have prepared a note on the decision.

THE FACTS

Grant Thornton acted as auditors for the Manchester Building Society. The Society offered lifetime mortgages to its customers. These were designed to allow older homeowners to release equity in their properties without selling them. The Society lent money to the borrower at a fixed rate of interest, but capital and interest were not repaid until the borrower died or went into a home.

The Society in turn funded the mortgages with borrowing at variable interest rates. It identified a risk that the variable rate which it paid might exceed the fixed rate it stood to receive from borrowers. As a result, it decided to hedge the risk by entering into derivative contracts known as interest rate swaps by which the Society paid a fixed interest rate on a notional sum while counterparties paid a variable rate on the same sum.

The underlying commercial calculation was that the variable rate paid by the counterparty would match the rate which the Society paid on its borrowing, while the fixed rate which it paid would be lower than the rate it received from borrowers. It concluded from this that it was bound to turn a profit. The swaps had to be declared on the Society's balance sheet at the 'mark to market' value ("MTM value"), in other words, the price which the swaps could be sold for at a given time. The MTM value is based on the estimated value of future payments which will change with fluctuations in projected interest rates. The value of the underlying lifetime mortgages, however, would stay the same. This

would lead to volatility in the Society's profits and a consequent need for more regulatory capital, *i.e.* the reserves it was required to maintain by the regulator.

Grant Thornton wrongly advised that volatility could be mitigated by using 'hedge accounting'. This would allow the value of the lifetime mortgages to be adjusted to offset changes in the MTM value of the swaps. The aftershock of the Credit Crunch of 2008 turned the interest rate swaps from assets to liabilities, but hedge accounting largely offset this.

However, when Grant Thornton realised its error and told the Society that it could not, in fact, apply hedge accounting, the effect was catastrophic. It wiped £28m off the Society's balance sheet value, left it with a capital deficit and led to it being banned from new lending. The Society broke the swaps to avoid further losses and sold its lifetime mortgage books.

THE LOWER COURTS

The Society brought proceedings in the Commercial Court. The main element of the claim was the cost of breaking the swaps. It quantified this at £32.7m. Grant Thornton admitted breach and fought the claim on causation and the *SAAMCO* cap.

Teare J found causation established. He side-stepped the question as to whether this was a *SAAMCO* 'advice' case (as alleged by the Society) or an 'information' case (as alleged by Grant Thornton). The relevant question, he said, was whether Grant Thornton had assumed responsibility for the losses claimed. He found that it had not. It would, he said, be "*a striking conclusion to reach that an accountant who advises a client as to the manner in which its business activities may be treated in its accounts has assumed responsibility for the financial consequences of those business activities".*

On his analysis, this determined the point in favour of Grant Thornton. However, he accepted *obiter* that the losses claimed would not have been suffered if what he neutrally called "*the information or advice"* given by Grant Thornton had been correct. He added that, if he were wrong about assumption of responsibility, he would assess contributory negligence at 50%.

The Society appealed. The Court of Appeal concluded that the judge had given the right answer for the wrong reasons. He had, it found, placed too much weight on comments by Lord Sumption in *BPE v Hughes-Holland* [2017] UKSC 21 about the *"descriptive inadequacy"* of the 'advice' and 'information' labels. Hamblen LJ, giving the judgment of the court, said that in determining whether a defendant had assumed responsibility for the losses claimed, *"It is first necessary to consider whether it is an "advice" case or an "information" case".*

He continued that *"It will be an "advice" case if it can be shown that it has been left to the adviser 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'. If it is an "advice" case, then the negligent adviser will have assumed responsibility for the decision to enter the transaction and will be responsible for all the foreseeable financial consequences of entering into the transaction".*

Conversely, *"If it is not an "advice" case, then it is an "information" case and… the negligent adviser/information provider will only be responsible for the foreseeable financial consequences of the advice and/or information being wrong".*

The Court of Appeal considered that this was clearly an 'information' case. Grant Thornton's role was limited to providing accounting advice *"and never came close to extending to responsibility for the entire lifetime mortgage/swaps business*".

The court went on to find that the judge had been wrong to conclude that the losses claimed would not have been suffered if the information given by Grant Thornton had been right. The logic of the Society's case, the court concluded, was that, if Grant Thornton had been right, it would not have broken

the swaps. But if it had not broken the swaps and held on to them, they would have continued to fall in value.

THE SUPREME COURT

The appeal was, exceptionally, heard by a panel of seven. Lord Burrows explained in his judgment that this was in anticipation of the court being asked to depart from *SAAMCO*. At times in her submissions, the Society's counsel appeared to be asking the court to do just that but, when pressed, she made clear that she was not seeking a change in the law but a clarification of the law.

It might seem surprising, at first sight, that further clarification was thought necessary just four years on from Lord Sumption's careful judgment in *BPE*. But the history of *Manchester Building Society* itself showed the continued scope for misunderstandings and divergent opinions as to how *SAAMCO* should be applied.

The panel was unanimous that both the judge and the Court of Appeal had reached the wrong result. Unhappily, however, for those seeking clarity, five members of the panel differed on some points with two of the others, who in turn differed with each other,

THE SIX QUESTIONS

The majority found that tort claims are to be approached by asking six questions which it formulated as follows:

1. Is the loss 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 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').

It went on to observe that the answer to the scope of duty question might be enough to determine a case without the need to consider breach or causation. What it termed 'the duty nexus question' is the *SAAMCO* analysis: whether and to what extent losses which pass the 'but for' test are within the scope of the duty owed. Lord Burrows, who gave a judgment of his own, would have preferred to avoid *"the novel terminology of the 'duty nexus'".*

THE PURPOSE OF THE DUTY

The majority held that the scope of a professional's duty is determined by reference to *"the purpose of the duty, judged on an objective basis by reference to the reason why the advice is being given"* and that *"one looks to see what risk the duty was supposed to guard against and then looks to see whether the loss suffered represented the fruition of that risk".*

Lord Burrows appeared to frame the test more widely but agreed that the purpose of the advice was central. He said *"it depends on a close analysis of the facts as to what the defendant has said and done and what the parties understood. As we shall see, the purpose of the advice or information… is of particular importance in working out the scope of the duty".*

Lord Leggatt, who also gave a judgment of his own referred back to *SAAMCO* and noted "*The scope of the duty of a valuer can likewise, as Lord Hoffmann indicated, …be identified by analysing the purpose of the service which the valuer undertakes to provide. From the known purpose of a valuation, Lord Hoffmann deduced that a valuer who enters into a contract to provide a valuation owes a duty of care."*

He added that to identify the policy reasons underlying the decision in *SAAMCO*, *"it is necessary to return to the purpose for which a lender commissions a valuation and the role which the valuation is reasonably expected to play in the lender's business decision. The purpose of the valuation is to provide the lender with an opinion on which it is entitled to rely of the current market value of the property offered as security for the loan. Clearly, the value of the security is an important consideration for a mortgage lender. It is, however, by no means the only factor relevant to the decision whether to make the loan".*

Both the majority and Lord Burrowes disagreed with Lord Leggatt's suggestion that the *SAAMCO* analysis was a question of causation. In his own judgment, Lord Leggatt quoted Lord Hoffmann as saying in *Nykredit v Edward Erdman* [1997] UKHL 53 that *"the extent of the valuer's liability 'has nothing to do with questions of causation'"* but suggested that he did not mean what he appeared to say.

The majority did, however, agree with Lord Leggatt that it woul*d "it would be desirable to dispense with the descriptions "information" and "advice" as terms of art and to focus instead on the need to identify with precision in any given case the matters on which the professional person has undertaken responsibility".*

They returned to the question of the purpose of the duty and said, *"In our view, for the purposes of accurate analysis, rather than starting with the distinction between "advice" and "information" cases and trying to shoe-horn a particular case into one or other of these categories, the focus should be on identifying the purpose to be served by the duty of care assumed by the defendant".*

Lord Burrows agreed that the labels were problematic but concluded tha*t "it is not easy to find shorthand replacement terminology".*

USE OF COUNTERFACTUALS

It has generally been accepted that the central question in an 'information' case is whether the claimant would have suffered the same loss even if the information had been right. If the valuers in *SAAMCO* had arrived at the right figures, the housing market would still have gone against the lenders. If the solicitor in *BPE* had drafted the loan agreement properly, the investor would still have lost his money because the project was hopeless. The question did not arise in an 'advice' case as the defendant is liable for all of the losses.

The Supreme Court has now indicated that this a subsidiary question and might not be appropriate in all cases. Lord Burrows held (emphasis added) that, *"Applying a counterfactual test can assist, <u>whether one regards the case as one of advice or information</u>, but such a test merely operates as a cross-check on one's decision as to that allocation of risk. Moreover, there is some room for choice in the precise counterfactual test that is used".* Lord Burrows, and Lord Leggatt, also expressly rejected the Society's argument that, where counterfactuals are used, the burden of proof should be on the Claimant.

The majority agreed (emphasis added) that *"the counterfactual test may be regarded as a useful cross-check in <u>most cases</u>, but that it should not be regarded as replacing the decision that needs to be made as to the scope of the duty of care*" and that in more complex cases there is greater scope *"… for abstruse and highly debatable arguments to be deployed about how the counterfactual world should*

be conceived". It would appear from the judgment that the majority, like Lord Burrows, considered there to be room for counterfactuals in what would previously have been considered 'advice' cases.

APPLICATION TO THE FACTS

The panel concluded that the lower courts had taken too restrictive view of Grant Thornton's duties. It was not enough to establish that its role was limited to advising on whether hedge accounting could be applied to the Society's business model. This is because it is necessary to identify the *purpose* for which the advice was sought, which was to determine whether the business model was viable. For Lords Leggatt and Burrows, but not it seems for the majority, the critical part of the advice was an email which misrepresented that the use of hedge accounting would be "*highly effective*" at avoiding volatility.

The Court of Appeal, in the panel's view, had identified the wrong counterfactual. The majority considered that the relevant no breach scenario involved the Society being protected from volatility, which was consistent with findings of the judge. Lords Leggatt and Burrows considered that both of the lower courts had got it wrong and that the correct counterfactual involved there being an effective hedging mechanism.

DISCUSSION

It is tempting to analyse the outcome as the equivalent of an 'advice case,' to use the now discredited labels. Yet the Supreme Court accepted that Grant Thornton was not advising on the merits of the Society's business model. In the words of the majority, the Society "*needed [advice on whether it was entitled to use hedge accounting] in order to make a commercial decision whether to enter into swaps to be matched against mortgages, in effect to begin to carry into effect its proposal for a new business model…"* That sounds like a textbook 'information' case on the law as it previously stood. The Court of Appeal, it will be recalled, thought that it was a clear information case.

Further, the significance which the majority seemed to place on the fundamental importance to the Society of the point on which Grant Thornton was advising, and the finding that it would have abandoned the business model if properly advised, is capable of being read as a retreat from *BPE.* In that case, Lord Sumption rejected submissions that the *SAAMCO* cap should not apply where the defendant should have reported a fact which was of fundamental importance to the claimant's decision to proceed.

This, then, suggests that placing the emphasis on the purpose of the duty owed might make it easier for Claimants to recover their losses, at least in claims against auditors. It is not, though, immediately obvious that focussing more clearly on the purpose of the duty would have suggested a different outcome in the various claims against solicitors and valuers in which the appellate courts have considered the application of *SAAMCO*.

Determining the purpose of the duty is likely, in some cases at least, to be a more difficult enquiry than asking whether the professional was under a duty to advise its client what course of action to take or to provide some of the information which the client needed to enable it to decide what course to take. There might well be several possible answers to the question as to what the purpose of the duty was. There may be more than one purpose. This could make it easier for a merits-orientated judge to find a route for claimants to recover all their losses.

That said, decisions such as *Main v Giambrone* [2017] EWCA Civ 1193 (solicitors) and Aneco Reinsurance v Johnson [2001] UKHL 51 (brokers) in which the courts have come down on the 'advice' side of the line seem to have been based as much on an examination of the surrounding circumstances as anything which the professional expressly agreed to.

The 'advice' and 'information' labels, while clear enough when properly understood, have caused confusion since *SAAMCO* was decided. But, as Lord Burrows indicated, they are a useful shorthand and we suspect that they may continue to be used in practice, by parties if not by the courts.

It is clear that counterfactuals have now been downgraded to a checking mechanism, and seemingly an optional one. Uncertainty remains as to how the checking exercise should be carried out, and how the court is to determine whether the counterfactual test proves its initial answer right or demonstrates it to be wrong. The panel seemed to conclude that counterfactuals should still be used in most cases, but it is not entirely clear how exceptions are to be identified. The answer may be that it is entirely at the discretion of the court.

It can be seen that the same result would be reached on the facts of *SAAMCO* without reference to a counterfactual. The purpose of the valuations was to identify the current market value of properties offered as security. It was, therefore, outside the scope of the duty to advise on the future of the housing market and losses arising from a reversal of the housing market were not recoverable.

The same follows for *BPE*. The purpose of drafting the loan agreement was to enable monies to be lent for a development project. It was outside the scope of the duty to advise on the viability of the project, so losses flowing from the project proving unviable could not be recovered.

However, the position could be different in auditor's claims such as *BTI 2014 v PricewaterhouseCoopers* [2019] EWHC 3034. There, the High Court hearing a summary judgment application struggled with the apparent tension between long-established authority that an auditor is liable where dividends are paid out in reliance on a negligent audit report and the *SAAMCO* counterfactual which it thought, at first sight, made those losses irrecoverable. This was because if the report had been right the divided would still have been paid. It is doubtful, however, whether this was a correct application of the counterfactual. The history of *Manchester Building Society* shows that, where counterfactuals are used, it can be difficult to determine what the appropriate counterfactual is. The three courts adjudicating on the matter arrived at four different answers. This adds further uncertainty.

Despite the refinements made by the Supreme Court we would hope that the courts would continue to approach *SAAMCO* on the basis set out in Lord Leggatt's judgment, albeit not expressly endorsed by the majority, that "*cases in which a professional adviser is liable for all the foreseeable consequences of a commercial transaction entered into as a result of negligent advice are likely to be rare. The position may be different where, for example, the claimant is a private individual relying on a financial adviser to recommend an investment. But in a commercial context it is unusual for a professional adviser to be asked to advise on the overall merits of a transaction or left to decide on the matters to consider in formulating their advice".*

In conclusion, the Supreme Court has refined the application of *SAAMCO*. The emphasis is now on the purpose of the duty. The 'information' and 'advice' labels have been dispensed with. The *SAAMCO* counterfactual has been relegated to a tool for cross-checking and it may not be appropriate to apply it in every case. The refined approach may lead to different outcomes in some cases, particularly complex claims against auditors, but it would not appear to point to a different outcome in the more straightforward claims against solicitors and valuers which have come before the courts in the past.

Further Information

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