Pay attention to the letter

Management of taxes | Professional standards



29 July 2021

Karen Eckstein examines the importance of correctly drafting engagement letters, particularly in terms of establishing the purpose of any advice given

Key Points

What is the issue?

One of the biggest factors in claims against professionals is the issue of the engagement letter and the scope of the retainer between the professional and their client.

What does it mean for me?

If problems later arise, the engagement letter will be forensically examined to determine the precise terms and scope of the retainer.

What can I take away?

Advisers who do not clarify the facts in writing leave themselves open to a challenge that facts had been imparted to the advisor but overlooked, or that incorrect advice was given despite the adviser having knowledge of the facts.

One of the biggest factors in claims against professionals is the issue of the engagement; letter and the scope of the retainer – the contract – between the professional and their client. Many professionals sadly treat the engagement letter as a ‘tick box’ exercise, regarding it as a form that must be completed in order to meet their firm’s internal processes before client work can begin. All too often, inadequate attention is paid to the terms of the retainer.

If problems later arise, the engagement letter will be forensically examined to determine the precise terms and scope of the retainer and the lack of care given to the drafting of the retainer comes home to roost. More focus is required on how precedents should be drafted, with attention given to guidance and training on how they should be completed.

There are a number of significant points to consider when completing an engagement letter:

1. Who are you acting for?
2. What have you agreed to do for the client?
3. What are you not doing for the client?
4. Who can rely on the work that you are doing?
5. What is the purpose of the work that you are doing?
6. Does the engagement letter include an ‘ad hoc’ clause?
7. Does the engagement letter include protections such as liability caps?

Establish the purpose of advice

The recent case of Manchester Building Society v Grant Thornton UK LLP [2019] EWCA Civ 40 has increased the focus on the fifth point above. There has been a lot of interest in this case recently and I don't propose to provide a forensic analysis of the case here. Of significance, though, is the specific focus on the purpose of the retainer in determining the losses that were recoverable as a result of the negligence of Grant Thornton.

In this case, Grant Thornton negligently advised MBS that an accounting method known as 'hedge accounting' could allow MBS to reduce the volatility of the market to market value of swaps on its balance sheet. This would allow MBS to keep the capital required to show liquidity to its regulator at an affordable level.

The incorrect advice was given by Grant Thornton in 2006, who then identified the error in 2013. MBS had to restate its accounts, showing reduced assets as a result. It then had insufficient regulatory capital and had to close the interest rate swap contracts early, at a cost of over £32 million.

The question before the Supreme Court was whether MBS could recover from Grant Thornton the £32 million cost of closing the interest rate swap contracts early, as well as the transaction fees. In essence, the issue rested on the purpose for which Grant Thornton's advice had been given and the extent to which it owed duty of care to protect MBS from losses.

The Court of Appeal had found that Grant Thornton's advice was limited to how the swaps could be treated in the accounts, and therefore that it did not assume responsibility for the financial consequences.

However, the Supreme Court found that MBS had asked Grant Thornton whether it could use hedge accounting to implement its proposed business model within the limitations of its regulatory requirements, and had received incorrect advice. It overturned the Court of Appeal's decision, stating that the scope of a professional's duty is defined by an objective assessment of the purpose of the duty. It held that MBS had suffered a loss which fell within the scope of duty owed by Grant Thornton, who were therefore liable for the loss suffered as a result of the incorrect advice.

The loss was reduced by 50% for contributory negligence on the part of MBS, because it had mismatched mortgages and swaps in a manner which the court

found to be ‘overly ambitious’. However, that doesn’t affect the principle that the court will now look specifically at the purpose of the advice when determining losses which are recoverable from the advisor.

Necessary protections

This case marks a change from the way that losses have been assessed previously. It will undoubtedly cause an increased focus on the issue of the purpose of advice when drafting an engagement letter, or when advice is given outside the specific terms of an engagement letter (see below on retainer creep).

A number of protections should be included within the engagement letter and terms and conditions in order to protect both the adviser and the client, including:

- Advice can only be relied upon if confirmed in writing.
- Advice can only be used for the purpose for which it is given.
- Advice may only be relied upon if acted upon promptly. For example, if advice is given in January, it cannot be relied upon in July without checking back with the advisor.
- Advice may not be relied upon if the facts upon which it was based have changed since the advice was given. Again, the client should check back with the advisor before relying upon the advice.

My recommendation to professionals is that they always confirm, when advising a client, the facts upon which the advice is based, the purpose for which the advice is given, and the advice itself. This avoids ambiguity and gives the client a chance to correct any factual errors before it is too late. It also means that in the event of a subsequent claim made against the adviser, there is clear evidence not only about the advice given, but also the basis upon which that advice was given and the purpose for which it was given.

In practice

What does this mean in practice? Consider the example of a client who seeks advice in relation to a proposed transaction. The advisor states in the engagement letter that he is ‘advising on tax in relation to the transaction’. Does this mean that he is advising on the tax consequences of the transaction, or on the most tax efficient way of structuring the transaction?

Although the adviser intended the first interpretation, the client may claim that their adviser failed to provide advice on a more tax efficient way of structuring the transaction. Arguments will then follow as to whether or not it would have been possible to structure the transaction in a more tax efficient way, and whether or not the other parties to the transaction would have been prepared to agree.

Such questions will become increasingly important and litigation will follow if the issue is not clarified in sufficient detail in the engagement letter. As the advisor is responsible for drafting the engagement letter, any disputed ambiguity as to the meaning of the retainer may result in the courts finding in favour of the client's interpretation, as it was within the adviser's ability to restrict the wording.

Advisers that do not clarify the facts in writing leave themselves open to a challenge that facts known to the client had been imparted to the advisor but overlooked, or that incorrect advice was given despite the adviser having knowledge of the facts. By setting the facts out clearly and asking the client to confirm if any facts are missing or incorrect, the advisor protects himself. Equally, the client is given a chance to correct any incorrect information, leading to the increased prospect of a successful outcome.

Retainer creep

Retainer creep is work done outside the agreed scope of the retainer. This is an increasingly risky area for advisers.

If an adviser has agreed to undertake work for a client in a specific area, and the client later asks the advisor to undertake a further specific piece of work, the advisor is likely to issue a new engagement letter or new schedule of services.

However, where the client merely asks a 'quick question' unrelated to the existing retainer, substantial risks arise. That work does not fall within the existing engagement letter, so none of the protections apply. As a result, there is ambiguity for the client and risk for the advisor.

The use of an 'ad hoc' clause in the engagement letter can be invaluable. This can say that the advisor will carry out 'such additional work as we may agree between us in writing' and will mean that the advisor can carry out some additional work under the terms of the existing engagement letter. It should not replace the need for a new engagement letter when substantial work is required but can be used when

small general queries arise. Each firm should have its own policy as to when the ‘ad hoc’ clause should be used as opposed to issuing a new engagement letter or schedule of services.

When doing work under the auspices of any ‘ad hoc’ clause, the principles referred to above still apply. The client should agree in advance that the work will be carried out under that clause. That agreement should be recorded in writing (email is sufficient) and should set out the facts, the purpose of the advice and the advice itself. Of course, the use of such a clause enables the firm to charge a fee for that work.

Firms need to have a process for ensuring that staff are aware of the scope of the retainer on all matters, so that they are aware when the ad hoc clause needs to come into play, and receive training on how to operate any ad hoc policy that the firm puts in place.

By operating these measures, firms should be able to mitigate substantial risk of claims, earn additional fees and increase client satisfaction by avoiding misunderstandings between themselves and their clients as to the terms of their engagement.