Law–Now Accountants, Lenders and Engagement Letters

Accountants frequently require lenders to enter in their standard engagement letters before carrying out certain work. Such engagement letters will clarify the scope of the accountant's instructions and, invariably, seek to limit their liability to the lender for such work. This article looks at those engagement letter banks are most likely to encounter and identifies some of the key issues for lenders.

Lenders are most likely to see such engagement letters covering any one or more of three scenarios:

(a) where a firm of accountants have been asked to perform a financial due diligence exercise and report on their findings to the lenders in the context of a company/business acquisition;

(b) in the context of a company acquisition, where the auditors are asked to provide a report in favour of the lenders concerning the solvency of companies about to undergo the Companies Act "whitewash procedure" in relation to the giving of financial assistance by that company; and

(c) where a loan agreement provides for a borrower's auditors to issue certificates from time to time confirming compliance or otherwise with certain covenants in the loan agreement, most likely the financial ratios.

Common issues for lenders:

- The most contentious item in any engagement letter is likely to be the cap which the accountants will seek to impose on their potential liability. The starting point for any consideration of a liability cap is the British Venture Capital Association (BVCA) and, what was then, the "Big 6" accounting firms Memorandum of Understanding of 18th February 1998. The Memorandum sets out the agreement reached between the BVCA and the Big 6 on the issue of liability caps in engagement letters in certain transactions.

  The Memorandum is not legally binding although it is generally followed in practice. It is still possible, however, for a lender to depart from the Memorandum where they consider the transaction warrants it.

  The Memorandum sets out the following approach: in any "private equity transaction" (which, for this purpose, essentially means a transaction where a bank, venture capitalist or other lender is investing in a private company through an acquisition of shares, whether or not there is any related debt) then, depending on the "transaction value" (being the aggregate of the new equity/debt that is subscribed or advanced), the liability of the accountants will be limited to an agreed level. The agreed levels are:

Transaction Value	**Limit of Liability**
Up to £10m (so-called smaller transactions)	An amount equal to the transaction value
£10m-£55m (mid-market transactions)	£10m plus one-third of the amount by which the transaction value exceeds £10m, subject to a maximum of £25m
Over £55m (larger transactions)	£25m

- Whist not of direct relevance to the engagement letter, there will be "competing interests" in relation to the engagement letter ad any underlying work. For example:

  (a) where the loan is syndicated, there are issues between the lenders themselves.

  Any report or certificate will be addressed to each lender or to the agent bank on behalf of the lenders. This presents a problem where the accountants have imposed a cap on their liability which is less than the full amount of the loan being made. Without any agreement to the contrary, any lender could recover directly from the accountant (potentially using up the entire liability cap) thereby leaving none available for the other lenders. Invariably in a syndicated loan there will be loss sharing provisions dealing with this situation;

  (b) where any report/certificate is also addressed to the borrower, a lender may want to prevent the borrower from taking any litigious action against the accountant without that lender's consent or otherwise specify how any recovered damages are to be applied or used;

  (c) in a leveraged finance transaction, there will be the competing interests of different funders: for example, senior lending versus mezzanine lending versus equity investors. The funders, especially any senior lender, may want to specify how and when any claim against the accountants can be made.

- The memorandum only applies to the preparation of due diligence reports in private equity transactions; where the deal is not a private equity transaction (as defined by the Memorandum) or the accountants are doing something other than preparing a due diligence report, it does not, strictly speaking, have any relevance. Accordingly, the Memorandum has no application to liability caps in financial assistance engagement letters for example.

What usually happens is that two liability caps are agreed; the first, being a cap in relation to the due diligence report and the second relating to any other report or certificate. The liability cap for the first should follow the Memorandum but there is no understanding or agreement as to the scale of caps to be applied to the second. In these circumstances the cap is "up for grabs". There does not seem to be any consistency, although the financial assistance cap is generally lower than that for the due diligence report.

In some circumstances, the accountants try to impose an aggregate cap on their liability for both the due diligence and financial assistance elements of a transaction. For example, in a larger transaction the accountants will cap their liability at £25m irrespective of whether their liability arises out of the due diligence exercise or financial assistance exercise. This deprives the lender of the slightly higher liability limit had two separate caps been agreed.

- Whilst there is no 'standard' form of engagement letter, the Memorandum does suggest the wording for particular clauses; for example, the liability cap wording and the proportionality wording (see below). When reviewing an engagement letter the relevant clauses should be compared to these "standards" to check for any deviations.

  The Memorandum warns venture capitalists and other funders that they should seek their own legal advice on whether these standards are appropriate for them in any given case.

- The engagement letter will probably state that any agreed division of the liability cap between more than one funder is not a concern for them. Effectively the accountants are saying that, if they are sued by a joint lender and they pay out, they can pay out without regard to any agreed division of those damages payments even if this means that the joint lender who sues them recovers more than their agreed share. The other joint lenders cannot then sue the accountants for further sums (if the cap has been reached) on the basis that they paid more than they should of done to the initial lender. It would be desirable to put accountants on notice of any agreed division of the cap so that they can effectively "police" the recovery of damages against them. There is an approved form of BVCA wording to do this, although accountants will probably be reluctant to accept it.

- "Proportionality" - the BVCA and accounting firms have agreed standard wording for proportionality clauses. The Memorandum allows accountants to incorporate this proportionality wording into engagement letters in larger transactions but not in smaller or mid-market transactions.

Under the general law, where the accountants are negligent and share their negligence with another third party (for example, with another advisor), the lender could sue the accountants for the full amount of the loss. The accountants would then be entitled to seek a contribution from that other third party to reflect the proportionate responsibility each of them had towards causing the loss.

By introducing proportionality wording, a lender can only sue the accountants up to the amount of the loss the accountants are responsible for. Accordingly, the lender could not sue the accountants for the full amount of the loss; they would have to seek the balance of the loss from the other third party. The net effect is that the risk of the other third party being unable to pay moves from the accountants to the lender.

- The engagement letter should make it clear, as would usually be the case, that it is the company, and not the lender, who is responsible for the accountants' fees.

- A financial assistance engagement letter will usually append the form of the report(s) they are to give. These will be the statutory report to the directors and the non-statutory report to the Lender. These should always be in the standard form.

  In the non-statutory report, the accountants will state that, "[as at a particular date], the aggregate of the company's assets as stated in its accounting records exceed the aggregate of its liabilities as so stated" (that is, the company has net assets). In the engagement letter the 'particular date' may be left blank. Ideally, when the reports are issued, this date will be the date on which the financial assistance is to be given or as close as possible to such date. It is useful, to avoid later argument, to make this clear in the engagement letter.

- It is important that both the engagement letter and any associated reports are appropriately addressed. This is particularly important in syndicated loan transactions. Ideally all reports should be addressed to the agent bank in its capacity as agent and security trustee. The precise wording will vary from deal to deal but should be along the following lines.

  > "[Name of agent bank] for itself and as agent and security trustee for and on behalf of the [Banks, Overdraft Bank, the Issuing Bank and the Hedging Counterparty] (as each such expression is defined in the facilities agreement dated, or to be dated, on or about the date hereof between, amongst others, [name of borrower] and [ ]) and their respective assignees, transferees and successors in title"

Occasionally, accountants will resist this and insist that any relevant bank is specifically named. They will further insist that, before any future syndicate bank can rely on any report, the incoming bank will have to sign an engagement letter in equivalent terms. Needless to say, this is inconvenient and, more importantly, a potential pitfall whereby a bank may lose its ability to rely on any accountants' reports as it is something an agent bank could quite easily overlook during the syndication process. If the incoming bank only later signs an engagement letter, the accountants might argue that they are not responsible for the loss suffered as the incoming bank never relied on their reports in making its lending decision (any such reliance being placed after the decision was made).

- Sometimes, accountants try to impose a time limit during which any claim against them must be made. Ideally, any such restrictions should be removed so that any relevant limitation periods are dealt with by the general law.

- Even in a bilateral lending transaction, how the reports are addressed may be of importance. For example, should the report also be expressly addressed to assignees and transferees of the lender? Or should the report be addressed to the lender and any other company within that lender's group of companies? For example, another entity within the group may be entering into hedging arrangements in reliance on the relevant report.

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