CLYDE&CO

Update

Recent Key Cases on Accountants' Liabilities

Key points

- Documenting the scope of an accountant's engagement is as important as ever
- "Bannerman" disclaimers against third party liabilities in audit engagements have been upheld
- In non-audit engagements, the courts have been increasingly willing to enforce limitation of liability clauses
- Multi-tiered dispute resolution clauses in engagements may give accountants options to resolve a dispute before proceedings are commenced
- The debate over accountants being able to rely upon the "illegality" defence, when sued by the liquidator of a company previously run by fraudulent directors, continues.
- Accountants need to take steps now in their engagements to deal with the Contract (Rights of Third Parties) Ordinance (Cap. 623)

There have been a number of important recent decisions which will impact upon accountants' potential liabilities. Many are favourable in restricting the scope of the duty of care that an accountant may owe its client, in limiting the length of time an accountant may be exposed to a claim, and in upholding limitations of liability in (non-audit) engagements. Possibly less helpful for accountants are the decisions which may be said to restrict the application of the defence of ex turpi causa. There are also some interesting developments in Canada on the scope of recoverable losses against an auditor.

Patrick Perry provides a round up of the relevant cases is set out below, along with some commentary upon the Contracts (Rights of Third Parties) Ordinance, which has just come into force in Hong Kong. Accountants need to be aware of the impact this Ordinance may have on their terms of engagement.

Scope of Duty

Swynson v Lowick Rose (High Court, 2014)

A director behind a company which sought due diligence services in relation to an acquisition alleged that the accountants owed him personally a duty of care, in addition to the duty owed to the company.

The Court found that it was essential to establish whether the accountant had assumed responsibility for the advice given to the director. This was an objective test. The Court held that the advisor's knowledge that the director might have relied on his advice was not an adequate basis for demonstrating an assumption of duty.

This decision is helpful in upholding the concept of the "corporate veil" and reducing the scope for third parties, such as the company's directors, to bring claims against accountants. The accountants' client was the company, and the Court was unwilling to find that any personal duty of care was owed to any other party.

Barclays Bank v Grant Thornton (High Court, 2015)

A company (the Company), having entered into a facility agreement with the claimant bank (Barclays) in respect of loan facilities, later went into administration leaving Barclays with a substantial loss (said to be £45 million). Barclays thereafter brought a claim against the defendant auditors (GT) for alleged negligence in their production, for the Company, of non-statutory audit reports provided to third parties, which had been sent to Barclays. In particular, the reports failed to identify the fraud of two employees of the Company, who had allegedly deliberately misled GT about the true sales and expenses position of the Company. The Court held that the disclaimers included in the reports were sufficient to preclude GT owing a duty of care to Barclays. However, the Court considered that there were, nevertheless, some circumstances in which auditors could owe a duty to third parties – for example, if reports provided to the third parties did not contain disclaimers.

This is another positive decision for accountants covering a very important area.

The Scottish case of *Royal Bank of Scotland v Bannerman* (2003) had caused alarm for the audit profession in creating a risk that a company's auditors could owe a duty of care to a lending bank if they knew or ought to have known that the bank would rely on their client's audited financial statements and they did not explicitly disclaim liability.

This led to the ICAEW in the UK and the HKSA in Hong Kong issuing risk management guidance on wording in audit statements which could assist accountants to help protect themselves against exposure to third party claims.

These "Bannerman" clauses were tested for the first time in the English courts in this case, and found to be valid. This will give considerable comfort to auditors going forwards in seeking to rely upon such disclaimers.

Mehjoo v Harben Barker & Ors (Court of Appeal, 2014)

In this case, the Court found that a duty to give specialist tax planning advice could not be inferred from a course of conduct relating solely to routine general tax advice. There was held to be a clear distinction between general tax mitigation and specialist tax planning advice. The Court of Appeal found that the accountant could not reasonably have known about specialist tax minimisation measures of the kind relied upon, and there was therefore no reason for them to raise these issues with the client.

The outcome of Mehjoo is reassuring for accountants. The Court of Appeal found that the scope and extent of an advisor's retainer was limited to the terms of their letter of engagement. Whilst exceptions (and implied terms) can exist, the Court were not prepared to infer that the accountants' duty extended to giving specialist tax planning advice, when this was outside their general expertise and the scope of their retainer.

Defences

Illegality

Stone & Rolls Ltd v Moore Stephens (House of Lords, 2009)

This 2009 judgment is important to note, to put the more recent decisions outlined below in context. In this case the auditors, Moore Stephens, successfully relied on the defence of ex turpi causa to bar a claim from their client company, Stone & Rolls Limited. This defence is known as the "illegality defence", and is a legal doctrine which states that a plaintiff will be unable to pursue a legal remedy if it arises in connection with his own illegal act.

The controlling shareholder of Stone & Rolls, Mr. Stojevic, used Stone & Rolls to deliberately carry out a scheme to defraud banks, and then pay away monies to himself or his other companies. As a result, the company became heavily insolvent and entered into liquidation. Stone & Rolls brought a claim against Moore Stephens for failing to detect that Stone & Rolls' transactions were fraudulent and bogus and for delay in stopping the continuing fraud.

The House of Lords, by a 3:2 majority, held that Moore Stephens were entitled to rely on the illegality defence to strike out the claim by Stone & Rolls. In summary, the House of Lords was of the view that Mr. Stojevic was the only shareholder, the sole director and controlling mind of the company, and hence Stone & Rolls was vested with the knowledge of the fraudulent scheme. Although Moore Stephens owed a duty of care to their client company and its shareholders, Stone & Rolls was precluded from suing its auditors in order to take advantage of and obtain benefit from its own fraud.

Moulin Global Eyecare Trading Limited (in liquidation) v The Commissioner of Inland Revenue (Court of Final Appeal, 2013)

This case concerned the recovery of profits tax by the liquidators of Moulin Global Eyecare Trading Limited ("MGET"), which was ordered to be wound up in mid-2006. The former directors of MGET, with knowledge of fraud, inflated the company's profits by creating false accounts, attracting profits tax (almost HK$89 million) in excess of what MGET would otherwise be required to pay. This was later discovered by the liquidators, who then attempted to reclaim the profits tax from the Inland Revenue Department on the basis that MGET did not make any taxable profits in the relevant years and that its reported profits were inaccurate due to frauds perpetrated by its former directors.

Central to the case was whether the guilty knowledge of the fraudulent directors should be attributed to the company. Here, Lord Walker took the view that the company should be attributed with the guilty knowledge of the fraudulent directors on public policy grounds and on the basis that the Inland Revenue Department could not be expected to inquire into the conduct of its taxpayer's business. In reaching his conclusion, Lord Walker pointed out that the questions of attribution are always sensitive to the factual situation, language and legislative purpose of any relevant statutory provisions. He further stated that the fraud exception does not apply to protect a company where the issue is whether the company is liable to a third party for the dishonest conduct of their director/ employee. More importantly, Lord Walker pointed out that the fraud exception to the rules of attribution does not necessarily apply to auditors, as internal fraud was the "very thing" from which the auditors had a duty to protect the company. There will be considerable debate in Hong Kong as to the extent to which auditors can distinguish Lord Walker's comments.

Jetivia SA v Bilta UK Ltd (Supreme Court, 2015)

The judgment is an important sequel to *Stone & Rolls Ltd*, and arguably narrows down the application of the illegality defence.

Bilta (through its liquidators) brought a claim against two former directors and a Swiss company, Jetivia SA, alleging that, between April and July 2009, the two directors caused Bilta to engage in fraudulent trading. The directors maintained in response that Bilta was, through its directors and shareholders, party to the illegality which precluded it from pursuing the claim. The defendants applied for Bilta's claims to be struck out. The application was unsuccessful at both first instance and on appeal to the Court of Appeal. In finally dismissing Jetivia's application, the Supreme Court held that the conduct of the company's directors could not be attributed to the company itself where there was a claim for breach of duty against the directors. The Supreme Court declined to provide any further clarification on the *ex turpi* causa defence, but the suggestion was made that Stone & Rolls should be confined to its own special facts.

Livent Inc. v. Deloitte & Touche, (2016)

In January 2016, the Ontario Court of Appeal rejected an Appeal by Deloitte's against a judgment of US$118 million and made a number of important findings concerning the potential legal defences available to an auditor in Canada.

The receiver of Livent, a publicly-traded live theatre production company, brought a claim against Livent's auditors, Deloitte, for failure to discover a fraud being perpetrated at the direction of Livent's former CEO and CFO, with the assistance of its accounting and IT departments and to the knowledge of most of Livent's audit committee. Livent hid its unprofitability through accounting manipulations, assisted by computer software it had designed to carry out these manipulations without a trace. After a change in management, Livent's accounting staff confessed and the fraud was discovered.

Whilst the trial Court in 2014 had rejected numerous of the allegations against Deloitte, it had held that the auditor was liable for damages arising from negligence in 1997 and 1998. In awarding substantial damages against Deloitte, the trial court dismissed the auditor's argument that the fraud was that of the company on whose behalf the claim was being brought, and so the company should not be able to seek redress for its own illegal conduct (the ex turpi causa argument). This argument was the subject of appeal, along with submissions that Deloitte's negligence was not the proximate cause of the loss and that Livent should not be entitled to claim for "deepening insolvency" losses, namely an increase in the liabilities of an already-insolvent company.

The Ontario Court of Appeal rejected all of the auditor's arguments. The Appeal Court took a narrow view on the ex turpi causa defence and held it was there only to protect the integrity of the Canadian legal system and did not give the court discretion to negate or refuse to consider the defendant's duty of care. Similarly, the corporate identification doctrine was construed to be of limited assistance, and not to be "a free-standing legal rule". The Court considered the UK Court of Appeal case of Galoo, which is authority for the proposition that an auditor cannot be responsible for ongoing trading losses of a company, but distinguished it as a matter of fact, as well as holding that such principles should not be incorporated into the laws of Ontario. The auditor's arguments that the damages should be reduced for contributory negligence of the company were also rejected.

In all, the Ontario Court of Appeal held the auditor responsible for the vast majority of the losses suffered by the company (and its creditors). For possibly public policy reasons, the Court took a broad view on causation, and was willing to hold that the auditor's negligence was a foreseeable and proximate cause of almost all of the losses. Yet, it took an extremely narrow view as to the applicability of the legal defences that have been held to be available to auditors in other commonwealth jurisdictions. Accountants will hope that this decision is confined to its facts, and the Canadian courts, and that the principles are not applied elsewhere.

Statutory Limitation Periods

Maharaj v Johnson (Privy Council, 2015)

Under Hong Kong (and UK) law, a Plaintiff has 6 years from the date of the breach to commence proceedings for breach of contract. In tort, the 6 year time period runs from the date of "damage". This has given rise to numerous decisions as to when "damage" should be said to have been suffered.

The Privy Council considered the concept of a "no transaction case" compared to a "flawed transaction" case and noted that in a "flawed transaction" case the claimant has entered into a transaction where, in the absence of the defendant's negligence, he would have entered into an analogous but flawless transaction. In this case the inquiry, for the purpose of ascertaining when damage is suffered, is whether the value of the flawed transaction was measurably less than the flawless one. In a "no transaction" case the claimant would not have entered into any transaction in the absence of the negligence.

In the present case, which concerned an issue over the validity of a deed, which caused the sale of a property to be lost, the inquiry was whether, and at what point, the transaction caused the claimant's financial position to be measurably worse. The Privy Council found that this was an obvious "flawed transaction" case but the fact that a transaction is flawed does not by itself mean that the claimant suffered actual damage on entry into it. When damage is suffered will depend on the facts of the case.

That said, in this case there had in fact been immediate damage suffered in 1986 when the defendant solicitors acted for the claimant in relation to the purchase of the property and the deed was executed. As at this point the claimants were exposed to risks, and the equitable interest they obtained in the property was significantly less valuable than the legal interest would have been. The claim was therefore statute barred under the relevant Trinidad and Tobago legislation.

Chinnock v Veale Wasbrough (Court of Appeal, 2015)

A firm of solicitors and a barrister were held not to have acted negligently by advising that a mother did not have a viable wrongful birth claim against an NHS trust. The Court found that, although the obstetrician had made a wrong diagnosis, the diagnosis actually made was not unreasonable on the information then available. Accordingly, the legal advice that was given on the medical evidence was not negligent. The main point of interest for other professions is that the Court also held that this claim would, in any event, have been statute-barred. The mother had known that she was unhappy with the advice in 2001. She had approached other lawyers in 2009. The Court took the view that she had had constructive knowledge of her cause of action since 2001 and that it was not reasonable to wait a further eight years before approaching other lawyers.

Chinnock is relevant when considering the Latent Damage Act 1986 in the UK and the Limitation Ordinance Cap 347 in Hong Kong. In both jurisdictions, a Plaintiff is given an extended period of 3 years to bring a claim in tort from the date of the facts required for bringing an action for damages. There is usually huge debate as to when that knowledge was said to arise. In this case, the decision was heavily influenced by the fact that Ms Chinnock said she was "dumbfounded" at the time by the advice that she received. Such a statement led to the Court concluding that she realised at the time that the advice was in question and so concluded that she ought consequently to have sought a second opinion at a much earlier stage.

The New China Hong Kong Group Limited & Orts v Ernst & Young & Wu Ting Yuk Antony (Court of First Instance, 2008)

This is an older case but, for accountants in Hong Kong faced with a "stale claim", which has been brought many years after the date of the alleged breach, one worth turning to.

The plaintiff alleged that EY had failed to highlight and warn the company of several substantial advances to 7 debtors that were made with insufficient security and whose ability to repay was doubtful in the years 1994 and 1995. The Plaintiff alleged that, but for EY's failure to warn, report or make disclosure in the audit reports, the company would have taken remedial steps or refrained from making further advances in subsequent years. Hence, the loss would have been avoided.

EY argued that the claims were already time-barred when the Plaintiff commenced the proceedings in July 2004 as it had been more than 6 years since the breach. In response, the Plaintiff argued that EY owed a continuing duty of care on the basis that subsequent advances were made using EY's 1994 and 1995 audited accounts up until 1999.

The Court confirmed that the essence of the duty of an auditor is to exercise reasonable care and skill when performing their audit work and in relation to the views expressed in the audit reports. Hence, any breach of duties arises from failures to exercise such care or skill, and a breach is committed the moment when the failures occur, which must be distinguished from when the resulting damage arises. The Court dismissed the Plaintiff's claim and held that the argument that every further advance gives rise to a separate breach and a separate cause of action is a substantial departure from the distinct concepts of breach and damages.

The case also dismissed the Plaintiff's arguments over s.26 of the Limitation Ordinance applying, for alleged fraud, concealment or mistake.

Limitations of Liability in Engagement Terms

In Hong Kong, s415 of the Companies Ordinance (previously s165 of the old Companies Ordinance) provides that any provision in a company's articles or in a contract entered into which seeks to exempt the company's auditor from any liability that would otherwise attach to the auditor in connection with any negligence, default, breach of duty or breach of trust occurring in the course of performance of the duties as auditor in relation to the company, is void.

Clearly, however, this restriction applies only to audit engagements. Accountants in Hong Kong who may wish to limit their liability in other engagements may be encouraged by the following recent (largely UK) decisions.

West v Finlay (Court of Appeal, 2014)

A "net contribution clause" is a contract term stating that, where more than one person is liable for the same loss or damage, the contracting party's liability will be limited to the fair and reasonable (or just and equitable) amount that a Court would apportion against it. The existence of such a clause can make a significant difference when more than one party may be liable for the loss. If one of the defendants is impecunious, the other can be held liable for the entirety of the loss under the principle of "joint and several" liability. A net contribution clause seeks to prevent that happening.

In this case, the Court upheld a net contribution clause in an architect's contract. Giving consideration to the normal meaning of the words, the clause was not ambiguous. Although the clause created an imbalance in the parties' rights under the contract and Finlay failed to draw West's attention to it, it was presented openly and Finlay dealt fairly in relation to it. Further, West was not induced to agree to the clause and could have renegotiated it, gone to another architect or even protected against the risk posed by it through another commercial route. Therefore, the clause was not contrary to the requirements of good faith or reasonableness under the Unfair Terms in Consumer Contracts Regulations 1999 and the Unfair Contract Terms Act 1977 which applied in the UK (and which are broadly analogous to the Control of Exemption Clauses Ordinance (Cap 71) and the Unconscionable Contracts Ordinance (Cap

458) in Hong Kong.

Elvanite Full Circle Limited v AMEC Earth & Environmental (UK) Ltd (High Court 2013)

The claimant claimed damages for losses from a professional consultant. In the parties' contract there was a term providing that the defendant would not be responsible for any consequential, incidental or indirect damages, and limiting the defendant's liability to the total paid for its services or £50,000 (whichever was less). The clause also provided that all claims against the defendant would be relinquished unless filed within a year following substantial completion of service. The Court considered the clause on an obiter basis and found it to be reasonable pursuant to the Unfair Contract Terms Act 1977. With regard to the requirement to "file" a claim within one year, the Court noted that High Court proceedings are commenced when a claim is issued, and the word filed was not apt to describe the commencement of proceedings. However, the clause could be properly read as a reference to the sending of a Letter of Claim as required under the CPR pre-action protocols.

This is an important decision in upholding the potential to limit a professional's liability by restricting the period within which a claim has to be brought, and thereby reducing the statutory limitation periods by contract.

Emirates Trading Agency LLC v Sociedade de Fomento Industrial Private Ltd

This case does not deal with limitations of liability as such, but is relevant in this context, as it deals with multi-tiered dispute resolution clauses. Such clauses provide for alternative forms of dispute resolution (for example, mediation or negotiations by senior management) prior to the commencement of a formal claim. In some ways, such clauses may deter (or delay) the bringing of a claim by the Plaintiff, by creating "hurdles" which they must cross before commencing formal proceedings.

In this case, the High Court decided that it could enforce a clause in the parties' agreement requiring them to seek to resolve the dispute by "friendly discussion" for four weeks before commencing arbitration proceedings.

The Court held that the provision was complete as no essential term was lacking and an obligation to seek to resolve disputes by friendly discussions imports an obligation to do so in good faith. A time limited obligation to seek to resolve a dispute in good faith was enforceable.

Contract (Rights of Third Parties) Ordinance (Cap. 623)

The Ordinance, mirroring the UK's Contracts (Rights of Third Parties) Act 1999, was passed in December 2014 and came into force in January 2016.

The Ordinance, while not abolishing the doctrine of privity, does provide for a mechanism for parties to expressly agree in a contract that persons who are not party to it will have rights under it. More importantly, it means that third parties may, in some circumstances, enforce the terms of a contract, even in the absence of express statement giving them such rights.

In summary, the Ordinance provides that a third party may enforce a term of a contract if:

1. The contract expressly provides that the third party may; or
2. The contract purports to confer the benefit of that term on the third party; and, in either case
3. The third party is expressly identified in the contract by name or as a member of a class or as answering to a particular description.

The new Ordinance has important implications for engagement terms. Accountants will not want third parties (such as creditors, or individual shareholders) seeking to argue that the engagement terms purported to confer a benefit upon them, and so they can also bring a claim for breach of contract. Accordingly, accountants will wish to expressly exclude the Ordinance insofar as it seeks to confer a benefit upon such third parties. However, there may be one limited respect in which an accountant may wish to rely upon the Ordinance. This is to expressly pass on the benefit of any limitations of liability or exclusions onto their own employees, who would not technically be parties to the contract.

Lastly, it is important to note that the Control of Exemption Clauses Ordinance (Cap. 71) will continue to apply and imposes restrictions on exclusions and limitations of liability.

Further information

If you would like further information on any issue raised in this update please contact:

Patrick Perry, Partner
E: patrick.perry@clydeco.com

58th Floor, Central Plaza,
18 Harbour Road, Wanchai
Hong Kong, China

T: +852 2878 8600
F: +852 2522 5907

Further advice should be taken before relying on the contents of this summary.