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AKINJIDE & CO

BARRISTERS, SOLICITORS
& ARBITRATORS

RECENT DEVELOPMENTS IN RELATION TO ACTION AGAINST AUDITORS

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INTRODUCTION

The role of the company auditor is of particular importance to shareholders of a company as they look to the auditor to provide them with an objective and professional report on the affairs of the company. This reliance on the auditor's report by shareholders and prospective investors or lenders has led to an increasing level of negligence claims being brought against auditors.

> *"I would not be surprised if some of us head for the Federal High Court very soon over some publicly quoted companies some of whom have been dormant since going "public", we have cause to believe that the certificate of the auditors misled us to part with our money."*
>
> **-** Akintunde Asalu, President of the Nigerian Shareholders Solidarity Association (the "NSSA") 1998.

When in 1996 Chief Anthony Ani (at that time the Minister of Finance) chose his professional colleagues over everyone else for the plumb job of duties collection at the ports, there were many complaints. These complaints centred on the accusation that it is precisely these accountants as external auditors to various institutions in Nigeria, especially banks which have misled the public by vouching for the health of these institutions, that subsequently went under. That is why the regime of Generel Sani Abacha made it known that it would review the Banking and Other Financial Institutions ("HOFID") and Company and Allied Matters Decree ("CAMD") to expand the duties of directors and auditors.

The auditors of companies are, for the most part, carried out by a relatively small team of experts whose failings make every partner in the firm personally liable for the negligence perpetrated by the team.

The liabillty of professional advisers for **negligent misstatment** has been developed through a series of cases over the years starting with *Hedley Byrne -v- Heller* (1964) AC 465.

The cases:

Bank references: In *Hedley Byrne -v- Heller*, a bank reference was given to a person about to extend credit to the bank's customer. The House of Lords determined that, in principle, a duty of care existed in these circumstances, although in that particular case there was no liability because of a disclaimer in the reference (which would not necessarily hold up today).

Mortgage valuations: In two cases decided at the same time at the House of Lords, it was decided that in preparing valuations for mortgages, surveyors owed a duty of care to a house purchaser *(Smith -v- Eric Bush and Harris -v- Wyre Forest DC* (1989) 2 WLR 790). In the *Smith* case, the report was shown to the purchaser, but in the *Harris* case, it was not. In each case, however, the purchaser paid the surveyor's fees. The House of Lords considered that there was sufficient proximity and it was foreseeable that the purchaser would rely on the report in making his house purchase.

Auditors: In *Caparo Industries -v- Dickman* (1992) 2 WLR 358, Caparo Industries, who were taking over Fidelity plc, claimed that it did so on the strength of the audited accounts (which they claimed were negligently prepared) and attempted to sue the auditors, Touche Ross. The House of Lords held that the auditors owed no duty of care for their audit work either to individual shareholders or to members of the public who might be potential investors (including bidders). Caparo has helped to head off a large number of claims against auditors from dissatisfed investors. But Caparo is unlikely to assist accountants outside a straightforward audit situation.

Can professionals be liable for advice given informally?

The courts have considered this question as well in two recent cases, both involving auditors. The first, *ADT -v- Binder Hamlyn* (1996) BCC 808, was a salutary tale of informal indications giving rise to a massive liability.

This case is a good example of how auditors can assume liability for their accounts to a third party in a situation where, but for the establishment of some special relationship, they would not have been held liable. The High Court (Mr Justice May) awarded £105 million (including interest and costs) against the partner of BDO Binder Hamlyn. The claim arose from the acquisition of Britannia Security Systems by ADT, the electronic security group, in early 1980.

Shortly before the acquisition, a representative of ADT met the BDO Binder Hamlyn audit partner who had signed off Britannia's accounts 11 weeks earlier. The audit partner confirmed at the meeting that he stood by the audited accounts. The Court found that, by giving this confirmation, the auditor assumed responsibility for the reliability of the accounts to ADT. (There was no dispute that the accounts had been audited negligently.)

The auditor had received little notice of the meeting and claimed that he was unaware of the progress of the bid. But, on an important finding of fact, the judge considered that even though the auditor was "neutral" as to the persuasive value of his confirmation, he was aware that ADT was relying on the accuracy of the accounts to go ahead with the bid.

Mr Justice May considered that the size of potential liability and the commercial problems over insurance did not outweigh all the relevant factors in determining liability, and stressed that the auditor failed to make any disclaimer or qualification to his remarks.

The author would like to point out that, as a result of this case, all major accounting firms now have strict policies on disclaimers.

Note that the case does not change the law on negligence; it merely further defines the situation in which a duty of care can arise.

The BDO in the Binder Hamlyn, after a seven year battle, agreed to pay nearly US$86 million (£50 million) in an out-of-court settlement with ADT.

The second, *Electra Private Equity Partners -v- KPMG* (1998) PNLR 135. Again, there was an informal meeting between the plaintiff company, which was thinking of investing in a certain Irish company, and that company's auditors. Certain assurances were given about the audited accounts.

The court found, however, that the auditors could not be liable for the investors' losses that were incurred by disastrous investment in the Irish company, even though the accounts were deficient, as comments about them by the auditors were made only on an informal basis and, in any event, the plaintiff company had its own advisers.

The test appears to be whether the maker of an informal statement actually assumes responsibility for the accuracy of that statement to the person to whom it is made. This approach was recently approved by the Court of Appeal in another auditors' case, *Peach Publish -v- Slater* (1998) PNLR 364.

In *Al Saudi Banque -v- Clark Pixley* (1989) 3 All ER 361, Millet J. held that no duty was owed by the company's auditors in the preparation of the annual audited accounts to the bank lending to the company.

The Times, Friday 19 September 1997 reports that Ernst & Young agreed to pay US$100 million (£60 million) for its role in a 1990 US banking crisis. As auditor of a local insurer, Ernst & Young, it was indicated at the closure of 45 banks and credit unions in the state of Rhode Island. The crisis started with the failure of a small bank insured by the Ernst & Young client, which led to a state-wide run on deposits and the unexpected collapse of the insurer, whose reserves were depleted. Ernst & Young denied any wrongdoing and was settled out of court because of the high cost of commercial litigation in the US. Part of the amount paid out was covered by its own insurance. The article goes on to report that in the four years to 1995, Ernst & Young had to pay out US$400 million out of a total of US$1 billion in US compensation settlements (according to the National Associatíon of Securities and Commercial Law Attorneys).

Principles Emerging

The following principles appear to emerge from this case-by-case analysis:

(a) Accountants will not generally be liable in negligence for the auditing of accounts other than to the company and possibly the body of shareholders generally.

(b) If accountants involved themselves in discussions with a third party a duty of care may not be established, but clearly where there is likely to be reliance by that third party, they risk establishing a duty of care.

(c) If accountants are employed to perform a particular task, such as undertaking an accountant's report in the course of a transaction, they may owe a duty of care to an interested party (such as a bidder or a lending bank), particularly íf identified and especially if the interested third party is likely to rely on the report. This applies equally to other professional advisers, quite apart from any liability they may incur by virtue of authorising prospectuses or other investment advertisements.

In the case of *Abbott and Others -v- Strong and Others* (9 July 1998), the plaintiffs are the shareholders of Resort Hotels Plc ("Resort"), and the claim is for damages arising out of sums subscribed in connection with a rights issue by Resort. The rights issue was made on the back of a circular which contained a profit forecast which had been reviewed by Coopers & Lybrand

Deloitte ("Coopers"). Two years after the rights issue, Resort went into administrative receivership. This was an application by Coopers to strike out parts of the statements of claim, it should be noted that the case itself is based upon several claims, including the express wording of Coopers' letter. These claims are still to be decided.

His Honour Judgc Ferris decided that the application turned upon whether Coopers owed a duty of care to the plaintiffs in respect of the accuracy of the figures stated in the circular beyond the duty of care (if any) which, on the true construction of Coopers' letters, Coopers owed to the plaintiff by reason of the representations contained in Coopers' letter.

Background Facts

The circular issued in connection with the rights issue included the letter from Coopers to the directors of Resort in the following terms:-

> *"We have reccived the accounting policies and calculations for the Forecast of profit... The Forecast, for which the directors of the Company are solely responsible... In our opinion, the Forecast, so far as the accounting policies and calculations are concerned, has been properly compiled and is presented on a basis consistent with the accounting procedures normally adopted by the Group."*

The circular also contained a statement that Coopers had not withdrawn consent to the inclusion of their letter in that circular.

It transpired that the circular contained material and substantial errors including an excessive profit estimate.

The plaintiffs argued their case upon the premise that Coopers owed to the plaintiffs a duty of care, in addition to any liability arising from the letter, to carry out all work for Resort with reasonable care. This judgment relates only to this duty of care claim and not to the claim based upon the express wording in Coopers' letter.

The Judge said:

> *"I do not find it comprehensible that a person (X) who makes a statement or gives advice to another (Y) for the purpose of assisting Y to make representations to a third party (Z), is to be regarded as owing a duty of care to Z when the participation of X in the preparation of Y's statement is unknown to Z."*

X is not assuming any responsibility towards Z for, so far as Z is concerned, the advice is Y's alone. The matter might be different if Y tells Z of X's participation even if X did not know that Y would do so.

The Judge said that this could not happen in the context of a rights issue where it is a well established practice that the documents shall contain a statement to the effect that the maker of a report has given and has not withdrawn his consent to the inclusion of his report in the document.

In the landmark case of *South Australia Asset Management Company* (sometimes known as BBL), the House of Lords saw fit, in effect, to limit the extent to which professionals involved in lending transactions could be liable for losses that accrued, by holding that falls in the property market where net losses that could be late at the door of valuers originally instructed to place a value on the proposed security.

The decision in this case is clearly good news for professionals and their insurers as it goes against the flood of litigation against professionals' insurers.

To what extent, therefore, can professionals be held liable for horrendous consequences of transaction in which they are involved? A number of recent cases have shed light on this question.

Hurlingham Estates Limited -v- Wilde & Partners (1997) 1 Lloyds 525

In the *Hurlingham Estates* case, solicitors were instructed to act in a transaction which involved the granting of a lease and then a sub-lease to an associated company, both at a premium. Unfortunately, the solicitor dealing with the transaction had experience only in commercial property matters and had no experience in taxation. The effect of the transaction which he set up was to expose his client to a tax liability which could have been avoided had a direct lease been granted to the associated company. The angry clients sued their solicitor in respect of one head liability.

The solicitor admitted that he had no knowledge of tax matters and argued that the terms of his retainer were only to do with the conveyancing aspects of the transaction. The court rejected this argument and held that, even if such a retainer had been specifically agreed, it would be difficult to believe that such agreement had been reached with the clients' informed consent.

The Judge found that it was entirely inappropriate for solicitors to undertake conveyancing transactions which might expose their clients to tax liabilities, such solicitors having no true knowledge. It was insufficient for the solicitors to plead that they only had conveyancing expertise. The solicitors should have been aware that there might have been tax implications of the proposed arrangement and advised their clients accordingly.

The solicitors were found liable.

Matrix Securities Limited –v- Theodore Goddard (1998) STC 1

In the *Matrix Securities* case, the plaintiff company instructed its solicitors to advise on a complex scheme involvíng property unit trusts, which was being set up for the purposes of obtaining tax relief. The solicitors, assisted by leading tax counsel, obtained clearance for the scheme from a tax inspector. Unfortunately, that clearance was later withdrawn by the Revenue's head office, which withdrawal led to the collapse of the scheme.

The plaintiff company sued both its solicitors and tax counsel for the losses sustained through the collapse of the scheme. The court, however, held that both the solicitors and counsel had not fallen short of the admittedly high standard of expertise expected of a City firm and leading tax counsel. Just because the scheme eventually floundered, there was no reason to find solicitors and counsel liable. They could not be expected to be liable for failing to produce for their clients Revenue clearance that was 100% reliable.

Hill -v- Mullis and Peake (Unreported 6 May 1998)

In the *Hill* case, the plaintiff was involved with the hotel business that went wrong. The court found in favour of the solicitors stressing that, throughout the transaction, the solicitor had exercised professional judgment and that although the choice was made as a result of such professional judgment might, with hindsight, be seen as wrong, this did not necessarily lead to a finding of liability on behalf of the solicitors. The solicitor (or other professional) could be liable only for losses that occurred as a result of an exercise of judgment if that exercise of judgment was one that no reasonably competent member of the profession could have exercised.

The *Matrix Securities* and *Hill* cases illustrate circumstancss in which professionals were involved with transactions that went wrong, but nonetheless were not found liable for losses.

The Client's Expertise

Recent cases have also made it clear that the courts will consider a client's own expertise and commercial awareness when deciding whether a professional has not fulfilled their duty of care to their client.

In *Reeves -v- Thring & Long* (1996) PNLR 265, the court stressed that professionals must use language that they can be reasonably sure their client will understand, and therefore, in the case of an experienced client; professionals would appear entitled to assume an appropriate level of knowledge and therefore not have to explain each and every matter in simplistic detail. *MHL -v- Giffen Couch & Archer* (1997) 3 All ER 808 reaffirms that the scope of professionals' duty of care (and thus whether they can be found liable for losses) will depend on the commercial experience of the professionals' client- the less experienced the client is deemed, the more the professionals have a duty to look after that client.

The French Experience

Companies in France are required to appoint for the purposes of the annual certífication of accounts and other legal steps in connection with the audit of a company's finances one or two auditors. In the exercise of their tasks, they are liable to the company for which they act as well as to third parties for loss and damage resulting from their fault or negligence (Article 234 of Law No. 66-537 of 24 July 1996 ("Law of 1996"), the French equivalent to the English Companies Act).

Article 1382 of the Civil Code requires that the loss and damage be caused directly by the fault or negligent act or omission complained of and that proof be brought of both the existence of that act or commission, as well as of the loss which is suffered. Not all of the auditor's acts give rise to liability, as an auditor is only liable to the extent he is required to guarantee the veracity and authenticity of the accounts. The obligations undertaken by the professional may be deemed to be either a duty to show reasonable care or an absolute duty, which is similar to the difference in contract law between a warranty and a condition. Article 1137 of the Civil Code provides that the standard expected of an auditor is that of the competent, diligent and active member of his profession.

Examples of fault for which an auditor would be liable include the failure to carry out any more of the tasks he is required to by law, such as examination

of the accounts, mention in the report the existence of company contracts with an incidence of financial risk and reporting irregularities to the competent authorities.

Limited Liability

Like all professional firms operating under a partnership, the accountants have found that the core of the problem is the joint and several liability of partners under partnership law. In general, partners are liable for the debts and obligations of the partnership without limit. Where a partnership is unable to pay its debts, a creditor is entitled to obtain payment from the private assets of the individual partners. Because the big firms have extensive financial resources, they are perceived to have "deep pockets" i.e., they are perceived to offer rich pickings to potential litigants!

The court procedures for awarding damages do not help them. Even where there are a number of defendants in a case, the plaintiff can bring a claim and enforce a judgment against any one defendant (other than the accountants) who must then seek contribution from co-defendants. The onus of establishing liability of other defendants and to credit risk therefore shifts from the plaintiff to the defendant with the deepest pockets.

Because of the foregoing considerations, all the major accounting firms are now believed to be looking at the possibility of limited liability.

KPMG has been the first firm formally to limit liability. It has incorporated a new company to take on the audít work of listed and regulated companies - the hígh risk audits. The company has received formal authorisation from the Institute of Chartered Accountants and has replaced the partnership as auditor of client companies at AGMs.

The main drawback of limited liability partnerships under English law is that the limited partners cannot participate in the management of the partnership without losing the right to limited liability. Further, at least one of the partners must be a general partner with unlimited liability. A further drawback to the limited partnership solution is that it destroys the ethos of partnership philosophy. ln addition, limited liability is only relevant in a "disaster scenario" when all of the forms, apart from the auditors' personal assets, have been exhausted. A huge claim may not result in the bankruptcy of individual partners but may result in the liquidation of the audit vehicle.

Defences

Some fo the relevant defences which an auditor sued for negligence may be able to deploy are:

(a) **Disclaimers**

Disclaimers may or may not be effective for a number of reasons.

They may be too narrowly worded; where they are contractual they may be outlawed (under English law, for example, by the Unfair Contract Terms Act 1997); and they may also be overridden by the actual behaviour of the person seeking to deny liability.

The most effective element of a disclaimer may be that part that denies reliance and breaks the "special relationshíp".

(b) **Contribution Claims/Cross Claims**

This doctrine enables a defendant to obtain a contribution from a third party in circumstances where there is common liability between the defendant and the third party. In *Employees Corporate Investments Pty Ltd -v- Cameron and ors* (1977-78) CLC 40, the cross claim was based on the auditors and directors being liable to the company for the same damage.

(c) **Contributory Negligence**

The starting point is section 1 of the Law Reform (Contributory Negligence) Act 1945, which states:

> *"Where any person suffers damage as the result partly of his oum fault and partly of the fault of any other person or persons, a claim in respect of that damage shall not be defeated by reason of the fault of the person suffering the damage, but the damage recoverable in respect thereof shall be reduced to such extent as the court thinks just and equitable having regard to the claimant's share in the responsibility for the damage".*

The 1945 Act does not apply when the plaintiff's claim is for damages for deceit (see *Alliance & Leicester -v- Edgestop* (1993) 1 WLR 462), or for breach of trust.

Under *Forsikringsaktieselkapett Vestor -v- Butcher* (1986) 2 All ER 488, the Law Reform (Contributory Negligence) Act 1945:

(i) applies to contract actions where the defendant was in breach of the duty of care which would have existed independently of the contract;

(ii) it does not apply to contract actions where the duty of care that has been broken would not have existed independently of the contract;

(iii) it does not apply to an action where the defendant is in breach of a straight contractual duty.

If auditors are sued in contract by a client, they are unlikely to have recourse by way of client contributory negligence in circumstances where the employees have also been negligent/ fraudulent. If sued in tort, they are in a more favourable position. In the context of defences, I have not examined here the defence of *volenti no fit injuria* – a legal principle which states that the plaintiff has voluntarily assumed the risk in the context of negligence. The plaintiff's express/implied agreement to assume the risk of a particular activity, and therefore absolve the defendant of responsibility, is seldom successful in relation to audits.

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