

‘Where does the buck stop when separate audits are carried out in the component organisations of a global commercial entity?’

Auditors are appointed by a company to investigate and form an opinion on the adequacy of its accounting records and returns and to report to the shareholders whether in their opinion the accounts give a true and fair view of its financial position: see per Bingham L.J. in *Caparo Industries Plc v Dickman* [1989] Q.B. 653, 680-681 cited with approval by Lord Bridge at [1990] 2 A.C. 605,625. The classic statement of the law was made by the House of Lords in *Caparo*, which provided that the audit duty was owed to the company, to protect it from the consequences of undetected errors and wrongdoing (e.g. fraud), and to the company's shareholders as a body to enable them to exercise their collective powers of scrutiny and control. Absent some special relationship, or an assumption of responsibility by the auditor, auditors will not owe duties to individual investors, existing or prospective, who claim to have relied on the audit opinion in reaching their investment decisions.

The auditors' general duty includes a duty to take care to prevent the company suffering loss through frauds committed against it: *Sasea Finance Ltd v KPMG* [2000] 1 All ER 676.

There appear to be three possible approaches to dealing with claims between auditors and companies affected by fraud, each of which presents problems of its own. First, the fraud could be attributed to the company, following the general rule, and the auditor's negligence in failing to detect it can be offset by some measure of contributory negligence on the part of the company. This is a workable position, although it may appear somewhat odd in view of the fact that the company is, *ex hypothesi*, fraudulent, and the auditor is only negligent.

The second method might be again to follow traditional rules and attribute the fraud of the employee to the company, and this fraud would preclude the company from

recovering any damages against the auditors who negligently failed to expose it. This may be the worst possible result, as the auditor would be relieved of any responsibility for the breach of an important duty. This was the result in the very recent case of *Stone & Rolls Ltd (in Liq.) v Moore Stephens* [2007] EWHC 1826, to which reference is made below.

The third avenue may be to argue that although the fraud of the employee would normally be attributed to the company, it would be inappropriate to do so in determining the liability of the company's auditors whose very duty is to detect such fraud.

The problem with this route, however, is that if there is no attribution at all, it would seem inequitable that a company would be held contributorily negligent if the employee is negligent, but not if his behaviour is more seriously wrong. Of course, the prospect of a claim for contributory negligence remains if there has been a fraudulent director or employee, on the basis that the company did not protect its own interests as it should.

These issues have been partly decided in two recent cases, but in somewhat curious ways.

The first is *Barings PLC v. Coopers & Lybrand* [2003] P.N.L.R. 34. The point was framed around a counterclaim by the auditors for deceit causing their loss, which was the money they owed Barings as a result of their own negligence. They relied on representations instigated by the fraudulent Mr Leeson. Evans-Lombe J rightly found them to have been made in the course of Mr Leeson's employment, and (more controversially) he followed normal principles of attribution and Mr Leeson's conduct was attributed to Barings. The judge declined to find that the auditors were officers of Barings and thus could not rely on the general rule of attribution (or fashion a special rule of attribution as was done in the *Arab Bank Plc v Zurich Insurance Company* (1999) 1 Lloyd's Rep 262). The judge's way of defeating the auditor's claim was different, but the result was substantially the same. Evans-Lombe J held that the cause of the auditor's loss was their own failure to investigate Mr Leeson's representations. He found the auditors to

be liable but reduced the damages payable by 50% in the early stages of the fraud, rising to 80% in the later stages.

The second case is the recent decision of the Court of Appeal in *Man Nutzfahrzeuge AG v Freightliner Ltd* [2007] EWCA Civ 910. There, Ernst & Young (EY) were auditors of the truck manufacturer ERF, which was 100% owned by Western Star in Canada (which was itself later acquired by Freightliner LLC). From 1997 onwards, ERF's financial controller had persistently manipulated its accounts. In 1999, when completing their audit, EY were aware, that Western Star was in negotiations to sell ERF to Man Nutzfahrzeuge (MN) and that the audited accounts would be made available to MN. The Court of Appeal were prepared to accept that the auditor of a subsidiary company might owe a 'special audit duty' to the parent company in respect of its audit of the subsidiary which the auditor knows is to be sold. Even then, however, liability would depend upon the parent company being able to establish that the scope of the special audit duty extended to the specific loss which the parent suffered as a result of the breach of such duty of care.

On the facts, the auditor was absolved from any duty to protect the owner of the subsidiary from liability for damages for deceit due to dishonest statements by the financial controller of the subsidiary as to the accuracy of the accounts.

The Court of Appeal relied heavily upon the test for the assumption of responsibility in the context of auditors' liability following the decision of the House of Lords in *Customs and Excise Commissioners v. Barclays Bank Plc* [2006] 4 All ER 256. This case concerned the extent to which a bank in receipt of a Freezing Order owed a duty of care in its handling of the frozen account to the party which has obtained a Freezing Order. The test as to whether a defendant has assumed responsibility to a claimant as explained by Lord Hoffman in the Barclays Bank case is as follows:

"In.....cases in which the loss has been caused by the claimant's reliance on information provided by the defendant, it is critical to decide whether the defendant (rather than someone else) assumed responsibility for the accuracy of the information to the claimant (rather than to someone else) or its use by the claimant for one purpose (rather than another). The answer does not depend upon what the defendant intended but.....upon what would reasonably be

inferred from his conduct against the background of all the circumstances of the case".

In applying that test, with its objective element, to the factual matrix as between EY and Western Star, the Court of Appeal found it "impossible to hold" that EY had assumed responsibility for the actual use made by the financial controller of ERF, on behalf of Western Star, of the information which the auditors had provided to Western Star.

The Court of Appeal upheld the findings of Moore-Bick J that

- (1) In conducting their audit in relation to the 1999 accounts, EY owed Western Star a general audit duty and were negligent in failing to detect the fraud by ERF's financial controller (by failing to verify the purchase ledger control account reconciliation and to investigate ERF's VAT position (para 395);
- (2) Nevertheless, to establish liability, it was necessary to show that EY assumed a 'special audit duty' in respect of the negotiations between Western Star and MN for the sale of ERF:
- (3) EY were aware of the negotiations between MN and Western Star for the sale of ERF and could foresee, and must be taken to have known, that Western Star would itself rely on the 1999 ERF accounts in those negotiations, as presenting a true and fair view of ERF's financial position;
- (4) The transaction which gave rise to the loss suffered by Western Star was the sale of ERF by Western Star to MN;
- (5) The loss suffered by Western Star was liability in damages for deceit arising from statements made by the financial controller in the course of negotiations between Western Star and MN;
- (6) Western Star was vicariously liable for the deceit practiced by the financial controller, who was representing Western Star at the material time (para 109 of the judgment) - The Judge declined, however, to attribute the knowledge of the financial controller to Western Star;
- (7) "[B]y suppressing what he knew [the financial controller] quite deliberately led MN to believe that ERF's accounts had been honestly maintained and that the financial statements based on them had been honestly drawn. Thus his

- concealment of the true position was nothing more than the means by which he made the false statements...” (para 114);
- (8) It had not been shown that EY knew that Western Star was intending (through the financial controller) to make representations as to the accuracy of the 1999 accounts in its negotiations with MN;
- (9) It could, therefore, not be said that that in making the audit statement as to the 1999 accounts, EY had assumed a duty to protect Western Star from liability “for dishonest statements which [the financial controller] might make as to the accuracy of those accounts”.

It seems at first blush difficult to reconcile the two different approaches in *Barings* and *Man Nutzfahrzeuge*. Although the fraudulent misrepresentations for which Freightliner was held to be vicariously liable might have given rise to damages exceeding the liability to which Western Star might otherwise be exposed as a consequence of their reliance on EY’s negligently prepared accounts, it is hard to see why EY should be absolved from any liability for breach of a special duty of care owed to Western Star in relation to the very transaction which gave rise to MN’s claim against them.

The case is of course distinguishable from *ADT Ltd v BDO Binder Hamlyn* [1996] BCC 808 where BDO Binder Hamlyn had audited the accounts of Britannia Securities Ltd, for which ADT, the electronic security group, was making a takeover offer. There, it was one of BDO’s partners who orally confirmed to ADT at a meeting that he stood by the audited accounts. After completing its takeover of Britannia ADT successfully claimed its losses from BDO when it turned out that Britannia’s accounts had been negligently audited. By orally confirming the accounts the auditor had assumed responsibility to ADT for their reliability.

Under sections 532-538 of the Companies Act 2006 (which came into force on 6 April 2008) companies are permitted to limit the liability of their auditors by contract so long as a court would find them “fair and reasonable”. The Act states that for a liability limitation agreement to be valid it cannot cover more than one financial year and it must

be approved by a resolution of the company's shareholders. For public companies this must be done at a general meeting, while private companies have the option of using a written resolution, and for group companies this means each UK company in the group and not just the holding company.

Despite the new provision, joint and several liability prevails in this area of the law. Under the Civil Liability (Contribution) Act 1978, the auditor may claim contribution from others who are liable, but recovery may prove difficult. This remains the case whether or not liability limitation agreements are not signed.

Another approach to the apportionment of blame for auditors' failure to expose fraud is the more recent decision of the Court of Appeal on attribution is *Stone & Rolls Ltd (in Liq.) v Moore Stephens* [2007] EWHC 1826 (which doubted the *Arab Bank* case referred to above). There, the liquidator of Stone & Rolls (S&R) sued the accountancy firm Moore Stephens (MS) in negligence as auditor of S&R. The liquidator claimed that MS negligently failed in the course of various audits to detect the dishonest behaviour of the individual (S) who was at the relevant time the sole directing mind and will of S&R.

S had dishonestly procured S&R to engage in a letter of credit fraud on banks through which substantial sums of money were channelled through S&R and applied for the benefit of S and others. The frauds gave rise to liabilities by S&R to the banks, in particular to a Czech bank. That bank sued S&R and S in deceit and was awarded substantial damages against both. S&R could not pay and went into liquidation. MS denied negligence and successfully applied to strike out the claim or for summary judgment contending that S&R was seeking an indemnity against liabilities it had incurred by its own fraud and that such a claim was barred by the principle of public policy expressed in the maxim *ex turpi causa non oritur actio*.

The Court of Appeal held that if, in order to advance a claim, it was necessary for the claimant to plead or rely on illegality, the claim was automatically barred, however good it might otherwise be, and the court had no discretion in the matter, *Tinsley v Milligan*

[1994] 1 AC 340 HL. S&R's claim relied upon, was based substantially on, arose out of and was inextricably linked with the fraud that was perpetrated on the banks. That fraud was actually perpetrated by S, who was S&R's sole directing mind and will. Although a company would not have attributed to it knowledge of a fraud when that fraud was being practised on the company itself (*Hampshire Land Co (No2)* (1896) 2 Ch 743 and *JC Houghton & Co v Nothard Lowe & Wills Ltd* (1928) AC 1 HL), this principle would ordinarily only apply in circumstances in which the agent intended to harm the company or it was the target of the agent's acts, and it was not enough to engage the principle that an agent's acts might result in harm to the company. The instant case was not, then, one in which the Hampshire Land principle applied. The principles of attribution required S's dishonesty to be imputed to S&R, which should therefore itself be liable for the frauds. S&R was neither the target nor the victim of its agent's dishonesty. It was itself the fraudster, and it made no difference that its frauds were likely, when and if found out, to result in the incurring of liabilities by S&R.

Importantly, the Court held that there was no support in the authorities for the proposition that if the very thing from which the defendant owed a duty to save the claimant harmless was, or included, the commission of a criminal offence, the public policy defence based on the *ex turpi causa* principle would be overridden so as to enable the bringing of the claim that relied on the claimant's illegality, S&R's claim relied upon its own illegality, and it therefore failed on the principle of *ex turpi causa*, which was not trumped by the "very thing" argument.

The case is currently the subject of a Petition to the House of Lords.

On the other side of the coin, and the other side of the Atlantic Ocean, auditors have been exposed to liability for securities fraud.

In *Overton v. Todman & Co.*, 478 F.3d 479 (2d Cir. 2007) the Second Circuit Court of Appeals held that an accountant has a duty to correct its certified opinions and may incur primary liability for securities fraud for failing to do so. There, plaintiffs alleged that

accountants for Direct Brokerage Inc. (DBI) issued unqualified opinions that the financial statements accurately reflected DBI's financial health. But the accountant allegedly failed to correct those opinions when errors in the financial statements came to light.

"The precise issue on appeal," Justice Chester Straub wrote for the Court, "is whether an auditor may incur primary liability under [section] 10 (b) and Rule 10b-5 when the auditor provides a certified opinion that is false or misleading when issued, subsequently learns or was reckless in not learning that the earlier statement was false or misleading, knows or should know that potential investors are relying on the opinion, yet fails to take reasonable steps to correct or withdraw its opinion and/or the underlying financial statements. We hold that under such circumstances, an auditor becomes primarily liable for securities fraud, assuming all the other elements of a securities fraud claim are present."

And in this case, Straub wrote, "since the complaint pleads precisely this theory of liability, we vacate the district court's dismissal and remand for further proceedings consistent with this opinion."

Reversing the dismissal of the securities fraud claim against the accountant at first instance, the Second Circuit held that "an accountant violates the 'duty to correct' and becomes primarily liable under Section 10(b) and Rule 10b-5 in the circumstances described. "[F]or many years," said Justice Straub, "we have recognized the existence of an accountant's duty to correct its certified opinions, but never squarely held that such a duty exists for the purposes of primary liability under [section] 10(b) of the 1934 act and [SEC] Rule 10b-5. Presented with an opportunity to do so, we now so hold."

For the uninitiated, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder prohibit the fraudulent sale or purchase of any security. Neither Section 10(b) nor Rule 10b-5 expressly permit injured investors to sue for securities fraud, but since the early 1970s, the Supreme Court, in cases such as *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), has recognised an implied private right of action for violations of Section 10(b) and Rule 10b-5. In the aftermath of *Bankers Life*, this implied

private right of action was used to reach not only primary participants in the alleged fraud, but also secondary participants, such as accountants, as aiders and abettors. The recognition of aiding and abetting liability changed, however, when the Supreme Court in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994) rejected an implied right of action for aiding and abetting under Section 10(b) and Rule 10b-5, and held that secondary actors (lawyers and accountants) can only be held liable if all elements of a securities fraud claim are met. The Court did not, however, define when secondary actors meet those elements and left open the question of when secondary actors qualify for primary liability. Since 1994, federal courts have struggled to draw the point after which auditors and other secondary parties may violate federal law by making or failing to correct a false or misleading statement.

Teresa Rosen Peacocke

3 Stone Buildings

Lincoln's Inn

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