

3 Stone Buildings Seminar

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Auditors' liabilities

Is Caparo the last word?

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Familiar territory

1. The manner in which the liability of auditors can be limited has troubled the courts at their highest levels for more than half a century. The decision in Caparo v Dickman [1990] 2 AC 605, was built¹, to a great extent upon the dissenting judgment of Denning LJ in Candler v Crane Christmas & Co Ltd [1951] 2 KB 164, a case in which a potential investor with whom accounts were discussed expressly, was nevertheless unable to rely upon them².
2. Of course, the standard of care expected of an auditor is that of a reasonably competent professional. In general, an auditor must make "a reasonable and proper investigation of accounts and stock sheets, and if a reasonably prudent man would have concluded on that investigation that there was something wrong, call his employer's attention to the fact."³ He is not required to draw the accounts themselves, turn every stone or open every cupboard.

¹ See the speech of Lord Bridge at 621-3

² Of course, the debate is much older than that and stems from the decisions of the House of Lords in Derry v Peek (1889) 14 App.Cas. 337; 5 T.L.R. 625, H.L and Nocton v Ashburton [1914] AC 932 and the development of the law of negligent misstatement itself.

³ Henry Squire Cash Chemist Ltd v Ball, Baker (1911) 27 TLR 269 at 271 per Alverstone C.J.

3. The auditor's duty is not subject to rigid categories and is generally to investigate "irregular or unusual matters" which might indicate "a real possibility that something is wrong."⁴ To put the position particularly graphically, the auditor is a watch-dog and not a bloodhound!⁵ This duty therefore, may go beyond reporting to the company's members upon the accounts, stating whether they give a true and fair view of its financial affairs and include a duty to report immediately and blow the whistle if, for example, fraud by a senior employee on a grand scale is discovered: Sasea Finance v KPMG [2000] 1 All ER 676 per Kennedy LJ.

Restrictions and Extensions

4. How can that liability be restricted or alternatively when should it be extended, not only in relation to the immediate client but especially in the case of third parties to whom information is disseminated? The legal tool of "assumption of responsibility", relied upon by Lord Oliver in the Caparo case⁶, based upon the broad principles applied in Hedley Byrne & Co Ltd v Heller & Partners Ltd [1964] AC 646⁷, and wielded by Lord Goff in Henderson v Merrett Syndicates Ltd [1995] 2 AC 145, for different purposes, has become the principal weapon with which the wide field of foreseeability has been constrained⁸. Lord Bridge preferred "proximity" constrained by what would be "just and reasonable".⁹
5. In Smith v Eric Bush [1990] 1 AC 831, Lord Griffiths was refreshingly honest about the concepts by which liability has been limited and in particular, the language used in different circumstances in Hedley Byrne & Co Ltd v Heller & Partners [1964] AC 465. He stated at page 862,

⁴ Pacific Acceptance Corporation Ltd v Forsyth (1970) 92 WN (NSW) 29 at 75.

⁵ See Re Kingston Cotton Mill (No 2) [1896] 2 Ch 270 at 288-289.

⁶ See page 637.

⁷ In which the majority decision in the Candler case was overruled.

⁸ The imposition of a duty of care based solely upon foreseeability, in JEB Fasteners Ltd v Marks, Bloom & Co [1981] 3 All ER 289 per Woolf J was rejected in Caparo, albeit that it was accepted that there may have been sufficient "proximity" on the facts.

⁹ See Caparo at 617-8 where Lord Bridge is relying upon Lord Reid in Dorset Yacht Co Ltd v Home Office [1970] AC 1004.

"The phrase 'assumption of responsibility' can only have any real meaning if it is understood as referring to the circumstances in which the law will deem the maker of the statement to have assumed responsibility to the person who acts upon the advice."

Lord Roskill in the Caparo case was equally frank about the state of judicial "science" and said

"Phrases such as "foreseeability," "proximity," "neighbourhood," "just and reasonable," "fairness," "voluntary acceptance of risk," or "voluntary assumption of responsibility" will be found used from time to time in the different cases. But, as your Lordships have said, such phrases are not precise definitions. At best they are but labels or phrases descriptive of the very different factual situations which can exist in particular cases and which must be carefully examined in each case before it can be pragmatically determined whether a duty of care exists and, if so, what is the scope and extent of that duty."

Emphasis on uncertainty

6. The state of the law seems therefore, neither to favour the claimant nor defendant. Not only does the test to be applied seem vague but the very process of applying it seems all but impossible to complete except on a case by case basis, following a full investigation of all the facts. In the recent case of Man Nutzfahrzeuge Aktiengesellschaft & Ors v Freightliner Ltd v Ernst & Young [2003] EWHC 2245, ("Freightliner"), Cooke J commented

"The law in the field of auditors' negligence and auditors' duties is in a state of development and transition and there are therefore, real difficulties in deciding cases on a summary basis without a full investigation of the detailed facts, unless they fall fairly and squarely within the decided authorities."

A similar insecurity crept into the recent case of Equitable Life Assurance Society v Ernst & Young [2003] EWCA Civ 1114 in which Brooke LJ noted

“In the present case, it is not as though a cause of action for negligence arising in contract is unknown, or even unclear; and for present purposes E&Y’s negligence is assumed. The debate is rather about concepts used to limit the scope of the legal consequences of negligence or of legal responsibility for negligence, where, as will appear below, the law is at present in a state of development and flux, and sensitive to the facts.¹⁰”

7. “Flux” appears to have been the prevalent factor for quite some time now. In Coulthard v Neville Russell [1998] 2 BCLC 143, directors sued the auditors of a company for failure to warn that a loan might be a breach of s151 Companies Act 1985 and should lead to a qualified auditors’ report. They claimed the loss caused as a result of disqualification proceedings. Chadwick LJ commented

“I remind myself that this is an application to strike outIn my view the liability of professional advisers, including auditors, for failure to provide accurate information or correct advice can, truly, be said to be in a state of transition or development. As the House of Lords has pointed out, repeatedly, this is an area in which the law is developing pragmatically and incrementally. It is pre-eminently an area in which the legal result is sensitive to the facts.”

8. His view remained unchanged as recently as last summer, in the case of Independent Advantage Insurance Company v Cook [2003] EWCA Civ 1103 where he stated as follows:

“In my view the law in this field has not yet reached a point where it can be said to be no longer in a state of development or transition. I am not persuaded that my observations in *Coulthard v Neville Russell*, the views of Lord Justice Clarke in *Siddell v Smith Cooper* or those of Lord Justice Jonathan Parker in *Andrew v Kounnis Freeman* have been overtaken by subsequent decisions – so that the courts can now feel confidence in drawing boundaries in marginal cases without an investigation of the full facts. The right course - unless (on its facts) the case is plainly and

¹⁰ See para 107 of the transcript

obviously within decided authority - is to let the matter go to trial so that the principles in this field of the law can be developed incrementally on the basis of a full appreciation of the actual facts.”¹¹

9. In BCCI (Overseas) Ltd (in liquidation) v Price Waterhouse [1999] BC 351, Laddie J was not afflicted by such indecision and uncertainty, albeit that the facts with which he had to deal were possibly more straightforward. He struck out BCCI's claims against its auditors to recover losses made on bad investments. He noted¹²:-

“The skill the auditor offers and for which he is paid is the skill in looking at the company's accounts and the underlying information on which they are or should be based and telling the shareholders whether the accounts give a true and fair view of the company's financial position. He is not in possession of facts nor qualified to express a view as to how the business should be run, in the sense of what investments to make, what business to undertake, what prices to charge, what lines of credit to extend and so on. Not only does he not normally have the necessary expertise but those are areas in respect of which his advice is not sought. When the company engages an auditor, it is not seeking his help in steering the management into making better management decisions.”

10. The Court did not feel able to take an equally robust approach in the case of Sasea Finance Ltd (in liquidation) v KPMG (supra), where the auditors had failed to warn of fraud by a senior employee. It was submitted that the duty of care owed by the auditors did not extend to losses claimed because transactions from which they flowed arose in the normal course of business and were part of ordinary risks associated with carrying on that business. The Court disagreed and also considered such issued unsuitable to deal with on a strike out application.

¹¹ See paragraph 17 of the report.

¹² See paragraph 57 of the report.

11. Given the enormity of the cost of a full trial in this type of case and the enormous burden of potential liability, it seems unfortunate that this area of jurisprudence seems to have taken so long to develop. Are we not entitled to some increment by now? Has any level of certainty been established?

Parameters

12. What then are the applicable parameters? When will the law "deem" the maker of a statement in the form of an auditor's report, financial statements or audited accounts liable to shareholders, potential investors or the public at large? The Courts have looked consistently for benchmarks in order to delimit liability in a way which is both satisfactory and sufficiently certain and to avoid a scatter gun approach. Lord Bridge in the Caparo case described the difficulty in the following terms:-

"To hold the maker of the statement to be under a duty of care in respect of the accuracy of the statement to all and sundry for any purpose for which they may choose to rely on it is not only to subject him, in the classic words of Cardozo C.J. to "liability in an indeterminate amount for an indeterminate time to an indeterminate class:" see *Ultramares Corporation v. Touche* (1931) 174 N.E. 441, 444; it is also to confer on the world at large a quite unwarranted entitlement to appropriate for their own purposes the benefit of the expert knowledge or professional expertise attributed to the maker of the statement."¹³

In perhaps, more vivid terms, Lord Oliver stated at 643:-

"To apply as a test of liability only the foreseeability of possible damage without some further control would be to create a liability wholly indefinite in area, duration and amount and would open up a limitless vista of uninsurable risk for the professional man."

The Caparo Mantra

13. Caparo, together with its twin sister, Galoo, has become a much repeated mantra :-

¹³ See page 621

- (i) Liability for economic loss due to negligent misstatement was confined to cases where the statement or advice was given to
 - (a) a known recipient whether a specific individual or the member of a ascertainable class;
 - (b) for a specific purpose;
 - (c) at the time the advice was given, the maker was aware of that specific purpose whether actually or inferentially;
 - (d) it is known whether actually or inferentially, that the recipient will rely upon the advice or statement without independent inquiry to his detriment;and
 - (e) the advice is acted upon by the recipient to his detriment.

- (ii) statutory audits are produced for the purposes of the shareholders to exercise of their class rights and not to enable decisions as to future investment to be made whether by them or others;

- (iii) there is no public policy reason why auditors should be deemed to have a special relationship with non- shareholders contemplating investment on the basis of the published accounts even where the company is particularly susceptible to a takeover;

- (iv) when certifying company accounts for the purposes of Companies Act 1985, an auditor owes no duty of care to a potential takeover bidder even if he is already a shareholder of the company.
Foreseeability, no matter how high, that a potential bidder might rely on the audited accounts did not suffice to found a duty of care, since there was no sufficient relationship of proximity between the auditor and the potential bidder;
and

 - (v) negligent auditing does not cause further trading losses but merely creates the opportunity for them to be incurred and accordingly, such losses cannot be claimed in damages.

14. Where does this leave one both in relation to the immediate client and third parties, almost fifteen years after Caparo was decided? The central questions remain who can claim, what for and finally whether particular losses are recoverable.

Some help?

Who?(Duty)

15. In Morgan Crucible Co plc v Hill Samuel & Co Ltd [1991] Ch 295, a takeover predator sued accountants of the target company for negligent misrepresentations in audited financial statements, un-audited interim statements published prior to the bid and documents issued to shareholders and served on the predator's advisers after the bid upon which the predator foreseeably relied when increasing its offer.
16. The application to amend the statement of claim and the claim itself having been dismissed by Hoffmann J at first instance, upon the basis that it fell decisively within Caparo territory, the Court of Appeal thought otherwise. In argument, Caparo was distinguished upon the basis that if, during the conduct of a contested take-over, after an identified bidder has emerged, the directors and financial advisers of a target company choose to make express representations with a view to influencing the conduct of the bidder, then, they owe him a duty not negligently to mislead him, an argument which the Court of Appeal considered "plainly arguable."
17. Given that express representations were made to a known bidder in circumstances in which it was highly probable that they would be relied upon, this hardly seems a surprising result, nor does it really take us outside Caparo territory.
18. A real "increment" was added to in Law Society v KPMG Peat Marwick [2000] 1 WLR 1921 in which a duty of care was held to exist between the Law Society, as trustee of the compensation fund and the auditors of a

solicitors' practice which subsequently failed, the auditors being employed as a direct result of the Solicitors' Practice Rules with knowledge that the audit was required for that purpose.

19. At first instance, Scott VC had applied Lord Bridge and Lord Oliver's tests in Caparo and concluded that they were satisfied, at least, for the purposes of the preliminary issue. As to the requirement that the imposition of a duty of care be "fair, just and reasonable", he accepted that there must be some appropriate control in order to limit the recoverable economic loss. He identified two limiting factors in the Law Society case. First, the effect of the negligent report would be spent within a limited amount of time, being only a year and secondly, the liability would be restricted to those clients whose monies had been misappropriated from the solicitor's account, a defined and limited class.
20. Perhaps this takes us very little further forward than the imposition of a duty of care in Smith v Bush, (supra) – liability to a very limited class in respect of a limited amount¹⁴. On similar reasoning, where assets are to be sold at a valuation to be fixed by accountants, the professionals carrying out such a valuation are potentially liable to either party: Killick v Price WaterhouseCoopers [2001] PNLR 1.
21. Interestingly, in New Zealand, auditors in a similar position to those in the KPMG case have been held to owe a duty to the duped clients themselves: Price Waterhouse v Kwan [2000] 2 NZLR 39, a conclusion which the court seemed to reject in the KPMG case, on the basis of a lack of "proximity".
22. Finally, the fact that the claim by directors in their personal capacity seeking the loss occasioned by directors' disqualification proceedings was not struck out in Coulthard v Neville Russell [1998] 2 BCLC 143,

¹⁴ It seems that it was the size of the potential class which may have been the defining factor in Millet J's rejection of a duty of care in Al Saudi Banque v Clark Pixley [1990] Ch 313.

must be an incremental step at least, from the restrictive approach to the purposes of accounts adopted in Caparo.

(ii) What? (Scope)

23. The question of the scope of the duty often becomes entwined with the question causation. As Laddie J noted in BCCI (Overseas) Ltd (in liquidation) v Price Waterhouse [1999] BC 351, the auditor is not employed to make management decisions. That is not his skill. The courts, however, seem to tack a very fine line between indoor management and day to day business decisions for which the auditor is not responsible on the one hand and losses as a result of some frauds and the pricing of products for which in some circumstances, it seems an auditor may be responsible.
24. In the case of Sasea Finance v KPMG [2000] 1 All ER 676 , it would seem that it was the seriousness of the fraud of senior management which pushed matters over the edge¹⁵, together with the acceptance of a duty to report fraud at high levels, in addition to the usual duties in relation to the accounts. In Barings plc v Coopers & Lybrand [2002] PNLR 321, however, Evans Lombe J also considered the duties of a group auditor in circumstances in which massive losses had been suffered by Barings' Singapore subsidiaries, as a result of the activities of the rogue trader Nick Leeson. It was held that the subsidiaries' losses could only be recovered if
- (i) the claim arose from a type of transaction that was foreseeable to the auditors;
 - (ii) the auditor should have contemplated that its advice would be relied on to prevent losses arising from that type of transaction;
- and
- (iii) it could be inferred that the auditor had accepted responsibility to protect the claimant from losses of that type.

¹⁵ [2000] 1 All ER at 683 b-f.

These elements were not present and the claim was struck out.

25. In Equitable Life Assurance Society v Ernst & Young [2003] EWCA Civ 1114, Ernst & Young, (“EY”), sought to have the claim for negligence in their performance of their audit duties in connection with the audit of Equitable Life Assurance Society’s statutory accounts for 1997, 1998 and 1999 struck out or alternatively, claimed summary judgment in their favour, on such a basis.
26. On appeal, the Society submitted that Langley J had been wrong to limit its bonus declaration claim and wrong to regard its lost sale claims as unsustainable in law. The claim arose as a result of the Hyman litigation as a result of which in July 2000, the House of Lords unanimously declared that the practice of awarding differential terminal bonuses, (“DTP”), which in most cases, neutralised the effect of guaranteed annuity options and prevented the Society from having to meet the full cost of guaranteed annuity rates, (“GARs”), together with ring fencing by which the Society might limit the effects of the GARs was unlawful.
27. The Society alleged that EY were negligent in the audit of its statutory accounts in failing to ensure that the accounts complied with Company law and in 1998-1999, after the legality of the DTP was put in question and EY negligently failed to warn it that its accounts ought to have included a note disclosing the consequences of losing the Hyman litigation.
28. According to the Society, the accounts should have included a provision for a 75% take up of the guaranteed annuity option which would have led to an additional provision being made in respect of the GARs of £900 million in 1997, £1.4 billion in 1998 and £1.1 billion in 1999. Such a provision would have made considerable inroads into the Society’s asset base and required drastic steps to be taken by way of sale of the

business and in any event, a much more conservative bonus declaration policy.

29. In relation to over generous bonus declaration, a matter which one might have equated with business decisions for which an auditor should not be made liable, the Court of Appeal determined that it was arguable that such sums should be recoverable because they were not obligations like commercial debts but sums which the Society could choose whether or not to become bound to distribute. The ability to cut back in the future did not necessarily extinguish such a loss¹⁶.
30. The approach adopted in the BCCI case was distinguished upon a threefold basis:
- (i) in this case there was assumed negligence which went to the actual status and accuracy of the audit report itself;
 - (ii) the bonus declaration claims are closely connected with the question of the Society's available resources rather than its day to day business or investments;
 - (iii) the loss of a chance of sale claims to go to the a fundamental question of the Society's viability, rather than to day to day management¹⁷.

There must be real doubt as to whether this distinction will hold water.

31. This should be contrasted with the decision in Temseel Holdings Ltd v Beaumonts (a firm) [2002] EWHC 2642 (Comm) in which auditors to a firm of insurance brokers failed to spot defects in their accounting procedures, causing the firm to under price its products. Tomlinson J held the auditors liable on principle for this loss because a function of employing auditors was to allow forward planning of the way the business should be conducted. Such a conclusion must create some tension both with Caparo and with the reasoning in Galoo Ltd v Bright Grahame Murray [1994] 1 WLR 1360 in which it was held that auditors

¹⁶ See paragraphs 90 –101of the transcript.

¹⁷ See paragraph 126 of the transcript.

could not be liable for allowing a company to continue trading rather than be wound up.

32. The same kind of issues arose in the recent Freightliner case. Ernst & Young, in the UK made an application for summary judgment/strike out of claims against it as a Part 20 defendant and the firm in Canada sought to set aside service upon it of out of the jurisdiction.
33. The claims arose out of a share sale contract containing the usual warranties, for the sale of the shares in ERF Holdings plc, which had a wholly owned subsidiary. Damages were claimed from Freightliner, the vendor's successor in title, for breach of warranties and for deceit and fraudulent misrepresentations which allegedly induced the sale.
34. Freightliner brought Part 20 claims against EY which had audited ERF's accounts and EY in Canada which had audited the group accounts. Claims were also made on the basis that EY had also been appointed to advise and provide information to the purchaser in relation to the sale and in connection with the due diligence enquiries. It was alleged that EY had failed properly to investigate, advise and report on "tip offs" in relation to the falsification of ERF's accounts.
35. The financial controller of ERF, had been fraudulent in preparing its records and it was alleged had actually been put forward to explain some financial statements both audited and un-audited, in the course of the negotiations and due diligence process. The effect of the misrepresentations did not themselves give rise to trading losses but obscured them, in turn, leading to business decisions and further investment by the purchaser upon the expectation of profits.
36. Cooke J accepted the statement of the general principles to be distilled from the Caparo case but went on to consider the two ways in which a shareholder can still succeed in making recovery for loss on a sale or purchase. He pointed out that the House of Lords envisaged the

possibility of a case where accounts are audited specifically for the purpose of submission to a potential investor as an exception to the general principle (see Lord Oliver at page 650g, 652e-g Lord Jauncey at page 662b-d and Lord Bridge at p621-e and 624c-f . . .). In such a situation, foreseeability of use was considered to be insufficient, but the question is whether the auditor on an objective basis, can be taken to have assumed responsibility for the use of the audited accounts by the vendor in the specific sale.

37. Additionally, although the hiring and firing of someone who is not a director is a matter of “indoor management”, the power of the parent company to remove the directors of ERF, had it been properly informed in its capacity as a shareholder, would have enabled it to secure the removal of Mr Ellis.
38. Cooke J concluded therefore, that there was a real prospect of success in the argument that EY had assumed responsibility in relation to the audit and due diligence and in relation to the causation argument.
39. EY had argued that the additional continuing losses as a result of Mr Ellis’ continued employment were irrecoverable as a matter of law as a result of Galoo. It was submitted that trading losses which occur after an audit are irrecoverable because the failure to report does not cause the future loss but merely creates an opportunity for it. This was held to be an arguable issue,

“In this context I note that the description of causation as a matter of common sense in Galoo has been referred to in the New Zealand case of Sew Hoy v Coopers & Lybrand [1996] 1 NZLR 392 (at page 399), as amounting to no more than saying that causation is a jury question of fact with the result that it must be rare that a court would be able to strike out an allegation that a particular loss was caused by a particular breach, (per MacKay J).¹⁸”

¹⁸ See paragraph 39.

This was the approach adopted by Glidewell LJ himself in Galoo.

Time to move on

40. Where does all this get us? It must be time for the state of flux to be at an end. We need more positive answers to the five questions posed by Brooke LJ in Equitable Life V Ernst & Young:
- (i) Does a legally enforceable duty of care exist?
 - (ii) If so, what is the scope of that duty?
 - (iii) What is the prospective harm, or kind of harm, from which the person to whom the duty is owed falls to be protected?
 - (iv) Has there been a breach of that duty?
 - (v) If so, was the loss complained of caused by that breach, or was it caused by some other event or events unconnected with the breach?
41. Part of the difficulty arises from the particularly narrow interpretation of the purpose of the accounts and therefore, the limited scope of the objective assumption of responsibility imposed in Caparo. These shackles have been loosened partially in the Law Society and Coulthard cases by reliance on the fact that in both cases the statement was provided for a known and particular purpose or transaction.
42. The question at the heart of the matter of course, is the size of the potential class to which the professional will potentially be made liable and accordingly, whether such a burden is acceptable. This is acknowledged, for example, by Neill LJ in James Mc Naughton Paper Group Ltd v Hicks Anderson & Co [1991] 2 QB 113, 125-127.
43. As we have already seen, the other mechanisms by which the extent of any potential liability can be restricted are causation and the scope of the duty, the “what” question. It was these tools which Langley J employed at first instance in the Equitable v EY case in order to attempt to cut down the enormous claim.

44. In future, the answer may be to loosen the ties on the legitimate use of accounts, especially, in circumstances such as those in Freightliner, where the accountants were also busy with due diligence in the context of a share sale negotiation and one might think, assumed responsibility in relation to the transaction and also to widen the scope of the duty to third parties to include not only identified bidders but the white knight considered by Slade LJ in Morgan Crucible¹⁹, leaving the ultimate extent of any liability to be delimited by means of pure causation arguments, together with disclaimers.
45. Such an approach would not necessarily be inconsistent with the principle of assumption of responsibility, could be delimited in time²⁰ and would not necessarily benefit a wholly unascertained or unascertainable class. However, it reduces the already limited scope for strike outs whilst potentially increasing the burden of large claims for the defendant.
46. The burden of such an approach could be reduced if only there were more certainty in relation to scope/causation arguments. When will the pricing of products or the award of bonuses be indoor management and when will it not? The decision in Equitable has hardly helped.

SJA

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¹⁹ See 321 where the white knight as opposed to the known bidder is rejected because he comes from an indeterminate class.

²⁰ See Scott VC in the Law Society case.