A VICTORY FOR COMMONSENSE

by Richard Curd, Cameron Markby Hewit

Auditors and their professional indemnity insurers will be encouraged by the judgment of the Court of Appeal in **Galoo Limited and Others -v- Bright Grahame Murray.** Valuable ammunition has been made available for deployment by those involved in the defence of claims against accountants in the following areas of potential liability:-

1. for losses alleged to be suffered by an audit client company in reliance on an unqualified audit report; and

2. to an identified bidder for shares in an audit client company.

It is important to remember, particularly in relation to the second area described above the case came before the Court of Appeal at an early interlocutory stage, namely on the hearing of an appeal against an order made in favour of the defendant auditors, Bright Grahame Murray ("BMG") striking out various claims pleaded against them as disclosing no reasonable cause of action. In the context of this application, the Court of Appeal was required to assume that all facts pleaded in the Statement of Claim were true and no evidence (other than documents referred to in the pleading) in relation to the facts pleaded was considered.

Summary of Facts

The first plaintiff, Galoo Limited ("Galoo") traded in animal health products. The second plaintiff, Gamine Limited ("Gamine") owned all the shares in Galoo. BMG were, at all all material times, the auditors of both Galoo and Gamine. It was alleged that the stock held by Galoo had been falsely over-stated in its audited accounts for the years1985 to 1990 and that, by their negligence, BMG had failed to detect the over-statements. If the true position had been known, it was alleged the Galoo would have entered into insolvent liquidation in mid-1986. However, as the over-statements were not detected, Galoo proceeded to trade and incurred trade liabilities of approximately £25 million from mid-1986 onwards, and also paid dividend of £500,000 in 1988.

In 1987, the third plaintiff, Hillsdown Holdings Plc ("Hillsdown") purchased 51% of the shares in Gamine pursuant to a written agreement (the "acquisition agree-

ment") which provided, as was alleged to be known by BMG, that the purchase price was to be calculated by reference to the accounts audited by BMG for 1986: they were to be treated as completion accounts and BMG were to send such accounts direct to Hillsdown. In addition, and the significance of this matter will be addressed below, the acquisition agreement also provided that Hillsdown's own accountants were to have full access to Gamine's books and records and an opportunity to review the accounts audited by BMG.

Although the acquisition agreement also provide for the gradual acquisition by Hillsdown of all the shares in Gamine, in the event the parties entered into a separate supplemental agreement in May 1991 by which Hillsdown purchased a further 44.3% of the shares in Gamine. It was not alleged that BMG were aware that Hillsdown would rely on any accounts which they had audited in calculating the purchase price pursuant to the supplemental agreement.
Following the acquisition of the initial shareholding in 1987, Hillsdown made loans to Galoo and Gamine amounting to more than £30 million in subsequent years.

Ultimately, both Galoo and Gamine entered into insolvent liquidation and claims were made against BMG by the liquidators of the two companies and, in addition, separate, claims were made by Hillsdown. I shall address the claims made against BMG in turn.

1. Claims made by the liquidators of Galoo and Gamine for breach of contract and in tort

It was alleged that BMG's negligent conduct of the audits of both Galoo and Gamine between 1985 and 1990 constituted breaches of their duties in contract (arising from their appointment as auditors to the two companies) and in tort. In consequence of such breaches, Galoo and Gamine claimed to have suffered the following losses by virtue of the fact that they continued to trade subsequent to mid-1986 when, if the true position had been known,the companies would have entered it liquidation:-

(i) loan accepted from Hillsdown of more than £30 million

(ii) trading losses of £25 million

(iii) the dividend payment of £500,000 made in 1988.

In relation to the loans from Hillsdown, Glidewell LJ (who delivered the leading judgment) refused to entertain the notion that the acceptance of a loan constituted a loss causing damage and considered that it would be more properly be described as a benefit to the borrowers. It should be noted, however, that Glidewell LJ accepted that a loss may have resulted form the use to which the loan was put by the borrower. Given that no such loss had been pleaded, it was not necessary for further consideration to be given to this issue, although the flavour of the judicial comment suggests that it will be difficult for such loss to be laid at the door of the auditors of the borrower.

It was in relation to the trading losses that Glidewell LJ embarked upon a thorough review of the relevant English authorities and cited with approval two Australian decisions namely the judgment of the Court of Appeal of New South Wales in **Alexander -v- Cambridge Credit Corporation** (1) and of the High Court of Australia in **March -v- Stramare** (2).

In addressing the question "How does the Court decide whether the breach of duty was the cause of the loss or merely the occasion for the loss? Glidewell LJ delivered the following answer:-

> "The answer in my judgment is supplied by the Australian decisions to which I have referred, which I hold to represent the law of England as well as Australia, in relation to a breach of duty imposed on a Defendant whether by contract or in tort in a situation
> analogous to breach of contract. The answer in the end is "By the application of the Court's commonsense".
>
> Doing my best to apply this test, I have no doubt that the Deputy Judge arrived at the correct conclusion on this issue. The breach of duty by (BMG) gave the opportunity to Galoo and Gamine to incur and to continue to incur trading losses; it did not cause those trading losses, in the sense in which the word "cause" is used in law".

On this basis, Glidewell LJ upheld the Deputy Judge's decision to strike out the claims against BMG by Galoo and Gamine.

(1) (1987) NSWLR 310

(2) (1991) 171 CRL 5062

So, in considering claims made against auditor, how should the "commonsense" test be applied?

It should be noted that Glidewell LJ commented in relation to the dissenting judgment given in **Alexander** that "not all Judges regard common sense as driving them to the same conclusion". The point must be made that, notwithstanding that the Court of Appeal's decision is undoubtedly welcome news for the accountancy profession, a considerable element of uncertainty will remain as the legal advisers to both claimants and auditors seek to predict the likely consequences of the application of the "commonsense" test to any particular case. To identify one area of possible uncertainty, it should be noted that Glidewell LJ did not deal in terms with the dividend payment of £500,000 made by Galoo in 1988 and seems to have dealt with this payment as part of the trading losses. However, one can easily envisage that audit clients may seek to distinguish trading losses incurred in the ordinary course of business from specific payments, such as dividends, which would not have been made if the true financial position had been known.

Claims by Hillsdown

Hillsdown sought to recover various items of economic loss on the grounds that BMG were in breach of a duty of care owed to Hillsdown in tort to exercise reasonable skill and care in relation to their audit of the accounts of Galoo and Gamine for 1986 to 1990. The items of loss should be considered separately:-

(i **Loss of the purchase consideration paid by Hillsdown for the acquisition of the initial shareholding in Gamine in 1987.**

It was alleged that Hillsdown would not have proceeded with the purchase of the initial shareholding and would not have made any payments (which had a total value of £1.72 million) if it had known the true financial position of Galoo and Gamine i.e. that the companies were unprofitable and worthless.

Glidewell LJ again considered the authorities in detail including the decision of the House of Lords in **Caparo Industries Plc -v- Dickman** (3) and (once again a decision of the Court of Appeal with regard to a striking out application) in **Morgan Crucible & Co -v- Hill Samuel & Co** (4).

(3) (1990) 2 A.C. 605

(4) (1991) CH 295

In concluding that the facts of the present case fell very much on the Morgan Crucible side of the fence,Glidewell LJ formulated the following test as to the circumstances in which a duty of care may be owed by the auditors of a target company to an identified bidder.

> "A mere foreseeability that a potential bidder may rely on the audited accounts does not impose on the auditor a duty of care to the bidder, but if the auditor is expressly made aware that a particular identified bidder will rely on the audited accounts or other statements approved by the auditor, and it tends that the bidder should so rely, the auditor will be under a duty of care to the bidder for the breach of which he may be liable".

In applying this text, Glidewell LJ upheld the Deputy Judge's reasoning that , given BMG were aware of the terms of the acquisition agreement and were to submit accounts direct to Hillsdown specifically in relation to the agreement, it was **arguable** that a duty of care was owed by BMG to Hillsdown, Accordingly, the claim should not be struck out, as the issue as to whether or not a duty of care in fact existed could only be resolved following the analysis of evidence trial.

In this context, attention should be given to the comments made with regard to the involvement or, at least potential involvement, of Hillsdown's own accountants in relation to the initial acquisition, given that it will frequently be the case that a bidder retains its own financial advisers with regard to such a transaction. What effect will the involvement of the bidder's investigating
accountants have?

It was submitted on behalf of BMG that the opportunity provided in the acquisition agreement for Hillsdown's own accountants to review Gamine's books and records and to review the completion accounts excluded a duty of care on the part of BMG to Hillsdown. In making this submission, BMG relied on Lord Oliver's summary in **Caparo** of the elements necessary to establish a duty of care as stipulated in **Hedley Byrne -v- Heller** (5) including that it must be known "either actually or inferentially that the advice so communicated is likely to be acted on by the advisee for that purpose without independent enquiry".

Although the acquisition agreement undoubtedly provided Hillsdown with an

(5) (1964) A.C. 465

opportunity for independent enquiry, Glidewell LJ agreed with the Deputy Judge's comments in that it was entirely possible that the function of Hillsdown's own accountants in the transaction was not the same as that of BMG and, until the evidence had been heard at trial, it would not be possible to determine the extent to which the involvement of Hillsdown's accountant militated against eh existence of a duty of care.

This point was taken up by Evans LJ in his concurring judgement when he referred to what he termed the "right of intermediate examination" on the part of a bidder as potentially being sufficient to exclude a duty of care on the part of the auditors. Although not wishing to make a premature judgment in relation to Hillsdown's claim against BMG in this respect, Evans LJ felt that, on the basis of the case as pleaded:

> "I would be inclined to the view that Hillsdown, who were known to be advised by an international firm of accountants and auditors and would have full access to the company's books, would not be likely to rely upon statutory accounts, draft or otherwise, prepared by (BMG), when deciding whether or not to bid for the company and, if so at what price"

The message for those with an acquisitive bent seems to be that the more eminent the firm of accountants that you retain, and the more detailed the brief which such firm is given in relation to the proposed acquisition, the less likely it is that a subsequent claim against the auditors of the target company will succeed; and you are more likely to be left with a remedy against your own accountants alone, however, unpalatable that may be from a commercial perspective.

In addition, and in relation to the element of mens rea with regard to reliance on the part of the auditor of the target company, as identified in Glidewell LJ's duty of care test, Evans LJ pointed out that such an element is akin to the "voluntary assumption of responsibility" which was discounted as a test of liability in **Smith - v- Eric S Bush** (6). It will, however, be important to consider, in connection with the defence of such claims against auditors, the perception of the audit partner as to his role in connection with a particular transaction.

(ii) <u>Loss resulting form the loans made by Hillsdown to Gamine</u>

(6) (1990) A.C. 831

It was not pleaded that BMG were aware that Hillsdown would rely on accounts which they audited in making loans to Gamine, nor that BMG intended that Hillsdown should so rely. Glidewell LJ concluded that the facts as pleads were not sufficient to establish a duty of care and the claim was struck out.

(iii) Loss of purchase consideration paid by Hillsdown for the acquisition of the further shareholding in Gamine pursuant to the supplemental agreement

Again it was not pleaded that BMG knew when auditing the relevant sets of accounts that Hillsdown would rely upon them in relation to the supplemental agreement, nor that BMG intended that Hillsdown should so rely. Once again, the claim was struck out.

Conclusion

The only claim to survive this notably successful interlocutory assault on behalf of BMG is the claim by Hillsdown in relation to the alleged loss of the purchase price of £1.72 million paid for the acquisition of the initial shareholding in Gamine in 1987 in reliance on accounts audited by BMG. However, the significance of the involvement of Hillsdown' own accountants in the transaction looms large and, in particular, the comments of Evans LJ not to contain a great deal of encouragement for Hillsdown, or for other companies who may be considering making such claims in the future. It has been reported that some, if not all of the issues, dealt with by the Court of Appeal are to be the subject of appeal to the House of Lords. The outcome of such an appeal is awaited with interest.