Accountants And Auditors: Liability And Recovery: The Regulatory Context

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The recent turmoil in the financial markets demonstrates an enduring truth. They are congenitally turbulent and driven by herd propulsion. The only new feature is the emergence of a global Serengeti after the dismantling of economic Berlin walls previously formed by fixed exchange rates, restrictions upon capital movements and separation of securities trading from banking. Derivative instruments serve to tweak the more mundane highs and lows for the sophisticated, but risk disaster given the unexpected. Barings and LTCM are but harbingers of future victims.

Better regulation promises to become a shriller cry. Regulation is not prevention. Its function is the best degree of deterrence and, when that fails, the best degree of loss containment and recovery, consistent with resources. Constant vigilance calls for many roles. While central banks and formal regulators such as the SEC in the USA and the FSA in the UK form the apex of the regulatory pyramid, its critical core comprises external accountants, auditors, and actuaries of banks and investment firms.

Their degree of familiarity and contact with clients is far greater than that of formal regulators. They bring (or should bring) the quality of independent assessment by reference to regulatory criteria which those who direct and manage their clients all too often lose sight of. The latter's failings may be the product of excessive ambition in the quest for higher returns for their shareholders and themselves through (often insidious) incentive schemes. They may also be the product of herd instinct, naivety, inadequately supervised delegation or other incompetence or worse. They all merit equal regulatory scrutiny.

Better regulation will inevitably entail that the roles of external accountants, auditors and actuaries become more extensive and intrusive. It took the collapse of BCCI and the recommendations of Lord Bingham to sharpen up whistle blowing duties. While more extensive roles provide new opportunities, they bring attendant risks.

In relation to accountants, auditors and (increasingly) actuaries, and more so than in relation to other professionals usually not protected by limited liability, a perennial problem for the courts is to devise an appropriate polity which does not impose impossibly burdensome and uninsurable potential liability.

This paper deals with likely developments.

The legacy of history

The perception of accountants reflected in current legislation and case law lags well behind the reality of their current role. Yet this is the backdrop which usually colours and indeed straightjackets the perspective of most practitioners and judges, especially in the U.K., in approaching claims. This is perhaps an inevitable consequence of training and only episodic experience. Developments tend to be spasmodic driven by the vicissitudes of the moment.

Developments may be traced through three stages: (1) the Victorian legacy; (2) Hedley Byrne and its aftermath and (3) the regulatory context.

(1) The Victorian legacy

Company legislation still focuses on the auditor's report to shareholders. This reflects the Victorian legacy. The original objective, starting with the Companies Act 1879, was to provide shareholders with an accurate account of the true state of the company from a source independent of the directors. The shareholders, having given actual consideration to it at an annual meeting, were thus enabled to make appropriate collective decisions. Late nineteenth century cases, grappling with the then relatively new phenomenon of the limited company, reflect the historic concern to avert the mischief of shareholders voting a dividend from capital (as distinct from presumed but fictitious profits) through ignorance of the true state of the company.

As late as 1990, that perspective of the company auditor's role still proved acceptable to the House of Lords in *Caparo Industries Plc v Dickman* in rationalising his liabilities in a takeover context. The case has since become a familiar mantra for defendants. It is telling, however, that in the assessment of statutory context in *Caparo*, no consideration was given to the Listing Rules of the London Stock Exchange (the Yellow Book) which are now (albeit not at the date of the events in *Caparo*) statutory requirements.

(2) *Hedley Byrne* and its aftermath

The recognition of liability in tort for negligent misrepresentation in *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* opened the door to tort claims against auditors by third parties (i.e. persons other than their clients) based upon alleged negligent misrepresentations contained in audit reports. The 1980's saw a surge of claims

against auditors by shareholders, prospective investors, banks and other creditors. This surge can now be seen to have met its Stalingrad in the 1990 decision of the House of Lords in *Caparo* in which a claim by the plaintiff shareholder and prospective investor failed. The rejection of the asserted duty of care was rationalised primarily in terms of the perceived purpose of a statutory audit and report. This was not to enable individual investment decisions but rather, first, to protect the company from undetected errors or wrongdoing and, secondly, to provide shareholders with reliable intelligence so as to enable them to exercise collectively their powers of control over management. This line of reasoning has been extended to preclude tort claims by banks and other creditors.

More generally the test for a duty of care was expressed in terms of actual or inferred knowledge (not intention) by the informant/adviser of (1) the required purpose of his advice whether described specifically or generally, (2) communication to the advisee, either specifically or as a member of an ascertainable class, for that purpose and (3) likely reliance by the advisee for that purpose without independent enquiry, together with actual reliance by the advisee to his detriment. A similar polity appears to have been reached in Australia, Canada and the U.S.A.

However, the stockade apparently erected around auditor's liability by *Caparo* is not unassailable. It is vulnerable to successful assault on several fronts and being by-passed. Reconnoitring the surrounding terrain reveals new lines of assault and future developments.

It is important to note that *Caparo*, following *Hedley Byrne*, reaffirms an objective test for a duty of care in tort. A subjective test based on intention was expressly eschewed. As later cases demonstrate, this formulation does not necessarily filter out all tort claims by third parties. As apparent from recent case law, four categories of circumstances may give rise to such claims.

The first is information given in takeover circulars and offer documents. There is usually little difficulty in establishing a duty of care in tort to recipients of such documents by an accountant who has consented to the inclusion of information provided by him. Such documents are known to be directed to particular recipients or class of recipients, who may rely thereon for investment purposes. Moreover, as well as liability in tort, an accountant may incur statutory liability to compensate investors who have incurred loss as a result of inaccurate statements in listing particulars or in a prospectus relating to unlisted securities.

Secondly, an accountant may owe a duty of care in tort to a third party in respect of statements made in negotiations on behalf of client. Whether such a duty arises depends very much on the particular circumstances and the proper analysis of the purpose of the relevant statement and to whom it was directed. For example, in negotiations for a sale of company an accountant or auditor may be asked to give the prospective purchaser some assurance as to the accuracy of relevant financial statements, including draft statements. He should tread carefully, as the giving of such assurance may result in liability in tort, which may appear hugely disproportionate to the degree of culpability. Relevant case law in this area demonstrates some fine distinctions and differences of analyses.

Thirdly, even in an audit context, claims based on information supplied by auditors of subsidiary companies to other group companies and auditors have survived strike out applications. Group audits usually involve a considerable amount of liaison and exchange of information, frequently in response to group audit programmes and instructions. The scope for incurring liability in respect of inaccurate information and advice is consequently considerable. Moreover, documents produced in the context of group audits provide fertile ground for exploring what should have been done and was not, e.g. group audit plans, instructions by group auditors to subsidiary auditors, reports by subsidiary auditors to group auditors and group review reports.

Fourthly, in exceptional circumstances the accountants and auditors of a company may owe a duty of care in tort to its directors. Thus the Court of Appeal recently refused to strike out such a claim where the alleged breach was failure to warn the directors that certain loan transactions contravened the prohibition against a company or its subsidiaries providing financial assistance to enable the purchase of its own shares.

(3) The regulatory context

A distinctive feature of the 1980's was increasing statutory regulation of the financial sector. A series of statutes establish different regimes. That established by the Financial Services Act 1986 is the most remarkable and extensive. The various current regimes are in the course of being rationalised under the aegis of a single main regulator, the Financial Services Authority. Rationalisation will be given further impetus when the Financial Services and Markets Bill is enacted.

The main features of relevant regimes are now familiar. Generally, regulated

institutions and firms need to be authorised by an appropriate regulator as a condition of carrying on business in a relevant financial sector. Authorisation demands compliance with a range of requirements relating to integrity, competence, avoidance of conflicts of interests, adequate financial resources, records and reporting etc. Regulators are given a panoply of powers including intervention powers. These are backed by criminal, civil and disciplinary sanctions.

Fundamental to the regimes are systems of monitoring and reporting by accountants, auditors and actuaries. Hence the previous observation that they provide the critical core of the regulatory pyramid. Increasing appreciation of their regulatory role, together with the perceived deep pockets (if not broad shoulders) they provide when things go wrong, are significant factors in assessing their future claims exposure.

Whistle-blowing duties

An area yet to be explored judicially is whether an accountant may incur liability, and if so to whom, arising from duties to warn or to "whistle-blow" to persons outside the company or firm by which he is retained. A feature of regulatory statutes in the financial sector is provisions pertaining to communications by an auditor to regulatory authorities or "whistle-blowing", directed particularly towards disclosure of fraud. In those statutes no duty to whistle blow is directly imposed. Rather the approach generally adopted is to provide that no duty of confidence to which the auditor may be subject should be regarded as contravened by disclosure to the relevant regulator. Nevertheless, a power is given to impose a whistle blowing duty by delegated legislation. The major professional bodies for accountants issued guidance as to communications with regulators under the Financial Services Act 1986. However, in the wake of the Bingham Report on the Supervision of BCCI, it was resolved to impose a whistle-blowing duty on auditors of firms in the financial services sphere. Rules imposing such duty have been made under the empowering provisions of the major regulatory statutes. Those made under the Financial Services Act 1986 impose duties on auditors to report matters to the "relevant regulator". In relation to a "qualifying person" or "qualifying undertaking" as defined, among the circumstances in which the reporting duty arises are those in which the matters are "such as to give the auditor reasonable cause to believe, as regards the person or undertaking .. that there is or has been, or may be or may have been, a contravention of any provision of the Act or any rules or regulations made under it and that the contravention is likely

to be of material significance". The rules have since been amended to extend their requirements to auditors of "closely linked" bodies as defined.

Contravention of whistle-blowing rules gives rise to disciplinary sanctions. Is an auditor who is subject to such rules under a duty of care whether arising in contract or tort to whistle-blow and if so to whom is the duty owed? The question is usefully addressed by reference to *Berg Sons & Co. Ltd. v. Mervyn Hampton Adams*, although statutory whistle-blowing duties did not arise for consideration. In that case huge losses were incurred by a fraudulent "one-man" company. The bank creditors' claims in tort against the defendant auditors failed on the basis that they were owed no duty of care. Also the liquidator through the company pursued a claim in contract and tort against the defendant auditors to recover losses, essentially for the ultimate benefit of the bank creditors. This claim failed because the auditors' negligence in failing to discover the fraud did not cause any loss. The only person to whom they were obliged to report was the fraudster himself and he was not misled. The judge reasoned: *Any company must in the last resort, if it is to allege that it was fraudulently misled, be able to point to some natural person who was misled by the fraud. That the Plaintiffs cannot do.*

Quaere the ramifications of this case in the context of regulators and whistle blowing duties. A fraudulently misled company may (e.g. by its liquidator) be able to point to a regulator who would not have been misled by the fraud and who would have intervened to prevent further loss, if its auditor had whistle-blown. The fact that all the shareholders and directors of the company may have been fraudulent and were not misled may not then be fatal to the success of the claim, at least by the company. The easiest way to rationalise such a result is that the scope of the auditors' duty of care to the company extends to informing a regulator of fraud if management, directors or shareholders do not respond appropriately. And if there is no regulator, does the scope of the auditors' duty of care to the company extend to informing a bank or creditor in such circumstances?

More difficult to establish may be a duty of care extending to whistle-blowing to third parties, at least where there is another entity, such as a company, through which the third parties' claims can be channelled against the auditors. *Anthony v Wright* is illustrative, although statutory whistle-blowing duties did not arise for consideration in that case. The facts were that a company received as trustee

money placed by investors. Its directors fraudulently applied the money to their own benefit. There was a deficiency on the company's liquidation. The investors sued the company's auditors in negligence. Lightman J. rejected their contention that the auditors owed them a duty of care and struck out the claim. The criteria for such a duty were not established. In particular the fact that the investors were beneficiaries under a trust, of whose existence the auditors were aware, was insufficient to support a special relationship. On the part of the auditors there was no apparent assumption of responsibility to the investors and no intention that the investors should rely on them. Nor on the part of the investors was there any suggestion of actual reliance on the audit reports.

Duty to audit as well as to report

However, the recognition of regulatory whistle-blowing duties is likely to encourage a collateral effect in relation to audit claims generally. It is likely to shift the focus hitherto centred on the audit report to the prior audit process itself, i.e. a wider duty to audit as well as to report. It is well established in Australia that the audit duty carries with it an incidental duty to warn the appropriate level of management or the directors during the course of the audit of fraud or suspicion of fraud discovered.

The importance of regulatory context and purpose

In assessing potential liabilities, it is the tradition of the general practitioner to proceed from case law without sufficient regard to the particular context from which a claim arises. The danger of such an approach in claims arising from a regulatory context is insufficient appreciation of that context, the interrelation of the roles of relevant defendants (and potential defendants and third parties) and the regulatory purpose.

In claims arising from a regulatory context, the starting point is familiarisation with relevant statutes, rules and regulations, guidance releases, consultation documents and relevant standards, guidance and practices. The next stage is analysis of relevant organisational structures, constitutional and internal control documents, audit plans, instructions and reports and the roles of various participants e.g. directors, management, compliance officers as well as external accountants, auditors, actuaries and regulators.

Only from such familiarisation and analysis can there be deduced a clear perception of the potential range of liabilities which may fairly be imposed.

The point may be illustrated by reference to the culture of disclosure encouraged under the FSA. Thus Principle 10 (reflected in rules and regulations made by the Securities and Investments Board - now the Financial Services Authority - and in equivalent SRO and RPB rules):

> "A firm should deal with its regulators in an open and cooperative manner and keep the regulator promptly informed of anything concerning the firm which might reasonably be expected to be disclosed by it."

Thus under financial supervision rules requirements are imposed as to routine and *ad hoc* reporting to the relevant regulator, including breach of financial resources requirements. The primary duty to do so lies on the firm concerned. No specific duty regularly to monitor compliance with such requirements is required to be imposed by the firm on its auditor. However firms are required to impose other related duties on their auditors: to submit a report to the FSA on the annual financial statements, to carry out prior necessary investigations, to send to the firm written statements on the firm's internal controls and management information and to provide further information or reports to the FSA at the latter's request. Suppose in the course of making investigations for the purpose of an annual audit report the circumstances are such as to give the auditor reasonable cause to believe that there has been a breach of financial resources requirements which the firm has failed to report, then the auditor is under a duty to report it to the "relevant regulator" under rule 3 of the Auditors (Financial Services Act1986) Rules 1994. This is a contractual duty for breach of which liability may be incurred by the auditor to the firm concerned.

The Financial Markets and Services Bill

Quite apart from increased powers given to regulators, this Bill builds on provisions relating to accountants and actuaries in the FSA and rules and regulations made thereunder: see Part XVII ss. 196-201. Specific provision is made in the Bill for actuaries. Further it elevates the "whistle-blowing" duty currently in the 1994 Rules to the proposed new Act itself: clause 198(7). This is likely to make the courts all the more receptive to arguments favouring a duty to speak out as well as to report.

Problems of parallel proceedings in a regulatory context

Consideration of claims against accountants (and others) arising from a regulatory context would be incomplete without mention of problems arising from parallel

proceedings. A scandal from a regulatory context (e.g. Maxwell, Barings, BCCI, Polly Peck) usually spawn a range of different proceedings and often in different jurisdictions. The multiplicity of proceedings pose opportunities and problems for both plaintiffs and defendants. The difficulties of a solution based on an unified approach were recently addressed by the Lord Chancellor in his recent KPMG lecture.

The problems reflect the different aims of the different proceedings which may be brought. Investigatory (e.g. by liquidators, regulatory and professional bodies), criminal, civil and regulatory proceedings all have different aims. There is no obvious hierarchy which may be invoked to prescribe a priority sequence of general application. Different events will merit different sequences. Moreover, much will depend on the will of the various potential initiators of different proceedings.

Applications are often made to stay disciplinary proceedings pending the outcome of civil proceedings. The general principle seems now to be clear:

> "the court has power to intervene to prevent injustice where the continuation of one set of proceedings may prejudice the fairness of the trial of other proceedings .. But it is a power which as to be exercised with great care and only where there is real risk of serious prejudice which may lead to injustice."

Regulatory contact and investigatory proceedings generate documents which attract discovery applications in civil proceedings. These applications are frequently met with claims to various kinds of privilege.

The scope for alleging public interest immunity (PII) is very limited. It has been doubted that it can be invoked successfully in respect of documents generated by disciplinary proceedings. It is more difficult to establish a PII claim in respect of a whole class of documents as distinct from in respect of particular documents with sensitive contents.

As to legal professional privilege, it is only maintainable in "judicial and quasi-judicial proceedings". Thus while a litigant is entitled to assert the privilege in courts and arbitration proceedings, certain types of investigation are grey areas. Since the protection of privilege is not available outside the courtroom, prima facie certain law enforcement and administrative bodies which have statutory

rights to compel the production of evidence required to enable them to discharge their functions could encroach upon a person's privilege. However, the legislature has been alive to this danger and has tended to include in the relevant enabling legislation an express protection of material which would qualify for legal professional privilege in judicial proceedings.

As to the privilege against self-incrimination, this almost certainly extends beyond court actions to investigations of a quasi-judicial character such as professional disciplinary proceedings. However, certain statutes have been held to have abrogated the privilege. These include statutes providing for the compulsory giving of information to regulators, inspectors etc. The courts have held that Parliament could not have intended that anyone questioned under these statutory powers should be entitled to rely on the privilege against self-incrimination since that would stultify the procedures and prevent them achieving their obvious purpose:

As to information obtained by regulators pursuant to statutory powers to obtain such information, restrictions are imposed on disclosure by them of such information subject to a range of exceptions including in favour of other regulators.

Containing liability

The coastline of liability is not, however, one of constant erosion against accountants and other financial professionals. It is matched by accretions in their favour. Common law developments in relation to characterisation of scope of duty, causation, loss of chance, contributory negligence, contribution and, potentially, statutory relief, provide significant succour. On the statutory front, the Limited Liability Partnership Bill is welcome. Moreover, it is hoped that the DTI's review of company law will encourage a clearer statement of the duties of directors which will assist greater recognition of their responsibility (as well as that of management and compliance officers) for defaults for which accountants and auditors too often bear undue allocation of blame.

The professional bodies of accountants and others, particularly construction professionals, are constantly campaigning for a more benign liability regime. They have sought the introduction of "full proportionate liability" i.e. a new statutory regime whereby the defendants would be liable to plaintiffs only for the amount of damages equal to their proportionate share (i.e. relative to other defendants or wrongdoers) of the fault in the plaintiff's loss. The introduction of such regime was rejected in a feasibility study in 1996. Following further consultation, the

formal rejection of such a regime was announced by the DTI in October 1998. Nevertheless, it is to be hoped that the DTI's review of company law may result in the repeal of section 310 of the Companies Act 1985 which currently renders void any provision which seeks to exclude or limit the liability of an auditor in relation to the company for negligence or other breach of duty.

While auditors may not be deserving of immunity to the extent accorded to certain financial services regulators under section 187 of the FSA, that section provides fruitful analogy for arguing that their regulatory role be recognised and rewarded with a degree of protection.

Final thoughts

Frequently detectable in attempts to allocate loss by causation, contributory negligence and other devices is a striving to give effect to a principle or concept of proportionality. By that I mean a principle whereby the extent of a defendant's liability in damages for breach of duty should bear a reasonable relationship to extent of his error or culpability. Although their regulatory role enlarges the exposure of accountants, auditors and actuaries to claims, the proportionality principle is likely to be a significant factor in moderating that exposure. Nevertheless, as the slimming of the Welfare State heralds a Brave New World of increasing dependence on private saving, however, it will be hard to persuade a court to apply this principle to reduce claims brought for the benefit of consumer victims of negligent accountants, auditors and actuaries as well as other financial advisers. Ultimately therefore, their competence and, failing which, their insurers become the new guardians of Welfare.

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