Caytons
Changing Perceptions

Assumption of Responsibility in Professional Liability Claims: Part 2

INTRODUCTION

In the typical professional liability claim, the claimant will be a former client. It will likely be common ground that the professional owed a coterminous duty in contract and at common law. The battleground will be over matters such as the scope of the duty, whether it was breached and whether any breach caused a loss. Less commonly, the claimant may be a third party which insists that, in carrying out services for its client, the professional also assumed a responsibility to that third party.

This is the second in a series of notes which looks at assumption of responsibility in the professional liability field. It focusses on claims against auditors.

A: RECAP

Part 1 traced the evolution of the law from the seminal decision of the House of Lords in *Hedley Byrne v Heller & Partners* [1964] AC 465. Several of the speeches referred to an assumption of responsibility, but subsequent cases confirmed that the duty was imposed by the court: it did not need to have been consciously accepted.

Anns v Merton BC [1978] AC 728 laid down a two-stage test to establish the existence of a duty. The first part involved considering whether there was a sufficient relationship of proximity between the parties for it to be in the reasonable contemplation of the defendant that careless by it was likely to cause damage to the plaintiff. If it was, the second part involved considering whether there were factors which might negative the duty which would otherwise arise.

The Australian courts rejected this approach. In *Council of the Shire of Sutherland v Heyman* (1985) 157 CLR 424, Brennan J preferred an approach by which the law developed "*incrementally and by analogy with established categories*".

Anns was overruled in *Murphy v Brentwood DC* [1991] 1 AC 398. It was long thought that the House of Lords had, in the meantime, endorsed a threefold test in the case of *Caparo v Dickman* [1990] 2 AC 605: (a) that it was foreseeable that the recipient is likely to suffer damage if the advice is wrong, (b) that there is a sufficiently proximate relationship between the parties, and (c) that it is fair just and reasonable to impose liability.

In fact, as a trio of Supreme Court cases culminating in *NRAM v Steel* [2018] UKSC 13 stressed, *Caparo* endorsed the Australian approach and rejected unifying tests. *NRAM* also underlined that, for an assumption of responsibility to arise, it would need to be established that it was reasonable for the claimant to rely on the defendant and reasonably foreseeable by the defendant that it would do so.

B: CLAIMS AGAINST AUDITORS

The starting point is that an auditor will not, without more, owe a duty of care to parties other than the company and its members as a body. There is a significant body of authority on the circumstances in which it may be appropriate to depart from this. The courts have considered claims by various other parties interested in the company's affairs, including investors, lenders, individual shareholders, group companies, purchasers, directors and employees. The categories are not mutually exclusive.

Investors

In *Caparo*, the Plaintiff had acquired ownership of a company named Fidelity Plc through the gradual purchase of shares. The Third Defendant was the company's auditor. It audited the accounts while the Plaintiff was building up its holding and did not yet have a controlling interest. They showed a profit of £1.3m. It was the Plaintiff's case that they should have shown a loss of £400,000. It claimed to have been a victim of fraud by the company's directors. The action was brought against the directors for deceit and the auditor for negligence.

Duty was tried as a preliminary issue. The Plaintiff maintained that it was owed a duty either as an investor or as an existing shareholder. The Judge found for the auditor. The Plaintiff appealed. The Court of Appeal was unanimous that the auditor owed no duty to investors. But the majority (O'Connor LJ, dissenting) held that one was owed to individual shareholders.

The House of Lords allowed the auditor's appeal. It held that it only owed duties to the company and the members as a body.

In the earlier case of *JEB Fasteners v Marks, Bloom* [1981] 3 All ER 289, Woolf J (as he then was) had fixed an auditor with liability in similar circumstances on the basis that loss was foreseeable. Lord Bridge and Lord Oliver (with each of whom the rest of the committee agreed) disapproved of his reasoning. They made clear that proximity should not be elided with foreseeability, which was not sufficient to establish liability.

The committee concluded that it was necessary to consider the purpose for which the accounts were audited before it could be determined whether a duty existed and what its scope might be. As Lord Bridge put it, the auditor's role was to protect the collective interests of the members in the proper management of the company. If it failed in this, the company would have a remedy against it. Lords Roskill, Oliver and Jauncey emphasised that, to the extent that an existing shareholder used the audited accounts to inform a decision to buy more shares, that was not the purpose for which they were prepared,

Lord Bridge went on to make the prophetic statement that:

> *It is never sufficient to ask simply whether A owes B a duty of care. It is always necessary to determine the scope of the duty by reference to the kind of damage* from which A must take care to save B harmless,

In support of this, he cited Brennan J's influential judgment in the Australian case of *Council of the Shire of Sutherland.* This appeared to suggest that "*kind of damage*" was to be viewed without magnification. Brennan J juxtaposed personal injury with economic loss. In fact, the enquiry is altogether more sharply focussed. Any doubts about this were laid to rest when Lord Hoffmann drew on *Caparo* to formulate the *SAAMCO* principle.

The necessity of considering the purpose for which professional advice is given was re-emphasised by the Supreme Court when it reviewed *SAAMCO* for a second time in *Manchester BS v Grant Thornton* [2021] UKSC 18.

The prospect of a duty to investors was revisited in *Electra Private Equity v KPMG* [2001] 1 BCLC 589. The Claimants were fund managers. They engaged KPMG to carry out due diligence into a company in which they proposed to invest. KPMG, in turn, requested information from the auditor. This was an Irish partnership within the same group, KPMG Stokes Kennedy Crowley. There were various meetings between the two entities. The auditor signed an audit report at a completion meeting with the Claimant and its solicitors.

The auditors made a strike out application. The Master dismissed it. An appeal to Carnwath J (as he then was) was successful. The Claimants appealed in turn and prevailed. Auld LJ, who gave the main judgment in the Court of Appeal, was satisfied that there were triable issues as to whether the auditor foresaw the purpose for which the Claimant required the accounts and whether, on the facts, it assumed a responsibility.

An unsatisfactory feature of this area of law is that a surprising number of the decisions which are treated as shaping its contours were on strike out or amendment applications, where the court was not concerned with whether the claimant had proved its case but simply whether it was properly arguable.

That said, *Yorkshire Enterprise v Robson Rhodes* (unreported, 17 June 1998) had strong parallels with *Electra Private Equity.* The Claimant was a venture capitalist. There had been direct dealings between it and the auditor of a company in which it invested. Bell J held that these sufficed to give rise to a duty of care.

Purchasers

Caparo was an unwelcome decision for the Plaintiff in *Morgan Crucible v Hill Samuel* [1991] Ch 295. It made its pleaded case untenable. This was a case about a takeover bid. The Plaintiff sought to distinguish its position from that of Caparo Industries Plc. It sought to amend its particulars of claim to allege that a relationship of proximity came into being when it made its bid. Hoffmann J (as he then was) was unimpressed with the argument. He declined to allow the amendment.

In the Court of Appeal, emphasis was placed on a letter from the auditor which was included in a circular to shareholders. This purported to confirm that a profit forecast had been made by the directors after due and careful enquiry. Slade LJ, giving the judgment of the court, held that it was properly arguable that a duty of care existed.

In *James McNaughton v Hicks Anderson* [1991] 2 QB 113, the Plaintiff company had been acquired by a rival. In advance of the purchase, the existing owner asked its auditors to expedite draft accounts so that these could be shown to the buyer. He also put the purchaser in touch with the auditors There was then a meeting at which the auditors answered questions posed by the buyer. The Judge found duty and breach established. The Court of Appeal disagreed.

Neill LJ (with whom Nourse and Balcombe LJJ agreed) acknowledged that he did not find it an easy case but came down on the side of holding that no duty of care existed. A combination of factors led him to this conclusion. He found that the accounts had been prepared for the existing owners. They remained in draft. The statements made by the accountants in response to questions were, he found, of a very general nature. The accountants had not been actively involved in the sale negotiations. The transaction was between experienced businessmen.

In the course of his judgment, he identified six considerations which he thought likely to be important in cases of this sort. These were (a) the purpose for which the statement in question was made (b) the purpose for which it was communicated (c) the relationship between the parties, (d) the size of the class to which the plaintiff belonged (e) the knowledge of the party making the statement and (f) the extent to which the plaintiff was entitled to and did rely on the statement.

These were directed towards the application of the now discredited threefold test, but the editors of *Jackson & Powell on Professional Liability* consider that the analytical framework remains useful under the modern approach.

Galoo v Bright Grahame Murray [1994] 1 WLR 1360 involved a successful strike out application. Galoo Limited was a wholly owned subsidiary of Gamine Limited. The Defendants audited both companies. A third company, Hillsdown Holdings Plc, acquired a majority shareholding in Gamine Limited. It made a series of loans to it and its subsidiary. All three companies brought a claim against the Defendants. They alleged that they had negligently failed to detect a fraud when auditing the Gamine companies' accounts. The Judge struck out the claim. His judgment was upheld in the Court of Appeal.

Glidewell LJ (with whom Evans and Waite LJJ agreed) considered there to be a fine distinction between *Caparo* and *Morgan Crucible.* The balance would be tipped, he concluded, where the auditor was made aware that a particular bidder will rely on the accounts and intended the bidder to rely on them. On this footing, he held that the Judge had been right to conclude that the plaintiffs had failed to plead facts could give rise to a *Hedley Byrne* duty.

In later cases, decisions like *Morgan Crucible* and *Electra Private Capital* were rationalised on the basis of auditors going beyond their statutory duties.

One such case was *ADT v BDO Binder Hamlyn* [1996] BCC 808. It proved disastrous for the auditor. The Defendant had audited a company named Britannia Security Systems Limited. The ADT Group planned to acquire the company. Its representative met with the Defendant's audit partner. He asked him to confirm that the accounts gave a true and fair view and that there had been no further developments, which he did. In fact, the accounts had been negligently prepared. ADT discovered that it had paid more than twice what the company was really worth.

May J held that the auditor had assumed responsibility. He gave judgment in the sum of £65m. This exceeded the auditor's PI cover by over £30m. It was a traditional partnership. The partners were personally liable for the shortfall.

The decision is described as "*somewhat borderline*" in *Salzedo & Singla on Accountants' Negligence and Liability*.

Lenders

The House of Lords in *Caparo affirmed* the judgment of Millet J (as he then was) in *Al Saudi Banque v Clarke Pixley* [1990] 1 Ch 313, in which he dismissed a claim by a series of banks which had lent to a company that its auditors had assumed a responsibility to them.

In *Berg Sons & Co v Mervyn Hampton Adams* [1993] BCLC 1045 the claim was originally brought by lenders in their own right. Presumably in light of *Caparo,* some of them discontinued. But, as the Judge put it, they simply retired behind the screen. They funded and controlled an action by the liquidator in the name of the company.

The claim by the remaining lenders failed. Hobhouse J drew from *Caparo* the proposition that the statement relied on had to have been made for the purpose of a specific transaction. He held that the Plaintiffs had been unable to show this. He further held that, although it was reasonably foreseeable that lenders might place reliance on the audited accounts, it was not reasonably foreseeable that they would solely rely on them in deciding whether to make loans to the company. There could, moreover, only be a limited period of time after the accounts were audited in which it would be reasonably foreseeable that a lender might rely on them.

In the Scottish case of *RBS v Bannerman Johnstone Maclay* [2005] CSIH 39, the equivalent of a strike out application by the Defender failed. On appeal to the Inner House of the Court of Session, the Lord Justice

Clerk (with whom Lord Osborne and Lady Cosgrave agreed) held that it would be inappropriate to determine on the pleadings alone that the claim was bound to fail. This was because the Pursuer had pleaded facts which might be capable of taking the auditor beyond its statutory role and establishing a duty of care.

The court agreed with the Outer House that the absence of any disclaimer could be relevant to the question of whether a duty existed, and not merely to whether there were factors to negative a duty which would otherwise arise. The point was not a new one, in this jurisdiction, at least. But it led the Institute of Chartered Accountants in England and Wales to recommend the use of disclaimers. The suggested form of what came to be known as the *Bannerman* clause was as follows:

> *This report is made solely to the company's members, as a body… Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinion we have formed.*

The effect of a slightly modified *Bannerman* clause was tested in *Barclays Bank v Grant Thornton* [2015] EWHC 320. Cooke J was satisfied that its existence meant that the Claimant lender could have no realistic prospect of succeeding on its claim. He gave summary judgment for the auditor.

That a *Bannerman* clause will not always provide such a decisive answer was illustrated in *Amathus Drinks v EAGK* [2023] EWHC 2312 (Ch). This was another case in which ownership of the company's shares had changed hands and the new owner alleged that the auditor had overlooked a fraud. The auditor sought summary judgment. It relied on *Barclays Bank*. The Master distinguished the case. This was because there was continued correspondence between the auditor and the buyer after the audit. He dismissed the application.

Directors

Coulthard v Neville Russell [1998] 1 BCLC 143 was a claim brought by the former directors of a company against its auditor. They had been disqualified because they had caused unlawful loans to be made by the company to another company which was in the process of acquiring it. The auditor applied to strike out the claim. It failed at first instance and on appeal.

Chadwick LJ (with whom Judge and Kennedy LJJ agreed) said that he inclined to the view that it was no part of an auditor's statutory duties to protect directors from the consequences of their own mistakes and wrongdoing. But he drew a distinction between the defendant's role as auditor and that of the company's accountant. The case against it, he explained, was that it had failed to give advice to the directors in its capacity as accountants. This was another way of saying that it had gone beyond its statutory audit role.

As Teare J noted in *Makar v PwC* [2011] EWHC 3835, this outcome was unsurprising on the facts. The Claimants' pleaded case in *Coulthard* was that they had sought and obtained advice from the accountants about the offending loans. In the case which he had to decide, the Claimant was a litigant in person. She brought a claim against the auditors of a company from which she had been dismissed as CEO and Finance Director. The basis for her claim was hard to decipher, but the Judge was satisfied that she had pleaded nothing remotely analogous to the discussions about the loan in *Coulthard*. He struck out her statements of case.

Employees

In *John v Price Waterhouse* (unreported, 11 April 2001), the Defendant audited various companies which handled aspects of Sir Elton John's professional activities. He was a director of them and entitled to a salary

which equated to a substantial proportion of their profits. Ferris J had no difficulty in rejecting the argument that this was sufficient for the auditors to owe him a duty of care.

Group companies

The fallout of the fraud of the futures trader, Nick Leeson, occupied the courts for some years. It will be recalled that he single-handedly brought down one of the City's oldest investment banks by recklessly gambling with its money and hiding his losses in an error account. Leeson was General Manager of the Singaporean subsidiary of the English company, Barings Plc. The Singaporean company had been audited for a time by Deloitte & Touche and later by Coopers & Lybrand. The parent company pursued both.

In *Barings v Coopers & Lybrand* [1997] 1 BCLC 427, Coopers & Lybrand sought to set aside service. This can be seen as a *de facto* strike out application. Chadwick J (as he then was) dismissed the application. The Court of Appeal upheld his judgment. Leggatt LJ (as he then was) gave the sole reasoned judgment. He rejected submissions predicated on *Prudential Assurance v Neman* (No 2) [1982] 1 All ER 354 that it would be contrary to principle to allow a shareholder to bring a claim in its own right for loss suffered by the company. He held that this was not that sort of case: it was a claim in which the plaintiff alleged that there was a freestanding duty of care,

Lord Bingham disapproved of this reasoning in *Johnson v Gore Wood* [2002] 2 AC 1. Johnson would, in turn, be criticised by the Supreme Court in *Sevilleja v Marex* [2020] UKSC 31 but approved by the majority on that point.

It might, at first sight, be wondered whether *Johnson* was what prompted Deloitte & Touche to make a belated strike out application in *Barings v Cooper & Lybrand* [2002] 2 BCLC 364, but the dates cannot be reconciled with this. Evans-Lombe J was more receptive to the application. He was satisfied that, although the claimant had pleaded that it had relied on the audited accounts in paying dividends and bonuses, it failed to set out any case that it was ever in the contemplation of the auditors that it would do so. He struck out the claim.

The point reemerged in *MAN v Freightliner* [2005] EWHC 2347. The main action was an international corporate dispute. ERF was a British truck manufacturer. In the 1990s, it was acquired by a Canadian company known as Western Star. This company was in turn acquired by Freightliner, an American subsidiary of Daimler Chrysler. Western Star was audited by the LLP through which Ernst & Young practised in Canada. The equivalent UK entity audited ERF after its acquisition. In 2000, Western Star sold ERF to the German truck manufacturer, MAN. Following the sale, MAN found discrepancies in the accounts. It investigated further. This revealed a fraud by the financial controller. It brought a claim against Freightliner, which was successful.

Ernst & Young failed at an earlier hearing to have the Part 20 claims summarily dismissed. It had more success at trial. Leading Counsel for Freightliner, the future Sir Geoffrey Vos MR, submitted that ERF's auditor owed it a duty as its sole shareholder. Moore-Bick LJ (sitting in the Commercial Court) had no difficulty in rejecting the argument in light of *Johnson v Goore Wood.*

The Judge accepted that E&Y (UK), as the entity was named in the judgement, must have foreseen that both Western Star and MAN would rely on the accounts as giving a true and fair picture, but observed that it is clear from the authorities that this is not enough. He held that there was nothing to support an assumption of responsibility.

A further difficulty for Freightliner, he concluded, was that its losses flowed directly from the financial controller's dishonesty, not the inaccuracy of the accounts. Even if E&Y (UK) had assumed a responsibility to Western Star, it would not be to protect it from losses arising from fraud.

The Judge went on to reject the existence of any duty arising from assistance which E&Y (UK) provided in the due diligence exercise. Its involvement, he found, was very limited.

Freightliner's contribution claim, premised on E&Y (UK) being liable to MAN for the same damage, unsurprisingly fared no better. He placed some weight on the fact that MAN was being advised by its own accountant, which has not always been seen as a bar, But he considered the most significant factor to be the absence of any direct relationship between the auditor and MAN. He made the illuminating observation that:

> *it is important to maintain a clear distinction between those cases in which all that can be said is that the auditors can foresee that a third party (perhaps even an identifiable third party) may make use of the company's accounts when deciding on a course of action and those cases in which the auditors have entered into a closer relationship with a third party of the kind necessary to give rise to an assumption of responsibility. A failure to observe such a distinction creates the risk of imposing a duty of care on auditors in favour of third parties in cases where they cannot fairly be said to have stepped outside their statutory function.*

Western Star's own auditor owed a straightforward contractual duty, but Freightliner failed to establish breach.

The judgment was upheld by the Court of Appeal. The reasoning of Chadwick LJ (with whom Dyson and Thomas LJJ agreed) differed from that of the Judge. He indicated that he would accept that it was within the scope of E &Y (UK)'s general audit duty to protect ERF from the consequences of the accounts containing misstatements, including those resulting from fraud.

He continued that, if it had it been necessary to decide the point, he would have accepted that the auditor owed a duty protect Western Star from the consequences of representations and warranties in the share purchase agreement. This was *obiter* and *Salzedo and Singla* suggests that the Judge's reasoning should be preferred.

C: SUMMARY

An auditor carrying out a statutory audit owes duties to the company and the members as a body. The members as a body can only bring a claim in the name of the company. The auditor will not, without more, owe duties to third parties. There is, however, a potential for the auditor to be found to have stepped outside its statutory role in circumstances which justify the imposition of a duty of care to a third party such as an investor or purchaser. Although the auditor does not as such owe duties to the company's directors, it might owe them in its capacity as the company's accountant. The use of a *Bannerman* clause in audit reports might be thought prudent but it is not a panacea.

D: COMING UP

In Part 3, we turn to consider assumption of responsibility in claims against valuers. Subsequent parts will look at cases involving lawyers, insurance brokers and construction professionals.

Further Information

Given the generality of the note it should not be treated as specific advice in relation to a matter as other considerations may apply.

Therefore, no liability is accepted for reliance on this note. If specific advice is required, please contact one of the Partners at Caytons who will be happy to help.

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