ONC Lawyers
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WHEN AUDITORS MEET LIQUIDATORS

Recent Developments in Auditors Negligence Claims

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When Auditors meet the Liquidators

Stone & Rolls Ltd v. Moore Stephens – Lessons to be learnt?

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Auditors’ negligence claim

• Expanding the auditors’ duty
  • Express an opinion on the financial position of the subject company
  • Duty owed to shareholders collectively Caparo v Dickman
  • Not guaranteeing the correctness of the financial position: Re London & General Bank (No 2)
  • Not a bloodhound or a watchdog: In Re Kingston Cotton Mill Co (No 2)
  • Duty to detect irregularities: Barings v. Coopers & Lybrand
  • Duty to report fraud (Sasea Finance v. KPMG)
  • Duty owed to creditors in case of corporate insolvency?? (Stone & Rolls; Days Impex (arguable))
Usual Defences to negligence claims

- Compliance with the auditing standards
- Exemption clauses
- Indemnity clauses
- Illegality defences
- Loss not proven
- Lack of causation
- Contributory negligence
- ...
Illegality Defence

• One cannot rely on his own wrong (*Holman v. Johnson*)

• Auditors’ usual arguments:
  • Wrongs committed by the fraudulent directors;
  • Managerial fraud difficult to be detected;
  • Auditors not liable for the collapse of the company due to managerial fraud!
Attribution

- When the claimant is a company:
  - Fictional person
  - Whose acts are acts of company? Directors?

- Auditors’ usual arguments:
  - Directors’ representations = Co’s representations
  - When auditors defrauded by directors → Auditors are defrauded by the Co.
  - Accordingly, the Co. cannot sue the auditors on its own fraud!
Stone & Rolls

- Salient facts:
  - S was the sole director and shareholder of the Co.
  - The Co. was S’s vehicle to perpetrate frauds, causing losses
  - The Co. gone bust and liquidators stepped in
  - Liquidators, in the Co.’s name, sued the auditors for negligently certifying the Co.’s financial statements
  - Auditors said S’s fraud was attributed to the Co.
  - Auditors argued that the Co. could not rely on its own wrong and sought to strike out the Co.’s claim
Stone & Rolls (cont’)

• HL – 3:2 striking out the Co.’s claim.
• Majority judgment without majority reasoning
• Lord Phillips (majority – against the Co.)
  • S managing all aspects of the Co’s business. Its fraud was the fraud of Co.
  • Rejecting in principle the “very thing” argument
  • No independent shareholder. No innocent party hurt.
  • Creditor’s interest? Arguable but would involve departure from Caparo v Dickman
Stone & Rolls (cont’)

• Lord Walker & Lord Brown (majority)
  • “Sole actor” scenario – S’s act was attributed to the Co. (no innocent parties for the auditors to protect)
  • Illegality defence not trumped by the “very thing” argument
Stone & Rolls (cont’)

• **Lord Mance (dissenting)**
  - Heavily influenced by the need to protect creditors
  - Co.’s right to claim against the negligent auditor is “beyond doubt”
  - “Very thing” argument – Auditors cannot get away when they are supposed to detect fraud. Such duty not affected by ownership in the Co.
  - No attribution if the fraud has rendered the Co. insolvent
  - “Sole shareholder”? – irrelevant for the fraud rendered the Co. insolvent to the creditors’ detriment
  - Co’s claim not seeking to profit from its wrong, but seeking compensation for auditors’ breach of duties
  - Co. suffering no loss? – turning a blind eye to the drainage of assets and accumulation of deficits
Stone & Rolls (cont’)

- Strong criticism:
  - “controversial decision” “[facts] extreme and exceptional” (per Lord Walker NPJ in Moulin Global)
  - “… difficult to anticipate what precedent, if any, Stone & Rolls will set regarding the illegality defence …”, “… there was a majority verdict, there was no majority reasoning…” (UK Law Commission)
  - “The decision in the Stone & Rolls case … should be confined in my view to the claim and the facts in that case” (Patten LJ in Bilta (No.2))
  - “[should be put] on one side in a pile and marked ‘not to be looked at again’” (Lord Neuberger PSC in Bilta (No2))
**Bilta (No 2) (2016)**

- **Facts:**
  - Co.’s directors committed VAT fraud
  - Co sued directors for losses
  - Directors claimed their fraud was attributed to the Co, and hence Co is barred from suing them
**Bilta (No. 2) (2016) (CA)**

- Patten LJ (CA):
  - Distinction between “liability cases” and “redress cases”
    - “Liability cases” – Co. as a wrongdoer being sued by a third party
    - “Redress cases” – Co. being the victim suing the wrongdoer
  - In “redress cases”, wrongs need not be attributed to the Co. even in a “one man” company if creditors’ interest is at stake
  - Lord Walker’s “sole shareholder” reasoning taking away legal protection to creditors and “has no place in the English law”.

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Bilta (No.2) (SC)

- Lord Sumption (JSC)
  - 1st scenario (co being sued by a third party): illegality defence not involved
  - 2nd scenario (co suing its directors): “breach of duty” exception applies preventing attribution
  - 3rd scenario (co suing a third party): illegality defence applies but “leaving aside the admittedly important question of the scope of an auditor’s duty”
Moulin Global Eyecare (CFA)

- Facts:
  - Directors fraudulently inflated the Co.’s profits, and thereby caused the Co. to file false tax returns and to be taxed excessively.
  - The Co. sought refund of tax paid to IRD
  - Q: Whether the filing of tax returns by directors could be attributed to the Co.
Moulin Global Eyecare (CFA) (cont’)

- Majority judgment (4:1), Tang PJ dissenting
- Lord Walker (delivering the majority judgment):
  - Patten LJ’s judgment in *Bilta (No2)* “has achieved a welcome clarification of the law in this area”
  - Attribution is sensitive to facts and purpose (retreat!)
Moulin Global Eyecare (CFA) (cont’)

Lord Walker’s view on auditors’ negligence case:

“The fraud exception does not appear to have been even raised as a defence, still less successfully relied on, in a claim by a company against its auditors for failure to detect internal fraud … with the sole exception of the extreme ‘one-man’ company case of Stone & Rolls. Again, internal fraud was the ‘very thing’ from which the auditors had a duty to protect the company.”

“… It is against insurers or auditors who have, for value, undertaken to protect protection against the risk of internal fraud, or to use reasonable professional skill to uncover internal fraud. Such insurers and auditors must be supposed to have had ample opportunity to acquaint themselves with the relevant business before undertaking these obligations. There is no reason for the law to apply the fraud exception so as to be absolve the contractual obligations of the insurers or the auditors (except, as the House of Lords held, in the extreme and exceptional circumstances of Stone & Rolls).” (another retreat!)
Topping Chance (CFI)

- “Very thing” argument – DHCJ S. Leung:
  “The present action is primarily brought in the interest of the shareholders (and creditors) of [the Co.] for the loss occasioned to the company by the alleged breach of [the auditor]. As a matter of principle, that the persons in charge of the company might have been fraudulent in withholding the true accounts is no answer to whether [the auditor] was in breach of the very contractual obligations to act as the gate-keeper of the company that [the Co.] has undertaken for remuneration. …”
**Days Impex (CFI)**

- P’s case (Judgment §36):
  - Fraudsters the effective owners
  - Fraudsters controlled all affairs of P
  - P was used by the fraudsters to perpetrate fraud
  - P was a “one man” company and the fraudsters’ guilty knowledge should be attributed to P

- Judge’s view on *Stone & Rolls*
  - “… a difficult case about the interaction between the doctrine of attribution, the fraud exception and the illegality defence”
  - “… difficult, if not impossible, to identify its ratio”
  - “… has been subject to severe criticism that its value as a precedent has been very much undermined”
  - “… difficult point of law in an area which is in the process of developing”
Conclusion

• Difficult for auditors to argue that the fraudsters’ wrong is attributed to the Co.:
  • If there are innocent parties involved: unlikely to succeed;
  • If Co. was insolvent or rendered insolvent by fraud: creditors’ interest may come into play;
  • Even for “one man” company: still not very likely due to the “very thing” argument.
When Auditors meet the Liquidators

(the Practical Aspects)

Ludwig NG
Senior Partner, ONC Lawyers
• Liquidators usually start by asking for docs and info from former Auditors.
Power comes from s.286B Cap 32 (formerly s.221)

Which provides:

Upon winding-up of a company, the Liquidators may apply to court for an order against the following people, to attend court to be orally examined and deliver books and papers in his custody:

“(4) The persons who may be subject to an order under subsection (1) are—
(a) an officer of the company;

(b) a person known or suspected to have in the person’s possession any property of the company;

(c) a person supposed to be indebted to the company; and

(d) a person whom the court thinks capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.
• An auditor could be (a) or (d)

• Can he refuse to answer the liquidator’s requests for info and docs?

(5) If a person is required to attend before the court under subsection (1)(a), but, after a reasonable sum has been tendered to the person for the person’s expenses for attending before the court—

(a) the person fails to attend before the court at the time appointed; and

(b) at the time of the court’s sitting, no lawful impediment to the attendance is made known to the court and allowed by it,

• the court may, by warrant, cause the person to be apprehended and brought before the court.
Case Study – Re Jumbo Fortune (HK) Ltd

- In practice, before the liquidator applies for a court order, he will make request in writing and invite the auditor to attend interview.

- **Re Jumbo Fortune (HK) Ltd (HCCW 143/2006)**
  - Respondent: Y H Cheung & Co. – former auditor of Jumbo Fortune (the “Company”)
  - Liquidator found a transaction between the Company and a company called Gold Talent International Holdings Ltd
  - Not recorded in the audited financial statements
  - Consideration not paid into Company’s bank account
  - Liquidators were suspicious of the veracity of the documents regarding the transaction
  - No books or records could be located.
Case Study – Re Jumbo Fortune (HK) Ltd (cont’)

- The documents filed by Gold Talent at the Companies Registry were presented by a secretarial service company with the same address as the Y H Cheung & Co.

- Another entity, Oriental Industry and Commerce Group Limited, the bank account of which was used in the purported transfer of US$900,000, had also engaged the same secretarial service company to present its documents for registration at the Companies Registry.
Case Study – Re Jumbo Fortune (HK) Ltd (cont’)

• R argued that as the audit working files are its own documents generated in the course of audit and not the property of the Company, the audit working files would not be within the scope of documents for which production may be required under section 221.

• R also argued that the information and documents of Gold Talent, not being the property of the Company, would not come within the scope of a production order.
Case Study – Re Jumbo Fortune (HK) Ltd (cont’)

- Hon Kwan J rejected R’s arguments.

“Under section 221, production may be ordered of documents relating to the Company. I am satisfied that the audit working files and documents and information of Gold Talent are documents and information relating to the affairs of the Company.”
Case Study – Re Jumbo Fortune (HK) Ltd (cont’)

- Requests for docs and info are not confined to particular transactions.

- It could cover virtually all audit working papers.
Case study - the use of s.221 against former auditor in New China Hong Kong case

Dramatis personae
• NCHK Group
• NCHK Capital
• NCHK Finance
  (the “Companies”)

In creditors’ voluntary liquidation

• R1: E&Y
• R2 & R3: Anthony Wu and Catherine Yen
New China Hong Kong case (cont’)

- R1 – tax representative, company secretary as well as auditor of the Companies
- R2 – partner of E&Y, director of NCHK Group from Nov 92 to Feb 93, financial advisor of NCHK Group, executive committee member of NCHK Group in his capacity as financial director
- R3 - partner of E&Y, responsible for audits of NCHK and its subsidiaries
New China Hong Kong case (cont’)

- In *Re New China Hong Kong Group Limited*, HCMP 3891/2002, 9 April 2003, the Liquidators applied under s.221 for an order, inter alia, requiring:

  1. R1 to produce its working papers and supporting documents relating to the audits of Cs from 1993 to 1997;
  2. R1 to produce all documents relating to its or R2's provision of financial advice to Cs as well as other documents created in R1 and/or R2's capacity as financial adviser; and
  3. R2 and R3 to be examined on oath concerning the affairs of Cs.
- Financial results of the NCHK group:

<table>
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<tr>
<th>Year ended 31 December</th>
<th>Profit/(Loss) HKS</th>
<th>Net Assets/(Liabilities) HKS</th>
<th>Net Current Assets/(Liabilities) HKS</th>
<th>Auditors’ Opinion</th>
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<tr>
<td>1993</td>
<td>-15,845,425.00</td>
<td>388,730,637.00</td>
<td>221,579,232.00</td>
<td>True &amp; fair view</td>
</tr>
<tr>
<td>1994</td>
<td>70,265,921.00</td>
<td>449,546,564.00</td>
<td>149,818,225.00</td>
<td>True &amp; fair view</td>
</tr>
<tr>
<td>1995</td>
<td>74,935,542.00</td>
<td>459,390,990.00</td>
<td>-37,642,533.00</td>
<td>True &amp; fair view</td>
</tr>
<tr>
<td>1996</td>
<td>-366,016,215.00</td>
<td>155,108,517.00</td>
<td>-590,733,215.00</td>
<td>Fundamental uncertainty, save for non-consolidation &amp; non-disclosure on 2 subsidiaries, true &amp; fair view</td>
</tr>
<tr>
<td>1997</td>
<td>-63,688,180</td>
<td>118,063,680.00</td>
<td>-764,113,607.00</td>
<td>Fundamental uncertainty, disclaimer of opinion</td>
</tr>
</tbody>
</table>
• Is a wholesale production of the audit working papers reasonable or necessary?

• E&Y has resisted production on the basis that the liquidators have not identified specific transactions which require investigation to show that the documents sought are necessary to the investigation.

• “In my view, it is not a must in every instance that specific transactions should be identified. Whether this ought to be done would depend on the nature and subject of the investigation”, per Hon Kwan J
• “The burden of complying with the order to give production of documents must be viewed in the context that E&Y is not a stranger but an officer of the Companies for the purpose of section 221.“ per Hon Kwan J

• Liquidators’ costs of this application borne by the respondents.
• *Re New China Hong Kong Group Limited* (unrep, HCMP 1725/2004, 14 Jan 05)

• Documents ordered to be produced in the Production Order (in HCMP 3891/2002):
  • Documents relating to Audits
  • Documents relating to Financial Advice
• Documents relating to Audits

• E&Y’s interpretation of the previous order:

  (1) the audit working papers of companies in the New China group of companies apart from the Companies containing information relating to the audits of the Companies are not within the Production Order, as it only covered “working papers and supporting documents relating to the audits of the Companies”;

  (2) “working papers” relating to an audit should be interpreted to mean the work papers or documents produced by the auditors in the course of the audit “which support the audit conclusion”, which is “consistent” with the HKICPA Handbook;
(3) “supporting documents” relating to an audit are the documents provided by the client which are reviewed by the auditors for the purpose of the audit and “which support the facts upon which the audit conclusion is based”;

(4) the Production Order only covers working papers and supporting documents relating to the audits of the Companies “in their individual capacity”, and does not extend to “consolidation files in their entirety”;

(5) the Production Order only covers the “annual audits” performed by E & Y for the Companies, and does not extend to any review exercise carried out by E & Y distinct from the annual audits or any special audit engagement;
- Hon Kwan J: “E & Y is not justified in its restrictive interpretation of the Production Order.”

- Other documents ought to be produced:
  1. the “permanent” files;
  2. the consolidation files;
  3. a report and related working papers of a special audit performed by E & Y;
  4. Audit strategies memorandum
  5. Summary review memorandum
  6. Review and approval summary for audit engagements
  7. All engagement letters signed by E & Y.
• Documents relating Financial Advice

• E&Y’s interpretation of the previous order:

(6) the Production Order does not cover the working papers in respect of the tax advisory work provided to the Companies or the documents and internal papers in relation to any proposed or contemplated restructuring of the New China group of companies and/or the Companies, claiming that such work done did not come within “financial advice” in the Order;

• Hon Kwan J: “The Production Order is not limited to documents created by Mr. Wu specifically in his capacity as financial adviser to NCHK Group.”
• The Production Order should cover:
  • advice and professional services rendered by E & Y to the Companies in relation to a proposed financial restructuring plan presented to the financial creditors
  • files relating to the preparation of financial due diligence reviews for companies in the group and the preparation of accountancy reports in the context of contemplated acquisitions by companies in the group
Case Study

- *The New China Hong Kong Group Ltd v Ernst & Young* (HCCL 41/2004, HCCL 2/2005)
  - L investigated and fought a number of s.221 CO summonses with EY
  - Actions commenced against EY in 2004 and AW in 2005 (the case was heard in 2008)
  - EY was auditors for whole period, also financial adviser. AW was lead partner.
• AW was director up to 1993, then financial adviser on the executive committee.

• Claims against EY – iro 94, 95 audited accounts, EY gave unqualified opinions (in 95 and 96) and failed to give warning of over-exposure to 7 debtors.

When did cause of action accrue?
When did cause of action accrue?

L: when the NCHK went into liquidation.

EY: when the audited reports were issued.

Answer: ?
What’s the loss caused by the negligent audit?

- The full amount of the loans?
- No, it’s just the chance to salvage what’s left of the bad loans (by realising securities and enforcing the loan).
- Hence, cause of action accrued shortly after the issuance of the audited reports when management was supposed to take necessary action if the audited reports had not been negligently prepared and had given the necessary warnings.
Hence, primary limitation of 6 years has passed.

What about secondary limitations under s.31 and s.26 LO?
S.31, Limitation Ordinance

(1) This section applies to any action for damages for negligence, other than one to which section 27 applies, where the earliest date on which the plaintiff or any person in whom the cause of action was vested before him first had both—

(a) the knowledge required for bringing an action for damages in respect of the relevant damage; and

(b) a right to bring such an action,

(referred to in this section as the “date of knowledge”) falls after the date on which the cause of action accrued.

(2) The period of limitation prescribed by section 4(1) in respect of actions founded on tort shall not apply to an action to which this section applies.
(3) An action to which this section applies shall not be brought after the expiration of the period applicable in accordance with subsection (4).

(4) That period is either—
   (a) 6 years from the date on which the cause of action accrued; or
   (b) 3 years from the date of knowledge, if that period expires later than the period mentioned in paragraph (a).

(5) In subsection (1) “the knowledge required for bringing an action for damages in respect of the relevant damage” (有關損害而提出損害賠償訴訟所需的知悉) means knowledge—
(a) of such facts about the **damage** in respect of which damages are claimed as would lead a reasonable person who had suffered such damage to consider it sufficiently serious to justify his instituting proceedings for damages against a defendant who did not dispute liability and was able to satisfy a judgment;

(b) that the damage was attributable in whole or in part to the act or omission which is alleged to constitute negligence;

(c) of the identity of the defendant; and

(d) if it is alleged that the act or omission was that of a person other than the defendant, of the identity of that person and the additional facts supporting the bringing of an action against the defendant.
s.31, LO

Key issues:-

• only applies to negligence, not contract

• “the knowledge required for bringing an action for damages in respect of the relevant damage” – what does it mean?

• whose knowledge?

• A few months before the NCHK case, these issues have been authoritatively answered in Kensland.

• Kensland sold a property to purchaser to be completed on 2 September 1997.

• On the completion date (2 September 1997), it (through TTC) only gave instructions on split cheques to purchaser’s solicitors in less than 2 hours.

• Purchaser was 6 minutes late to deliver cheques (1:06 pm).

• Kensland, on advice on TTC, treated this as repudiation, forfeited the deposit and refused to complete.

• Purchaser immediately sued Kensland on 3 September 1997.
Kensland Realty Ltd v. Tai, Tang Chong (cont’d)

- Kensland won at First Instance (5/4/2000) but lost in CA (23/1/2001) and lost again in CFA (10/12/2001)
- When would it be deemed to have “the knowledge required” to bring an action against TTC for negligent advice?
• Answer: 3 September 1997!

Why? Because of s.31(5) and (7) LO

• What is required is the knowledge of “damage”, NOT legal knowledge of “liability” or “cause of action”.
The New China Hong Kong Group Ltd v Ernst & Young (the “NCHK case”)

• The Court summarised the principles in Kensland as follows:-

  (1) The knowledge which sets time running under s. 31 LO consists both of the plaintiff’s actual knowledge and knowledge which is imputed to him (para. 68);

  (2) S.31 is concerned the plaintiff’s knowledge relating to the damage incurred and not with the defendant’s liability. The section has nothing to do with whether the plaintiff knew that the defendant’s conduct amounted in law to negligence or that he had a good claim against the defendant (paras. 73, 74);
The NCHK case (cont’d)

(3) S. 31(5)(a) LO establishes a low threshold. The knowledge required to set time running is likely to be satisfied where a plaintiff becomes aware of some actual damage, provided that it is not so trivial as to be not worth bothering about (para. 79);

(4) S. 31 LO does not require the plaintiff to have detailed knowledge of all the acts and omissions set out in the particulars of his pleadings as constituting negligence. What matters is the plaintiff’s knowledge of what lies at the core of the pleaded case. The requisite knowledge is not of the acts or omissions as pleaded but knowledge of the facts constituting “the essence of the complaint of negligence” distilled from such pleading (paras. 103, 105);
The NCHK case (cont’d)

(5) Knowledge of the “essence” of the act or omission is gained “the moment at which the plaintiff knows enough to make it reasonable for him to begin to investigate whether or not he has a case against the defendant”: Hoffmann LJ in *Broadley v. Guy Clapham & Co.* (para. 107);

(6) The plaintiff must be shown to have actual or imputed knowledge of all the facts which are essential to the complaint which is eventually formulated as his negligence claim (para. 108).
s.31, LO (cont’d)

- Hence, it could be seen that the threshold is rather low. Further, the burden is on the plaintiff to prove that he did not have such knowledge.

- In the NCHK case, the plaintiff argued that it was only after the s.221 CO proceedings, which took a few years to conclude, and after full analysis of the transcripts, that the full extent of EY and AW’s breaches of duty have become clear.

- However, the court found that whilst the s.221 CO transcripts may provide further evidence to support the claims, the essence of the claims was known long before that.
Known by whom?

• Note that the **plaintiff** in the NCHK case is the **company** acting through the liquidators, **NOT the liquidators**.

• Hence, it’s the knowledge of the company that counts, **NOT the liquidators’**.

• What’s meant by the knowledge of the company?

• Rules of attribution: knowledge of the defendants and those (within the company) who conspired with him doesn’t count

• Knowledge of directors who are in a position to act would count.
The NCHK case (cont’d)

- The court held that the essential facts in this case are that:-
  - NCHK’s business was conducted in a reckless manner and that the defendants failed to give the necessary warning and signed unqualified opinions of its audited accounts.

- It was found that the finance director and some other directors were aware of these facts well before the winding up of NCHK in 1999. It was not pleaded and no evidence was presented that they were in any way connected with the alleged negligent acts of EY and AW.

- Hence, NCHK and the liquidators, when they took over, were fixed with the knowledge of the essential facts through these directors.
Concealment under s.26 LO

• Can the liquidators then argue that there was deliberate concealment under s.26 LO?

• L argued that EY and AW were uncooperative in providing info, and fought a number of s.221 summonses requiring them to produce documents (in which they all lost), thus substantially lengthening the investigation process.
s. 26 LO provides:

“(1) Subject to subsection (4), where in the case of any action for which a period of limitation is prescribed by this Ordinance, either –

(a) …

(b) Any fact relevant to the plaintiff’s right of action has been deliberately concealed from him by the defendant;

(c) …

the period of limitation shall not begin to run until the plaintiff has discovered the …… concealment or could with reasonable diligence have discovered it.
s. 26 LO provides:

(2) …

(3) For the purpose of subsection (1), deliberate commission of a breach of duty in circumstances in which it is unlikely to be discovered for some time amounts to deliberate concealment of the facts involved in that breach of duty.
The court in the NCHK case held:-

‘In this connection, it should also be borne in mind Lord Browne Wilkinson’s statement in Sheldon that “facts relevant to the plaintiff’s right of action” do not include facts which improve the plaintiff’s prospect of success. The liquidators’ complaint as to concealment of details of E&Y’s audit work; destruction of the audit working papers; or the obstruction or opposition to the section 221 proceedings, are therefore clearly irrelevant for the present purpose. They are not essential matters or “relevant facts” for the purpose of section 26(1)(b).’ (para 137)
solutions • not complications