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Legal and Practical Considerations in Auditors' Negligence Cases

Ludwig NG
Solicitor Advocate, Partner
ONC Lawyers

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CONVENTIONAL DESCRIPTION OF THE AUDITOR'S DUTIES

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Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

- **Guang Xin Enterprises Ltd (in CVL)** (HCA 2788/2001, judgment dated 21 May 2002; CACV 263/2002, judgment dated 13 march 2003)

- Per DHCJ R Tong:-

  Standard of Care

  Para 35: ….an auditor is neither an insurer nor a detective; that he is a watch-dog but not a bloodhound. In **In re Kingston Cotton Mill Company (No. 2)** [1896] 2 Ch. 279, Lindley L J said (at p.284):-

  "… an auditor's duty is to examine the books, ascertain that they are right, and to prepare a balance-sheet showing the true financial position of the company at the time to which the balance-sheet refers. But it was also pointed out that an auditor is not an insurer, and that in discharge of his duty he is only bound to exercise a reasonable amount of care and skill."

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Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

Scope of Duties

Para 38: **Scrutinise management** (Citing from **Caparo Industries plc v. Dickman** [1990] 2 AC 605, per Lord Oliver):

"It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."

Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

Para 40:

But not business adviser (quoting **Bank of Credit and Commerce International (Overseas) Ltd. v. Price Waterhouse** [1999] BCC 351, Laddie J)

"… the auditor is employed by the company to exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts…. telling the shareholders whether the accounts give a true and fair view of the company's financial position. He is not in possession of facts nor qualified to express a view as to how the business should be run, in the sense of what investments to make, what business to undertake, what prices to charge, what lines of credit to extend and so on…."

- ***Still less whether the company should carry on its business*.** (DHCJ R Tong's words)

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Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

- The DHCJ's dicta has important implication for the claim in the **Guang Xin** case, which is a "**trading loss claim**".

  Para 4:-

  "…at the heart of the Statement of Claim is an allegation that by reason of the alleged incorrect reporting of the Defendant, the Plaintiff continued trading from the publication of the 1994 Accounts to the date of its demise in 1998 thereby suffering loss."

  Para 41:-

  *"Traditionally, a claim against auditors was based on their failure to uncover misfeasance by the management in misapplying assets of the company, ….. In recent years, large scale liquidations have prompted the emergence of what I shall call "**trading loss cases**" where the auditors were blamed for the trading losses of the continued existence of an insolvent company…."*

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Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

- DHCJ Tong concluded that the claim should be struck out, amongst various reasons, on the ground of '**causation**':

  Para 62

  "... Were trading losses flowing from a decision to trade based on inaccurate financial information provided by the auditors the kind of damage which the auditors had promised to save the company from harmless? In my judgment, the law has firmly answered that question in the negative.

- Citing the case **Alexander v. Cambridge Credit Corporation Ltd.** (1987) 9 NSWLR 310, the DHCJ endorsed this passage (para 65):-

Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

"…Initiation of a train of events which results in loss to the plaintiff does not, per se, make the initiator liable for those losses…. Cambridge [the plaintiff] continued to trade after 1971. Had [the auditor] performed its duty properly it would not have done so. In that sense all losses incurred after 1971 were caused or facilitated by or would not have been incurred but for the breach of duty. But [the auditor] was not liable for all losses. Trading exposes a company to risks. A business can be run properly and yet make a loss. ***[The auditor's] breach of duty was not regarded as the cause, in the legal sense, of the losses which arose simply from continued trading.*** *What caused those losses were the dangers inherent in the marketplace and the directors' management decisions which, with the benefit of hindsight, can be seen to have been the wrong decisions to take…. Cambridge's auditor … was under no obligation to take care to protect it against trading losses. Its job was to audit the company's figures."*

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Guang Xin Enterprises Ltd (in CVL) (HCA 2788/2001)

- DHCJ R Tong's decision (to strike out the claim against the auditor) was affirmed by the Court of Appeal (Rogers VP, Le Pichon JA, CACV 263/2002, judgment dated 13 March 2003)

- So, is that the end of the claim in "trading losses"?

- Fast forward to 2017, the liquidators of an insolvent company made a similar claim against the defendant auditor in **Days Impex Limited (in liquidation) v Fung, Yu & Co** (HCA 1035/2014, date of judgment: 24 Oct 2017).

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Days Impex Limited (in liquidation) (HCA 1035/2014)

- **Days Impex Limited (in liquidation)** (HCA 1035/2014, date of judgment: 24 Oct 2017) DHCJ Alex Lee

  Para 2:

  "…It is a major plank of the plaintiffs' case that the defendants had breached their duty owed to the plaintiffs by signing off unqualified "clean" opinions on the status of the plaintiffs' accounts and by failing to detect and report the massive import/export fraud which the controlling shareholder and director had caused the plaintiffs to commit. It is said that had the fraud been detected earlier and reported to the relevant authorities, the fraud would not have continued for so long and the plaintiffs' losses would have been lesser."

Days Impex Limited (in liquidation) (HCA 1035/2014)

- Whilst not disputing the authorities cited in the **Guang Xin** case, the DHCJ put emphasis on authorities that cast the scope of the auditors' duties a bit wider:-

  Para 13:

  Having considered the submissions from both sides, I am unable to accept that an auditor's duty is as narrow as to be restricted to the provision of information and advice, but may extend to detecting material irregularities in the company's accounting statements. ***See Barings v Coopers & Lybrand*** *[1997] 1 BCLC 427 in which Leggatt LJ said:*

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Days Impex Limited (in liquidation) (HCA 1035/2014)

" The primary responsibility for safeguarding a company's assets and preventing errors and defalcations rests with the directors. But material irregularities, and a fortiori fraud, will normally be brought to light by sound audit procedures, one of which is the practice of pointing out weaknesses in internal controls. An auditor's task is to conduct the audit as to make it probable that material misstatements in financial documents will be detected. Detection did not occur here, and there therefore is a case for [the defendants] to answer." (Emphasis supplied)"

- Hence, in addition to assessing if the accounts present a true and fair view, the auditor should also detect material irregularities and fraud.

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Days Impex Limited (in liquidation) (HCA 1035/2014)

Para 14:

Moreover, … in appropriate cases an auditor's duty may even extend to reporting any fraud he detected during the course of his work for a client. Thus, in ***Sasea Finance Ltd v KPMG*** *[2000] 1 All ER 676, it is said:*

"If, for example, the auditors discover that a senior employee of a company has been defrauding that company on a grand scale, and is in a position to go on doing so, then it will normally be the duty of the auditors to report what has been discovered to the management of the company ***at once****, not simply, when rendering the auditors' report, to record what has been discovered weeks or months later.*

…

Days Impex Limited (in liquidation) (HCA 1035/2014)

The guidelines also acknowledge that there may be occasions when it is necessary for an auditor to report directly to a third party without the knowledge or consent of the management. Such would be the case if the auditor suspects that management may be involved in, or is condoning, fraud or other irregularities and such would be occasions when the duty to report overrides the duty of confidentiality….*

Para 15:

The reference to "The guidelines" above is the Auditing Guidelines (Feb 1990 edn). There are similar guidelines applicable to Hong Kong issued by the Hong Kong Society of Accountants... Of particular relevance are (1)SAS 110: The Auditors' Responsibility to Consider Fraud and Error in the Audit of Financial Statements: (2)SAS 200: Planning (3)SAS 240: Quality Control for Audit Work

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Days Impex Limited (in liquidation) (HCA 1035/2014)

Para 17:

*In my **humble** view, the weight of the authorities is such that it is highly arguable that an auditor's duty is more than just providing information and advice on his client's financial statements. Moreover, I am inclined to the view that what is said in **Sasea Finance** about an auditor's duty to "blow the whistle" is also apposite to Hong Kong.*

- Hence, it seems that DHCJ Lee and DHCJ Tong have quite different views (or at least emphasis) on the scope of the auditor's duties, notably in **Days Impex**, it is held that the auditor has a legal duty to report fraud, at once, to the management, or even third parties.

Days Impex Limited (in liquidation) (HCA 1035/2014)

- How about the issue of causation (the basis for DHCJ Tong to strike out the liquidator's claim in **Guang Xin**)?

  Para 29:

  Mr Lai [counsel for the auditor] submits that allowing a company to remain in existence does not, without more, cause losses from anything and that giving an opportunity to a company incur and to continue to incur trading losses does not cause those trading losses in the sense in which the word "cause" is used in law….Based on the above, Mr Lai submits that … the alleged failure on the part of the defendants to detect fraud, even made out, at most only provided an opportunity to the plaintiffs to sustain loss. It is insufficient to make out the legal causation….

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Days Impex Limited (in liquidation) (HCA 1035/2014)

Para 30:

*In **Galoo v Bright Grahame Murray**, a case which is heavily relied on by Mr Lai, it was held that the negligent audit certificate merely created the opportunity for the company to incur and continue to incur trading losses, the cause of the losses being the unsuccessful trading. However, **Galoo** was distinguished in **Sasea Finance** on the ground that, where the auditor's duty was to draw attention to a fraud, he was responsible for the company continuing to trade fraudulently. The Court of Appeal in **Sasea Finance** said that the subsequent frauds were "the kind of transaction against the risk of which [the auditor] had a duty to warn".*

Days Impex Limited (in liquidation) (HCA 1035/2014)

Para 31:

I also have regard to the following legal principles and case authorities drawn by Mr Joffe [counsel for plaintiff] to my attention … it is well-established that negligence needs to be an "effective cause", but what this is in any given case is largely be a question of fact and a matter of application of ***judicial "common sense"****:* ***Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd*** *[1997] AC 254*

- What exactly is meant by "judicial common sense"?

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Days Impex Limited (in liquidation) (HCA 1035/2014)

- The judge in ***Days Impex*** did not actually refer to ***Guang Xin*** in his judgment and expressly distinguish it.

- A possible way to distinguish ***Guang Xin*** and ***Days Impex*** (instead of just relying on 'judicial common sense') is that ***Guang Xin***'s claim is not premised upon discovery of fraud and prevention of further fraud. As DHCJ Tong said:-

  Para 97

  *In **BCCI**, Laddie J (at page 371F) based his decision on denying recovery of trading loss on the fact that the trading activities were not "touched by fraud or imprudence which the ... defendant should have discovered and disclosed." I also draw comfort from the fact that such a distinction was indeed drawn in **Sasea Finance v. KPMG** [2000] 1 All E R 676: see in particular, the judgment of Kennedy LJ at page 683b-f.*

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Days Impex Limited (in liquidation) (HCA 1035/2014)

- **Hence, in order to succeed in a trading loss claim, fraud need to be expressly pleaded as the cause of the company's continuing loss.**

- It is also worthy to note that in HK, the CFA has held that an NED (and principal legal adviser) could be liable for 'trading loss' if she failed in her duty to "blow the whistle" and put the company into liquidation when it's obviously insolvent and has no prospect of trading out of its financial difficulties.

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Moulin Global Eyecare Holdings Ltd (in liquidation) v. Olivia Lee (2014)

- **Moulin Global Eyecare Holdings Ltd (in liquidation) v. Olivia Lee** (2014) 17 HKCFAR 466

  "… a claim quantifying Moulin's loss as at least HK$1.23 billion by reference to the increase in its net deficiency from 31 March 2001 (the date of the first accounts after the defendant became a director), when Moulin contends provisional liquidators would have been appointed had the defendant discharged her duties, and the date of appointment of the provisional liquidators on 23 June 2005 ("the IND Loss")."

- This particular claim of Moulin never goes to trial.

- Whilst "trading losses" claims may have uncertainty, it's clear that specific losses – overpaid tax and dividends, and other losses specifically caused by failure to detect irregularities, are claimable items.

- An early case in this area **Extramoney Limited** HCA 8437/1987 (Judgment dated 15 January 1994) is a claim for overpaid tax and dividends

- The trial lasted 36 days and the judgment is 111 pages long.

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Extramoney Limited (HCA 8437/1987)

- The claim:-

  Para 1

  "…the genesis of which can traced to a simple complaint of oversight by professional auditors in failing to detect an allegedly inflated statement of profits in the audited accounts of a certain company which led … to an overpayment of profits tax by the company concerned and the declaration and payment of a dividend for which they now seek to hold the auditors liable."

Extramoney Limited (HCA 8437/1987)

- There're two plaintiffs.
  - Extramoney, and its grandparent
  - Carrian Holdings Limited (in liquidation)

- It is alleged that Extramoney wrongfully treated a profitable stock transaction conducted by Mr. George Tan (the sole controller of Extramoney and Carrian at the material times) as its own and inflated its profits, resulting in overpaid dividends (to its parent and grandparent) and overpaid tax.

Extramoney Limited (HCA 8437/1987)

- The defendants raised many defences, one of which is the commonly invoked defence of “reliance on management representation”, i.e., if the accounts were wrong, the auditor was just relying on the management’s representation.

- The court (DHCJ D Fung) dealt with this defence as follows:-

  Para 131

  “… First of all, that it would be totally improper for an auditor merely to accept the say so of the shareholder or the management even of a private company without verification. A reasonably prudent auditor should confirm management representations by reference to contemporaneous documentation…”

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Extramoney Limited (HCA 8437/1987)

Para 132

“Secondly, … an auditor has to guard against … the natural tendency of management to rewrite the corporate history of the past year if such a course entailed fiscal or other advantages. In the words of the Defence expert Mr. Morrison, "one takes a cautious approach to management representations rather than accepting everything wholeheartedly"…. Management manipulation of corporate financial results being a contingent evil which a reasonably careful auditor ought to guard against….”

- In short, reliance on management representation could hardly exonerate a careless auditor.

Extramoney Limited (HCA 8437/1987)

- In **Extramoney,** the Plaintiffs have successfully proved that the accounts were wrong and that the auditor was negligent, yet the action failed. Why?

Para 179

“There is no doubting the common sense point, consistent with all the authorities, that "so long as the company is solvent the shareholders are in substance the company": the controlling shareholder is in essence the company: per Dillon L.J. in Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd. [1983] Ch. 258 (CA) at 288G -H.

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Extramoney Limited (HCA 8437/1987)

Para 189

"It cannot be over-emphasised that the reality of this case is that it is the companies Extramoney and Holdings and not their shareholders or creditors who are suing the Defendants. Further, Extramoney has never been in liquidation and, so far as concerned Holdings, it was at all times material to this case a financially solvent company. ***Additionally****, no fraud or misfeasance has been committed by Mr. Tan vis-a-vis either Plaintiff. Last but not least, both Plaintiffs were at all times private companies wholly owned and controlled by a single individual, Mr. Tan.*

- As no fraud is alleged against Mr. Tan, his knowledge is the company's knowledge.
- Although DHCJ Fung was not express, he was here dealing with the important concept of **"Attribution of Corporate Knowledge"**

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Extramoney Limited (HCA 8437/1987)

- As it was a deliberate decision of Mr. Tan to shift the Disputed Profits to the company, he (and the company) could not be said to be misled by the wrong accounts that the auditor had failed to qualify.

- The judge awarded nominal damages of HK$1.

- Defence to overpaid tax claim – why not go after the CIR?

Extramoney Limited (HCA 8437/1987)

- The Defendant Auditor in the ***Extramoney*** case counterclaimed that the Plaintiffs had failed to mitigate by claiming refund from the CIR.

- If overpaid tax (as a result of directors' fault and auditor's negligence) could be re-claimed from the CIR, then the liquidators should not be able to recover the same from the auditor.

- So, what should the Plaintiffs do if they want to claim auditors for overpaid tax?

- Could the company recover from the CIR tax overpaid as a result of auditor’s negligence? Answer: it depends

Moulin Global Eyecare Holdings Limited (in liquidation) v CIR, FACV 5/2013

- The case could be said to turn on the interpretation and application of s.70A of the Inland Revenue Ordinance:-

  Para 7

  "…Under s 70A, a taxpayer may obtain repayment ***"if, upon application made within 6 years after the end of a year of assessment … it is established to the satisfaction of an assessor that the tax charged for that year of assessment is excessive by reason of an error or omission in any return or statement submitted in respect thereof…"****. In respect of the tax year 2003/2004, MGET's case is that the tax paid was excessive by reason of errors in the return or statement submitted in respect thereof, because MGET's profits had been deliberately and fraudulently inflated by the management of MGET.*

Moulin Global Eyecare Holdings Limited (in liquidation) v CIR, FACV 5/2013

Para 8

The Commissioner rejected these applications… On 21 March 2012, the Court of Appeal … decided that the fraudulent knowledge of MGET's management that the profits had been inflated should be attributed to MGET such that MGET had not been prevented from giving notice of objection within time nor was there any error within the meaning of s 70A."

- Hence, if the 'error' is caused with the fraudulent knowledge of the taxpayer, it is not really 'error' within the meaning of s.70A.

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Moulin Global Eyecare Holdings Limited (in liquidation) v CIR, FACV 5/2013

- Up to this point, Tang PJ (dissenting minority) and Lord Walker NPJ (majority) are in agreement. What's different between them is on the application of the **“Attribution of Corporate Knowledge”** rules – when "guilty knowledge" of the corporate actors (directors or employees) could be attributed to the company. Lord Walker NPJ summarised those rules in para 106 of the judgment.

- Tang PJ held that the "fraud exception" applies hence guilty knowledge (fraud) of the directors was not attributed the taxpayer (Moulin), hence Moulin could be said to have made an 'error' (within the meaning of s.70A), whereas Lord Walker held that it does not (i.e., no exception, i.e., the guilty knowledge of the director is attributed to the company => no 'error".)

Moulin Global Eyecare Holdings Limited (in liquidation) v CIR, FACV 5/2013

- Lord Walker NPJ:-

  Para 135

  "The liquidators cannot therefore rely on … section 70A, because MGET must be taken as having known that its returns were false, and … a deliberate lie is not an "error" for the purposes of that section."

- It could be said that Lord Walker applied his "judicial common sense" and decided that the guilty knowledge of the directors in this particular case should be attributed to the company.

Moulin Global Eyecare Holdings Limited (in liquidation) v CIR, FACV 5/2013

- However, it is important to note that in the course of his judgment, Lord Walker NPJ indicated that the “fraud exception” would generally apply in an action against auditors of an insolvent company, i.e, the guilty knowledge of the fraudulent director is NOT attributed to the company. Hence the company CAN sue the auditor.

- Lord Walker substantially resiled from his position in the controversial case of ***Stone and Rolls Ltd v Moore Stephens (HL(E))*** [2009] 1AC 1391.

Stone and Rolls Ltd v Moore Stephens (HL(E)) [2009] 1AC 1391

- **Stone and Rolls** is a case where an insolvent company that committed fraud through its sole shareholder and director sued the auditor for negligence. In that case, Lord Walker ruled against the plaintiff on the doctrine of *ex turpi causa* - a claimant is not allowed to maintain a legal action should it arise from his own illegal act.

Para 100

The decision of the House of Lords in Stone & Rolls [2009] 1 AC 1391, to which I was a party, has been the subject of a good deal of academic commentary, mostly critical (see for instance Professor Eilis Ferran, Corporate Attribution and the Directing Mind and Will (2011) 127 LQR 239; and the article by Professor Peter Watts mentioned in para 62 above). The issue of attribution arose in the context of a defence of ex turpi causa pleaded by auditors sued for breach of duty. The Law Lords were split three-two, and it is difficult to extract a clear ratio from the speeches of the majority.

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Stone and Rolls Ltd v Moore Stephens (HL(E)) [2009] 1AC 1391

- **Stone & Rolls** is not central to the case of **Moulin v CIR**, but it is in the case of **Days Impex**:-

  Para 35

  *Mr Lai distills the following principles from the highly controversial case of **Stone & Rolls Ltd v Moore Stephens** which he submits have not been undermined by subsequent cases:*

  (1) the issue of attribution very much depends on context and purpose of the proceedings in question; and

  (2) in a "one man" company case, the controlling fraudster's knowledge could be attributed to the company in an audit negligence claim against an auditor.

Stone and Rolls Ltd v Moore Stephens (HL(E)) [2009] 1AC 1391

Para 37

*With respect, I recognize the logic and force of Mr Lai's aforesaid submissions. However, **Stone & Rolls**, which is the foundation of his submissions, is admittedly a difficult case about the interaction between the doctrine of attribution, the fraud exception and the illegality defence, as each of the Law Lords had given differing reasons for the decision so that it is difficult, if not possible, to identify its ratio. Thus, it is said in the joint judgment of Lord Toulson and Lord Hodge JJSC in **Bilta (UK) Ltd v Nazir (No 2)** that:*

*" We conclude that **Stone & Rolls** should be regarded as a case which has no majority ratio decidendi."*

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Stone and Rolls Ltd v Moore Stephens (HL(E)) [2009] 1AC 1391

- Hence, in auditor's negligence cases, the knowledge of the director (even a sole controlling one) is not attributed to the company if the company is insolvent and the director has been fraudulent at the material times, otherwise there will be no such attribution.

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PRACTICAL ASPECTS

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- Liquidators usually start by asking for docs and info from former Auditors.

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- 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—

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(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.**

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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: 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 Respondent.
- 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')

- The Respondent 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.
- The Respondent 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.*"

- Requests for docs and info are not confined to particular transactions.
- It could cover virtually all audit working papers.

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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

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New China Hong Kong case (cont')

- R1 –tax representative, company secretary as well as auditor of the Companies
- R2 – partner of R1, 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 R1, 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.

- **Is a wholesale production of the audit working papers reasonable or necessary?**
- The Respondents 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 court ordered production of all documents relating to the audit of the group.

- However, the Respondents' put a restrictive interpretation on the 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 for the Companies, and does not extend to any review exercise distinct from the annual audits or any special audit engagement;

- Hon Kwan J: “It is not justified to put such a restrictive interpretation on 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;
  (4) Audit strategies memorandum
  (5) Summary review memorandum
  (6) Review and approval summary for audit engagements
  (7) All engagement letters signed.

LIMITATION PERIOD

- ***The New China Hong Kong Group Ltd v Ernst & Young*** *(*HCCL 41/2004, HCCL 2/2005)
  - NCHK – founded by TTT, incorporated in 1992, went into CVL in 1999.
  - The liquidators fought a number of s.221 CO (private examination) summonses with the auditors to obtain documents and evidence (of negligence).
  - Actions commenced against the auditors in 2004.

- The claims against the auditors were in respect of the 1994, 1995 audited accounts, which the auditors gave unqualified opinions (in ‘95 and ‘96) and allegedly failed to give warning of over-exposure to 7 debtors.
- Action commenced in 2004, time barred?

When did cause of action accrue?

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When did cause of action accrue?

Liquidators: when the NCHK went into liquidation (in 1999). Hence primary limitation of 6 years expired in 2005.

Auditors: when the audited reports were issued (in 1995/1996). Limitation expired in 2002.

Answer: ?

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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) – it's a "loss of chance" claim.
- 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, limitation period starts to run shortly after the ‘96 audited accounts were issued, primary limitation of 6 years expired in 2002. It’s expired by the time the action was commenced in 2004.

What about secondary limitation under s.31 of the Limitation Ordinance?

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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.

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(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)**.

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?

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s.31, LO (cont'd)

- In the NCHK case, the liquidators 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 auditors' 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 ?
(how to apply the Attribution of Corporate Knowledge rules)?

- 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.

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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 the auditors.
- Hence, NCHK and the liquidators, when they took over, were fixed with the knowledge of the essential facts through these directors ➔ s.31 LO does not help.

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Question 1

An auditor is a:-

a. blood hound
b. golden retriever
c. watch dog
d. pussy cat

Question 2

Which of the following is closest to the expiry of the primary limitation period for an action in negligence against an auditor is:-

a. six years from appointment of provisional liquidator
b. six years from appointment of liquidator
c. six years from commencement of winding-up
d. six years from issuance of the audited accounts

Question 3

When would the knowledge of fraudulent director be attributed to the company:-

a. in a negligence claim against the auditor
b. in a s.70A, Inland Revenue Ordinance claim for tax refund based on 'error'
c. in a misfeasance claim against the director
d. when the company was insolvent at the material time

Thank you! 

ONC Lawyers

Ludwig Ng
Senior Partner
ONC Lawyers

Office: 19th Floor, Three Exchange Square,
8 Connaught Place, Central, Hong Kong

Suite 504-43, 5/F, West Tower, Shanghai Centre,
No.1376 Nanjing West Road, Jing An District,
Shanghai 200040, China

Direct: (852) 2107-0315
Phone: (852) 2810-1212
Fax: (852) 2804-6311
Email: ludwig.ng@onc.hk
Web-Site: www.onc.hk

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