Barings v Coopers & Lybrand; Johnson v Gore Wood; Standard Chartered Bank v Pakistan National Shipping Corp: Some Temporary Relief for Auditors?

In an article entitled *Subsidiaries' auditors and their liability*, (1997) 18 CoLaw 333, I expressed some concern at the Court of Appeal's decision in *Barings plc v Coopers & Lybrand* [1997] 1 BCLC 427 ('1997 Case'). Coopers & Lybrand Singapore ('C&LS') was seeking to prevent overseas service of a writ by Barings plc ('PLC') and Barings Securities Ltd ('BSL'). BSL and PLC were the intermediate and ultimate parent companies of Barings Futures Singapore Pte Ltd ('BFS'), the employer of one Nick Leeson. The writ alleged that C&LS, as auditors of BFS, had been negligent in not detecting the loss-making activities of Mr Leeson. It was alleged that this was in breach, not just of a contractual (and tortious) duty to BFS, but also of a tortious duty to BSL and PLC as the indirect shareholder/parents of BFS.

In upholding the possibility of this tortious duty to the parent companies, and thus the service of the writ, Leggatt LJ said:

> 'In my judgment, the argument about duty of care is concluded by the simple fact that C&LS knew that their audit and report on the consolidation schedules were required so that the directors of Barings could comply with their obligation to provide accounts which showed a true and fair view of the financial affairs of the group'

This use of s 227 Companies Act 1985 (requiring consolidated accounts) to imply a duty to parent companies when under the ruling in *Caparo Industries plc v Dickman* [1990] 2 AC 605 a shareholder would not otherwise be owed such a duty, raised a number of difficult issues. In my earlier article I posed these as a series of questions.

> 'Is it right that a legal system that firmly maintains that parent companies are not liable for the debts of their subsidiaries should also allow parent companies to sue the auditors of those companies for negligence? What about the double claims (shareholders and company) for effectively the same loss that concerned the Court of Appeal in the *Prudential* case? If the resources of a subsidiary's auditors were limited, such double claims might give a parent shareholder a partial preference over its subsidiary's creditors…
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> Also, what if BFS had been a partly owned subsidiary with outside minority shareholders? Would the parent be able to sue, benefiting from s 227, but the minority not under the ruling in *Caparo*?'

There was a danger that this deeply unsatisfactory, albeit interlocutory, decision of the Court of Appeal might stand unchallenged because it seems that the various

Barings companies are now settling their actions with the various parts of Coopers & Lybrand. However, before 1993, the auditors of BFS were Deloitte & Touche (Singapore) ('D&T') and they were also being sued by BFS in contract (and tort) and by BSL and PLC in tort. D&T have decided to fight on and this has produced two further cases, *Barings v Coopers & Lybrand (Nos 4 and 5)* [2002] PNLR 16 and [2002] EWHC 461. *Barings No 4* looks at the claims by BSL and PLC and *No 5* at a preliminary point in the claim by BFS.

In a carefully reasoned judgment in *Barings No 4*, Evans-Lombe J struck out the claims by BSL and PLC against D&T. The claims were that, but for the negligence of D&T in failing to spot early losses incurred by Mr Leeson:

1. BSL would not have gone on to lose nearly £400 million lent some 15 months later to BFS to finance Mr Leeson's activities;
2. BSL and PLC would not have lost their value as companies of £400million and £1,000 million respectively when Mr Leeson's activities brought down the whole group 2 years later; and
3. PLC would not have paid out £12 million excess bonuses on the basis of overstated profits in BFS's 1992 accounts.

In claims 1. and 2. D&T argued that *Caparo* itself laid down a 'Purpose Test' which could be defined as follows:

> 'Where a claimant claims damages in tort flowing from a negligent misstatement he must plead and prove not only that the loss for which compensation is claimed was caused by the defendant's breach of duty to the claimant, and was foreseeable, but also that the claim arises from a transaction or class of transactions, that was within the contemplation of the defendant at the time he undertook the relevant duty and for the purpose of which the transaction, inter alia, he provided his services, and that the claimant relied on those services for the purpose of that transaction.'

Evans-Lombe J reviewed not just the auditor liability cases but the many recent valuer cases and concluded that where the claim is made by a third party for negligent misstatement (as against a claim based on contract), such a purpose test did have to be met. It is probably spelt out most clearly by Lord Bingham in *Reeman v Department of Transport* [1997] 2 Lloyd's Rep 648, a case alleging negligence in inspecting a fishing boat, where he said at 685:

> 'The cases show that before a plaintiff can recover compensation for financial loss caused by negligent misstatement his claim must meet a number of conditions. Among these are three particularly relevant here. The statement (whether in the form of advice, an expression of opinion, a certificate or a factual statement) must be plaintiff-specific: that is, it must be given to the actual plaintiff or to a member of a group, identifiable at

> the time the statement is made, to which the actual plaintiff belongs. Secondly, the statement must be purpose-specific: the statement must be made for the very purpose for which the actual plaintiff had used it. Thirdly, and perhaps overlapping with the second condition, the statement must be transaction-specific: the statement must be made with reference to the very transaction into which the plaintiff has entered in reliance on it.'

Mere knowledge that a subsidiary's accounts are going to be used by a parent to create Group accounts is not enough to plead a claim that the subsidiary's auditors may be liable to that parent as Leggatt LJ had suggested in the 1997 Case. Evans-Lombe J clearly believed the Court of Appeal to be wrong and in refusing to follow it said:

> 'The Court of Appeal was considering an application under Ord 11 for service outside the jurisdiction. Had the appeal succeeded it would have stopped the proceedings against C&LS in limine. Conclusions of law arrived at in such application cannot preclude the court of trial from re-examining those conclusions in the course of a trial.'

Evans-Lombe J ended this part of his judgment with a reminder of the dangers of the 'but for' test in a world apparently subject to 'chaos theory' (but for the flap of a butterfly's wing etc.).

> 'It is circumstances like these which illustrate the necessity for a "*control mechanism*", highlighted in many judgments dealing with this area of law [ie negligent misstatement]. To the outsider it would seem far-fetched that the negligence of a subsidiary auditor of one of the minor subsidiary companies of a complex and substantial banking group should expose that auditor to liability for massive damages flowing from the collapse of the entire group, notwithstanding that it can be said that but for his negligence that collapse would not have taken place.'

In striking out claims 1.and 2., Evans-Lombe pointed out that the 1997 Case had already been criticised by the House of Lords in *Johnson v Gore Wood* [2001] 2 WLR 72. Indeed D&T also argued on the basis of *Gore Wood* that claims 1.and 3. were for losses that were merely reflections of the loss made by BFS and could only be claimed by BFS. Although he had already struck out claim 1. and was to strike out claim 3 on the factual grounds that it was BSL, not PLC that had paid out the bonuses, Evans-Lombe did also consider this reflected loss argument.

In *Gore Wood*, Mr Johnson and his companies had been negligently advised by the solicitors Gore Wood. One of the companies, Westway Homes Ltd, settled its claim, but later Mr Johnson brought his own action in contract and tort for the negligent advice given directly to him. The House of Lords held (Lord Cooke partly dissenting) that, in the words of Lord Millett:

> ‘Where the company suffers loss caused by the breach of duty owed both to the company and to the shareholder… the shareholder’s loss, insofar as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company’s creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder…
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> Reflective loss extends beyond the diminution of the value of the shares; it extends to the loss of dividends… and all other payments which the shareholder might have obtained from the company if it had not been deprived of its funds… The same applies to other payments which the company would have made if it had had the necessary funds, even if the plaintiff would have received them qua employee and not qua shareholder and even if the plaintiff would have had a legal claim to be paid. His loss is still an indirect and reflective loss which is included in the company’ claim.’

BSL and PLC conceded that in respect of claim 1. the loans that had not been repaid by BFS were (under this wide definition) reflective of BFS’s losses incurred by Mr Leeson. However, it was argued that the reflected loss rule could only apply where the company (BFS) had an effective claim. In *Gore Wood*, Lord Bingham has said:

> ‘Where a company suffers loss but has no cause of action to recover the loss, the shareholder in the company may sue in respect of it… Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it, but neither may recover loss caused to the other by breach of the duty owed to that other…

It is not entirely clear what sort of situation Lord Bingham had in mind, possibly the sort of facts that arose *Galoo Ltd v Bright Graham Murray* [1994] 1 WLR 1360, where the alleged negligence of the accountants in auditing the accounts:

a. allowed the company to carry on trading at accumulating losses, for which the auditors could not be held liable; and

b. caused a shareholder to pay too much for taking a controlling interest for which the auditors might be liable, at least if they knew that that was one of the purposes of those accounts.

BSL and PLC attempted to apply it to a case where BFS could not itself sue because of an absolute defence D&T might have. D&T were arguing that they only signed off on the audit because Mr Jones, the Finance Director of BFS, had fraudulently signed a representation letter confirming that the financial statements presented to the auditors involved no irregularities, material errors and omissions. The actual status of this letter was the subject of *Barings No 5*. In the meantime, Evans-Lombe J held that as settlements and limitations stopping a company's claim, did not free shareholders to seek reflected losses (*Gore Wood* and *Giles v Rhind*, 24th July 2001, unreported), neither should this defence. In fact, in *Barings No 5* he held that the letter had not been fraudulent, leaving BFS with a potential claim that could stop any claim from BSL and PLC, had any such claim survived *Barings No 4*.

As for claim 3. about the bonuses, BFS and PLC again conceded that if BFS succeeded in a claim for negligence in the auditing of the 1992 accounts, then it would fail as reflected loss. D&T of course still got the claim struck out on the admitted facts. It is interesting, however, that D&T did not attempt to strike this claim out using the *Caparo* argument, presumably because BFS and PLC could argue that D&T did know (or at least ought to have known) that the 1992 audited figures would be used for such a purpose. But that is only putting the liability of a subsidiary company's auditors to the parent company on the same footing as the liability of any auditor to a company's shareholders. Between *Gore Wood* and *Barings No 4* the reasoning of the 1997 case should now be ignored.

To complete the story, however, it is worth looking quickly at *Barings No 5*, which was a hearing just to consider whether D&T had an unanswerable defence to the negligence claim in contract and tort brought by their former client BFS. As is standard practice with auditors, before signing off an audit and issuing an auditors report, D&T required a responsible employee of the audited company to sign a 'representation letter', confirming in the opinion of that employee that there were no irregularities etc.

D&T argued that Mr Jones, the nominal Finance Director of BFS, in fact knew little or nothing about the workings of BFS, and made no specific enquiries about its workings before signing the representation letter. That letter amounted to the opinion of an 'expert' that implied that the opinion was founded upon a reasonable factual basis. Mr Jones' behaviour did not just amount to negligence (which might give rise to arguments about reducing D&T's liability) but to reckless deceit under the test in *Derry v Peek* (1889) 14 App Cas 337. Such deceit was a cause of D&T signing the audit report, which was a cause of their being sued for negligence. In *Standard Chartered Bank v Pakistan National Shipping*

Corp (No 4) [2001] QB 167, the Court of Appeal held that in cases of deceit, a cause is to be treated as the only cause. As Ward LJ said:

> ‘Commercial fraud must be condemned. It can only properly be condemned by an award of the whole of the damage which the defendants intended to cause. Highwaymen in commerce forfeit the right to just and equitable treatment. In my judgment in the law of deceit there is to be no apportionment’

Mr Jones deceit was in the course of his employment for which BFS were therefore vicariously liable and that vicarious deceit should ‘trump’ D&T’s alleged negligence and release D&T altogether from liability.

This raises a very difficult public policy issue of whether a company’s normal vicarious liability for its directors and other agents’ deceit or negligence should release or reduce the liability of negligent auditors whose very purpose is to try and reduce the misdeeds of such agents. BFS argued that since the decision in *Meridian Global Funds Management v Securities Commission* [1995] 2 AC 500, the courts have some flexibility in what rules of attribution to apply in corporate cases. For example, in *British Racing Driving Club v Hextall Erskine* [1996] 3 AllER 667, the court had declined to attribute directors’ actions to the company.

However, following two Australian cases, *Duke Group Ltd v Pilmer* [1999] SASR 64 and *Daniels v Anderson* (19950 16 ACSR 607, the latter with startling similar facts to the Barings situation, Evans-Lombe J concluded that the normal rules of vicarious liability should apply and an auditor’s liability could be so released or reduced. The doctrine of vicarious liability can not release auditors from all liability for failure to detect fraud, as can be seen from *Sasea Finance Ltd v KPMG* [2000] 1 BCLC 236 and the New Zealand case *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 559. But, on the facts at least as provisionally presented in *Barings No 5*, Evans-Lombe J was not convinced that Mr Jones had been recklessly deceitful in any case.

D&T is continuing to fight and the full trial is going to have to come back to this very difficult issue (for the Antipodean struggle with it, see (2002) 23 CoLaw 156). It would also be fascinating to know if any deal Coopers & Lybrand (or their insurers) struck took into account D& T’s partial success in the continuing litigation. Following *Barings No 4*, however, the rest of the battered accounting profession may for the time being be sleeping a little easier in their beds.

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