Fishburns LLP

ACCOUNTANTS' LIABILITY UPDATE

JUNE 2011

In this edition of the Update we review a recent Supreme Court decision involving the Institute of Chartered Accountants in England and Wales ("ICAEW") in which the Court ruled that it was contrary to the principle of res judicata to allow a second complaint of discreditable conduct against an accountant to proceed. We consider the implications of an important Court of Appeal decision which suggests that a foreign financial regulator can, through the Financial Services Authority (FSA), compel accountants to provide it with documentation relating to present or former clients, especially regarding instances of alleged fraud. We look at a number of other decisions of potential significance to accountants and their professional indemnity insurers including one where the Court of Appeal clarified that a company's accounts can provide a *"true and fair view"* of its assets and liabilities even if a hidden liability is not reflected in them when such liability is unknown and undiscoverable, and two other cases which have important ramifications for accountants and insurers in limiting liability for claims from disgruntled clients. The on-going issue of legal professional privilege for accountants is once again revisited by the Court of Appeal and we conclude with a look at a recent decision which demonstrates that there are limits to the enquiries that tax advisers are expected to make when they are presented, in an 'off hand' way, with new information. The decision also provides useful guidance as to the division of responsibility between accountants and solicitors where both are retained.

DISCIPLINARY PROCEEDINGS – DOUBLE JEOPARDY

In *R (On the Application of Coke-Wallis) (Appellant) v ICAEW (Respondent)*, the Supreme Court was asked to determine whether it was an abuse of process for the disciplinary panel of the ICAEW to prefer a second disciplinary complaint against a chartered accountant after the first complaint, which covered the same allegations, had been dismissed on an evidential technicality.

The appellant, a chartered accountant and ICAEW member, had been convicted in 2003 of failing to comply with a direction issued by the Jersey Financial Services Commission.

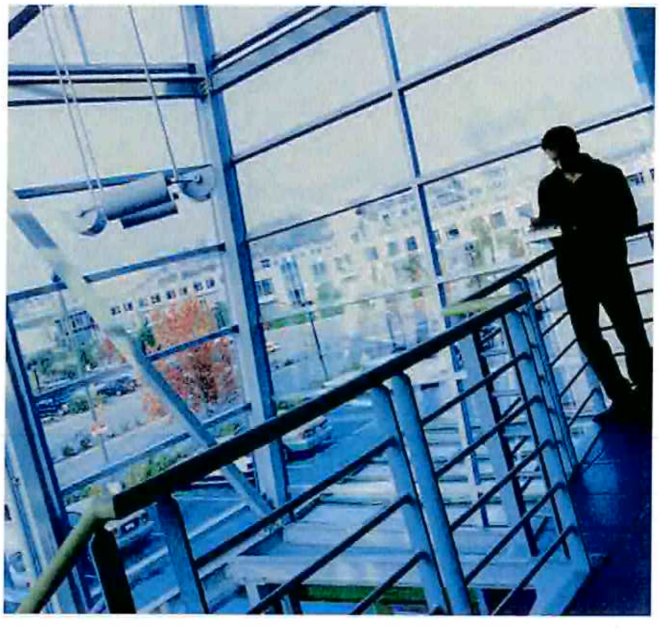
As a result of the conviction the ICAEW brought a complaint of discreditable conduct against the appellant under (4)(1)(a) of its byelaws, which the appellant successfully defended. Notwithstanding this the ICAEW subsequently preferred a second complaint, not relying on the conviction, but instead detailing the appellant's conduct that had lead to his conviction and alleging the same breach of the same byelaw.

The appellant applied to have the second complaint dismissed, relying on the grounds that:

- he had previously been acquitted (*autrefois acquit*);
- had already been judged in the matter (*res judicata*); and
- the second set of disciplinary proceedings was an abuse of process.

The appellant's application was dismissed on the basis that the two complaints did not allege the same thing: the first was based on the fact of the conviction while the second was based on the underlying conduct.

The disciplinary committee then upheld the second complaint and the appellant's membership of the ICAEW was terminated.



On an application for judicial review, the appellant's argument eventually fell to be considered by the Supreme Court. It was established that fundamentally the first and second disciplinary actions were the same; the conviction was merely proof of discreditable conduct and therefore the act complained of in the first complaint was not the fact of being convicted, but the failure to comply with the Jersey Financial Services Commission's direction. The Supreme Court held that the principle of *autrefois acquit* did not apply to disciplinary matters, which were civil not criminal proceedings. However, *res judicata* did apply to civil proceedings and in this case to proceedings before a disciplinary tribunal established under byelaws. As such, once the ruling in the first disciplinary action was made the decision became final. So it was contrary to res judicata to allow the second complaint arising from the same circumstances. The Supreme Court expressed no opinion on the abuse of process argument.

Comment

Disciplinary actions against accountants will usually be prosecuted only once. Where a second set of disciplinary proceedings is brought against the same accountant and the complaint is similar, arising out of the same facts, those proceedings will be susceptible to challenge. Although not all professional indemnity policies for accountants include cover for costs of defending disciplinary proceedings, insurers who do provide such cover may take some comfort from this decision.

FOREIGN INFLUENCE

The recent decision of the Court of Appeal in R *(On the Application of AMRO International & Another) v FSA & Others* suggests that a foreign financial regulator can now quite easily, through the Financial Services Authority (FSA), compel accountants to provide it with documentation relating to present or former clients, especially regarding instances of alleged fraud.

The facts date back to 2002, when the US Securities and Exchange Commission (SEC) was investigating a group of companies that had been accused of short selling in the US, and were the subject of legal proceedings there. To this end, SEC needed documentation and information from those companies' accountants, Goodman Jones LLP, who were based in the UK. It wrote a letter to the FSA requesting its assistance in obtaining a broad range of documents from Goodman Jones.

The FSA was not obliged to accept this request, and considered a number of factors under the Financial Services and Markets Act 2000 (FSMA) in deciding whether or not to do so, namely whether SEC would give corresponding assistance if requested, whether the case concerned a breach of the law with no close parallel in the UK, the seriousness of the case, its importance to persons in the UK and the public interest. It accepted the request and appointed investigators to assist SEC, who in turn endeavoured to compel Goodman Jones to produce the relevant documents by issuing notices to this effect under the FSMA. However, the companies, along with Goodman Jones, requested that the High Court judicially review the FSA's decision. Applying a test of *"necessity and expediency"*, the High Court decided that the FSA had erred in law and therefore quashed both the investigators' appointment and the notices to Goodman Jones requiring the production of the documents.

On appeal, the Court of Appeal disagreed with the High Court's reasoning. In relation to the FSA's acceptance of SEC's request, it held that the FSA has no duty to investigate or verify the information provided by an overseas regulator and that the FSA need not try to second-guess such a regulator in these circumstances. It was satisfied with the relatively low threshold of the FSA having asked *"pertinent questions"* of SEC and received *"sensible answers"*. It confirmed that the test for the production of notices is one of the *"relevance"* of those documents to the underlying action, which it described as a *"relatively low hurdle"*. It deemed cooperation between national financial regulators, especially in relation to allegations of financial fraud or misconduct, as being of the *"greatest importance"*. Interestingly, the Court also ruled that any Memoranda of Understanding between individual regulators are irrelevant to the FSA's decision making, and that the sole requirements to be considered are those found in UK statutes.

In this decision, the Court of Appeal placed significant emphasis on international cooperation between financial regulators, and the decision is obviously a welcome development for financial regulators. For accountants, however, it may give rise to the receipt of frequent and possibly broad requests for documentation or information from overseas regulators, which they will not be able to easily challenge or resist. The power of such regulators over accountants and financial services providers has now been significantly strengthened in the struggle against fraud and financial misconduct.

IT'S NOT TRUE AND FAIR

In *MacQuarie International Investments Ltd v Glencore UK Ltd*, Court of Appeal clarified that a company's accounts can provide a *"true and fair view"* of its assets and liabilities even if a hidden liability is not reflected in them when such liability is unknown and undiscoverable. This is potentially a helpful development for accountants and their professional indemnity insurers.

The seller of a holding company of an energy group supplying gas to UK customers had given several accounts warranties in respect of the group. It transpired post-completion that, as a result of a computer error, a liability of £2.4 million was not included in the group's management and audited accounts. As a result, one of the distribution companies transporting the gas to the target undercharged one of the target's subsidiaries, and therefore issued it with an invoice for the amount of the aforementioned liability. Had this liability been included in the accounts, the purchase price would have been reduced by this amount. It was claimed that the accounts and the management accounts warranty had been breached, as the accounts did not give a *"true and fair view"* and were misleading.

The High Court disagreed with the above contention, referring to the fact that the liability was both unknown and could not reasonably have been discovered at the time the accounts were drawn up. On appeal, the Court of Appeal agreed, holding that the warranties had not been breached. Moreover, the Court also noted that the accounts had been prepared in accordance with the relevant professional accounting standards, and held that this was strong evidence that the accounts indeed provided a *"true and fair view"* of the group's liabilities.

It seems therefore that, in respect of accounts warranties and the provision of a *"true and fair view"* of assets and liabilities, the onus is now likely to be placed more on the process of preparing those accounts than their accuracy. Both sellers and accountants are therefore now less likely to be found responsible for the consequences of a hidden liability, so long as all relevant accounting standards have been properly and diligently adhered to.

LIMITED OPTIONS – SUCCESSFUL LIMITATIONS OF ACCOUNTANTS' LIABILITIES

Two cases from 2010 below have important ramifications for accountants and insurers in limiting liability for claims from disgruntled clients. The first considers the thorny issue of when a claim against an accountant becomes time-barred in law; and the second considers limitation of liability clauses in an accountant's letter of engagement.

Limited Time

In *(1) Pegasus Management Holdings SCA (2) Ivan Harold Bradbury v Ernst & Young [2010] EWCA Civ 181*, Ernst & Young had advised the Claimants prior to April1998 on the sale of the Second Claimant's business and the investment of the sale proceeds in a suitable further business via the First Claimant in order to mitigate his tax liability. The Claimants alleged that Ernst & Young's advice was negligent because the First Claimant ended up with a liability for corporation tax when it made a disposal at a loss pursuant to their tax planning advice.

Ernst & Young sought summary judgment on the basis that the claim was time-barred, the cause of action in tort arising by April 1998, which was more than six years before the claim was issued in November 2005.

Rimer LJ, who whom the other judges concurred, had little trouble agreeing with the first-instance judge and upholding Ernst & Young's application. The Claimants had argued that their cause of action in tort was not complete until after April 1998 because it was only later that they suffered any actual damage. Relying on a long line of cases going back to 1997, the Court held that the Claimants nevertheless suffered damage when they entered into the transaction in March/April 1998 without getting what they ought to have got. It did not matter that the Claimants' loss was only potential and contingent at that time; it was enough that the Claimants did not receive what they ought to have received. The Court was influenced by its view that this was a *"wrong transaction"* case where the Claimants entered into a transaction on the basis of allegedly negligent advice that was not what they had intended.

Limited Engagement

In the High Court, *(1) Derek Dennard (2) Michael Gearon (3) Graham Turner (4) Colin Dixon v PriceWaterhouseCoopers LLP [2010] EWHC 812 (Ch)* concerned, among other things, the effectiveness of the Defendant accountants' attempt to limit their liability to the Claimants in their engagement letter to the higher of five times the aggregate fees paid or £1m.

PriceWaterhouseCoopers advised the Claimants on the value of their interest in a company bidding for PFI projects, which the Claimants wished to sell to Barclays, who subsequently sold that interest on to a third party for over 700% more. The Claimants claimed that PriceWaterhouseCoopers' valuation of their interest was negligently low, with which Vos J agreed, and so sought damages of the difference between the negligent valuation and the true value of their interest at the time.

However, Vos J agreed with PriceWaterhouse-Coopers that their limitation of liability clause was effective. There was some debate over whether it had been incorporated into the engagement, but the Judge found that a series of emails was sufficient to do so. He also held that the limitation was reasonable, by reference to section 2(2) and Schedule 2 of the Unfair Contract Terms Act 1977. Although PriceWaterhouseCoopers were in a stronger bargaining position, the Claimants were savvy, experienced and powerful businessmen who had chosen to use them in full knowledge of the limitation clause, which the Claimants understood that accountancy firms customarily used.

Limiting Conclusions

Accountants and their insurers will welcome these two clear examples of claims failing due to limitation, both of time and of liability. The first decision in particular is a clear example of the Court's increasingly conservative interpretation of when time starts to run for a claim in tort, which is a relief for Defendants although it might encourage Claimants to issue proceedings sooner.

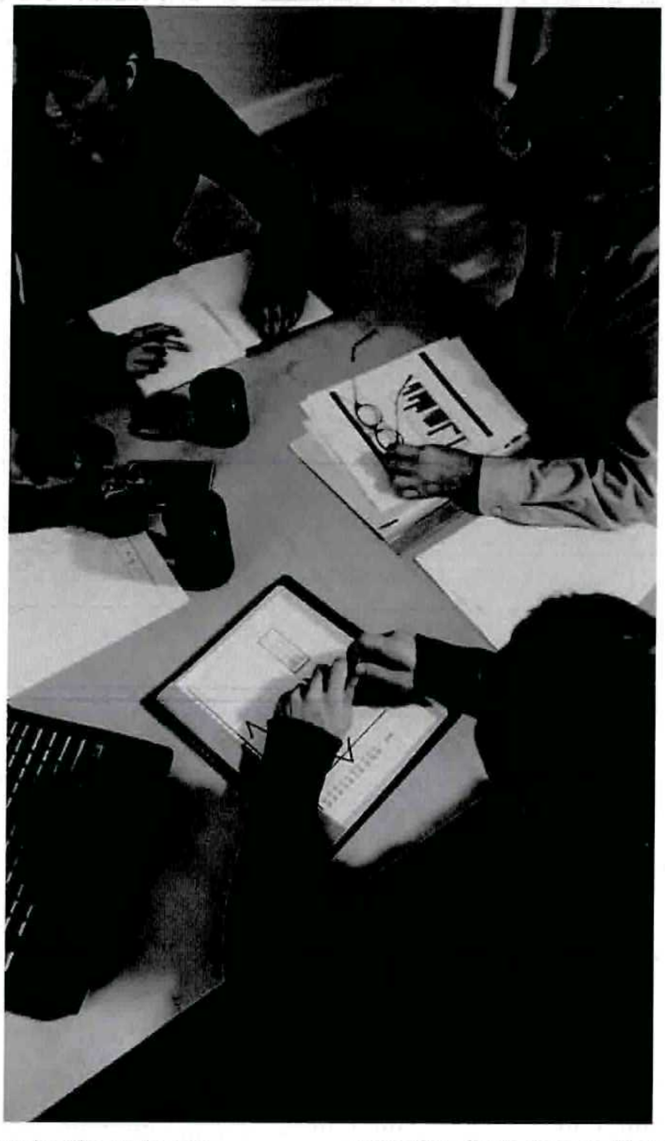
However, both cases are specific in their application. It was key in the first case that it was a *"wrong transaction"* case rather than a *"no transaction"* case (where the Claimants would not have entered into the transaction at all if the advice was correct) or an alternative *"category three"* type of case. It is also a question of fact as to whether the Claimant has or has not received what they ought to have received by a particular date.

The second case also succeeded on its particular facts, especially the Court's view of the experience and power of the Claimants; PriceWaterhouseCoopers were perhaps fortunate with the sophistication of their clients and that the limitation clause was incorporated. It is still important to ensure that engagement letters are comprehensive and clear and that limitation clauses are clearly incorporated into them; such clauses must also be reasonable for the particular client concerned.

A LAWYER'S PRIVILEGE – AN UPDATE ON LEGAL PROFESSIONAL PRIVILEGE FOR ACCOUNTANTS

Readers with long memories may recall that in our December 2009 update we reported the decision of the High Court in *R (on the application of Prudential Plc and another) v Special Commissioner of Income Tax and Another [2009] EWHC 2494 (Admin)* on the application of legal professional privilege to accountants. Since our last update, this case has now been considered by the Court of Appeal, which firmly decided in favour of the status quo.

The case started life as a judicial review to the High Court by Prudential Plc and Prudential (Gibraltar) Limited (together "Prudential") of notices with which they were served in exercise of HMRC's investigatory powers and in order to investigate a commercially-marketed tax avoidance scheme. Prudential argued that the notices sought material covered by legal professional privilege ("LPP"), on the basis that the material was communications between client and accountant for the purposes of obtaining skilled professional advice on tax law and conducting litigation concerning tax liabilities. HMRC did not accept this and countered that Prudential was asking the Court to extend the ambit of LPP to create a new or extended right.



With some reluctance, Charles J agreed with HMRC at first instance and upheld the traditional view of LPP. He ultimately found that the existing authorities showed that LPP applied only to legal advisers (and belonged to their clients) and that it did not extend to other professionals with important specialist knowledge of the law and who advise on the law. He was also influenced by the safeguards inherent in the duties and obligations that lawyers owe to the Court, which other professionals do not.

However, Charles J accepted that accountants rather than solicitors now advise their clients on many aspects of tax and company law and that there is force in the argument that a *"level playing field"* should be created on the disclosure of legal advice to clients of lawyers and of accountants. He had clear sympathies with this imbalance and suggested that the need for absolute confidentiality in respect of legal advice *"may need revisiting"*.

Charles J gave permission for Prudential to appeal and the Court of Appeal accordingly heard this matter last year, which had picked up the ICAEW, the Bar Council and the Law Society as interested parties on the way.

In *R (on the application of (1) Prudential Plc (2) Prudential (Gibraltar) Limited) (Appellants) v (1) Special Commissioner of Income Tax (2) Philip Pandolfo (Inspector of Taxes) (Respondents) & (1) Institute of Chartered Accountants in England & Wales (2) General Counsel of the Bar (3) Law Society (Interveners) [2010] EWCA Civ 1094* the Court of Appeal also rejected Prudential's arguments, but Lloyd LJ giving the leading judgement was much more robust that the Court was bound by earlier precedent to maintain the status quo of LPP. He felt that any change would produce a rule uncertain in nature and content and that there were difficulties in defining to exactly what kind of adviser any wider LPP would apply.

Lloyd LJ was heavily influenced by the fact that Parliament had considered LPP and accountants, yet declined to change the law, save for making specific provision in certain statutes as to what information tax advisers could be required to produce. He accordingly concluded that it was for Parliament, not the Courts, to change the scope of LPP.

Comment

The Court at first instance in *Prudential* had clear sympathies with Prudential's arguments to extend LPP and *"level the playing field"* between accountants and lawyers. However, the Court of Appeal had no such sympathy and returned firmly to the status quo on LPP, leaving any changes to Parliament alone. It is currently unclear whether Prudential intend to appeal the judgement.

Outside of Court, views are nevertheless changing and accountants are now much more involved in the law and litigation than was historically the case. Their involvement is only set to increase, particularly with the rise of alternative business structures, where lawyers and other professionals can work side-by-side, which may have further implications for the scope of LPP. Perhaps an old-fashioned British compromise might be a solution, where accountants accept some of the duties and obligations that lawyers have historically owed to the Court in order to benefit from the privileges that flow from it, perhaps by becoming *"authorised litigators"*.

For the time being, though, accountants should consider carefully the extent to which their conduct in litigation and the privileges afforded to them differ from those of lawyers. It may be prudent to make clients aware of these limits at the outset to prevent future complaints, although as Charles J noted these limits are not preventing clients from seeking accountants' advice and benefiting from their expertise.

Insurers should also be aware of the limited extent to which accountants' advice to their clients need not be disclosed. Until further notice, it seems clear that accountants will generally be required to provide such information and documents as HMRC or others may require in keeping with their professional guidance and obligations.

OUT OF THE BLUE – WHEN NEW INFORMATION REQUIRES NEW ADVICE

Claims against tax advisers can arise where the client happens to mention, in a casual manner, what turns out to be an important piece of personal information – whether, for example, health issues, or a change in marital status – and it is later contended that the adviser failed to advise on the consequences. This is a particular danger for accountants acting in connection with complex transactions. The professional will generally be under a continuing duty to advise in light of the client's changing circumstances up until the completion of the deal. For that reason, any argument that the defendant was not specifically requested to consider the impact of the additional information is unlikely to win through.

However, the recent High Court decision in *Swain Mason v Mills & Reeve [2011] EWHC 410* demonstrates that there are limits to the enquiries that tax advisers are expected to make when they are presented, in an 'off hand' way, with new information. The decision also provides useful guidance as to the division of responsibility between accountants and solicitors where both are retained. It will, therefore, be of interest to accountants and their insurers where CPR Part 20 claims are contemplated, or are being defended, against solicitors.

The claim was brought against a law firm, but the decision is of direct relevance to accountants providing tax advice to private clients. The defendant solicitors were advising a businessman and his family in connection with a management buy-out (MBO). A few weeks before the MBO completed, the defendants were 'blind copied' into an email that formed part of a chain containing a comment by the client that he was about to undergo a surgical heart procedure. A short while after the deal was finalised, the client died during the procedure. If the MBO had been delayed until after his death, his family would have avoided significant inheritance tax and capital gains tax liability on the consideration for the sale.

The claimant executors of the deceased's estate contended that the defendant solicitors should, upon learning of the heart procedure, have advised the client to delay the transaction until the procedure had been carried out.

The defendant solicitors argued that the scope of their duty to advise on the personal tax consequences of the MBO was coloured by the fact that the client's accountants were still acting as personal tax advisers. However, the judge held that the defendants were not entitled to assume that the accountants were advising the client as to the tax aspects of the deal. If there was any uncertainty as to who was advising the client about what, it was for the defendant solicitors to clearly delimit their own area of responsibility from that of the accountants. (This will, of course, equally, be a sensible strategy for accountants to adopt when advising in tandem with solicitors). Accordingly, the defendant solicitors were under a duty to advise as to how to structure the transaction effectively from a personal tax perspective.

However, the judge found that, given the way that information about the heart procedure had been communicated, it did not trigger a duty to provide advice as to the tax consequences if the client were to die during the procedure. There was nothing to suggest that the client wanted to draw the information about the heart procedure to the defendants' attention. Nor was there anything in the relevant email to indicate that the procedure was anything other than routine.

The decision is a helpful one to accountants, and their insurers, in that it stands for the proposition that tax professionals are not (at least, not always) at fault for failing to make exhaustive enquiries as to the possible effect of information buried in tangential comments made by the client. Clients must, instead, take a common sense view as to the professional's knowledge of their personal affairs.

NEWS ROUND-UP

AUDIT ENQUIRY NEWS

The House of Lords' Economic Affairs Committee has recently issued a report on its inquiry into Auditors' market concentration and their role to better understand the dominance of the Big Four and its effects on competition and choice; and whether traditional, statutory audit still meets today's needs.

The report is a tough summation of the UK audit market, confirming its huge market concentration and berating the Big Four firms for their lax role in the financial crisis and calling on the Office of Fair Trading ("OFT") to investigate. The report says it is *"clearly an oligopoly with all the attendant concerns about competition, choice, quality and conflict of interest"*. It also criticises the firms for failing to give any warning of the banking crisis, and describes its regulatory structure in the UK and internationally as *"complex and unclear."*.

The report highlights that in 2010 the Big Four Firms audited 99 of the FTSE 100 largest listed companies, which change auditors every 48 years on average. In the UK financial sector, there is even less choice – only the Big Three, since Ernst & Young are not active.

The report contains 3 main recommendations:

- A detailed investigation of the large-firm audit market by the OFT, with a view to an inquiry by the Competition Commission so that all the interrelated issues surrounding concentration, competition and choice can be thoroughly examined in depth and in the round;
- Prudence should be reasserted as the guiding principle of audit;
- A new framework of banking supervision should provide for bank audit to contribute more to the transparency and stability of the financial system.

We understand that the OFT board were scheduled to meet in April to decide whether to open an investigation. Although at the time of going to press it is unclear what the outcome of this meeting was, we will continue to monitor developments in this area.

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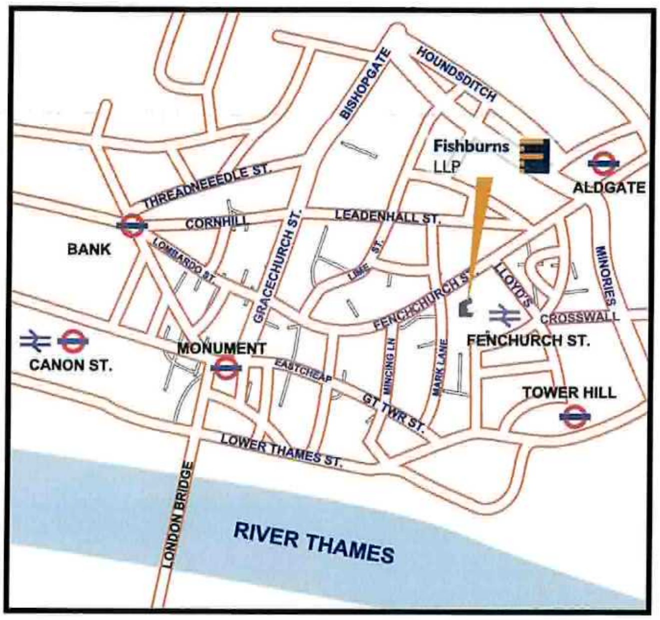

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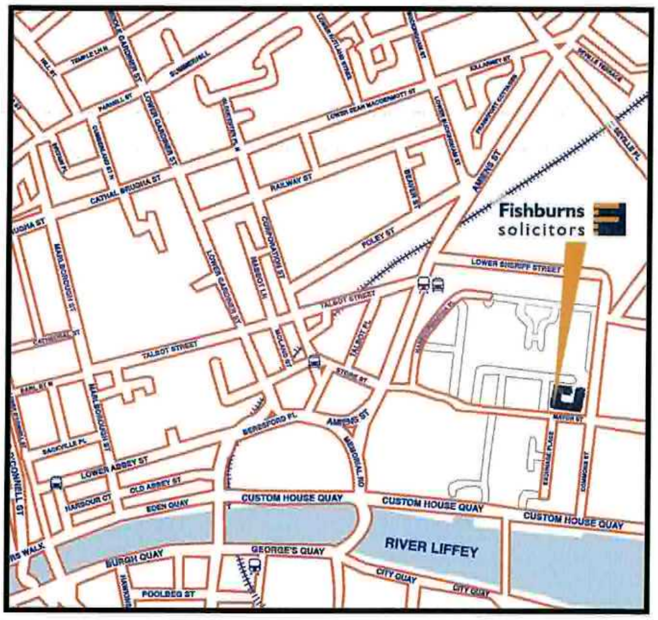

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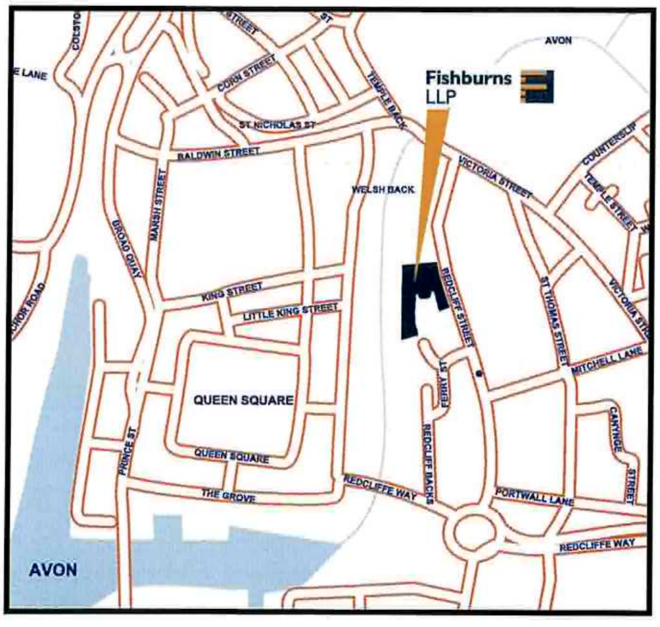

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