

Accountancy Update

In this issue

Walking the tightrope of control	1	Casenotes	3	Stop Press	4
		• <i>Contribution between a negligent defendant and fraudulent defendant</i>			
		• <i>Pre-action disclosure refused in dispute between financial institutions</i>			

Walking the tightrope of control

Jane Howard and Catherine Elford reflect on the key issues raised during our recent seminar on global network risks and ways of managing them



Jane Howard
+44(0)20 3060 6888
jane.howard@rpc.co.uk

Catherine Elford
+44(0)20 3060 6135
catherine.elford@rpc.co.uk

There are a number of cases relating to international networks currently before the courts and this trend looks set to continue. The claims, all of which have so far been brought in the US, involve various different networks. Some have been progressing through the courts for years (the Parmalat securities litigation¹ is a case in point); others are relative newcomers on the scene (such as the claims against BDO International² and RSM International (RSMi)³). One issue arises time and again: namely the extent to which the international ‘umbrella’ organisation controls, or could be said to control, the member firm responsible for the engagement in question.

Why is the issue of control so important?

A finding of control is a critical requirement of many of the allegations made against the international entities, both under common law and statute. For a finding of agency under common law, claimants must show not only a relationship between a principal and an agent (ie the

international organisation and the member firm responsible for the work in issue) but also evidence that the principal controlled the actions of the agent.

Claims brought under statute, most notably the US securities legislation and, in particular, s20(a) Securities Exchange Act, also require a finding of control. The particular requirements for s20(a) are set out in the box overleaf.

The meaning of control

In spite of its importance to both common law and statutory claims, “control” remains a nebulous and therefore flexible concept. Several courts have grappled with the type of control required in order to succeed with a claim of agency or under s20(a). Some courts have concluded that actual control is required, others (and this appears to be the current trend) have ruled that the potential to control is sufficient (at least in the context of an application for dismissal or summary judgment). In addition, some courts require evidence that the international

organisation exercised control over the particular engagement in question, in addition to exercising general control over the actions of member firms.

What amounts to control?

From the outset, it is important to appreciate that none of the cases considered below are determinative of the issue as to what conduct could constitute control, as they are all judgments arising from interim applications rather than a full trial of the issues of law or fact.

In some cases, it seems that the court has not needed to look too far to find evidence of either control or the potential to control. In the BDO International case, the court found that the network’s constitutional documents contained a persuasive indication of control. Indeed, it was alleged that BDO International’s Articles of Association included, as one of the entity’s objectives, “the management and control” of the member firms. Similarly, the agreements governing the relationships between the international organisations and

the member firms included certain mandatory obligations, rather than being restricted to recommendations or guidance.

Other cases, notably the Parmalat litigation, are less clear-cut, forcing the court to consider whether the international organisations exercised control over the actions of member firms in areas such as marketing, quality reviews, and the audit of Parmalat itself. Here the umbrella organisations involved were Grant Thornton International (GTI) and Deloitte Touche Tohmatsu (DTT). Allegations that they directed how the member firms should

the claimants have been allowed to pursue their claims to trial.

This control of, or ability to control, the particular engagement in question appears to be especially important. It is notable that it was the lack of such specific evidence which led the New York court to dismiss the claim against RSMi (a case which, on its face, appears to have bucked the current trend).

In that case, whilst there was evidence of RSMi exercising quality control over member firms, there was no evidence that it had been involved in the audit of Star Energy and, for this

any suggestion (express or implied) that they are working either as a joint venture or in partnership with one another.

- Member firms should be encouraged to sign off opinions in their own name and there should be no direct interference by the international organisation in the work of member firms.
- Where quality reviews of member firms are being carried out, these should be confined to historic (as opposed to open or live) matters – thus removing the potential to influence the work in question.

It remains to be seen exactly what factors will ultimately determine the outcome of the cases currently progressing through the courts. Some control of member firms by umbrella organisations is, of course, necessary and/or desirable. Moreover, quality control and monitoring is arguably one of the best ways to seek to ensure that ‘mistakes’ are not made in the first place. Given the current economic climate, network organisations will be walking a tightrope for some time, seeking to balance the risks and rewards of network status.

“A finding of control is a critical requirement ...”

refer to themselves in their marketing literature and the existence of requirements on member firms to use professional standards and general auditing procedures promulgated by them, seemed to persuade the court that the issue of control should, at the very least, be considered further at a full trial.

In respect of the Parmalat audit itself, it was alleged that DTT had exercised control and influence when it intervened in, and arbitrated, a dispute between the Brazilian and Italian audit partners. It was alleged that the Brazilian auditor expressed some concerns regarding the transfer of inter-company debt within Parmalat and the lack of documentation generally on Parmalat’s files and wanted to qualify his audit opinion. He is alleged to have discussed this with the Italian auditor, who did not agree with his views. Apparently DTT “removed” the Brazilian auditor from office, rather than let his concerns come to light. GTI allegedly exhibited control over the Parmalat audit in a different way. It is alleged that, after Parmalat’s collapse, GTI suspended the Italian audit partners involved in the audit and then, a few weeks later, expelled the Italian member firm from the network (actions which one might regard as entirely understandable in the circumstances). Nonetheless, the court seemed to find the evidence persuasive, such that

reason, the court was persuaded to release RSMi from the action.

Staying the right side of the controlling line

Taken at face value, the case law suggests that any control by an international organisation should be discouraged. Such a conclusion would, however, be somewhat naïve, as a degree of control is necessary in order to enable the network organisation to fulfil its various roles. Without it, it is difficult to see how the network would operate at all. So how can the risks associated with control be managed such that the rewards of network membership can still be enjoyed?

It is difficult to say with any finality, given that the courts have not conclusively determined what type of conduct would be deemed **too** controlling.

However, some points to bear in mind are:

- When issuing guidance to member firms, international organisations should emphasise (save where there is a genuine need for strict compliance) that the guidance is not mandatory, rather it is merely a recommendation which member firms could adopt.
- Independence statements (which should also clarify the role of the umbrella organisation) should be included in member firms’ domestic terms of business.
- Member firms and international organisations should avoid

¹ In re *Parmalat Securities litigation* [04 MD 1653 (LAK)]

² *Banco Espirito Santo International Ltd v BDO International* [2008] No 3D07-599

³ *Star Energy Corporation v RSM Top-Audit and RSM International* [08 Civ 00329 (DC)]

Requirements for a finding of liability under s20(a) Securities Exchange Act:

- A violation by a primary violator (ie a mis-deed by the member firm carrying out the engagement)
- Control, either direct or indirect, of the primary violator by a third party (the international organisation)



Adrian Sargent
+44(0)20 3060 6040
adrian.sargent@rpc.co.uk

Contribution between a negligent defendant and fraudulent defendant

A recent decision¹ clarifies how the courts will approach issues of contribution, contributory negligence and apportionment, when assessing damages in negligence proceedings against a professional, where another defendant has been fraudulent.

The Cheshire Building Society (the building society), now part of Nationwide, made two advances totalling £11.5m to a borrower for the purchase of a commercial property. Dunlop Haywoods (the valuer) fraudulently overvalued the property (true value - £1.5m). Cobbetts (the solicitors) acted for the building society in relation to the secured loans. The building society sued the valuer in deceit and the solicitors in negligence.

Before the trial the solicitors served a contribution notice on the valuer. The building society obtained summary judgment against the valuer on the basis of its fraudulent actions. The valuer then went into liquidation. The solicitors settled the building society's claim against them for £5.5m.

Two issues remained for determination at trial: (1) what damages could the building society recover from the valuer; and (2) what damages could the solicitors recover from the valuer on their contribution claim. The second issue also involved the court deciding the amount of the solicitors' notional damages

exposure to the building society. The solicitors relied on the building society's contributory negligence and on their own contractual liability cap (£5m per retainer).

The judge held: (1) the building society could recover £15.5m from the valuer as damages in deceit, (2) the solicitors would have been liable to the building society in negligence for £13.2m (but for their other defences), (3) the solicitors (but not the valuer) had the benefit of a contributory negligence defence of 50%, therefore the appropriate sum to be apportioned on the solicitors' contribution claim against the valuer was £6.6m, and (4) the apportionment split of £6.6m should be 80:20 in favour of the solicitors.

The judge's reasoning can be broken down. First, the "same damage" must be identified under s1(1) Civil Liability (Contribution) Act 1978² (the Act). The £13.2m was considered to be the same damage for which both defendants were liable. This reflected a deduction made for heads of loss which related solely to the fraud. The judge rejected the solicitors' argument that the "same damage" figure should take account of their defence of contributory negligence and the benefit of the liability cap, on the basis that s2(3) of the Act itself provides that the total contribution of any defendant cannot exceed

the damages for which he might be liable as limited by any contributory negligence or limit imposed by agreement.

Second, the starting point was identified for apportionment. Here, the starting point should not be £13.2m, but rather £6.6m, (ie after taking account of the solicitors' 50% contributory negligence defence) on the basis that the solicitors should not be exposed to an increased contribution claim from the valuer, simply because the valuer was fraudulent and could not benefit from that defence.

Next the £6.6m figure was apportioned, 80% to the valuer and 20% to the solicitors, reflecting the relative causal potency and moral blameworthiness of their actions. In the final stage the judge deducted 20% of £6.6m from £5.5m (the settlement figure) to give the value of the contribution judgment (£4.2m) the solicitors obtained against the valuer.

- ¹ *Nationwide BS v Dunlop Haywards* [2009] EWHC 254 (Comm)
² S1(1): "Subject to the following provisions of this section, any person liable in respect of any damage suffered by another person may recover contribution from any other person liable in respect of the same damage (whether jointly with him or otherwise)."

Pre-action disclosure refused in dispute between financial institutions

In *Anglo Irish Corporation Plc (Anglo) v West LB AG*¹ (West) Anglo applied for pre-action disclosure of some of West's internal documents pursuant to CPR 31.16. Anglo contended that it had a claim in negligent misstatement based on its purchase of derivative instruments from West.

The first three conditions of CPR 31.16 were not in dispute. The argument focused on the final condition; that disclosure is

desirable to dispose fairly of the anticipated proceedings, assist the dispute to be resolved without proceedings or save costs.

Anglo's application was refused. The judge said "*deals in financial instruments are often entered into between such institutions with relatively limited documentation. That is the situation here. To go further and require disclosure by one of the institutions of its internal documentation relating to the deal, should be rare in this*

kind of situation... it is one thing to require such an exercise mutually in the course of proceedings which have been commenced, but another to impose it unilaterally on a party against whom no proceedings have been taken".

- ¹ [2009] EWHC 207 (Comm)



Stop Press

Andrew Williamson
+44(0)20 3060 6286
andrew.williamson@rpc.co.uk

FRC publishes an update on Going Concern for Directors of Smaller Companies

In March 2009 the Financial Reporting Council (FRC) published an update that is intended for directors of smaller companies, that qualify for the small companies regime in the Companies Act and who choose to apply the Financial Report Standard for Smaller Entities. The purpose of the update is to assist the directors of smaller companies by summarising the criteria that must be met in order to produce their annual accounts on a going concern basis and identifying some basic procedures that may be used to support their conclusions on going concern.

Possible procedures include preparing a budget, trading estimates, cash flow forecasts or a similar analysis for a period of up to 12 months from the date of approval of the annual accounts.

The APB announces its intention to update UK and Irish Auditing Standards on Auditing for 2010

The Auditing Practices Board (APB) intends to update its auditing standards for the new, clarified, International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). These new standards will be effective for audits of financial statements for periods ending on or after 15 December 2010.

Supplementary material will be announced where it is considered necessary to address specific UK and Irish legal and regulatory requirements, provide guidance related to legal and regulatory matters relevant to an audit and maintain APB requirements and

guidance that are necessary to prevent changes in audit practice to the detriment of audit quality.

New Practice Direction on Pre-Action Conduct comes into force from 6 April 2009

On 6 April 2009, the new Practice Direction which supplements Civil Procedure Rule 3 came into force. The new Practice Direction is entitled "*Practice Direction – Pre-Action Conduct (PDPAC)*". PDPAC outlines the conduct that the court will expect of parties prior to the start of proceedings in all claims commenced after 6 April 2009. Although compliance with PDPAC is not mandatory, the courts have the power to seek an explanation of the parties pre-action conduct in cases where proceedings are started after 6 April 2009.

Certain sections of the PDPAC apply to all cases, including those where there is a specific pre-action protocol in place. S3 applies to the parties' conduct in cases where no specific pre-action protocol applies. Specific topics that are covered by the PDPAC include ADR, costs, disclosure, experts, issuing a claim and limitation.

The SEC blocks auditor liability deals

The US Securities and Exchange Commission (SEC) has indicated to the UK Government that it will not accept liability limitation agreements (LLAs) between auditors and British companies registered with the SEC. This will have the effect of disallowing LLAs with around half of the FTSE 100 companies. The SEC's main concern appears to be that the negotiations required between auditors and company directors to agree the limits of liability might compromise auditor independence.

The Professional Services Global Competitiveness Group has published a report outlining the medium and long term challenges facing the UK professional services sector. The report discusses the dangers of the UK accountancy industry being at a disadvantage to those in Europe who have liability limitation (eg Germany) and those economies like Australia which have recently implemented liability limitation. The report discusses the opportunity presented by the change of leadership at the SEC and urges the government to continue to press the SEC to approve the principle of LLAs. The report recognises the difficulties associated with LLAs and concludes that the government should consider alternative solutions to keep the UK accountancy industry competitive in the international market.

RPC news

Our most recent Breakfast Briefing on 29 April 2009 focused on global risk and the liability issues facing global networks. The Briefing was oversubscribed which reflects the increased risks that global firms are currently having to deal with. The speakers were Jane Howard, Ross Goodrich and Catherine Elford. For anyone who was unable to attend, a copy of the seminar pack is available.

Please email seminars@rpc.co.uk.

Editors

Jane Howard
+44(0)20 3060 6888
jane.howard@rpc.co.uk

Maria Oats
+44(0)20 3060 6862
maria.oats@rpc.co.uk



Tower Bridge House
St Katharine's Way
London E1W 1AA
+44(0)20 3060 6000

Accountancy Update is a summary of recent developments. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the editors.

© Reynolds Porter Chamberlain LLP www.rpc.co.uk