

HKSA continues its advocacy action on the proposal for an equitable system of liability

The Professional Risk Management Committee (PRMC) of the HKSA has responded to the Standing Committee on Company Law Reform's (SCCLR) June 2003 Consultation Paper in Phase II of its Corporate Governance Review (http://www.info.gov.hk/cr/download/scclr/cgr2_e.pdf) on 'Auditors' Liability'.

The HKSA's submission, sent to the SCCLR on 17 October 2003, contains a PRMC Paper supplementing the HKSA's original submission dated 16 April 2002 entitled 'Proposal for an equitable system of liability' (<http://www.hksa.org.hk/professionaltechnical/submissions/docs/proposal-4th.pdf>), which recommended amendments to the existing system of joint and several liability in Hong Kong by the introduction of a modified system of proportionate liability in certain areas.

HKSA submission dated 17 October 2003

The PRMC Paper considers that the focus on auditor's liability in the SCCLR's Consultation Paper is too narrow and runs the risk of clouding the more fundamental issue, which applies to all professionals. It starts with an update on the various issues raised in the HKSA's original submission by reference to recent important developments around the world. A number of key jurisdictions have already introduced or are now committed to the introduction of a system of proportionate liability, most notably Australia.

It then addresses the arguments raised in paragraph 22.50 of the SCCLR's Consultation Paper against the question of both proportionate liability and the

ability of an auditor to cap its liability in respect of claims. It also sets out the arguments in support of repeal of section 165 of the Companies Ordinance in as far as it prohibits an auditor from limiting liability in respect of audit work, and summarises the views as to why it remains appropriate to amend the current system of joint and several liability.

It concludes with serious advice to the Government that it should take steps now to introduce a well-thought-out system of proportionate liability to avert the possibility of a very damaging professional crisis, which would not be in the public interest and would be damaging to Hong Kong's position as a major regional financial centre.

A summary of the salient points of the PRMC Paper is set out at the end of this article. A full copy of the HKSA's submission is available at:

(http://www.hksa.org.hk/professionaltechnical/corporategov/SCCLR_II.pdf).

STEPHEN CHAN, HKSA DEPUTY DIRECTOR (ETHICS & ASSURANCE) AND SECRETARY TO THE HKSA PRMC, AND STEVE ONG, HKSA ASSISTANT DIRECTOR (ASSURANCE)

A summary of the salient points of the PRMC Paper responding to the issue of professional liability in the SCCLR's Consultation Paper in Phase II of its Corporate Governance Review

Recent developments

- There is an update on the various issues raised in the HKSA's original submission by reference to recent developments around the world to illustrate that there is indeed an urgent need to push reform for an equitable system of liability: the demise of Arthur Andersen & Co which gives a clear indication of the risks which all professionals face; the case of *Bannerman* which resulted in the decision that an auditor might owe duties of care to third parties if it knew, or ought to have known, that they would rely on the audited accounts and the auditor did not disclaim liability to such third parties; the potential exposure faced by auditors in the recent English Court of Appeal decision in the case of *Equitable Life Assurance Society*. This will put the auditors to the considerable cost and uncertainty of having to defend very significant litigation; but the *Barings* case brings in contributory negligence with the judge applying reductions of claims in favour of the auditors.
- It is highlighted that the most significant developments are perhaps to be found in Australia where there has been serious market failure in the professional indemnity insurance market leading to a significant risk that services will be carried out by uninsured persons such that there will be no one to sue for damages in the event of negligence causing economic loss. The crisis has arisen as a result of a significant contraction in the number of insurers offering professional indemnity insurance, vast premium increases and increases in applicable conditions and self-insured retentions. The Australian Government published on 8 October 2003 the CLERP (Audit Reform and Corporate Disclosure) Bill 2003 (<http://www.treasury.gov.au/contentitem.asp?pagelD=&ContentID=700>) which will amend the relevant legislation



to ensure that proportionate liability applies to damages for economic loss for misleading or deceptive conduct.

- The conclusion to be drawn from these recent developments is that all professionals, including auditors, remain exposed to significant potential liability which is all too often exacerbated by the effect of the principle of joint and several liability.

Comments on the arguments against proportionate liability and capping in the SCCLR's Consultation Paper

- The law as it currently stands, particularly in claims for economic loss, is unfair and inequitable. This is particularly the case where the 'deep pocket' defendant is only peripherally responsible for the loss claimed.
- The recommendations of the UK CLRSG that the UK equivalent of section 165 of the Companies Ordinance should be amended to enable an auditor to limit its liability contractually with the company and in tort with third parties are considered suitable for Hong Kong. In any event, the ability to cap liability should go hand in hand with proportionate liability as has been proposed in Australia.
- The ability to incorporate has no bearing on the issue of joint and several liability and the significant potential exposures arising therefrom. The size and number of claims made will not be affected by the way in which audit firms choose to structure themselves.
- It seems entirely appropriate that the directors and officers should be liable for losses which the company might have suffered as a result of their negligently made management decisions. The apportionment of liability through the system of proportionate liability is fair and equitable in this respect. Further, management can purchase directors' and officers' liability insurance in order to protect themselves against any increased risk of liability.
- If a limit can be put on liability for negligence, it should apply to all professions which is why the HKSA has been pressing for a wider review of the system of joint and several liability.
- In cases of economic loss, which often involve commercial entities used to taking risks, there does not appear to be a justification for relieving the plaintiff of a financial burden at the expense of a defendant. The equitable solution is for the contribution of each of the parties to be assessed according to their relative blameworthiness. This may mean that a plaintiff does not recover in full in certain circumstances but at least it will be able to make some recovery. At least the solvent defendant will not have had to bear an unfair share of the total loss suffered.

Section 165 of the Companies Ordinance

- Section 165 of the Companies Ordinance is to be repealed to the extent that it prohibits an auditor from limiting his liability in respect of audit work. The recommendations of the UK CLRSG in this respect are particularly helpful. The position of the

company and its shareholders will not be prejudiced as a result provided that it is a condition that the limit on liability should be approved by the company at the AGM.

- The repeal of the relevant part of section 165 of the Companies Ordinance will be beneficial but cannot be the total answer by reason of the continuing uncertainties for an auditor's liability that exist particularly in respect of claims by third parties.

The case for proportionate liability

- The HKSA is encouraged by the consultation process being undertaken by the SCCLR but the breadth of the issues on which comments have been invited is too narrow.
- It firmly believes that there is a danger in seeking to review issues on a piecemeal basis in a restricted context since this can give rise to further unfairness and inequalities between different groups or professions. This is borne out by the arguments against capping liability and proportionate liability set out in paragraph 22.50 of the SCCLR Consultation Paper.
- It maintains that the case has been made out that the system of joint and several liability operates unfairly, particularly in the professional indemnity arena, and that a case has been made out for the introduction of a system of proportionate liability. The real issue is where the boundaries of such a system should lie.
- It is encouraged to note the wide-ranging reforms proposed by the Australian government in order to address the professional indemnity crisis there. The proposals extend to all professionals and have been taken in the name of consumer protection which the HKSA recognises is essential. The proposals call into question the perceived wisdom that the principle of joint and several liability should be sacred in order to protect a plaintiff's position. That requirement no longer appears justified particularly in respect of claims by commercial entities for economic loss against a negligent professional.
- It is not suggesting that the principle of joint and several liability should be abolished in its entirety. What is more important is to establish an equitable system of liability particularly in respect of claims for economic loss where the potential damages can be so significant.
- It concludes that it is far better to address the issue responsibly now rather than be forced to introduce changes hastily in response to a similar crisis to that faced in Australia. A number of jurisdictions such as Canada, certain States in the USA, Ireland, Bermuda and now Australia have 'bitten the bullet' as far as proportionate liability is concerned and it is appropriate for the Government to do so too for the reasons outlined in this Paper and in the HKSA's earlier submission.