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Tackling the growing rise in third party claims against auditors

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Tackling the growing rise in third party claims against auditors

Wanda Karow, Associate at Mills & Reeve, lists ways for accountants to tackle third party claims made against them

We are seeing a growing trend of claims against accountants arising out of audits and tax advice. As businesses have failed during the recession and continue to struggle during these difficult times, people often target professionals with PI cover to recover their losses. Accountants are no exception.These claims are typically by third party investors in failed businesses claiming to have relied on accountants' audit or tax advice before investing in the business. How should insurers and their insured accountants tackle these claims? We set out below a summary of the law with some practical tips.

The law

It used to be the case that professionals would not be liable at all to third parties for negligent misstatements unless there was a contractual or fiduciary relationship with the thirdd party, or fraud. The position today is different. Accountants owe duties of care to their own clients, but also to third parties if there are special circumstances. In short, third parties need to establish that the firm of accountants assumed a responsibility to them and they relied on the accountants' advice.

Leading case

The key authority is Caparo Industries plc v Dickman. Caparo invested in Fidelity plc. Caparo made claims against directors of Fidelity and its auditors. In short, Caparo alleged the directors had deceitfully misrepresented the true state of the company and the auditors had negligently audited the accounts. It argued that the auditors should have known from press releases before the accounts were drawn up that the company was in trouble and vulnerable to a takeover bid and that Caparo might rely on the accounts. Ultimately, the House of Lords approved the first instance judgment that there was no duty of care to Caparo either as an existing shareholder or a potential investor. Any claim would have to be made by the company on behalf of all shareholders against the auditor. In essence, the Lords were not prepared to find the auditors had assumed a responsibility to Caparo.

A recent authority

The ruling in Caparo has not deterred claims by third parties. Only last year, in Arrowhead Capital Finance Limited (in liquidation) v KPMG LLP, a third party investor argued that KPMG had assumed a responsibility to provide it with accurate tax advice on a business. In that case KPMG had given VAT advice to its client, Dragon Futures Limited ("Dragon"). KPMG excluded in its terms of business any rights of a third party to rely on the advice. Arrowhead claimed to have relied on the tax advice in providing a loan to Dragon and pursued KPMG. The claim failed because there was nothing in the KPMG retainer, terms of business, or subsequent correspondence that supported any assumption of responsibility beyond that which KPMG owed in respect of its advice to Dragon.

Analysis

The judgement is encouraging because it shows courts are reluctant to impose duties on accountants to third parties but it is clear in that case the claim probably would have succeeded but for KPMG's tightly worded retainer.

In practice, third parties need to establish that:

- The accountant was aware of the nature of the transaction which the third party had in mind.
- The accountant knew or ought to have known that his statement would be communicated to the third party either directly or as a member of a class.
- The accountant knew or ought to have known that the third party was likely to rely on the statement in deciding whether or not to proceed with the transaction.
- The third party actually relied on the statement to its financial detriment.

Practice tips

- Brokers should check on renewal that their clients have robust risk management procedures in place including tight retainer letters limiting liability to third parties.
- Third party claims are difficult to make out and the onus is on the third party to establish an assumption of responsibility and reliance – press them to do so at an early stage to flush out the weak claims..
- The accountant knew or ought to have known that the third party was likely to rely on the statement in deciding whether or not to proceed with the transaction.
- Also identify at the outset: (a) exactly what terms the accountant agreed with their client; and (b) any evidence the fee-earners knew about the involvement of the third party investor and whether it would be relying on their work.

If you require further advice or information surrounding your insurance and risk management arrangements, please contact MFL Professional using the details provided below.

This document does not present a complete or comprehensive statement of the law, nor does it constitute legal advice. It is intended only to highlight issues that may be of interest to clients of Mills and Reeve LLP and MFL Professional. Specialist legal advice should always be sought in any particular case.© Mills and Reeve LLP 2013.

Contact Stuart Dugdill, Director of Professional Liabilities, to discuss your PI arrangements:

T: 0161 236 2532
W: www.m-f-l.co.uk/accountants

Contact Wanda Karow, Associate at Mills and Reeve LLP

T: 0161 235 5453
E: wanda.karow@mills-reeve.com