Technical Bulletin
Managing the professional liability of accountants [N1]
(Issued July 1999)

Appendix I - Legal Considerations

The Hong Kong Common Law System

1. Hong Kong law is rooted in the English system. Prior to 1 July 1997, English common law and the rules of equity were in force in Hong Kong so far as they were applicable to the circumstances of Hong Kong or its inhabitants and subject to such modifications as such local circumstances may require. Common law and equity may be amended by enacting legislation in Hong Kong.

2. After the change of sovereignty on 1 July 1997, the UK Privy Council ceased to be the court of final appeal for Hong Kong and was replaced by the Court of Final Appeal of Hong Kong SAR. There is no certainty that Hong Kong will always follow the existing or future precedents of the UK Court.

3. By and large, however, the establishment of liability under Hong Kong law has so far tended to follow the same route in law as the UK and certain other common law jurisdictions.

Defences to an Action for Negligence

4. Examples of defences to an action for negligence are:

   (a) that no duty of care had been owed to the plaintiff in the circumstances; or

   (b) that there had been no negligence; or

   (c) that the negligent act or omission had not been an effective cause of the plaintiff's loss; or

   (d) that the action was statute-barred.

Standard of Work

5. Where there is a contractual relationship, unless an express agreement is made between the accountant and his client to the contrary, the standard of work required of an accountant is defined by Section 5 of the Supply of Services (Implied Terms) Ordinance Cap 457, whereby there is an implied term that the supplier (i.e. accountant) will carry out the service with reasonable care and skill. The same standard is applied by common law where there is a duty of care in tort.

6. The standard of skill and care required is that of a reasonably competent accountant. In deciding whether the standard has been achieved, a Court will have regard to the general practice of accountants in like circumstances and to the accounting and auditing standards and guidelines set down by the HKICPA. However, it cannot be assumed that mere compliance with a guideline or standard will be a full defence to a negligence action. At the same time, opinions expressed or advice given will not give rise to liability merely because in the light of later events they prove to have been wrong, even if they amounted to an error of judgement, provided that they were arrived at using reasonable care and skill.

Liability to Third Parties

7. There are circumstances in which a member may owe a duty of care not only to his client but also to a third party. Such a duty can arise independent of any contract and may entitle that third party to make a claim against the member. The law relating to this area is complex and subject to change but the general position is that a duty of care may be owed to a party where:-

   a) advice or information is given by the member;

   b) the member is aware or intends that the advice or information will be communicated to the third party directly or indirectly;

   c) the member is aware of the specific transaction or the purpose which the third party has in contemplation; and

   d) it is likely the third party will rely on the advice or information for that transaction or purpose.

   In these circumstances, if the advice or information given is negligent, then subject to any disclaimer (as discussed in paragraphs Nos. 53-60 of the Bulletin) the member may be liable to the third party for any loss suffered as a result of his reliance on the advice or information.

8. Each case will turn on its own facts but the following are examples of cases in which a duty of care has been held by the Court to exist.

   (a) In Yue Xiu Finance Company Ltd & Anor v Agnew & Ors [1996] 2 HKC 122, the Hong Kong Court of Appeal held that auditors owed a duty of care to a third party purchasing the company's shares on the grounds that the auditors knew, or should have known, that the Plaintiff would rely on the financial statements, where a clause in an agreement for the sale of the shares provided that the price of the shares would be adjusted depending on the level of profit reflected in the audited financial statements of the company concerned. The Court said that a special relationship existed between the parties since the auditors were fully aware of the transaction and knew that the figures would be relied upon by the Plaintiff in deciding whether to exercise its rights under the agreements.

   (b) Similarly, in Morgan Crucible Plc v Hill Samuel Bank Ltd [1991] Ch 295, the Court decided that it was arguable that an accountant, who audited financial statements which were included in a circular issued by the target company in the context of a hostile takeover, owed a duty of care to the potential buyer and was liable to the buyer if the financial statements were inaccurate and negligently prepared.

(c) The action in the case of ADT v BDO Binder Hamlyn [1996] BCC 805 arose out of a bid made by ADT for Britannia Securities Group. ADT sought and received confirmation from a Binders partner that the latest accounts audited by the firm showed a true and fair view of Britannia's financial position. The Court held that such confirmation was given and that Binders had therefore assumed responsibility, and owed a duty of care, to ADT for the reliability of Brittania's accounts. A similar claim however failed in Peach Publishing Ltd v Slater & Co (CA, February 13, 1997, unreported).

(d) In Al-Nakib Investments (Jersev) Ltd & Anor v Longcroft & Ors [1990] 3 All E.R. 321 the Court had to decide whether or not directors of a company owed a duty of care to persons who subscribed for shares in reliance on a prospectus. The Court held that no duty was owed to purchasers who relied on the document to purchase shares in the aftermarket (as opposed to subscribers for the shares). However, in Possfund Custodian Trustee Ltd & Anor v Diamond 7 Ors [1996] 1 W.L.R. 1351 it was decided that it was arguable that a duty of care was owed by, amongst others, a company's auditors to purchasers in the aftermarket who relied on misleading or misstated financial statements in a prospectus.

(e) Section 40 of the Companies Ordinance imposes a statutory liability for inaccurate statements in a prospectus.

9. The following are examples of circumstances in which the Courts have decided that no duty of care was owed; the Caparo decision being particularly well known.

(a) The effect of the House of Lords in Caparo Industries Plc v Dickman [1990] 2 AC 605 was to prevent companies contemplating a take-over bid and those contemplating the acquisition of shares from relying on the audited accounts for that purpose. In doing so, the House of Lords imposed a narrower test for the duty of care based on foreseeability of damage, proximity of relationship and reasonableness and also expressly affirmed the decision in Al Saudi Banque & Ors v Clark Pixley [1989] 3 All E.R. 361 that no duty of care was owed to a bank lending money on the strength of the audited accounts, since they had not been prepared with that purpose in mind, nor did the accountants know they were being used for that purpose.

(b) Similarly, the Court of Appeal in James McNaughton Papers Group Ltd v Hicks Anderson & Co [1991] 1 All E.R. 134, in circumstances where accountants drew up a draft set of accounts for the company's chairman, held that the auditors of a target company did not owe a duty of care to the bidder who relied on the accounts. The Court, following in the wake of Caparo said that in determining whether a duty of care arises, regard must be had to the purpose for which the statements were made and communicated; the relationship between the adviser, advisee and any relevant third party; the size of any class to which the advisee belongs; the state of knowledge of the adviser; and reliance on the statements by the advisee.

(c) In another decision arising out of the Yue Xiu case, reported at [1995] 3 HKC 158, the High Court in Hong Kong decided that the auditors of two companies did not owe a duty of care to a licensed money-lender who advanced funds to the two companies, allegedly in reliance on their audited accounts. The plaintiff had failed to plead the matters necessary to establish a duty of care (as discussed in paragraph No. 7 above).

10. Where an accountant is informed or becomes aware that a third party will be relying on his work, or that a report he has prepared will be used by a third party, it would be prudent to assume that there is a risk that he may owe a duty of care both to his client and to the third party concerned, unless he disclaims liability, as discussed in paragraphs Nos. 53-60 of the Bulletin.

Excluding or Limiting Liability

11. The following are the main relevant considerations.

Statutory appointments under the Companies Ordinance

(a) Section 165 of the Companies Ordinance makes void any provision in a company's articles or any contractual arrangement purporting to exempt the auditor or any director or officer of the company from or to indemnify him against any liability for negligence, default, breach of duty or breach of trust.

The effect of Section 165 of the Companies Ordinance is to prevent an auditor, or any director or officer of the company, from disclaiming, limiting or obtaining an indemnity against any liability in respect of a breach in relation to the company.

Whilst it is believed that this section only covers audit work as distinct from other work carried out by the auditor for the audit client, this question has not yet been decided by the Court. It has been held in the UK that a liquidator is an officer of the company (see Halsbury's Laws of England 4th Edition (1996 Reprint) Volume 7(a) 601), and accordingly, the restriction will also apply to liquidators.

On the other hand, Section 358 of the Companies Ordinance grants discretionary power to the Court to relieve wholly or partly from liability the officers of the company; and persons employed by a company as auditors; in respect of negligence, default, breach of duty, or breach of trust, where they have acted honestly and reasonably, and where, having regard to all the circumstances of the case, including those connected with their appointment, they ought fairly to be excused.

However, there have been no reported incidences of Section 358 relief being granted by the Hong Kong courts. It is often pleaded on behalf of auditors and other officers. Relief was refused to a director in Standard Chartered Securities Ltd v Arthur Lai [1995] HKC Lexis 1229. In Tang Eng Guan v Southland Co [1996] 2 HKC 100 the Court of Appeal agreed that Section 358 relief might arguably be granted to the directors concerned but did not decide whether or not it should.

Non-Statutory Professional Services

(b) There is no prohibition on seeking to limit liability in non-statutory audit engagements and it is an increasingly common practice adopted by the larger practices. In addition, audits of foreign corporations will not be governed by the Companies Ordinance and the relevant foreign law may permit limitation of the auditor's liability (many jurisdictions, however, do not).

It should be noted, however, that a limitation of liability may be subject to the application of the Unconscionable Contracts Ordinance. Under the Ordinance, the Court may limit the application of, or revise or alter, any unconscionable part of a contract. On the other hand, the Ordinance has only very limited effect on accountants in that it only applies to contracts where one of the parties "deals as consumer". In other words, the Ordinance will probably have effect only on liability limitation clauses in contracts for the provision of personal financial, investment or tax services to individuals (as opposed to services to businesses).

In addition, the Control of Exemption Clauses Ordinance is also relevant. Although this contains a number of provisions which apply only to "consumer" contracts, there is a general prohibition against excluding or restricting liability for negligence except insofar as the exclusion satisfies the test of "reasonableness".

This Ordinance introduces extensive restrictions upon the enforceability of exclusions and limitations of liability for negligence and breaches of contract. Section 7 of the Ordinance makes void any exclusion or limitation of liability for negligence, even in a case where the other party has agreed to it, unless the party seeking to rely on that exclusion or restriction can show that it was a fair and reasonable one in the circumstances. If a clause is held to be unreasonable, it is struck out in its entirety, leaving liability completely unlimited.

Because the Courts look at each individual case on its own facts, there is little general guidance as to what exclusions or restrictions of liability will be regarded as reasonable. There has been no judicial guidance, either in Hong Kong or in the UK (which has a similar statute) as to what might be regarded as reasonable in the context of a contract for services between an accountant and his/her client. There are, however, a number of specific factors which the Courts may take into account when considering reasonableness.

These include, but will not necessarily be restricted to, the following:

(i) whether the client knew or ought to have known of the term - it must have been brought to the client's attention before entering into the contract rather than being buried in the small print on the back of a standard form;

(ii) the nature and relative bargaining positions of the parties - the more sophisticated the client and the greater his bargaining power, the more likely it is that the term will be held to be reasonable;

(iii) the resources of the accountant and the availability to him of insurance cover - the greater his resources, the higher any limit on the extent of liability should be;

(iv) the nature of the transaction and the size of the likely loss - the larger the transaction and any potential loss, the higher the limit should be;

(v) the availability of similar services from another provider without the client having to accept a similar exclusion or limitation - if there are other providers of similar services in the market who do not impose similar limitations then the client may not be able to argue that he was forced to accept the term;

(vi) the size of the fees payable - the higher the fees, the higher the limit should be;

(vii) the difficulty of the task and the risk involved;

(viii) whether any inducement was received by the client to agree to the term - an inducement to accept the term would make it easier to argue that the term was reasonable.

A total exclusion of liability is most unlikely to be considered reasonable other than in exceptional circumstances.

Contributory Negligence

12. Under Section 21 of the Law Amendment and Reform (Consolidation) Ordinance Cap 23 the Court can reduce the damages awarded to the extent that the Court thinks "just and equitable" having regard to the claimant's (i.e. plaintiff's) share in the responsibility for the damage.

13. The decision of the New South Wales Court of Appeal in AWA v Daniels (1992) 10 ACLC 933, which is likely to be followed in Hong Kong (although a similar agreement was rejected at first instance in a Hong Kong case, Extramoney v Chan, Lai, Pang & Co), suggests that damages may also be reduced proportionally where there has been negligence on the part of a director, employee or servant of the plaintiff.

14. However, in Hong Kong, it is still open to question whether or not contributory negligence can be used to limit liability to damages in a claim based on breach of contract. In England, the Court of Appeal, in Barclays Bank v Fairclough (1995) 76 BLR 6 decided that contributory negligence could be pleaded in a breach of contract claim but only where there is a breach of a contractual duty of care which was concurrent with a duty of care in tort. A plea of contributory negligence may not succeed where the action is based on breach of a strict contractual duty which is independent from any duty of care in tort.

Limitation Period for the Commencement of Actions

15. Limitation periods are laid down by the Limitation Ordinance Cap 347.

16. There is no specific limitation period for "statutory breaches". Breach of statutory duty will either give rise to a claim in contract (where the contract incorporates statutory duty) or in tort, (breach of statutory duty is a distinct tort in itself). Therefore the appropriate time limits for contract/tort will apply.

17. The limitation period for actions based in contract is 6 years after "the cause of action accrued". In contract the cause of action accrues on the date when the breach takes place. Taking an audit as an example, the breach is normally regarded as having occurred on the date when the negligent audit opinion is signed. Therefore, as a general rule, no action may be brought for breach of contract 6 years after the date of signing of the audit opinion.

18. In tort, the limitation period is again 6 years after the cause of action accrued other than for personal injury. However, in tort the cause of action only accrues when the plaintiff suffers damage. Therefore, in a number of cases, the limitation period for claims in tort may expire after that for breach of contract. Again taking an audit as an example, it is conceivable that a third party, such as a bank, might rely on an audit report to make a loan to the company. This loan might be made some time after the signing of the audit report. Assuming the bank can establish a duty of care owed by the auditor, its cause of action would only accrue when the loan was made, and thus the damage suffered, and therefore the limitation period would not begin to run until that point.

19. Where an action is based upon the fraud of the defendant or where the defendant deliberately conceals facts which are relevant to the right of action of the plaintiff (and the Courts have upheld that "deliberate concealment" includes a deliberate commission of a breach of duty which is not communicated to the plaintiff) or where the action is for relief from the consequences of mistake, then the limitation period (6 years) will not begin to run until the plaintiff discovers the fraud, concealment or mistake, or could with reasonable diligence have discovered it.

20. The Limitation Ordinance also provides for extension of the limitation period in respect of "latent damage". This basically applies to actions in tort where the plaintiff does not have "the requisite knowledge" to bring an action. In such cases, the limitation period will either be 6 years from the date the cause of action accrues or, if later, 3 years from the date when the requisite knowledge was acquired. This part of the Limitation Ordinance is based on the United Kingdom statute and was designed for situations where a party's negligence causes damage which may remain undiscovered for a period of time. An example would be an engineer's negligence causing damage to the foundations of a building which may remain hidden for several years. In those circumstances, even though the negligence has taken place and the damage occurred, the plaintiff may not yet know about it. In theory this section can also apply to claims against accountants where their negligence and the damage caused by the negligence remains undiscovered for a period of time. Note that there is no necessity for any fraud, deliberate concealment or mistake.

21. Finally, the Limitation Ordinance provides a long stop limitation period of 15 years from the date on which the allegedly negligent act occurred. Although it is not clear, it would appear that this section will apply even if the claim arises from the fraud of the defendant.

    In any event, it is clear that an accountant may face claims for professional negligence up to 15 years after the completion of his engagement.

N1: This statement is based on similar guidance issued by The Institute of Chartered Accountants in England and Wales (ICAEW) appropriately adapted to the local context. The Society gratefully acknowledges the permission given by the ICAEW in this respect.

| Part I | Part II | Part III & IV |

| Appendix I | Appendix II | Appendix III | Appendix IV | Appendix V |