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Re Company Law Reform – The Caparo Judgement

Dear Mr Barry,

Further to my letter of today's date, I now write in response to the request for views on whether there would be value in codifying in statute the nature of the duty owed by auditors to members of the company as it was set out in the case of *Caparo Industries plc v Dickman*, House of Lords (1990).

We believe that the Caparo Judgment has limited the duty of auditors in a way that causes major problems for individual shareholders and, indeed, to all users of company accounts.

In the course of his judgment Lord Bridge of Harwich said "The only support for an unlimited duty of care owed by auditors to all who may foreseeably rely upon them is to be found in some jurisdictions in the United States of America where there are striking differences in the law in different states. In this jurisdiction I have no doubt that the creation of such an unlimited duty would be a legislative step which it would be for Parliament, not the courts, to take." The forthcoming Companies Bill gives Parliament the opportunity to consider how far it is reasonable to move towards the position in parts of the USA, as referred to by Lord Bridge, and then codify the result.

We do not wish to criticise the judgment of the noble Lords in terms of the law and precedent as it stood at the time. However, the outcome in our view nullifies to a large extent the protections for the public in general that Parliament and the Accounting Standard setting bodies intended in making such strict provisions about the content of company accounts and their audit.

Lord Oliver of Aylmerton in his contribution to the judgment took a narrow view of the intentions of Parliament in this respect. We venture to disagree with this and believe that the importance of orderly and informed markets and the ability of lenders and traders to deal with companies after placing reliance on their accounts would have been part of the consideration.

The Lords also appear to have taken a narrow definition of loss. A possibility of loss due to failures by auditors can arise if shareholders are not alerted to problems or wrongdoing. With such an alert, it can be possible for shareholders to take action to rescue the situation before it is too late. The Lords appear to have considered only loss due to mis-pricing of shares.

To conclude we strongly believe that auditors should be left in no doubt that they have a responsibility to all potential users of company accounts to ensure that they represent a true and fair view. We recognise that we should not seek to move so far in the direction of general financial liability that one error by one member of an auditing firm can bankrupt all the partners. Thus it may be necessary to link this with some limitation of open-ended financial liability to all comers; we are discussing how best to achieve a balance in this respect and hope to make positive suggestions shortly.

All this notwithstanding, as a suggestion that one need not be overly concerned on this issue, we append a quotation from a leading textbook on Tort.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'D Blundell', with a horizontal line underneath it.

David Blundell
Chairman

Extract from Tort Law – B.S. Markesinis & S.F. Deakin, Oxford University Press

“The House of Lords’ view of the limited purpose of the annual audit has been called ‘an artificial interpretation, which takes no account of commercial reality’. The annual audit is one of the few reliable means shareholders have of obtaining information concerning the internal operation of a company. The fear of the floodgates also appears to have been misplaced in that instance. If a company’s shares are boosted by false information in advance of a take-over bid, any loss will tend to be concentrated on to the successful take-over bidder. Even then, the plaintiff will have to prove that the report was a material factor in his decision to launch the bid. He may be required to show that he would not have bought the shares but for the report, which may be difficult to do in practice. The auditor may also be able to refute allegations of a lack of care in preparing the account. These are illustrations of the point that the imposition of a duty of care does not, by itself, lead inevitably to liability; indeed Bingham LJ, in the Court of Appeal, thought they might well fail at the full trial of the action on one of these grounds. In relation to policy, the prospects of ‘defensive accounting’, excessive liability insurance premiums, and accountancy firms going out of business if a duty of care were imposed were all raised in Caparo. But the experience of other legal systems—such as Germany, the Netherlands, and certain states of the USA—which have flirted with the imposition of a more extensive liability, suggests that these fears may have been greatly exaggerated. A knowledgeable American judge has thus observed that: ‘The sky has not fallen on the accounting profession’ as a result of making auditors potentially liable for their faults.”