HKSA continues its advocacy action on the proposal for an equitable system of 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 so 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).

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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?pageId=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.