Hong Kong – Claim pleading duty of care against auditor struck out for “putting the cart before the horse”

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Introduction

In *Chan Kam Cheung v Ronnie K W Choi & Anor* [2022] HKCFI 3028, a judge upheld a master’s (judicial officer’s) decision to strike out the plaintiff shareholder’s action against the former auditors of the company. The judge reiterated the principle that, save for special circumstances, no duty of care is owed by an auditor to potential investors or individual shareholders.

Key points

- The decision demonstrates that the Hong Kong courts are willing (where appropriate) to take a pro-active role in dismissing defective claims at an early stage.
- The decision reinforces the fundamental legal principles that underpin the purpose of a statutory audit report which is prepared to allow the shareholders as a body to exercise their powers and the limited circumstances in which a duty of care may otherwise be owed by auditors.
- No duty of care is owed by auditors to potential investors or individual shareholders in respect of their investment decisions.

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Background

The claim against the auditors stems from a long-standing shareholder dispute between the plaintiff and other members of the company.

In 2011, the majority shareholder sought to buy-out the plaintiff’s shares in the company. During the negotiations, the plaintiff (an individual shareholder) was apparently refused access to the company’s accounting records – this triggered a series of actions between the plaintiff, the company and the other shareholders. In 2012, the plaintiff commenced an unfair prejudice petition seeking primarily a buy-out order and, alternatively, a winding-up of the company. The application for a winding-up order was struck out and the remainder of the proceedings was stayed pending conclusion of a mediation. While the parties jointly obtained an expert report on the valuation of the plaintiff’s shares in 2013, no buy-out agreement was agreed and the proceedings remained dormant.

In late 2019, the plaintiff (in his capacity as a shareholder of the company) issued proceedings against the company's auditors. The first defendant had been the company's auditor from 2003 until mid-2015; thereafter, the second defendant performed statutory audits on a yearly basis. The plaintiff claimed that the alleged failure to properly audit the company's accounts negatively impacted the company's net asset value and, in turn, the value of his shares so that his bargaining position was weakened during his buy-out negotiations. The plaintiff also claimed that the audits had led to his receiving less by way of dividends.

The basis of the plaintiff's claim that the second defendant owed him a duty of care was that they allegedly knew that he required the audited accounts to conduct his financial affairs and assess the value of his shares for the intended purchase by the majority shareholder taking into account the long-standing shareholder dispute.

The second defendant applied to strike out the plaintiff's claim against them before filing any defence, primarily on the basis that the claim disclosed no reasonable cause of action given that they owed no duty of care to the plaintiff as an individual shareholder.

Decision

For the purposes of the strike out application, the court had to treat all the facts pleaded by the plaintiff as true and could only exercise its powers to strike out if it was plain and obvious that the plaintiff's claim was bound to fail. In particular, the court would have to find that the plaintiff's claim against the second defendant was obviously unsustainable and the pleadings unarguably bad. Despite the high threshold, the master (a judicial officer) struck out the plaintiff's claim against the second defendant at the first instance hearing.

Decision on Appeal

The plaintiff appealed the master's decision before a judge. The issues for the court were essentially the same, given that the appeal hearing was *de novo* (i.e., a re-hearing). No further evidence was filed by either party.

The judge upheld the master's decision to strike out the plaintiff's claim as against the second defendant.

The judge affirmed the principle derived from the seminal authority of *Caparo Industries Plc v Dickman*[1], that an auditor's duty of care is owed to the shareholders as a body to enable them to exercise their shareholders' powers and not to individual shareholders. In particular, the judge noted that advice to individual shareholders for present or future investment in a company is not part of the statutory duty owed by auditors. Only in limited circumstances – where an auditor was aware (i) of the nature of the transaction which the individual shareholder had in contemplation; (ii) that the advice or information would be communicated to the shareholder; and (iii) that it was very likely the shareholder would rely on that information (here the audited accounts) in deciding whether to engage in the transaction in contemplation – would a duty of care arise (the "salient feature" requirements, as set out by Lord Bridge in *Caparo*).

The second defendant's legal representatives argued that for a duty of care to arise there must be an identifiable or specific transaction which simply was not the case here according to the pleadings. By contrast, in *Yue Xiu Finance Co. Ltd & Anor v Dermot Agnew & Others*[2], based on the pleadings the auditors had been aware of the nature of the transaction concerned and knew that their audit report would be relied on to determine the price of the acquisition. The judge considered that (in the present case) no basis had been established in the plaintiff's claim for the second defendant's knowledge in circumstances where there was no specific transaction and no evidence of ongoing negotiations between the shareholders to establish a duty of care.

While the plaintiff sought to rely on certain communications with second defendant, both in correspondence and at general meetings, regarding the audited accounts to establish a duty of care, the judge noted that such communications took place *after* the submission of the second defendant's audit reports. Therefore, these events were irrelevant and could not be used to establish a duty of care on the part of the second defendant in accepting the engagement to audit the accounts. In the judge's own words (at paragraph 36 of her decision):

Notes

1. [1990] 2 AC 605
2. [1996] 1 HKLR 137

> *"In the circumstances, the relevance of those events escapes me. Given the timeline, they cannot possibly be relevant to the existence of a duty of care for it would be a case of putting the cart before the horse."*

The plaintiff also claimed that second defendant's alleged negligence led to his receiving less dividends. However, the judge noted that the declaration and distribution of dividends required a board resolution – a supervening event – which had not been dealt with in the plaintiff's pleading. As such, there was no connection between the alleged negligence and the loss of dividends. In any event, the judge also noted that the plaintiff had failed to identify that he had suffered any specific or unique "loss" as an individual shareholder, given that any loss of dividends applied to all shareholders of the company equally.

Comment

This court's decision serves as an important reminder for claimants to plead clearly, by reference to established legal principles, the facts upon which an alleged duty of care is stated to arise given the powers of the court to strike out unmeritorious claims – particularly in relation to negligence claims against auditors by individual shareholders or potential investors.

For now, there are some important takeaway points:

- A duty of care is owed by auditors to the shareholders as a body and not to individual shareholders. Advice to individual shareholders for present or future investment in a company is not part of the duty owed by auditors, unless the salient features identified in the *Caparo* case are present and clearly pleaded.
- If an individual shareholder or potential investors claim that a duty of care is owed to them by auditors, it will be important to identify a specific transaction which the auditors were aware of at the material time.
- For individual shareholder claims, it is also important to identify whether any specific or unique "loss" has been suffered by the individual shareholder, as opposed to a loss suffered equally by all the shareholders of the audited company.
- Only events taking place before the audit engagement is accepted can be used to establish a duty of care – subsequent events cannot be relied on retrospectively for this purpose. Dates and timelines based on authentic documents are telling.

Contact us

Please contact Antony Sassi or David Smyth if you have any queries regarding the issues raised in this article, or if you wish to consider any commercial dispute resolution matters in Hong Kong.

RPC acted for the second defendant in these proceedings.

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