

## A question of privilege

The Court of Final Appeal has made a significant decision on the disclosure of key documents.



In our autumn 2008 edition of CPA Protect, we reviewed (in “A voyage of discovery”) the first instance decision of Madam Justice Kwan in *Akai Holdings Ltd (In Compulsory Liquidation) v Ernst & Young*.

Ernst & Young (EY) wanted discovery of the transcript of interviews (Transcripts) conducted by the liquidators of Akai under section 221 of the Companies Ordinance (Cap 32). Madam Justice Kwan granted EY discovery of the Transcripts because they:

- were relevant to the proceedings brought by Akai (relevance being the touchstone of discovery);
- did not attract privilege as a matter of fact; and
- did not attract privilege as a matter of law.

### Inside this issue:

Page 4

A question of control?

Page 5

Knowing one’s limitations

Page 6

A matter of circumstances

It is not always easy for CPAs to know what to tell their PI insurers

Page 9

Resolving the anomaly

Obtaining Security of costs against an overseas company under section 357 of the Companies Ordinance

Page 10

Engagement letters

The first line of defence

The liquidators appealed to the Court of Appeal, which affirmed the first instance decision. Undeterred, the liquidators appealed to the Court of Final Appeal (CFA). On 24 February 2009, the CFA unanimously upheld the liquidators' appeal. The CFA's reasons were set out in the judgments of Mr Justice Bokhary PJ and Lord Hoffmann NPJ, with whom the other three judges agreed.

## The CFA's reasoning

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The CFA focused on legal professional privilege and its application to the Transcripts. In particular, the court looked at the liquidators' purpose in obtaining the Transcripts.

In her first instance decision, Madam Justice Kwan said that legal advice privilege had no application to the Transcripts, as they clearly did not amount to a communication between the client and the lawyer seeking or giving legal advice. Based on the English Court of Appeal's decision in *Three Rivers District Council v Bank of England (No 5)* [2003] QB 1556, Madam Justice Kwan ruled that legal advice privilege does not extend to preparatory materials, even if they are prepared for the purpose (1) of being shown to the lawyer, or (2) at the lawyer's request and subsequently sent to the lawyer. She took the narrowest possible view of the *Three Rivers* decision, a case that has been widely criticised.

As a general principle, the CFA noted that legal professional privilege is a "practical thing". The protection it affords a client cannot be confined merely to what lawyers and clients say or write to each other. It may extend to information gathered or generated in a variety of circumstances and conditions. In Hong Kong, the entitlement to confidential legal advice is a basic right enshrined in Chapter III of the Basic Law. The CFA has already

made it clear – in *Ng Ka Ling v Director of Immigrations* (1999) 2 HKCFAR 4 – that such basic rights should be given a "generous interpretation".

The CFA stated that information can be acquired for the dominant purpose of:

- (1) seeking legal advice in connection with litigation that is "in real prospect"; or
- (2) seeking legal advice as to whether or not a cause of action exists.

In either case, the right to confidential legal advice will protect that information from disclosure.

The question for the CFA was whether this protection applied to the Transcripts? In Lord Hoffmann's opinion, the issue could be decided by answering two simple questions:

- Did the liquidators conduct the examination for the sole or dominant purpose of obtaining advice from their solicitors about starting or conducting legal proceedings?
- Were such proceedings reasonably anticipated at the time?

In her first instance decision, Madam Justice Kwan concluded that ascertaining whether Akai had a recoverable cause of action was only one of several purposes behind the section 221 examinations that resulted in the Transcripts. In her view, litigation was not reasonably in prospect in this particular case.

## Dominant purpose

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However, in front of the CFA, Akai argued that Madam Justice Kwan's view ignored clear evidence (set out in the liquidators' affidavit)

about the liquidators' dominant purpose behind the section 221 examinations. Akai argued that the evidence showed the following:

- Akai's only assets were possible legal causes of action, which required investigation and litigation;
- the main object of the liquidators in carrying out their function was the realisation of such legal causes of action as could be established through legal advice; and
- at the time of all but two of the examinations, a protective writ naming EY as a defendant had already been issued for the purpose of protecting any causes of action, pending further investigation through the private examination process.

The CFA found that the liquidators had resorted to section 221 examinations for the dominant purpose of putting the Transcripts in front of the liquidators' legal advisers for advice about litigation that was in active contemplation and therefore in real prospect at the time. The CFA ruled that the Transcripts constituted part of the confidential investigations and preparations for proceedings against third parties (including EY), and were therefore covered by legal advice privilege. In the CFA's view, this would have been much the same exercise as the investigations that EY would have carried out when preparing its defence, which would clearly be privileged. In the court's view, the only difference between EY's own investigations and the liquidators' examinations was that EY knew who the liquidators were examining under the section 221 procedure, while the liquidators did not know to whom EY might be speaking.

However, the CFA's comment ignores a crucial difference between EY's position and that of the liquidators. It is true that EY were free to speak to

any witness they wished and could seek assistance from the very same people examined by the liquidators in the section 221 interviews. However, unlike the liquidators, EY could not compel those individuals to answer EY's questions under oath on pain of contempt of court proceedings if they refused to do so. In the circumstances of Akai's demise, it was unlikely that certain key witnesses would voluntarily assist EY or could be relied upon to give EY full and frank answers.

Of course, EY could compel any of the examinees to give evidence by subpoenaing them. However, when doing so, EY would not enjoy the advantage of already having the examinees' earlier answers given under oath and recorded in a transcript. Unlike the liquidators, EY would not be in a position before the trial to know which of the examinees' evidence would help EY. The liquidators, though, would be able to cherry-pick the examinees whose evidence would assist them, confident that the evidence given at trial would be consistent with that supplied in the earlier examination as the examinees would otherwise run the risk of a perjury prosecution.

As a result, the section 221 examination process puts a liquidator in a far better position evidentially to anyone the liquidator decides to sue in the name of the company. Over a hundred years ago, the English Court of Appeal in *Re Norwich Equitable Fire Insurance Company* (1884) 27 Ch D 515 recognised the liquidator's advantage in this regard, but it noted that it was "an advantage that the legislature intended to give him".

## Inquisitorial nature

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Madam Justice Kwan thought that the inquisitorial

character of section 221 was at odds with the adversarial nature of litigation. If she was right, private examinations such as those carried out under section 221 could never be protected by litigation privilege.

According to Lord Hoffmann, Madam Justice Kwan had focused not on the intention of the liquidators but instead on the intention of the statute. The decided cases agree that the purpose of the statute is to allow the liquidators to reconstitute the state of knowledge that the company should possess. Madam Justice Kwan took the view that this inquisitorial basis for the statute was inconsistent with the examination being for the purpose of obtaining legal advice about starting litigation.

However, according to Lord Hoffmann, the question that had to be asked next was why did the liquidators want to reconstitute the state of knowledge of the company? If the dominant purpose was to obtain legal advice regarding probable litigation, then the privilege would apply. According to Lord Hoffmann, the fact that section 221 examinations are not adversarial was irrelevant. The contemplated proceedings against EY were the relevant proceedings to be considered and these were necessarily adversarial.

## Subsequent discovery

The court acknowledged that once the transcripts or notes of private examinations conducted under (or under the threat of) section 221 were not covered by legal professional privilege, they would be discoverable. However, the court would still have to agree to their disclosure through the exercise of its discretion under rule 62 of the Companies (Winding Up) Rules (Cap 32H). But as the CFA had decided that the Transcripts were

covered by legal professional privilege, the court turned down the chance to spell out just how the court's discretion under rule 62 might be exercised.

## A general rule?

The interesting question is whether the *Akai* case is authority for the proposition that section 221 transcripts and notes are legally privileged because such examinations are always conducted with the dominant purpose of obtaining advice about probable litigation, and consequently attract legal professional privilege. Alternatively, does the decision merely say that, on the particular facts of this case, the dominant purpose test was satisfied.

In our view, the decision does not lay down any broad principle about section 221 transcripts and notes. The fact that the liquidators had already filed a protective writ in all but two of the examinations was clearly a significant factor in the CFA deciding in the liquidators' favour. Nevertheless, the decision will encourage liquidators to couch their affidavit in support of section 221 proceedings in terms of "legal advice regarding the pursuit of claims on behalf of the company" so as to try and claim the privilege. This is likely to become a standard ploy.

While it is fair to say that the liquidators start the investigation process in a weak position and may need special powers for the purpose of investigating a company's affairs, there is no obvious reason why they should be entitled to carry that advantage forward when it comes to litigating against third parties. In extreme cases, liquidators may possess a transcript of evidence given under oath by a company's directors that could provide a third party with a full defence to claims brought by the company. If the company's

documentation is otherwise incomplete (the usual reason for section 221 examinations), the only evidence of that defence will lie in that undiscoverable transcript.

## The examinee's position

Another important question is what is the position of the examinee in a case where the liquidators' main purpose for the examination is probable legal proceedings against the examinee? In those circumstances, the resulting transcript (as in the *Akai* case) would be privileged. Arguably, though, the examinee would not be entitled to a transcript of their own examination (this argument has in fact already been raised following the CFA's decision although not yet decided).

In our view, this argument fails both legal and common sense tests. If the transcript records information provided by the examinee, privilege cannot apply to information known to the other side. If privileged information is disclosed (for example, through discovery) or otherwise becomes public knowledge, the privilege is lost. Common sense dictates that the same must apply where that information originates from the other side.

It could be said, though, that while the information in the transcript is not privileged, the transcript itself is. Arguably, the fact that the transcript records the information in the form given under oath makes it of greater importance than the information itself. However, this neglects a simple practical point. The examinee or their lawyers are entitled to make notes of the examination. If these notes are taken down verbatim, the examinee will then have their own matching transcript. On that basis, even the form of the transcript could be in the examinee's possession. It therefore makes

little sense to say that the transcript taken down by the liquidator is privileged, when the examinee possesses exactly the same information in the identical form in their lawyer's notes.

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**Toby Brown**

**t.brown@kennedys.com.hk**

**+852 2848 6316**

# A question of control?

A recent decision of the United States District Court, Southern District of New York, in the Parmalat Securities Litigation has raised a few eyebrows amongst international accounting firms as they ponder whether their global firms could be targeted as additional defendants in litigation against member firms on the pretext that the global firms exercised control over the member firms in the conduct of their audit work.

In a decision that is a departure from virtually every other US court to consider the issue, District Judge Lewis A Kaplan handed down his opinion on 27 January 2009 on summary judgment motions brought by Deloitte Touche Tohmatsu (“DTT”), Deloitte & Touche LLP (“DT-US”) and James Copeland, the CEO of DTT and DT-US. The claims against the three Deloitte defendants, brought under provisions of the Securities Exchange Act 1934, rested on the premise that DTT (the Deloitte global firm), DT-US and Mr Copeland were all vicariously liable for the alleged fraud of Deloitte Italy, one of Parmalat’s former auditors.

Whether DTT could be held liable for any securities violations and other actions of Deloitte Italy depended on whether DTT had a principal-agent relationship with that member firm or whether DTT controlled the actions of the member firm. On the principal-agent issue the judge concluded that the totality of the evidence (which included evidence of the structure and internal relationships of Deloitte generally, DTT’s alleged authority over the professional practices of its member firms and DTT’s alleged exercise of that authority in connection with the Parmalat

engagement), raised a genuine issue of fact as to whether Deloitte Italy was an agent of DTT with regard to the Parmalat audit. On the control issue the judge ruled that the plaintiffs had presented sufficient evidence to permit a jury to find that DTT had the ability to influence the preparation of

member firms’ audit reports generally and one of the Parmalat audit reports in particular. The judge also held that there were issues of fact regarding whether DTT could establish the “good faith” defense under the Securities Act. While Judge Kaplan noted that DTT may well prevail at trial,

he held that there were issues of fact that precluded throwing the lawsuit out at this stage and accordingly, the issues would have to be argued in full at trial.

As for DT-US, which argued that it was also entitled to summary judgment because it did not control DTT, the judge likewise denied the motion because he believed that sufficient evidence had been adduced to permit a jury to find that DT-US might have exercised control over DTT. Again, the issue would have to be determined at trial. Similarly, the judge found that there was also an issue of fact regarding whether DT-US could establish the good faith defence on the evidence presented.

Finally, the motion brought by Mr Copeland was also dismissed because the plaintiffs succeeded in establishing that there was a genuine issue of fact as to whether Mr Copeland, as the CEO of DTT and DT-US, controlled both entities.



**Chris Sharrock**  
[c.sharrock@kennedys.com.hk](mailto:c.sharrock@kennedys.com.hk)  
**+852 2848 6349**

# Knowing one's limitations

In professional negligence cases, it is not always easy to know when someone has suffered damage.

In a recent English decision – *Pegasus Management Holdings SC and Ivan Harold Bradbury v Ernst & Young (a firm) and Ernst & Young LLP* [2008] EWHC 2720 (Ch) – the High Court has ruled that a professional claim in respect of a capital gains tax reinvestment relief scheme is statute barred.

## Background

In April 1997, Mr Bradbury sold his business for a large sum of money. He wanted to avoid (or at least minimise) a significant tax liability on the sale proceeds, so he asked his accountants, Ernst & Young (EY), for their advice. A year later – and relying on EY's advice – Mr Bradbury subscribed £90m for shares in a recently incorporated Luxembourg company called Pegasus. This company intended to acquire other qualifying businesses subsequently, so as to make good Mr Bradbury's claim for reinvestment relief.

In October 2002, Pegasus discovered that there was a flaw in the reinvestment relief scheme. If Pegasus sold one of the businesses it had acquired, it would make a capital gain for tax purposes and become liable to pay corporation tax on that gain. In other words, the tax reinvestment relief scheme did not achieve its intended purpose.

In November 2005, more than seven years after Mr Bradbury had acquired the shares in Pegasus,

Mr Bradbury and Pegasus started proceedings against EY for damages for giving negligent tax advice. In particular, they said that EY had failed to advise Mr Bradbury properly about all the steps that had to be taken in order to claim full reinvestment relief for capital gains tax.

As regards the claim brought by Pegasus, the court had little difficulty in concluding that the company had no real chance of showing that EY owed it any duty either in contract or tort. The harder question, though, was whether Mr Bradbury's claim was time-barred. While conceding that any claim in contract would be time barred, Mr Bradbury argued that he was entitled to pursue a claim in tort because he had not suffered any damage before the limitation period began to run.

The limitation issue was tried as a preliminary issue.

## The ruling

The main question for the court was whether there had been actual damage and, if so, when it was inflicted. After considering numerous professional negligence decisions, Mr Justice Lewison said it was clearly established that a client suffers damage if they do not get what they ought to have got. As to when damage was suffered, he continued:

*“where the client has engaged professionals in connection with a transaction to secure for him some property or rights and, because of*

*the negligence of those professionals, the client acquires less valuable property or rights than he would have done if he had been given correct advice, he suffers damage at the time of the transaction, even if the property or rights are worth no less than he actually paid for them.”*

In this particular instance, the transaction which Mr Bradbury had completed was the purchase of the shares. The purpose of seeking EY's advice was to devise a scheme which would offer Mr Bradbury reinvestment relief. Applying the above principle, Mr Justice Lewison was satisfied that the damage was sustained at the time the transaction took place, even though there was no evidence to suggest that the value of the shares had depreciated. This was because Mr Bradbury had not acquired what he ought to have acquired – namely, an effective reinvestment scheme.

Accordingly, Mr Bradbury suffered actual damage as soon as he bought the shares in Pegasus in April 1998. As a result, Mr Bradbury's claim in professional negligence was statute barred.

## Conclusion

The decision demonstrates how difficult it can be, in professional negligence cases, to determine exactly when damage is suffered and when the limitation period expires. As the judge said: “It ought to be relatively straightforward to decide when a person has suffered damage. Unfortunately, it is not.”

In professional negligence cases, the focus of the court is on whether the claimant got what they ought to have got when acting on professional advice. In most cases, this will have occurred at the moment when the claimant concluded the transaction on their professional adviser's recommendation, because this will have been the point in time when the claimant received less from their bargain than they expected.

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**Chris Sharrock**  
**c.sharrock@kennedys.com.hk**  
**+852 2848 6349**

# A matter of circumstances

It is not always easy for CPAs to know what to tell their PI insurers

Most professional indemnity policies taken out by certified public accountants (CPAs) in Hong Kong require them to notify their insurers about circumstances of which they become aware during the policy period and which may give rise to a loss or claim against them. But what constitutes “a circumstance” in this context? This article looks at recent legal authorities and suggests what should and should not be notified.

## Typical condition

A typical condition requiring a CPA firm to notify “circumstances” to its insurers might read as follows:

*“The Assured shall give to the Underwriters notice in writing as soon as practicable of any circumstance of which they shall become aware during the period specified in the Schedule which may give rise to a loss or claim against them. Such notice having been given any loss or claim to which that circumstance has given rise which is subsequently made after the expiration of the period specified in the Schedule shall be deemed for the purpose of this Insurance to have been made during the subsistence hereof.”*

This was the notification clause in issue in the recent English Court of Appeal decision in *HLB Kidsons v Lloyd’s Underwriters subscribing to Lloyd’s policy No 621/PK1D00101*.

## Rationale

But what is the rationale for such clauses? Professional indemnity policies are written on a “claims made” basis. This generally means that insurers are only required to cover claims which are first made against an insured firm during the policy period. That may work well for actual claims against the firm but, as we all know, CPAs may (during the course of a policy period) become aware of problem situations that could give rise to future claims against the firm – ie after the policy has expired.

To cater for such situations, insurers permitted insureds to report circumstances of which they became aware during the policy period and which might give rise to future claims (“circumstances”). Provided such circumstances were notified to insurers in accordance with the policy’s notification requirements, the insurers would agree to cover future claims arising from such circumstances that were made against insureds after the policy period had expired.

This was particularly important to insureds who took out a policy with different insurers in the subsequent year, as it would be a standard exclusion of the new policy that it did not cover (1) circumstances of which the insured was aware prior to the start of the new policy, or (2) circumstances notified to the previous professional indemnity insurers.



## The Rothschild case

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In the 1998 English decision of *J Rothschild Assurance plc v Collyear*, the judge had to decide whether a valid notification of circumstances had been made by a life assurance company that wanted to be indemnified by its professional indemnity insurers. The indemnity was in respect of losses sustained as a result of compensating investors following a review of pension misselling.

In the two years prior to the notification, the industry regulator had published bulletins about investors being given wrong advice on transferring out of occupational pension schemes and into personal pensions. This had been followed by the publication of a report by KPMG following their review (on behalf of the Securities and Investments Board) of sales by a representative sample of firms undertaking pension transfer business. The KPMG report concluded that 91% of files examined by them did not comply with conduct of business rules.

On 27 January 1994, a few days before the expiry of their professional indemnity policy, J Rothschild Assurance plc (JRA) sent a letter (via their solicitors) to their professional indemnity insurers. In that letter, they referred to the KPMG report and to a further communication that they had received from their regulator about how the problem of pension misselling was to be addressed. The letter went on to say that the regulatory authorities were going to require all pension transfers and opt-outs to be checked and, where appropriate, compensation paid to investors who had suffered loss. JRA asked their insurers to accept the letter as a notification of circumstances which may give rise to a claim against them. Their insurers disputed that this constituted a valid notification under the policy

because no criticism had been levelled against JRA itself and no cause for concern specific to any of JRA's investors had been identified.

The notification clause in JRA's policy was similar to that set out at the beginning of this article, although the obligation to notify was described as a condition precedent to their right to be indemnified.

Mr Justice Rix ruled that the letter written by JRA's solicitors was a valid notification of circumstances which might give rise to a claim. He noted that the test of materiality for notice was merely circumstances that "may" give rise to a claim and not circumstances that were "likely to" give rise to a claim. He also said that it was legitimate to test the notice given by JRA against subsequent developments. What had actually happened in this case showed that JRA was justified in saying that there were circumstances that might give rise to a claim against them; the KPMG report had identified problems which the regulatory authorities had provisionally determined would necessitate a review of past business and the provision of financial remedies.

## The Friends Provident case

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A similar situation arose in *Friends Provident Life and Pensions Ltd v Sirius International Insurance Corporation*, a 2004 decision of the Commercial Court in England. This was another case involving the notification of possible future claims arising from pensions misselling.

Friends Provident was the purchaser – and successor to the rights and obligations – of London & Manchester Assurance Co Ltd (LMA), whose business included the giving of financial

advice to individuals in relation to their personal pension plans. On 28 January 1994 – three days before the renewal of its professional indemnity policy – LMA informed its insurers that it knew of no circumstances likely to give rise to a claim under the policy apart from the following:

*"2. Pensions Transfers and Opt Outs which are a matter of public record and relate to all pensions providers. Detailed investigation will be conducted into pensions related transactions in accordance with any SIB/LAUTRO guidelines and notification of any potential claims given to underwriters in the usual way."*

Subsequently, as a result of further investigation, LMA was required to pay over £9m to various clients by way of compensation and Friends Provident sought to recover this sum from LMA's insurers, relying on the notification of circumstances which had been made on 28 January 1994. The relevant notification clause in LMA's primary policy was similar to that in the *Rothschild* decision above.

In the *Friends Provident* case, the insurance was split into two layers. The primary insurance was underwritten by a Lloyd's syndicate and provided cover of £1m. This was supplemented by an excess layer policy (providing another £4m of cover) which was underwritten by various Lloyd's syndicates and the defendants in the action, who were members of the London companies' market. While the Lloyd's syndicates accepted liability for the claims made by Friends Provident, the companies refused to do so on the grounds that:

- (1) their policies only covered claims actually made within the policy period; and
- (2) even if the policies did extend to claims arising out of circumstances notified during the policy

period, LMA had failed to notify them of any such circumstances within that time.

The judge therefore had to consider a number of issues relating to the construction and effect of the excess layer policies. One such issue was whether LMA's letter of 28 January 1994 constituted notification of the circumstances to the primary and excess layer insurers. The letter was in fact addressed to "Lloyd's Underwriters c/o Bowings" (LMA's brokers).

The judge concluded that the notification was to the primary insurers only and not to the excess insurers, it being common ground that the company insurers were not informed of the contents of the letter at the time. As for the notification to the primary insurers, it was recognised that the notification letter was prepared for the purposes of the prospective insurers at Lloyd's for the subsequent policy period. However, since those insurers were the same as for the expiring year, the letter was capable of constituting notice to them of the circumstances described in it.

## The Kidsons case

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Perhaps the most helpful guidance on the notification of circumstances comes from the trial judge's decision in the *Kidsons* case. In her judgment, Mrs Justice Gloster referred to a circumstance as comprising a "fact, event, happening or state of affairs".

As far as the insured's awareness is concerned, this means the insured being aware for the first time of the relevant circumstance. As regards a circumstance "which may give rise to a loss or claim against" the insured, the circumstance should be one which, when objectively evaluated,

creates a reasonable and appreciable possibility that it will give rise to a loss or claim against the insured. There need not be a certainty, probability or likelihood that it will do so. What matters is that there is a state of affairs from which the prospects of a claim (whether good or bad) or loss emerging in the future are real, as opposed to false, fanciful or imaginary. That is what must be notified.

Next, the written communication by the insured to insurers should be sufficiently clear and unambiguous. It should leave the recipient in no reasonable doubt that the insured is, by the communication, purporting to give notice of a circumstance for the purpose of triggering coverage under the policy. As for the timing of the notification, the insured in the *Kidsons* case had to give notice in writing “as soon as practicable”. This required written notice to be given by (or on behalf of) the insured as soon as reasonably possible after it had become aware of the relevant circumstance. Finally, any subsequent loss or claim to which the circumstance had given rise must be sufficiently causally related to the fact, event, happening or condition comprising the notified circumstance that it could fairly be said to have arisen out of it.

Although the Court of Appeal in *Kidson* disagreed with the trial judge’s findings on the facts, it did not offer any guidelines of its own about the identification and notification of circumstances that may give rise to a loss or claim against the insured. To that extent, the Court of Appeal missed an opportunity either to endorse the guidelines suggested by Mrs Justice Gloster or to suggest general principles of its own. Consequently, it remains unclear whether the guidelines suggested by the trial judge set out the correct legal test.

## Advice to insureds

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We think that the approach adopted by Mrs Justice Gloster in the *Kidsons* case has much to recommend it. So we suggest that it is followed by CPA insureds when deciding whether or not to notify a circumstance to their professional indemnity insurers. Insureds should also pay careful attention to whether the notification requirement is a condition precedent to their right to be indemnified under the policy. If it is, strict compliance with the condition will be required.

Furthermore, insureds should always ensure that the notification, when made, is provided to all relevant insurers. In the case of risks placed in the London market, this could involve notification to each of the leading Lloyd’s underwriter, any following-market Lloyd’s underwriters and members of the company market.

The extent of the notification requirement could well change from one policy to another and, in any event, it probably makes sense for insureds to instruct their brokers to make the notification on their behalf. However, it would be worthwhile following up with the broker shortly afterwards to ensure that the instructions have been carried out and that all relevant insurers (including any excess layer insurers) have been notified.

Finally, where the notification relates to a developing situation which may still be under investigation, insureds should always ensure that their insurers are kept fully up to date with developments, as and when they occur.

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**Chris Sharrock**  
**c.sharrock@kennedys.com.hk**  
**+852 2848 6349**

# Resolving the anomaly

## Obtaining Security of costs against an overseas company under section 357 of the Companies Ordinance

A recent Court of Appeal decision, *Akai Holdings Limited (in compulsory liquidation) v Ernst & Young* held that section 357 of the Companies Ordinance (Cap. 32) may apply to overseas companies if their central management and control is in Hong Kong. This judgment resolves an anomaly, which was judicially recognised some 20 years ago under both English and Hong Kong case law.

The action involves a listed company, Akai Holdings, which was incorporated in Bermuda. It had a place of business in Hong Kong and was an overseas company registered under Part XI of the Companies Ordinance. Akai Holdings was liquidated both in Bermuda and in Hong Kong with both liquidations administered from Hong Kong. The liquidators of Akai Holdings issued proceedings against the company's former auditors, Ernst & Young (EY), following the collapse of the Akai group.

In May 2008, EY applied for security for costs up to the conclusion of trial in the sum of HK\$198,614,000 relying on Order 23 rule 1(1)(a) of the Rules of the High Court and section 357 of the Companies Ordinance. At first instance Mr. Justice Stone dismissed the application under Order 23 rule 1(1)(a) on the ground that Akai Holdings was ordinarily resident in Hong Kong (its

central management and control being in Hong Kong). This issue was not pursued by the parties on appeal.

The application of section 357 was heavily contested in the Court of Appeal. Under the Companies Ordinance, section 357 only applies to companies which are formed and registered under the Companies Ordinance (or existing companies which are companies created under earlier Companies Ordinances). It does not apply to Part XI or overseas companies whether they are ordinarily resident in Hong Kong or not. Accordingly, prior to this judgment, a defendant could not obtain security for costs against an overseas company pursuant to section 357 of the Companies Ordinance.

At first instance, Mr. Justice Stone felt bound by both English and Hong Kong case law that section 357 of the Companies Ordinance had no application to Akai Holdings as a registered overseas company. He acknowledged that this created an anomalous situation for an overseas company with its central management and control in Hong Kong, an anomaly that was judicially recognized some 20 years ago in *Insurance Co of the State of Pennsylvania v Grand Union Insurance Co Ltd* [1988] 2 HKLR 541 and again cited in *Charter View Holdings (BVI) Ltd v Corona*

*Investments Ltd* [1998] 1 HKLRD 469. It was said that, whilst this situation “could, if it be thought appropriate, be removed by slight amendment to section 357”, such an amendment has not yet taken place. Accordingly, Mr. Justice Stone felt precluded by authorities from circumventing the anomaly that has been thrown up by reason of the non-amendment of section 357 of the Companies Ordinance.

On appeal, Mr. Justice Tang (with Madam Justice Yuen and Mr. Justice Chung both agreeing) overturned the lower court's decision and held that it is proper to construe section 357 so that it applies also to an overseas company ordinarily resident in Hong Kong. In coming to this decision, Mr. Justice Tang adopted a purposive approach. He recognised the present anomaly and felt the Court was bound to interpret the word “company” in section 357 purposefully, bearing in mind the object and context of the substantive provision. He was not persuaded that any of the authorities were binding, and in giving the section a purposive construction he believed that the section could apply to a company which is registered under Part XI of the Companies Ordinance. He noted that there is no rational basis for treating overseas limited companies ordinarily resident in Hong Kong differently from those incorporated in Hong Kong. After all, overseas companies which are

ordinarily resident Hong Kong are commonplace in the 21st century and it is clearly unsatisfactory if a defendant is unable to obtain an order for security for costs which otherwise would be entirely appropriate (but for the narrow construction of section 357).

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**Gigi Shuen**  
**g.shuen@kennedys.com.hk**  
**+852 2848 6305**

# Engagement letters

## The first line of defence

While some people would argue that a firm's best line of defence is its client selection criteria, there is little doubt that a well-drafted engagement letter can help shield accountants from many types of legal liability. In the current economic climate, it may be time to review yours.

Accountants are better placed than most to ride out the current global financial crisis. The growth of financial laws and regulations such as the Sarbanes-Oxley Act in the US in 2002 – which followed the high profile failures of companies like Enron and WorldCom – and the increased awareness of the importance of financial risk management led to more work for accountants providing risk management services. The recent round of corporate failures is likely to continue that trend.

On the other hand, those same corporate failures are almost inevitably going to increase the frequency and size of claims against accountants. This is particularly true of claims against auditors, as their audits of failed companies become subject to greater scrutiny by insolvency practitioners and shareholders. History shows that a recession always leads to claims against professional advisers with deep pockets and particularly those who carry professional indemnity insurance. Accountants then become a prime target.

So now is a good time for accountants to review their own risk management practices. A well-

drafted engagement letter is now the first line of defence against claims that unfortunately look far more likely than in the past.

### Standard format

Most CPA firms have standard form engagement letters, often following the forms recommended by the HKICPA. This will include separate forms for audit and non-audit work. This is a good start but standard forms can lull firms into a false sense of security. They should be reviewed on a regular basis to ensure they are up to date. Perhaps more importantly, the standard form proposed in each case should be reviewed with a view to ensuring that, where possible, it excludes or limits liability for those risks associated with the particular type of work for which the CPA will not be liable. This sort of preparatory work may seem a chore at the time but it can pay dividends in the long run.

(For a more detailed discussion of whether engagement letters can exclude or limit liability, please see "Limiting and disclaiming liability" in CPA Protect, Winter 2007)

### Reducing the limitation period

For many years, contracting parties have been able to stipulate in their contract that legal proceedings must be started within a shorter period of time than that provided under limitation

statutes such as the Limitation Ordinance (Cap 347) in Hong Kong. This principle was established in 1922 in the English case of *Atlantic Shipping Co Ltd v Louis Dreyfus & Co*. Some CPAs in Hong Kong already include provisions in their engagement letters that seek to reduce the time within which legal action can be brought against them following the completion of a particular engagement.

Readers will be aware that, under section 4 of the Limitation Ordinance, the limitation periods for actions based on simple contracts or on tort are six years from the date on which the cause of action accrued. In the case of a breach of contract, time under the Ordinance will begin to run from the date of the breach, whereas, in tort, time will only begin to run from the date on which damage is suffered. As will be apparent from the "Knowing one's limitations" article featured earlier in this issue, it is not always easy to determine when the limitation period in tort begins to run. However, this should not stand in the way of CPAs attempting to agree reduced limitation periods with their clients in their engagement letters, should they wish to do so.

Of course, it will be necessary for CPAs to ensure that any such provisions in their engagement letters are drafted in clear and unambiguous language and that they do not offend the reasonableness test imposed by the Control of Exemption Clauses Ordinance (Cap 71). The onus

of demonstrating that such provisions are reasonable will fall on the CPA firm.

### Overseas companies audits

Section 165 of the Companies Ordinance (Cap 32) will render void any contractual provision (or any provision contained in a company's articles of association) by which auditors seek to exempt themselves from liability for negligence in relation to their client company. However, it should be noted that the section only applies to a company as defined in section 2 of the Companies Ordinance – ie "a company formed and registered under this Ordinance or an existing company". ("Existing companies" are those which were formed and registered under the Companies Ordinances of 1865 and 1911.)

Many listed companies conducting business in Hong Kong are in fact incorporated in overseas jurisdictions such as the Cayman Islands, Bermuda or the British Virgin Islands. Such companies are not subject to section 165 of the Companies Ordinance and are therefore able to provide indemnities and the like to their directors, officers and auditors, subject to any provisions in their home legislation that prohibit this. Generally, though, such home legislation does not contain provisions that correspond with section 165 (although this should always be checked through a local lawyer).

It is, of course, unlikely that an auditor's engagement letter with an overseas company client will contain an express indemnity provision relieving the auditor from liability for negligence in relation to that company. On the other hand, it is not uncommon for the articles of association of such companies to include such provisions. The next question is whether the relevant provisions of the articles can be relied upon by the auditor on a standalone basis, or whether they have to be incorporated specifically into the auditor's engagement letter to become enforceable against the company.

Under Hong Kong law, the leading authority on this question is the English Court of Appeal's 1925 decision, *In Re City Equitable Fire Insurance Company Ltd*. In that case article 150 of the company's articles of association provided that none of the directors, auditors, secretary or other officers of the company should be answerable for any loss or damage sustained in the execution of their respective offices unless such loss or damage arose through their own wilful neglect or default. The Court of Appeal decided that, although the auditors had committed breaches of duty to the company, they had acted honestly and their conduct did not amount to wilful neglect or default. Article 150 therefore applied and exonerated them from liability.

However, the court went on to say that the measure of the auditor's responsibility depended upon the terms of their engagement. If there was a "special contract defining the duties and liabilities of the auditors" (ie an engagement letter), then that contract would govern the question and the articles would only be looked at in the absence of any engagement letter. In the *City Equitable* case, there was no such letter, which is why the auditors were entitled to rely upon the relief contained in article 150.

## The Moulin Global case

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Interestingly, this issue was one of the matters requiring determination in the very recent Court of First Instance judgment in *Moulin Global Eyecare Holdings Ltd (in liquidation) v Olivia Lee Sin Mei* (6 April 2009). In that case, proceedings were issued against Ms Lee, alleging negligence in the conduct of her duties as a non-executive director of Moulin Global.

Ms Lee sought to strike out the action on two main grounds. First, she had the benefit of a deed of indemnity between herself and Moulin Global in which the company had covenanted not to sue her and had also agreed to indemnify her for all amounts that she might be required to pay to settle any proceedings taken by anyone against her. Second, she argued that she was entitled to rely on the indemnity in her favour contained in bye-law 166 which was implied into the contract of engagement between the parties. Although Ms Lee did not satisfy the stringent requirements of a strikeout application by her reliance on the deed of indemnity, Deputy High Court Judge Carlson agreed that she was entitled to rely on the indemnity contained in bye-law 166. Judgment was therefore given in her favour.

In particular, the deputy judge agreed that, in the absence of any service contract between the parties, the provisions of bye-law 166 should be implied as a term of Ms Lee's appointment as a non-executive director and member of the audit committee. Of course, if there had been a service contract, one would need to look at that contract for the terms of the appointment. The court held that the situation was on all fours with the Court of Appeal's decision in *Re City Equitable*.

The deputy judge went on to rule that the

indemnity did not fall foul of section 165 of the Companies Ordinance because Moulin Global was incorporated in Bermuda (and registered as an overseas company under Part XI of the Companies Ordinance). Ms Lee was also able to establish that section 98 of the Bermuda Companies Act of 1991 permitted companies to exempt or indemnify any officer (including a director) from or against any loss or liability arising from negligence or breach of duty, in the absence of any fraud or dishonesty (and none was alleged in this case).

## Incorporating key provisions

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It is, of course, inconceivable these days that auditors will not have engagement letters. So if auditors of non-Hong Kong incorporated companies wish to avail themselves of any indemnity provisions or other relief from liability afforded by the company's bye-laws or articles of association, they will need to ensure that such provisions are incorporated into the firm's engagement letter with the client.

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**Chris Sharrock**  
**c.sharrock@kennedys.com.hk**  
**+852 2848 6349**

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**Richard Bates**  
**r.bates@kennedys.com.hk**  
**+852 2848 6308**

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# Contacts



**Chris Sharrock**  
Partner  
+852 2848 6349  
c.sharrock@kennedys.com.hk



**Rupert Skrine**  
Partner  
+852 2848 6301  
r.skrine@kennedys.com.hk



**Toby Brown**  
Solicitor  
+852 2848 6316  
t.brown@kennedys.com.hk



**Joanie Ko**  
Solicitor  
+852 2848 6318  
j.ko@kennedys.com.hk



**Gigi Shuen**  
Solicitor  
+852 2848 6305  
g.shuen@kennedys.com.hk

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**Auckland**  
Level 6  
70 Shortland Street  
PO Box 3158  
Auckland  
New Zealand  
T +64 9 379 9011  
F +64 9 379 9025

**Belfast**  
64–66 Upper Church Lane  
Belfast BT1 4Q1  
Northern Ireland  
United Kingdom  
T +44 28 90 240067  
F +44 28 90 315557

**Dubai**  
PO Box 212620  
403 Sheikh Essa Tower  
Sheikh Zayed Road  
Dubai  
United Arab Emirates  
T +971 4 321 5685  
F +971 4 321 5695

**Hong Kong**  
11th Floor  
The Hong Kong Club Building  
3A Chater Road  
Hong Kong  
T +852 2848 6300  
F +852 2848 6333

**London**  
25 Fenchurch Avenue  
London EC3M 5AD  
United Kingdom  
T +44 20 7667 9667  
F +44 20 7667 9777

**Madrid**  
Paseo de la Castellana no 50,  
3a Planta  
28046 – Madrid  
Spain  
T +34 91 523 7210  
F +34 91 523 7212

**Singapore**  
One Phillip Street  
#13-00  
Singapore 048692  
T +65 6891 9390  
F +65 6438 7914

**Sydney**  
Level 31, Citigroup Centre  
2 Park Street  
Sydney NSW 2000  
Australia  
T +61 2 8215 5999  
F +61 1300 761 156

**Associated offices**  
Abu Dhabi, Dublin, Karachi,  
Lisbon, New Delhi, Mumbai,  
Paris, Santiago and Warsaw

# Kennedys

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