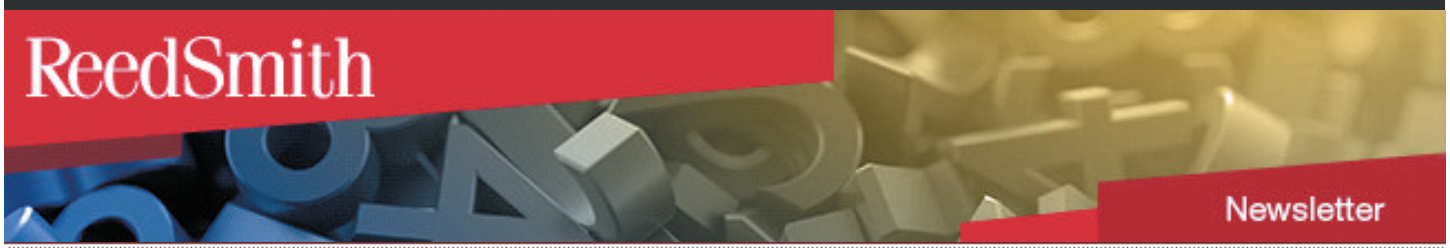

Accountancy forum

Welcome to Reed Smith's accountancy forum newsletter. This newsletter will cover a range of issues affecting accounting firms, with a core focus on liability and regulatory risk. In this edition, we look at the impact of the recent SFO v. ENRC case on legal professional privilege, recent court decisions and hot topics in the industry, such as the independent review of the FRC. Please do get in touch with any questions and let us know if there's a particular issue/case that you'd like us to cover in an upcoming edition, we would love to hear from you.

Legal professional privilege: recent cases in the Court of Appeal and High Court

by Jane Howard (Partner, London Head of professional liability), Eoin O'Shea (Partner, London) and Elizabeth Mason (Associate, London)

The recent important decision of the Court of Appeal in *Director of the Serious Fraud Office v. Eurasian Natural Resources Corporation* [2018] EWCA Civ 2006 (SFO v. ENRC)* has moved the law of legal professional privilege (LPP) in a realistic and commercial direction, whilst also leaving the door open to an appeal to the Supreme Court. We set out below our detailed analysis of SFO v. ENRC.

In addition to SFO v. ENRC, the decision in *Financial Reporting Council Ltd v. Sports Direct International plc* [2018] EWHC 2284 (Ch) also has potentially wide-ranging implications for the financial services sector, in particular in relation to the circumstances in which regulators can pierce LPP. This is summarised in our Case Summaries section below.

The law of privilege

LPP takes two forms. The first is 'legal advice privilege', which applies to communications between clients and their lawyers in connection with the giving of legal advice. However, the present law is that legal advice privilege does **not** apply to communications between a client (or the client's lawyer) and third parties.

The second form of LPP is 'litigation privilege'. It **does** apply to communications with third parties – but only if litigation is reasonably in prospect. To be protected, the 'dominant purpose' of the communications must be dealing with this litigation.

SFO v. ENRC

The facts

The background facts to SFO v. ENRC are (in summary) as follows. The SFO was investigating alleged bribery. It sought disclosure of certain documents and argued for a significant curtailment of LPP in relation to, in particular, litigation privilege.

The most important documents that the SFO sought disclosure of were notes of interviews between the company's lawyers and employees, and materials generated as part of a 'books and records' review by forensic accountants.

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First instance decision

The judge at first instance, Geraldine Andrews J, agreed with the SFO. She made two key findings. First, in relation to legal advice privilege. Following the 2003 decision in *Three Rivers No. 5*, the law was that employees of a company who were not empowered to instruct lawyers and receive their advice were not the lawyers' clients but mere third parties. Thus, discussions with the company's employees to ascertain the facts about a particular work event were not protected. Although many people considered, and still consider, that *Three Rivers No. 5* was wrongly decided, it was nevertheless binding on Andrews J and her decision on that ground was therefore unsurprising.

Secondly, the judge also found that litigation privilege did not apply either. She found that litigation was not reasonably in prospect when the interviews took place and the forensic work was done. The SFO had commenced an investigation, but that was not the same as a criminal prosecution. A criminal prosecution could only be reasonably contemplated by the prosecution services once the potential defendant had sufficient knowledge of the facts to satisfy them that there was a good chance of obtaining a conviction, which was not demonstrated here. This ruling was new law and highly controversial.

The judge also found that the 'dominant purpose' requirement was not satisfied. Again, quite controversially, she held that a desire to avoid litigation is not a good reason to invoke litigation privilege; and in this case it was clear that ENRC wanted to avoid litigation. It was also relevant that, in her view, ENRC had always intended to show the documents to the SFO as part of promised cooperation and, therefore, LPP could not apply.

Court of Appeal decision

A very senior Court of Appeal (the President of the Queen's Bench Division, the Chancellor of the High Court, and Lord Justice McCombe) was convened to consider the appeal, in which the Law Society also intervened and made submissions.

The Court of Appeal was critical of Mrs Justice Andrew's approach to litigation privilege and the more controversial propositions on which important parts of her decision were based.

Litigation privilege

It was relevant that, prior to the creation of the documents, ENRC was aware of whistleblower allegations, was told and appeared to accept that an SFO investigation was to be expected, and had hired external lawyers and forensic accountants to investigate. The overall context was that a criminal prosecution was possible. On the facts, the Court of Appeal found that a prosecution (that is, litigation for these purposes) was in contemplation at the material times and that the documents were created for the dominant purpose of litigation. The judge had been wrong to find that relevant materials had been promised to the SFO by ENRC – the evidence showed that ENRC had never expressly agreed to disclosure.

The Court also made some very valuable statements of principle. Among the most important are:

- It is a question of fact in each case as to whether the defendant is "aware of circumstances which rendered litigation between itself and the [prosecutor] a real likelihood rather than a mere possibility". (This is a restatement of the principle in the well-known *USA v. Philip Morris* case of 2003.)
- There should be no distinction between contemplation of civil or criminal proceedings when considering litigation privilege: "It would be wrong for it to be thought that, in a criminal context, a potential defendant is likely to be denied the benefit of litigation privilege when he asks his solicitor to investigate the circumstance of any alleged offence."

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- In criminal investigation cases, litigation might reasonably be contemplated prior to any contact with the police or government. Evidence that might demonstrate that such contemplation is reasonable, such as statements and actions of company executives or advice of external lawyers, cannot be ignored in determining this issue. Once the authorities are in contact and talking about possible prosecution, the position is stronger again.
- The fact that the underlying facts are initially unclear to a client (such as a company) does not in itself prevent litigation from reasonably being in contemplation.
- Heading off, avoiding or settling proceedings is a proper purpose within the scope of litigation privilege, just as advice given for the purpose of resisting or defending such contemplated proceedings is within the scope. The judge's distinction between the two was wrong.
- In general, the court must take a realistic and commercial view of the facts when it comes to establishing 'dominant purpose'. In another important statement of public policy, the Court held that it is "obviously in the public interest" that companies should not lose the benefit of LPP when investigating allegations of wrongdoing before going to a prosecutor.

Legal advice privilege

The Court of Appeal's view was that this case was primarily about litigation privilege. It appears to have accepted that the 2003 decision of the Court of Appeal in *Three Rivers No. 5* (about most employees not being the 'client' in relation to legal advice) tied its hands for this limb.

However, quite unusually, the Court of Appeal made it very clear that it disagreed with *Three Rivers No. 5*. The Court of Appeal does not overrule its own past judgments, that being the function of the Supreme Court. However, the Court of Appeal said that, if it were open to it to do so, it would have accepted the arguments that the *Three Rivers No. 5* view of the nature of clients was outdated, based on 19th-century authorities, which obviously did not take the modern corporate context into account. It said that the *Three Rivers No. 5* position disadvantaged large companies, which was not a principled outcome. It also noted that *Three Rivers No. 5* is out of step with much of the common law world (and has been specifically rejected in at least two other jurisdictions as being unprincipled and/or impracticable). Accordingly, the door for an appeal to the Supreme Court on this issue (and difficulties presented by *Three Rivers No. 5*) has been left wide open for a willing party. The SFO has announced it will not be appealing. It remains unclear, however, whether there will be an appeal by any other parties (in relation to legal advice privilege). A final and authoritative resolution of the difficulties presented by *Three Rivers No. 5* cannot be put off indefinitely.

Comment

SFO v. ENRC is an important 'win' for supporters of a commercial approach to LPP. The slaying of some of the more startling propositions of the first instance judgment in relation to litigation privilege is especially significant. **Of course, cases always turn on individual facts, but the reality is that investigations and other work preparatory to potential criminal prosecutions can now take place with far greater confidence that LPP will be protected.**

On legal advice privilege, the signs are also encouraging. The Court of Appeal's criticism of Three Rivers No. 5 is an unexpected bonus for the many practitioners and academics who have been saying similar things over the years. At some point, whether in an appeal of this case or in another, the Supreme Court will have to grapple with legal advice privilege and the 'client issue'.

Conclusion

Challenges to LPP will not disappear and so the issue of privilege remains an

important one for the accounting profession (and the financial services sector more broadly). The law of privilege is a vital element of the rule of law. The principled justification for LPP is to promote the frank exchange of information with lawyers and so the SFO v. ENRC decision is to be welcomed. **Privilege now clearly applies in circumstances where there is a genuine concern about future prosecution and there is no longer any artificial distinction between civil and criminal proceedings.**

* Reed Smith represented its client, The Law Society of England and Wales, as an intervener in the Court of Appeal proceedings.

Case summaries

Negligent professional advisers not liable for decisions of management

Manchester Building Society v. Grant Thornton UK LLP [2018] EWHC 963 (Comm)

The Commercial Court has held that the only losses that a claimant is able to recover in a negligence claim are those for which a defendant adviser has assumed responsibility.

Manchester Building Society (MBS) brought a claim against Grant Thornton (GT) following advice received in relation to interest rate swaps in connection with MBS's 'lifetime mortgages' programme. Under a lifetime mortgage, equity would be released and no payments would fall due until the owner entered a care home or died. From 2006, MBS purchased interest rate swaps to hedge the interest rate risk. The International Financial Reporting Standards (IFRS) require that such swaps be included on a company's balance sheet. GT advised that, to limit the volatility, 'hedge accounting' could be used. Hedge accounting, a method of accounting where the ownership of security and the opposing hedge are treated as one entry, attempts to reduce the volatility created by the repeated adjustment of a financial instrument's value.

In 2013, when MBS learned that hedge accounting was not permitted, it prepared its accounts properly (without hedge accounting) and the reported financial position indicated significant losses and smaller assets. Accordingly, MBS did not have sufficient regulatory capital and it decided to close out the swaps, resulting in associated losses (MBS claimed its losses were £48.5 million).

The High Court found that GT had acted negligently as any reasonably competent auditor would have concluded that the financial position of the building society for 2006 – 2011 was materially misstated by applying hedge accounting. Of the £48.5 million claimed, MBS proved recoverable losses of £420,460; however, Mr Justice Teare held that GT was responsible for only £315,345, which he considered were the only losses for which the accountants had assumed responsibility (the £315,345 represented 75% of the penalty costs of breaking the swaps, restructuring and advisory costs, and hedge accounting fees). MBS's recoverable losses were reduced by 25% by reason of its own contributory negligence in buying 50-year swaps which greatly exceeded the likely duration of the lifetime mortgages.

The crux of the decision is that GT could only be liable for losses for which it had accepted responsibility: the advice on hedge accounting concerned the manner in which swaps and mortgages must be presented in the published accounts. As such, GT was not held to be responsible for protecting the client from the losses flowing from the purchase of interest rate swaps where there had been a sustained fall in interest rates. The losses incurred in breaking the swaps (which accounted for the vast majority of the losses claimed in the

action) flowed from market forces, for which GT had no responsibility.

This case is a timely reminder that confirming the scope of duty at the outset of a matter is imperative. Cases will always turn on their factual matrix and it will be at the court's discretion to determine whether, and for what, responsibility had been assumed by the defendant.

Audit client ordered to provide documents to FRC in landmark ruling

Financial Reporting Council Ltd v. Sports Direct International plc [2018] EWHC 2284 (Ch)

In the recent decision of *Financial Reporting Council Ltd v. Sports Direct International plc* [2018] EWHC 2284 (Ch), a new precedent has been set on the FRC's powers under the Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR). Last month, Mr Justice Arnold noted in his ruling that this was believed to be the first application of its type to have reached the courts.

The FRC is currently investigating Grant Thornton (GT), the auditors of Sports Direct International (SDI), in relation to its audit of SDI's financial statements for the year ending 24 April 2016. The investigation arose from reports that an SDI subsidiary (S) worked with a delivery company (B), which was owned by the brother of the founder of SDI. (The founder of SDI also held positions as director and majority shareholder of SDI.) B was engaged following tax advice from SDI's accountants. The FRC was considering GT's conduct in not disclosing the relationship between S and B as being between related parties in the 2016 financial statements.

The FRC applied to the High Court for an order against SDI following SDI's failure to comply with a notice which required the production of documents that the FRC considered relevant to its investigation. This notice was issued pursuant to Schedule 2 of SATCAR and rule 10(b) of the FRC's Audit Enforcement Procedure. The FRC had asked for certain documents related to the audit; and SDI produced most of the documents sought, but claimed legal advice privilege in respect of the remainder.

The court heard arguments on whether legal advice privilege could be claimed on the grounds that (i) having been attached to lawyer-client emails, a document was eligible for privilege (the communication issue); (ii) SDI waived its privilege by sending copies of documents to GT for the purposes of audit extended to the FRC (the waiver issue); and (iii) disclosing documents to the FRC would infringe SDI's privilege (the infringement issue).

Arnold J held that (i) SDI was not entitled to legal advice privilege in respect of pre-existing documents sent as email attachments (at [42]); and that (ii) SDI had not waived privilege by giving the documents to FRC, given that the regulatory process is entirely distinct from the process of audit (at [56]). In relation to the infringement issue (at (iii) above), it was held that the production of documents to a regulator by a regulated person, solely for the purposes of a confidential investigation by the FRC into the conduct of the regulated person (here, GT), is not an infringement of the legal professional privilege in respect of those documents. Arnold J ruled accordingly that the same was true of the production of documents to the regulator by a client (of a regulated person).

This decision is being appealed. Arnold J himself noted that the point to resolve was not straightforward, leading him to make this ruling with "some hesitation". The Court of Appeal will have much to consider.

Relevantly, this case may have an impact on any terms of an engagement. It follows that the client's consent to the production of privileged documents to the regulator will not be required following the Court's decision. As noted above, the production of documents to a regulator by a regulated person solely for the purposes of a confidential investigation by the FRC into the conduct of the regulated person is not an infringement of any legal professional privilege.

Industry news

Deal or no deal? New government guidance for a ‘no deal’ Brexit

https://www.gov.uk/government/publications/accounting-and-audit-if-theres-no-brexit-deal/accounting-and-audit-if-theres-no-brexit-deal

The government has published guidance specific to accounting and audit in the event of a ‘no deal’ Brexit. This guidance intends to inform individual and business stakeholders of what they will need to do in the “unlikely event that” negotiations conclude with no agreement. While planning for a ‘no deal’ Brexit accelerates as 29 March 2019 draws closer, the assurance is given that this “does not reflect an increased likelihood of a ‘no deal’ outcome”.

The guidance provides a concise overview of practical considerations that auditors, accountants and companies will need to take into account following a ‘no deal’ Brexit. Currently, the UK follows EU rules and regulations for accounting, corporate reporting and audit. The guidance provides that the rules in these three areas will remain largely unchanged, but sets out the implications of a ‘no deal’ scenario for the treatment of corporate entities and qualified individuals across the continental divide.

Key insights include the following:

- Dormant UK-registered companies would need to prepare individual accounts if they have a parent company incorporated in the EU, where they are currently exempted from having to do so. The exemption will stand for dormant UK companies with a UK parent.
- UK businesses with an EU branch would be treated as a third country business, and would have to comply with local EU Member State reporting provisions: complying with reporting obligations of the Companies Act 2006 may no longer be treated as sufficient.
- UK companies listed on an EU market may be required to provide additional assurances that their accounts comply with IFRS in accordance with EU third country requirements.
- Auditors must be in possession of a qualification recognised in the UK in order to sign reports on behalf of an audit firm approved in the UK. In turn, an individual’s UK audit qualification may no longer be recognised in EU member states (with the exception of Ireland where the qualifications used are the same as those offered by UK qualifying bodies).

It appears that the main issues will stem from whether or not reporting practices conform to the appropriate standards across UK and EU Member State rules, and whether professionals’ qualifications are recognised across jurisdictions.

Reed Smith will continue to monitor the negotiations, and will report again on this topic in the event of an agreement, and on any updates to this guidance.

Revised Bannerman audit disclaimer guidelines issued by ICAEW

https://www.icaew.com/technical/audit-and-assurance/working-in-the-regulated-area-of-audit/audit-reports

Revised guidance issued by ICAEW on 23 May 2018 includes details of where exactly in an audit report the disclaimer should be placed. It also provides

practical advice regarding the disclaimer and engagement letters, including a helpful appendix covering possible responses to questions from clients.

ICAEW first issued guidance on such disclaimers in January 2003, following the Scottish judgment in *Royal Bank of Scotland plc v. Bannerman Johnstone Maclay and others*, which highlighted the potential exposure of auditors to third parties who assert that they rely on audit reports, where auditors have failed to expressly disclaim responsibility to those third parties.

One reason that ICAEW felt compelled to update its guidance was the advent of ISA 700 (Revised June 2016). ISA 700 addressed (among other things) the layout of the audit report and the 2003 Bannerman guidance did not fit with the revised standard. Accordingly, having taken advice from leading counsel, the ICAEW now recommends that the Bannerman disclaimer is positioned directly and prominently above the auditor's signature (rather than in the opening paragraphs of the audit report). This guidance is in aid of ensuring a consistent approach, so that clients know exactly where the paragraph should be positioned in their audit reports, and so that those reading the report know where to expect to see it.

New protocol for professional negligence disputes

https://www.justice.gov.uk/courts/procedure-rules/civil/protocol/prot_neg

On 30 April 2018, an amendment to the Pre-Action Protocol for Professional Negligence came into force following a pilot that was run to establish a scheme of adjudication as an additional alternative dispute resolution (ADR) process for professional negligence claims, including those involving accountants and auditors.

Adjudication is a compulsory dispute resolution mechanism that is widely used in the construction industry. It is not, however, featured as a common form of ADR in professional negligence disputes. With adjudication, the costs are relatively low, but the parties have no control over the outcome. In contrast, mediation, which has been a feature of the protocol since it was first released in 2001, leaves much more control in the hands of the parties to reach a negotiated settlement, or not. Adjudication is generally a quick procedure, and the parties are responsible for their own legal costs.

The amendment requires that adjudication is addressed in the letter of claim: whether the claimant wishes to refer the dispute to adjudication, and specific reasons should the claimant not want to. If they do wish to adjudicate the matter, the claimant should propose three adjudicators, or seek a nomination from the nominating body.

The ADR options available under the protocol now are mediation, arbitration and adjudication. Adjudication is unlikely to be attractive in high value, complex cases, but may well have its place in lower value cases, for which it could prove a viable alternative to other, more widely used, methods of ADR.

Double-barrelled audit review takes next steps, and aims for Big 4

https://www.gov.uk/government/publications/financial-reporting-council-review-2018

A national-level review backed by the Audit Quality Forum, the FRC and the ICAEW, and which has the support of the Department for Business, Energy and Industrial Strategy, is beginning to take shape. One review, which will be led by Sir John Kingman, chair of UK Research and Innovation and chairman of Legal and General plc, aims to determine whether the audit profession is "fit for purpose". Sir John has been asked to consider ways to remove conflicts of interest, including whether a public body should appoint the auditors of large listed companies.

Sir John's review expands to the effectiveness of how audit is regulated:

Business Secretary Greg Clark aims to make the FRC the best in class for corporate governance and transparency, while helping it fulfil its role of safeguarding the UK's business environment. The FRC's procedures, especially in relation to the Big 4 firms, will be examined for independence and rigour. A consultation calling for evidence and information, including specific examples, on the effectiveness of FRC ran from 6 June to 6 August 2018, and asked 45 questions targeted at those organisations that fund the FRC, organisations that are regulated by the FRC, and those that prepare accounts or conduct audits, among others.

The review has been criticised for being too large in its scope; it will cover topics ranging from whether auditing and accounting should be spun off and ringfenced, to whether 'going concern' audit opinions should be abandoned. Michael Izza, the ICAEW chief executive, said that "In the current environment, what business needs to do is to regain public trust and audit is clearly part of that. This needs to be done sooner rather than later. A full market review would kick this into the next decade."

In parallel, Andrew Tyrie, head of the Competition and Markets Authority (CMA), has been drafted in to examine competition in the audit industry. This is in response to concerns raised by Mr Clark about competitiveness in the audit market and conflicts of interest. Mr Tyrie has commented that "The CMA has been considering for some time how best to contribute to the work being carried out to improve audit."

Mr Clark is taking a firm stance to support these parallel inquiries, and once he has had the opportunity to consider the conclusions of each, he has indicated he would act on recommendations, and be ready to legislate if required.

Reed Smith will continue to monitor for updates on these reviews: the Kingman inquiry is set to conclude by the end of 2018, and Mr Tyrie may either conduct a two-year full market investigation, affording the CMA extensive powers in relation to the outcome, or a lighter-touch six-month market study.

Hong Kong High Court rules against Big 4 firm

https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=115275&QS=%28to%2Bdetermine%2Bwhether%2B{or}%2Bnot%2Bto%2Bcommence%2Bproceedings%2Bagainst%2BKPMG%29&TP=JU

China Medical Technologies (in liquidation) (CMED), whose executives have been charged in the United States for defrauding investors out of over US$400 million, has issued a claim against 91 partners at a Big 4 firm (as well as some former partners) in relation to their work on the auditing of the company. The Hong Kong office of the Big 4 firm was CMED's auditor from August 2005 to August 2009 and provided unqualified audit opinions in respect of the financial statements of CMED and its subsidiaries for the financial years ended 31 March 2004 – 2008, as well as advice and services to the CMED group for the financial years ended 31 March 2004 – 2010. The CMED liquidators have identified possible causes of action against the Big 4 firm, which may provide a source of recovery to CMED and its creditors.

The Big 4 firm (and its associated firm) refused to comply with a 2016 Hong Kong High Court order to provide copies of audit work papers to Borrelli Walsh Ltd, CMED's liquidator, arguing it would violate China's national security laws. The associated firm's alleged refusal to provide copies of work papers prevented CMED's liquidators from using analytical software to conduct keyword searches, highlights and annotations on the voluminous work papers and this caused significant delay to the liquidators' review of the documents. The Big 4 firm claimed that the papers could not be disclosed as its associate member, a company outside of its control, would not agree to the disclosure. In a much-awaited judgment dated 23 March 2018, Judge Anthony To held that the Big 4 firm's conduct was "obstructive and uncooperative" and ruled in favour of the liquidators.

Key dates

Reminder of key dates:

- **15 November 2018: Reed Smith's Annual Competition Forum**
  Attend our annual event, where we will be joined by the General Counsel of the Competition and Markets Authority, the Director of Competition at the Financial Conduct Authority, the Chief Economist of Ofcom and members of our global competition team. Don't miss this opportunity to discuss current issues in competition policy and enforcement with key opinion formers. Click here to register.

- **20 November 2018: Reed Smith's Financial Sector Update**
  Join us for a two-hour seminar on current regulatory issues and enforcement trends within the financial services industry. The seminar will be split into a number of panel discussions where our lawyers will discuss current pitfalls and what to expect in 2019. Click here to register.

- **8 January 2019: Amendments to Takeover Code come into effect**
  The UK Takeover Panel has published important changes to its rules governing takeovers of public companies in the UK. The most significant changes are consistent with the UK Takeover Panel's seemingly ongoing intention to rebalance the Takeover Code more in favour of target companies, as well as other stakeholders, such as employees.
