CORPORATE COLLAPSE - Pitfalls for Directors, Auditors and Bankers

JONATHAN HORSFALL TURNER

Allen & Overy
Solicitors, London

Nobody loves a banker, except when they wish to borrow money from one. Certainly nobody loves a banker when the money borrowed must be repaid. Provided one has the money, one generally puts up with the fact that it must be handed over, but if one does not have it, who better to blame than the banker himself.

There is in fact an element of truth and justification in placing some of the blame in this quarter. The nations of Latin America and Africa were tempted by the open cheque books of bankers through the 1970s, money for projects or just money for balance of payments. The day came for repayment and we were into the Third World debt crisis.

Companies too have now fallen victim to the bankers' seeming generosity: multi-option and multi-currency loans, loans for leveraged buy-outs and buy-ins, a galaxy of tempting wares on display at the international bank. Unfortunately, the after sales service has proved rather more costly than projected - with soaring interest rates, and wildly fluctuating exchange rates. The only thing that fell were the projected sales to meet the debt service.

The individual too has not been immune. Panic borrowing through the 1980s to finance mortgages to maximum levels itself contributing to spiralling price rises of real estate, followed by high interest rates, recession, and redundancy. A former Deputy-Governor of the Bank of England has told banks that they have a social and moral obligation to help the estimated one million people in Britain who have serious debt problems.

In an ever-increasing attempt to protect the borrower against himself, UK governments have insisted that detailed information on true interest rates be shown, that individuals who have effectively borrowed money under hire purchase and similar arrangements, are given cooling off periods before they are bound by the contracts they have entered into.

On the sovereign debt scene, the initial stigma that was suffered by countries in default has given way to a self-righteousness and in some cases, a belligerence against the bankers who tempted them by lending so much money. Lech Walensa, on a State visit to London just last month, told the Chairman of Lloyds Bank that the banks who had extended so much credit to Poland would get their money back if only they would themselves invest more in Poland.

I well remember a signing of an Algerian loan agreement some years ago at Grosvenor House in London when the Ambassador from Algeria to the Court of St James said at the celebratory luncheon: "Ladies and gentlemen, whether or not this loan is repaid depends not upon us, but upon you."

If a borrower who cannot repay blames the banker for his impoverished state, why should not the other creditors do so too. It is an automatic reflex for someone who is owed money to try to implicate those people who are around and who have supposedly the deepest pockets. After all, in many countries, banks, when faced with similar problems on the insolvency of a corporate, have turned to the host government and tried to twist its arm into bailing the banks out.

But to what extent in the United Kingdom have banks been made legally liable for the debts of their customers? The concern of banks has arisen by reason of s214 of the Insolvency Act 1986 which introduced the concept of wrongful trading by which a director could be made personally liable to contribute to the assets of an insolvent company if it continued trading after the director in question "knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation".

Director, in this context, means more than just a director who is on the board, it includes the shadow director. The shadow director is defined in s22(5) of that Act. A shadow director in relation to a company means a person in accordance with whose directions or instructions the directors of the company are accustomed to act, but so that a person is not deemed a shadow director, by reason only that the directors act on advice given by him in a professional capacity.

It is a bank's natural wish to control the excesses of its corporate customers, at any rate at the point in time when the writing appears to be on the wall. The covenants in a rescheduling document are a central part of its existence. It is normally the lawyer who turns to his client bank in a meeting and cautions him against including items which if carried out and lead to loss could implicate the bank as a shadow director. A bank which in the knowledge of the fact that there is no reasonable prospect of avoiding an insolvent liquidation, nevertheless extends credit on the basis of active involvement in the management of a company should take care that this active involvement does not go beyond counselling a course of action to become an instruction to act in a particular manner.

Strangely enough, there is little authority to assist in determining what is or is not considered by the courts to amount to conduct which would make a bank or its officers a shadow director. In the case of ***Re M.C. Bacon Limited*** an attempt to show that National Westminster Bank had become a shadow director failed, although the grounds on which it was abandoned, that the company's directors were too incompetent to be able to carry out any instructions given to them, even if they had wished to do so, are somewhat questionable!

A person would obviously be a shadow director if he owns a company in which he instructs nominee directors who are required or intended to act solely in accordance with the instructions of the principal. It would also seem that if a bankrupt appointed a relative or friend to the board of a company he owned, merely because he could not himself be a director by reason of disqualification, and the relative or friend was to act in accordance with the bankrupt's instructions, then this would give rise to a shadow director status for this appointor.

In reality banks do not on the whole get themselves into such a position, they do not consciously set out to control the actions of the board in such a manner that the bank is a person in accordance with whose directions or instructions the directors are accustomed to act. In general banks will investigate a company, will discuss with a company the best way out of its difficulties, or try to assist in turning the company round, but will rarely be involved in its management to such an extent that it is really the decision of the bank as opposed to the board as to whether the company should cease trading or go into liquidation. The bank may say that unless X or Y is done, there will be an event of default, but that is a different thing. The end view must be from the UK that banks should take care but the risks are slight.

There are however, some cases where a bank does assume liability to the extent of a director's potential liabilities. For instance, it is not unusual for an indemnity to be given by banks where a company appoints a corporate doctor to try and sort out its problems. Equally, if a bank appoints a nominee director to the board, it will be liable on the basis of an implied indemnity. Auditors too may require an indemnity to be given to them by the banks in order to carry out a liquidation.

In other cases however, banks may assume liability in circumstances they do not intend. For instance for misrepresentation in relation to information memoranda on a syndicated transaction where they may have liability to other banks. The ***European American Bank*** case was an instance of this in the late 1970s. The memoranda had not disclosed that the proceeds of the loan to be made would be applied directly in reduction of the outstandings of the bank and when the shipping company concerned went bankrupt, the other banks sued.

The sub-participation market has also given rise to claims against the selling bank. In some instances the sub-participation has been made at a time when the seller must have known that the loan in question was suspect and the sub-participant has claimed against the seller in order to be bought out. In one current corporate collapse in the UK a bank is claiming that vital information was withheld at the time that the sale was made and the seller may well have to pay up.

A further area of potential liability which has already been seen in the US and appears to be heading for the UK and the rest of Europe is lender liability for environmental damage. The liability of an operator can extend to operations of banks when enforcing their security or in taking control of the property by participating in the management of the borrower. A draft directive on Civil Liability for Damage Caused by Waste was issued in late 1989 by the European Commission, more potato crisps. It looks inevitable that it will become law in some shape or form and may impose a strict liability under civil law for damage and injury caused to the environment by waste. Liability cannot be excluded by agreement. A producer of waste would include a person having actual control of the waste, so the ramifications for secured lenders on enforcement is obvious.

In a further search round for the deepest pockets in the event of an insolvency, the auditors and their insurers must be seen to be a prime target. In the case of banks looking for a scapegoat, and in the absence of some possibility of getting at other banks who have lent to the company, the directors and the auditors are about the only categories in the firing line - always assuming, of course, that the lawyers have successfully kept their heads well below the parapet.

The scope of financial reporting required to be carried out by an auditor was transformed in the UK in the 1980s by the requirements of companies legislation and in the minds of the public in general this appears to have led to an expectation that the auditor and accountant should be liable to anyone who relies on the information produced. But for the auditor, the detailed legal framework encouraged a legalistic approach to accounts which did not consider the consequences of the information produced. The House of Lords held in the ***Caparo*** case that liability for loss arising from negligent mistakes only arose where the statement or advice had been given to a known recipient for a specific purpose of which the adviser was aware and upon which the recipient had relied and had acted to his detriment.

Lord Oliver said that the necessary relationship might be held to exist where:

(1) The advice was required for a purpose made known to the adviser at the time that the advice was given;

(2) The adviser knew his advice would be communicated to the recipient in order that it should be used for that purpose;

(3) It was known that the advice was likely to be acted upon without independent inquiry; and

(4) It was indeed acted upon to the recipient's detriment.

In the ***Al Saudi Banque*** case, the banks contended that they had granted, renewed, continued or increased facilities to the company on the basis of the accuracy of the audited accounts. They alleged that the accounts failed to show that the company was insolvent and that the auditors had been negligent. Millett repeated that in claims for damages for economic loss resulting from negligent misstatements the courts had been concerned to avoid liability "in an indeterminate amount for an indeterminate time to an indeterminate class". Ultimately it was held that the auditors had no duty to report to the banks and indeed had not done so. They did not supply copies of the reports to the banks or send copies to the company with the intention or in the knowledge that the reports would be forwarded to the banks. No duty of care was held to arise.

In the ***Morgan Crucible*** case the plaintiff claimed that its revised bid was based on the profit forecast made by the company, its accountants and its merchant bank advisers, and that it had been made clear that this would be the case before the profit forecast was made. The court however held, that no duty of care was owed by the company's accountants to the offeror. It was pointed out that the purpose of the defence documents in a bid was to advise shareholders whether to accept the bid and that there was nothing to suggest that they were meant for the bidder.

There are however indications that ***Caparo*** may not be followed or interpreted so rigidly. The Court of Appeal have allowed an appeal against the decision of Hoffman in ***Morgan Crucible*** on the basis that there was an arguable case that a duty of care was owed. Slade said that it was at least arguable that this case could be distinguished from ***Caparo*** on its assumed facts that each of the directors in making the relevant representations was aware that Morgan Crucible would rely on them for the purposes of deciding whether to make an increased bid, and indeed intended that it should. That was one of the purposes of the defence documents.

If information is included in takeover documents which has been specifically compiled for that purpose, for example a profit forecast, the courts may yet find that ***Caparo*** still provides the freedom for a duty of care to be established, if the information were to have been made available for a specific purpose known to the provider, the information will be provided to the other parties involved, whether under the City Code or otherwise, and it would be reasonable for those other parties to rely on that information, and the information may well be acted upon.

I should also mention that under s57 of the Financial Services Act, a procedure is laid down under which banks and other authorised persons may approve investment advertisements and circulars. These are generally issued with a specific transaction in view and it is thought that ***Caparo*** will not limit the fact that if the approval is given negligently that the authorised persons will be liable even to a very broad base of persons. Section 57 is clearly intended to give protection to the public at large and it would seem unlikely that a court would not find that a duty of care arose in such a case. The approval under the Act is given for the express purpose of enabling the document to be distributed on a wide basis. Auditors, however, rarely approve documents under s57.

The recent corporate traumas of such companies as Polly Peck and Ferranti, as well as Charterhall and Levitt, have all led to inquiries from banks to their lawyers as to their ability to sue the auditors. ***The Times*** of 14 January 1991 disclosed that LIT Financial Services was considering action against Stoy Heyward who had approved the 1988 accounts of Levitt which had stated that the group made pre-tax profits of about eight million. Explaining to a Japanese bank that it is unlikely to be successful in suing the auditors because of the ***Caparo*** principle is not an easy task. Disbelief is writ large on the face of the Japanese banker.

It has been suggested that auditors should be asked to supply responsibility letters to would-be investors and lenders, linking the transaction and its main features with the audited accounts. A model responsibility letter was indeed published in the ***International Financial Law Review***, "intended to put the lending banks back to the position which prior to ***Caparo*** they thought they had held". It is perhaps akin to the type of comfort letter produced to managers on a capital market bond issue.

Auditors who have been approached for such letters have in my experience not been overjoyed by the prospect. Who can blame them? It is a question, of course, of the norm of the market place, as to whether they will be prepared to sign them and at what cost. For it is perfectly true that there is probably a price for everything and that if sufficient work is done and paid for, that comfort may be available.

One of the sources of the problem arises from the over-cosy relationship between auditors and their corporate clients. They do have a conflict of interest in preparing a company's accounts for they rely on that company for not only the audit work, but also for much advisory work and in many cases, for some of their legal work as well. Although I am happy to say that accountants have not yet achieved that growth in the legal service areas in the UK that they have in some other countries. Perhaps it should be a rule that no accountant should audit and advise the same client.

It is in any event clear to all that the position must be resolved. There must be some clear understanding between the public, including within that phrase the banking community, and auditors, as to what is expected of them and as to what potential legal liabilities that will result in. Whether that can be done by internal regulation of the accounting profession or will require statutory force, remains to be seen. Article 62 of the Fifth EEC Directive still under discussion provides for the liability of auditors to the company, to the shareholders and to third parties. The text provides that the laws of the member States shall ensure that at minimum, compensation is made for all damage sustained by the company.

Mr Justice Hoffman said in the ***Morgan Crucible*** case that the courts do not have the information on which to form anything more than a broad view of the economic consequences of their decisions. If the wider economic effects of the decisions are contrary to the public interest, the legislature must correct it.

Ladies and gentlemen, watch this space!