

## A tricky question of disclosure

Professional services firms need to be very careful when dealing with confidential client information.



The Court of Final Appeal gave its judgment in the *Nam Tai Electronics v PricewaterhouseCoopers* case on 31 January 2008. In a unanimous decision, the CFA concluded that PwC had breached its duty of confidentiality to Nam Tai, a former client. However, only nominal damages of HK\$100 were awarded against PwC, with the issue of costs still to be determined.

### Background

The underlying facts were relatively straightforward but gave rise to a number of complex legal issues. PwC had previously acted as Nam Tai's auditors. They had also undertaken a due diligence review on Nam Tai's behalf in respect of Albatronics (Far East) Co Ltd, in whom Nam Tai wanted to invest up to HK\$70m. The due diligence report questioned both the integrity of Nam Tai's management and the wisdom of

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proceeding with the intended acquisition. Nam Tai disagreed with the review's findings.

Notwithstanding PwC's adverse recommendation, Nam Tai proceeded to acquire a controlling interest in Albatronics. However, despite attempts to restructure the company, its board resolved in mid-1999 to put Albatronics into voluntary liquidation. PwC, along with several other accountancy firms, sought appointment as liquidators of Albatronics. At that time, PwC was advising Sony, one of the principal creditors of the troubled electronics manufacturer. In the light of PwC's earlier due diligence review of Albatronics, Nam Tai objected to PwC's appointment on the grounds of conflict of interest. It communicated its objection to Albatronics' creditors.

PwC actively sought appointment as liquidators of Albatronics. In answering Nam Tai's assertion that PwC had a conflict arising out of the due diligence review it had conducted for Nam Tai, PwC disclosed confidential information. While the fact that PwC had conducted the due diligence review was in the public domain, it was not generally known that PwC had recommended that Nam Tai should not to proceed with the acquisition of Albatronics. In the event, individuals from another firm were appointed as liquidators of the company.

This formed the background to the litigation between Nam Tai and PwC. PricewaterhouseCoopers claimed that its disclosure of confidential information fell outside the scope of its duty of confidentiality (and was therefore justified) because it was made in order to counter Nam Tai's objection to PwC's appointment as liquidator on the grounds of conflict of interest. Both Mr Justice Waung and the Court of Appeal accepted PwC's argument, but Nam Tai appealed to the Court of Final Appeal.

## Scope of duty of confidentiality

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Mr Justice Ribeiro, who gave the main judgment in the Court of Final Appeal, acknowledged that the case concerned the limits of PwC's accepted duty of confidentiality. In particular, the court had to decide whether PwC's disclosure was required to protect its own interests or was made with Nam Tai's express or implied consent.

## Consent

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It was a question of fact whether Nam Tai had consented to the disclosure, thereby waiving the duty of confidentiality. An objective approach was required in determining whether there had been any express or implied waiver. One way of tackling the question was to ask whether the conduct of the client was inconsistent with maintaining confidentiality in respect of the disputed communication. In cases of implied waiver, the conduct had to convey clearly the meaning of the waiver relied on.

## Protection of own interests

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This principle depends on the existence of an implied term permitting someone under a duty of confidentiality to disclose confidential information in circumstances where that disclosure is necessary for the business efficacy of their ordinary contractual transactions. For example, such a term would be implied so as to permit a bank to disclose details of the amount owing by a customer in a writ seeking payment of an overdraft. To that extent, it operates on a limited basis. However, it has been held to encompass a "self-defence exception", where disclosure is permitted in order to protect one's own interests in defending litigation or disciplinary proceedings initiated by a client or a third party (in the second

case, the proceedings must relate to dealings with the client) or in pursuing a cause of action against a third party.

## Application to Nam Tai

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The self-defence exception could not apply in this case because:

- (1) Nam Tai had not launched any legal or disciplinary proceedings against PwC, nor had any such proceedings been issued against PwC by a third party; and
- (2) PwC was not seeking to establish its legal rights in litigation or other proceedings against a third party.

However, the CFA accepted that a term could be implied – either as a matter of business efficacy or of law – that Nam Tai and PwC had agreed that disclosure of otherwise confidential information could be made where such disclosure was required for the protection or furtherance of either party's legitimate interests ("the defensive disclosure term"). However, each defensive disclosure would need to be scrutinised to ascertain whether it was, in fact, made for such purpose.

The CFA decided that PwC's efforts at securing an appointment as liquidator of Albatronics were undertaken as part of the firm's ordinary professional activities and therefore in pursuit of its legitimate interests. The disclosure formed part of those efforts and, for the purposes of the defensive disclosure term, should be regarded as having been made in furtherance of PwC's legitimate interests.

But for PwC to show that its disclosure was fairly required as a defensive response to Nam Tai's allegation of conflict of interest, it had to establish

that its disclosure was in response to Nam Tai's allegation. It was here that PwC's position became more difficult. Even if the court ruled that the disclosure was in response to Nam Tai's allegation, it would still be necessary to inquire whether (1) the disclosure was necessary; and (2) PwC should have taken other steps before resorting to the disclosure of confidential information. Did the disclosure exceed what was fairly required by way of self-defence?

Unfortunately for PwC, the Court of Final Appeal concluded that, in the light of the parties' mutual dealings, the content of Nam Tai's allegation did not justify a response in the terms of the disclosure made by PwC. The statement that PwC would have a conflict of interest if appointed was capable of bearing different meanings, some of which had nothing to do with PwC making either a positive or negative recommendation regarding Nam Tai's acquisition of Albatronics.

Indeed, an allegation of conflict founded on a perceived impediment to PwC acting impartially as liquidator because of its possible preconceptions about past management misdeeds was an allegation that was wholly consistent with PwC having given a negative, and not a positive, recommendation. So it was a non sequitur to suggest that the disclosure that PwC had made a negative recommendation was a required response. The court came to the same conclusion when viewing the conflict of interest allegation from the creditors' perspective, and ruled that the disclosure constituted a breach of PwC's duty of confidentiality owed to Nam Tai as a former client.

It was agreed by both parties, though, that Nam Tai had suffered no pecuniary loss as a result of the disclosure, which explains why nominal damages of only HK\$100 were awarded.

## Implications

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These are probably best summed up by Mr Justice Ribeiro's concluding remarks:

*"Disclosure of confidential information in the confidant's own interests without the confider's express consent is fraught with danger, since reliance on implied consent or upon the self-interest qualification is likely to be susceptible to challenge and subject to a degree of uncertainty."*

As for PwC's reaction to the CFA's decision Chris Harford, general counsel of PwC Hong Kong/China, commented:

*"Protecting the confidentiality of client information is something of great importance to PwC, and disclosing such information in any circumstances is not something we do lightly. The court recognised that, in the face of attack, it is permissible to disclose confidential information in properly defending oneself. We believed we had acted in accordance with that premise, but the court found, ultimately, that we had stepped over the line (with nominal damages being awarded). This is an important reminder to professional service firms about the care that needs to be taken in dealing with client confidential information, no matter what the circumstances."*

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The author is very grateful to Chris Harford of PwC for his help over this article.

# New Watchdog update

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In the Winter 2007 issue of *CPA Protect* ("New Watchdog" on p 5), we reported on the role of Financial Reporting Council (FRC) in investigating auditing and financial reporting irregularities of Hong Kong's listed companies.

Between its establishment in July 2007 and March 2008, the FRC has received 20 complaints. Ten of the complaints came from the public and 10 from regulators. Most of the complaints relate to non-compliance with financial and reporting requirements.

The FRC has completed its review of nine of the complaints. Two cases were referred to other regulators and law enforcement agencies for follow-up action. Five cases were not pursued because the complaints had no merit. One investigation and one inquiry should be completed in May.

The FRC has taken an average of six weeks to review a complaint, during which time it has collected information from the relevant listed companies and auditors.

The Council of the FRC works closely with other regulators and law enforcement agencies. It has signed memoranda of understanding

with the Stock Exchange of Hong Kong Limited, the Hong Kong Monetary Authority, the Insurance Authority, the Securities and Futures Commission and the Hong Kong Institute of Certified Public Accountants. It also maintains close contact with local law enforcement agencies such as the Hong Kong police and the Independent Commission Against Corruption, as well as keeping in touch with regulators in mainland China.

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# Section 221 applications

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Section 221 of the Companies Ordinance and its predecessor sections have been with us for a very long time – its origins can be traced back to the Companies Ordinance 1865. It has been described as a vital part of the statutory insolvency regime, and there are corresponding provisions in the UK, Australia, Singapore, Canada and New Zealand. Because section 221 and its overseas equivalents have been around for so long, there is a wealth of authority on its scope and purpose.

But first, a reminder of the Court's powers under section 221. These are:

- (1) The power to summon – at any time after the appointment of a provisional liquidator or the making of a winding-up order the Court may summon before it any officer of the company, or person known or suspected to have in his possession any property of the company (or who is thought to be indebted to the company), or any person whom the Court deems capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.
- (2) The power to examine – such individuals may be examined on oath in relation to the matters referred to in (1) above and may be required to sign a written statement.
- (3) The power to order production of documents – the Court may order the individuals in (1) above to produce any books

and papers in their custody or power which relate to the company.

- (4) The power to apprehend – if an individual refuses to comply with a summons, he may be apprehended and brought before the Court for examination.

As liquidators are usually strangers to the affairs of the companies to which they are appointed, they will often rely on orders for examination and production to reconstitute the knowledge of the company, particularly where the records may be inadequate and there is little or no chance of receiving any help from the former management. The liquidator's powers are wide and general, although he has an obligation to satisfy the court that the information or documentation he seeks is reasonably required to enable him to carry out his functions.

Because its powers are discretionary, the Court must endeavour to strike a balance between the liquidator's reasonable requirements and the need to avoid making an order that is unreasonable, unnecessary or oppressive to the party from whom documentation or information is sought. General principles have been developed by the Courts over the years with regard to the balancing exercise which the Court must undertake. The principles can be summarised as follows:

- (i) The liquidator must show that the documents are reasonably required to enable him to

carry out his functions; he does not have to establish that the documents are necessary to enable him to do so.

- (ii) The case for making an order under the section in respect of a former officer of the company is usually stronger than in respect of a stranger who owes no fiduciary duties to the company and is not under any statutory duty to assist the liquidator.
- (iii) There is an element of oppression in requiring a party to provide information which exposes him to potential liability.
- (iv) An order for oral examination is likely to be more oppressive than an order to produce documents.
- (v) It is oppressive to require a person suspected of wrongdoing to prove the case against himself on oath prior to proceedings being brought.
- (vi) An order is not necessarily oppressive because it is inconvenient for the party subject to it or because it causes him a lot of work or may make him vulnerable to future claims.
- (vii) Because of the summary nature of the procedure and the need for expedition the Court cannot be expected to indulge in fine judgements as to the precise width of the order that should be made.
- (viii) The Court must take care not to restrict the width of the order sought by the liquidator in a way which would risk making it ineffective.

Of course, arguments arise from time to time as to the precise meaning of words or phrases forming part of section 221 and its overseas equivalents, but the Courts (including the Courts of Hong Kong) have established a series of precedents which provide valuable guidance for both liquidators and those on the receiving end of section 221 summonses. Although case law has narrowed the scope for argument in a number of important areas, we would always recommend CPAs to seek advice from their lawyers if they find themselves in a situation where a liquidator is threatening to resort to the section 221 procedure.

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# Having a closer look

## Auditors can be compelled to produce audit working papers.

Under section 179 of the Securities and Futures Ordinance (SFO), the Securities and Futures Commission (SFC) can require an auditor (or an employee of the auditor) to produce audit working papers relating to a listed corporation. The auditor or employee may also have to provide explanations to the SFC in respect of the working papers produced.

The SFC can exercise this power in relation to a listed corporation where there are circumstances suggesting:

- that the listed corporation has been conducted with intent to defraud creditors, for any fraudulent or unlawful purpose, or in a manner oppressive to its members;
- that the listed corporation was formed for a fraudulent or unlawful purpose;
- that, during the process of listing the corporation or at any time since the formation of the corporation, individuals have engaged in defalcation, fraud, misfeasance or other misconduct;
- that at any time since the formation of the corporation, members have not been given all the information with respect to its affairs that they might reasonably expect to be given.

These powers can also be exercised where the SFC decides to help regulators outside Hong Kong in connection with an investigation that relates to the corporation.

In exercising its powers under section 179, the SFC acts via an “authorised person” who will be of the rank of associate director of enforcement or above.

### Implications for auditors

- Auditors effectively have no option but to comply with a lawful direction issued by the SFC as non-compliance without reasonable excuse constitutes a criminal offence. The auditor should act promptly.
- Compliance with the requirements of section 179 of the SFO will not (of itself) render auditors liable to any person for civil actions arising from contract, tort, defamation, equity or otherwise.
- Auditors must maintain confidentiality in respect of all matters relating to the SFC’s investigation and must not inform the audit client of the SFC’s demand for the production of working papers.
- The Hong Kong Institute of Certified Public Accountants recommends that auditors may wish to issue a letter to the authorised person explaining that their audit is performed in accordance with statements of auditing standards and is not therefore planned and conducted in contemplation of being used by the SFC in its investigation.
- The SFC will usually allow the auditor the option of producing the working papers either at its office or the SFC’s office. If the first option is

chosen, the auditor must keep the working papers in secured facilities under the control of the designated audit partner, until advised by the authorised person that such procedures are no longer required.

- Auditors should also be aware that, if the SFC discovers any alleged misconduct on their part, the SFC may disclose such alleged misconduct to the HKICPA or the relevant law enforcement agencies.

### Recommendations

Auditors who receive directions under section 179 of the SFO should always seek prompt legal advice. In particular, legal advice is likely to be of assistance in:

- ensuring that the SFC has complied with the provisions of the SFO;
- responding to the SFC;
- cases where the SFC wishes to seek explanations from the auditor in connection with the working papers of a listed corporation;
- reviewing the potential exposure of the audit firm to criminal and/or civil liability.

Finally, auditors should note the HKICPA’s recommendation (under paragraph 15 of statement 1.307 of the member’s handbook) that auditors should establish their own policies and procedures in relation to the production of audit working papers to the SFC as a risk management

practice. In particular, a senior partner of the auditor with professional risk management responsibility should be the designated partner to deal with the SFC’s authorised person and to liaise with the auditor’s lawyers.

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# Extending a professional indemnity policy (2)

Brit Syndicates v Italaudit SpA (formerly Grant Thornton SpA) - the final chapter

House of Lords, England

Date of judgment: 12 March 2008

In the Spring 2007 issue of *CPA Protect* (“Extending a professional indemnity policy” on p 11), we reported on the English Court of Appeal decision in this case, which involved the construction of an extension to a professional indemnity policy issued by Brit and other insurers to member firms of Grant Thornton International



(GTI). The Court of Appeal ruled in favour of Brit and denied coverage to GTI. The House of Lords has now overturned that decision and ruled that GTI is entitled to protection under the policy.

## Background outline

First, a brief recap. The policy extension (under which GTI sought cover) provided as follows:

“Grant Thornton International is included as an assured firm but solely in respect of claims made against Grant Thornton International arising from claims made against a member firm of Grant Thornton International insured by the terms and conditions of this policy.”

GTI’s notification under the policy was made as a result of proceedings in the US against GT Italy and GTI arising from GT Italy’s audit of a subsidiary of Parmalat. Brit had avoided the policy against GT Italy and argued that, as a result of the wording of the above policy extension, coverage was no longer available to GTI because GT Italy had ceased to be a “member firm of Grant Thornton International insured by the terms and conditions of this policy”.

The policy contained two insuring clauses. The first provided indemnity to assured firms against claims

in respect of international work (basically, work referred by another member firm); and the second provided indemnity to an assured firm if, by reason of its membership of GTI, it was held legally liable for the negligence of another member firm.

Brit’s case was that, for GTI to have cover under the policy extension, the claim made against GTI:

- would have to arise from a claim made against GT Italy, and
- be a claim that GT Italy was itself insured against by the terms and conditions of the policy.

Accordingly, if GT Italy was not insured against the particular claim at issue or (more fundamentally) had no overarching cover as a GTI member firm, then GTI could not be entitled to coverage under the policy.

GTI’s case was that the policy extension included GTI as an assured within the meaning of the second insuring clause. The words “arising from claims made against a member firm of Grant Thornton International” reflected the limitation of cover under that insuring clause to legal liability incurred by reason of membership in GTI for any negligence etc on the part of another GTI member firm. Furthermore, the phrase

“insured by the terms and conditions of this policy” was merely descriptive of the member firms of GTI whose negligence etc was relevant to those insured by the policy. The phrase did not introduce a positive requirement that either the claim or the member firm should be validly covered under the policy.

## House of Lords decision

Lord Mance, who gave the leading judgment, acknowledged that the rival arguments were finely balanced. He expressed surprise, however, that neither party had adduced any evidence about the background to the policy. The House of Lords was therefore being asked to construe the policy in what was almost a complete vacuum.

With regard to the second insuring clause, Lord Mance thought it would be very odd if individual member firms were given full cover in respect of their liability for claims incurred by reason of their membership in GTI, but GTI itself was not. He was not persuaded by the additional argument that, because GTI was the umbrella organisation, it was not a member of GTI and could not therefore incur liability by reason of its membership in GTI. He went on to say that, if Brit’s argument was right, GTI would need another policy insuring it for a vicarious or partnership claim, such as that made against it in the US proceedings.

On balance, Lord Mance considered that GTI’s construction of the policy was preferable. The policy extension therefore gave GTI, as an assured firm, the protection of the second insuring clause, without any need to show that the claim against GT Italy was itself one which was insured under either of the two insuring clauses. This meant that the phrase “insured by the terms and conditions

of this policy” did not relate to the earlier words “claims made” but rather to the words “a member firm of Grant Thornton International”.

There was also the separate question of whether GT Italy had ceased to be “a member firm of Grant Thornton International insured by the terms and conditions of this policy” within the policy extension because of GT Italy’s breach of warranty when completing its proposal form, so that coverage never actually attached to GT Italy. Again, Lord Mance decided in favour of GTI, adopting similar reasoning to that applied earlier.

## Implications of the decision

It is clear from the House of Lords’ judgment that the decision could have gone either way. This is because the policy wording was not as clear as it could and perhaps should have been. A timely reminder, therefore, to ensure that your policy wordings use clear and unambiguous language and that you understand what they say.

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# Professional indemnity cover

## A cautionary tale



Professional indemnity insurance (PII) is very much part of professional business life. We all hate paying the premiums but at least we can rest assured that, in the event of a claim, we will be covered by our insurance. At least, that’s the theory. But how our cover measures up in practice often depends on our attitude to PII and whether we regard it as a friend or foe.

## Contrasting approaches

Let us look at this in the context of two hypothetical but otherwise very similar CPA practices in Hong Kong – similar, that is, in

terms of size and fee income, but very different when it comes to their attitude towards risk management.

High Risk CPA Ltd regards PII as a burden and purchases the minimum amount required under the Corporate Practices (Professional Indemnity) Rules, taking into account its fee income and the number of principals in the practice (say, HK\$15m). Low Risk CPA Ltd, on the other hand, regards its PII as a necessary but useful risk management tool and takes advantage of the current soft market conditions by purchasing HK\$150m worth of cover.

## Megabux Ltd

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Low Risk was the auditor of Megabux Ltd, a listed company, for the year ended 31 March 2004. It resigned and was replaced by High Risk for the following year. Megabux collapsed in late 2005, amid allegations of serious management fraud. Liquidators were appointed. Solicitors acting for the liquidators wrote to both firms in June 2006, alleging professional negligence in the conduct of their respective audits. The claimed losses totalled HK\$100m.

## Different responses

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Consider now the responses of the two firms.

Low Risk resigned as auditors because it felt uneasy about retaining Megabux as a client, although it found no evidence of fraud on the part of the company's management during the 2004 audit. When Megabux collapsed in late 2005, Low Risk made a precautionary notification to its insurers under its PII when renewing its policy at the end of December 2005. Although it had no reason to suspect that

a claim was "likely" (the trigger for notification under its PII policy), it notified the matter as a circumstance which might give rise to a claim in the future.

The notification was accepted by Low Risk's insurers. This meant that, when a formal claim was made in June 2006 and reported to the insurers, coverage was confirmed, albeit on the basis of the 2005 policy terms and conditions as the initial notification had been made prior to expiry of that policy. As Low Risk maintained the same policy limits in both years, this did not present them with a problem. The claim was subsequently settled for HK\$20m, inclusive of Megabux's costs. Both the settlement and Low Risk's costs of HK\$5m were funded by their insurers.

High Risk's position was rather different. When Megabux collapsed in late 2005, it realised the potential for a future claim but decided to say nothing to its PII insurers on renewal at the end of December 2006. However, it increased its indemnity limit to HK\$100m for the 2006 policy because it considered a claim to be quite likely.

High Risk duly notified the claim to its insurers on a timely basis but they did not immediately confirm coverage. Instead, they reserved their rights under the 2006 policy and launched an investigation into the reasons for the large increase in the indemnity limit, suspecting that High Risk must have had an inkling that a claim was possible. They did not accept High Risk's explanation that the non-disclosure prior to renewal was inadvertent and sought to avoid the 2006 policy on the grounds that High Risk had acted fraudulently.

## Consequences for High Risk

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High Risk ended up suing its insurers, seeking a declaration that it was entitled to coverage under the 2006 policy. However, prior to discovery, High Risk eventually discontinued the action on a "walk-away" basis when a damaging internal email came to light which made it obvious that the non-disclosure had been intentional. Thus it did not have the benefit of any insurance at all and incurred costs of HK\$3m in pursuing its insurers. Moreover, in its action with Megabux, High Risk insisted on taking the case to trial,

despite receiving (and turning down) an offer to settle for HK\$10m, inclusive of costs. The judge ruled against High Risk and awarded Megabux damages of HK\$50m. Costs were also awarded against High Risk. These were later assessed at HK\$12.5m. High Risk decided to appeal

## Risk management

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A fanciful story? Perhaps, but members of the accountancy profession in Hong Kong do adopt strongly contrasting attitudes towards the issue of risk management. Of course, most CPA firms will have well-developed and sophisticated risk management procedures in place. Inevitably, however, there will be some who do not.

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