ORD 13/0036, ORD 13/0037 & ORD 13/0041

IN THE HIGH COURT OF JUSTICE OF THE ISLE OF MAN
CIVIL DIVISION
ORDINARY PROCEDURE

Between:

HEATHER CAPITAL LIMITED (in liquidation)	Claimant
and	
KPMG AUDIT LLC	Defendant
and	

IN THE MATTER of the Defendant's Application Notice dated 23rd September 2014

Judgment of His Honour Deemster Corlett
delivered at Douglas on 17th November 2015

Introduction

1. This judgment concerns the Defendant's application dated 23rd September 2014 to strike out the whole or part of the Claimant's claim on the grounds that it discloses no reasonable grounds for bringing the claim or is otherwise likely to obstruct the just disposal of the proceedings (Rule 7.3(2) of the Rules of the High Court 2009).

2. The hearing of the application took place on 22nd and 23rd September 2015 when the Claimant was represented by Mr Simon Salzedo QC and the Defendant by Mr Rhodri Davies QC.

3. Heather Capital Limited ("Heather") operated an investment scheme which lent money in the property market. It operated as an exempt international collective investment scheme, as the "master fund" with a master fund/feeder fund structure. The scheme was suspended in January 2009 and Heather was ordered to be wound up by the court in July 2010. The Defendant, KPMG Audit LLC ("KPMG") is, and was at all material times, the Isle of Man member firm of KPMG International Cooperative, a global network of professional firms providing audit, tax and advisory services. KPMG was Heather's auditor from August 2006. In these proceedings, Heather's liquidator alleges that, in the course of its audits KPMG negligently failed to detect and report frauds and imprudent lending by Heather's management and as a result thereof Heather and its shareholders suffered substantial losses after August 2007. It is said, particularly by KPMG, that a key matter for consideration is that Heather was severely affected by the dramatic falls in the property market which occurred in 2007/2008.

4. The Liquidator has issued three sets of related proceedings against KPMG based on these allegations of professional negligence. In the first action, the Liquidator seeks to recover damages on behalf of Heather in respect of its own alleged losses ("the Heather Proceedings"). In the other two actions, Heather seeks damages as assignee

of its shareholders, Aarkad plc ("Aarkad") and Lomond Capital LLC ("Lomond") in respect of losses allegedly suffered by them ("the A&L Proceedings"). The total damages claimed exceed £100 million, although KPMG allege that there is substantial duplication between the losses sought to be recovered in the three sets of proceedings.

Factual Background

5. The factual background, based on the Liquidator's pleadings, which must for these purposes be assumed to be accurate, is as follows.

6. Heather was incorporated in the Isle of Man on 31st August 2005. Its two executive directors were Mr Gregory King and Mr Santo Volpe. Both are alleged by the Liquidator to have been fraudsters, although it is right to say that, so far as I am aware, neither have been charged with any criminal offence.

7. Heather had two 'feeder' companies, Aarkad, an Isle of Man company, and Lomond, a Delaware company. Aarkad and Lomond raised funds from international investors who were their shareholders and then invested them in Heather. Together they owned the entire share capital of Heather (save for 100 management shares owned by Heather's promoter).

8. Heather itself made loans to:

   (1) a number of Special Purpose Vehicles ('SPVs') incorporated in Gibraltar;
   (2) Mathon Plc ("Mathon"), an English company; and
   (3) Bathon Limited ("Bathon"), a Scottish company.

9. The ostensible function of the SPVs, of Mathon and of Bathon was to make secured loans to third parties to fund early stage property developments. However, the Liquidator says that this is not entirely what occurred, particularly in the case of the SPVs and Bathon.

10. KPMG became Heather's auditor pursuant to a letter of engagement dated 3rd October 2006. KPMG also became the auditors of Aarkad during 2005 and Lomond during 2006. KPMG was the auditor of the financial statements of Heather, Aarkad and Lomond for various accounting periods between 2006 and 2008, namely the 17, 16 and 12 month period ending 31st December 2006 (Lomond, Heather and Aarkad respectively), the 9 month period ending 30th September 2007 (all 3 companies), the 12 month period ending 31st December 2007 (all 3 companies) and the 12 month period ending 31st December 2008 (all 3 companies). KPMG also undertook an unaudited interim review for the 6 month period ending 30th June 2008 (all 3 companies).

11. KPMG was never the auditor of the SPVs, Mathon or Bathon. Mathon and Bathon were audited by Gerber, Landa & Gee ("GLG"), a Scottish firm of accountants.

12. Between October 2005 and February 2007 Heather made loans of approximately £95 million to ten of the SPVs. According to the Liquidator these loans ("the SPV Loans") were fraudulent in that they were not genuine investments but a means for Messrs King and Volpe to divert money from Heather for purposes of their own.

13. This fraud took place before KPMG's alleged negligence. The earliest date from which the Liquidator claims any losses against KPMG is 10th August 2007 and the last of the SPV Loans had been made by Heather by February 2007. In consequence, the Liquidator recognises that KPMG cannot be held responsible for any losses suffered on the SPV Loans themselves.

14. During the course of KPMG's audit work it discovered, in March 2007, that the documentation for the SPV Loans was unsatisfactory and it raised questions as to how it could be satisfied as to the validity of those loans.

15. In the meantime the SPV Loans were repaid via a Glasgow law firm called Cannons Law LLP ("Cannons") over the period from April to June 2007. The Liquidator alleges that these repayments were achieved by circular loans made by Heather that were routed through Mathon and Bathon and ultimately back to Heather. Thus, the money originally advanced to the SPVs was never repaid. Instead, new money was advanced to Mathon and Bathon and routed back to Heather via the client account of Cannons.

16. It is common ground that the making of circular loans did not itself lead to any net loss for Heather because it received back what it lent out. Any loss was therefore avoided or Heather has to give credit for gains in the form of recoveries of the repayments of the earlier loans which completely offset its losses under the later circular loans. Accordingly, the Liquidator accepts that KPMG is entitled to credit in respect of the repayments made. The Liquidator does however say that the circular flow of money will have artificially increased the Net Asset Value, or NAV, upon which Sargon Capital Ltd ("Sargon"), and thus Mr King (who owned Sargon), depended for the calculation of administration fees. To that extent the circularity is by no means of neutral effect.

17. Essentially Mr Volpe took the blame for the unsatisfactory state of affairs concerning the SPV Loans and he resigned as a director of Heather on 1st September 2007. Mr King, however, remained.

18. KPMG qualified its audit opinions for the accounts of Heather, Aarkad and Lomond for the audit periods ending 31st December 2006 and the 9 months to 30th September 2007 to reflect that it was unable to verify and reconcile the SPV Loans (albeit that these had now, ostensibly, been paid off). These audit opinions were issued on 17th December 2007.

19. On 29th February 2008, Bathon (which was not and had never been a subsidiary of Heather) was sold, ostensibly in an arm's length transaction, and a debt of £72 million from Bathon to Heather was repaid. The Liquidator alleges that this was not in truth an arm's length transaction (but was orchestrated by Mr King) and that the majority of the £72 million apparently repaid to Heather was funded by further circular loans routed through Mathon. Once again, the Liquidator accepts that KPMG is not responsible for losses suffered directly by reason of the alleged fraud in relation to Bathon.

20. Mathon, meanwhile, was conducting a genuine lending business with funds provided by Heather. The Liquidator does not allege that all of the loans advanced by Mathon were illegitimate. The Liquidator has alleged, however, that many, but by no means all, Mathon loans were 'impaired' (see paragraph 42 of the Liquidator's Reply). The Liquidator defined the impaired category in Appendix A to a letter of 23rd May 2014 as

including loans which did not comply with Heather's lending criteria, or were made to an uncreditworthy borrower or where the value of the security *"proved inadequate"*. Other loans by Mathon were characterised as 'good' loans, which were repaid for at least 80% of the value of the loans.

21. Heather suspended its investment fund in January 2009. It then entered into insolvent liquidation in July 2010 and Mr Paul Duffy of Ernst & Young was appointed as Liquidator at that time.

22. It is said that Heather would have avoided three types of losses:

    (1) the entirety of the loans advanced by Heather to Mathon after the earliest Relevant Date, totalling up to £86.1 million ("the Heather Loans Claim");

    (2) alleged overpayments of fees to Heather's Administrators (first Abacus, then Capita) based on the overstatement of the Net Asset Value (NAV) of Heather, totalling up to £0.5 million ("the Heather Fees Claim"); and

    (3) the investigation costs incurred by the Liquidator investigating the events that led to Heather's insolvency, of £2.4 million ("the Heather Costs Claim").

23. It is also said that Aarkad and Lomond, in turn, would have avoided three types of losses:

    (1) the entirety of the investments by Aarkad and Lomond in Heather after the earliest Relevant Date of up to £51.3 million ("the A&L Investment Claim");

    (2) the overpayment of fees to Sargon as promoters based on the overstatement of the NAV of Aarkad and Lomond of up to £19.4 million ("the A&L Fees Claim"); and

    (3) the investigation costs incurred by the Liquidator investigating the events that led to Aarkad and Lomond's insolvency, of £2.4 million ("the A&L Investigation Costs Claim").

Procedural History

24. The Liquidator has issued three sets of proceedings. The first was issued on 23rd July 2013 by which the Liquidator claims damages of up to £90 million due to Heather. Two further claims were issued on 23rd July and 8th August 2013, brought by Heather as assignee of Aarkad and Lomond, by which the Liquidator claims damages of up to £73 million. There is a single set of statements of case in the Aarkad and Lomond claim which are separate from those in the Heather claim.

25. Particulars of Claim were served on 19th November 2013, followed by KPMG's Request for Further Information and Defences on 28th March 2014. Since this strike-out application was filed in September 2014, there have been several witness statements, culminating in that of John Swanson MacKenzie, solicitor for the Liquidator, dated 21st August 2015. Lengthy skeleton arguments were filed in August and September 2015 and the court had before it six files of various sizes and a substantial number of authorities.

26. While I have considered the relevant witness statements (the Second and Third Statements of Kathryn Elizabeth Ludlow and the First and Second Statements of Mr MacKenzie), for my part I question whether they are properly admissible; firstly, on the basis that it is generally the rule in this jurisdiction that no evidence as to the facts is admissible on a strike out application; secondly, on the basis that the statements are almost wholly concerned not with facts but with comment and argument, these being matters which should be reserved for skeleton arguments and oral submissions. Nevertheless, I accept that by a consent order dated 13th November 2014 the parties were given permission to exchange evidence, no objection has been taken to its admission, and I have considered it. Whether this is the correct approach in law is a matter for another day.

Brief Summary of the Respective Cases on this Application

27. It is helpful at this stage to set out a brief summary of the parties' positions on this strike-out application, taken from their respective skeleton arguments.

KPMG's Case

28. On this application KPMG submits, in summary, that the Liquidator's claims should be struck out because, as is established by the authorities, an auditor is not responsible (as a matter of legal causation and/or scope of duty) for losses claimed solely on the basis that, "*but for*" the auditor's negligence, the company would have ceased trading and therefore avoided future trading losses (see *Galoo v Bright Graeme Murray* [1994] 1 WLR 1360, CA*; BCCI (Overseas) v Price Waterhouse* (No 4) [1999] BCC 351*,* Laddie J*).* It is also claimed that the A&L Proceedings include inadmissible claims by shareholders for reflective loss (contrary to *Johnson v Gore Wood* [2002] 2 AC 1*).*

29. In addition, it is submitted that the Liquidator's pleadings do not plead a proper case in negligence in respect of the key category of allegedly imprudent lending. In a witness statement by his solicitor filed, it is said, extremely late (21st August 2015), the Liquidator has apologised for previous statements in which he inaccurately denied the use of hindsight and has now admitted that he has not properly set out the extent to which he says the accounts audited by KPMG were over-stated at the time. Nor has he set out what he says could have been seen to be amiss with the loan book at the time. The Liquidator now proposes to remedy these defects, not by a pleading but through witness statements or expert reports to be served at some point before trial. This proposal it is claimed is insufficient and unacceptable, and in any event still does not grapple with the fundamental flaws summarised in the previous paragraph.

30. The Liquidator makes three principal allegations of negligence against KPMG:

- The SPV Allegation –

  (1) the Liquidator alleges that KPMG became aware that, in relation to the SPV Loans, the executive management of Heather were (a) seeking to deceive KPMG by providing false information or fabricated documents; and (b) may have operated the business dishonestly and been perpetrating a fraud on investors. It is said that KPMG failed to take appropriate action. In particular, the Liquidator alleges that KPMG failed to discover enough and that it should have detected and reported that Mr King and Mr Volpe were

operating a "Ponzi" scheme under which repayments to Heather were funded by Heather itself and that the SPV Loans were not genuine;

(2) KPMG denies this (and all other) allegations of negligence. However, in the light of the Liquidator's Voluntary Particulars, KPMG accepts, for the purposes of this application only, that the Liquidator has pleaded a sufficient case of negligent conduct in respect of the SPV Allegation, albeit that no complete cause of action results.

- The Bathon Allegation -

(1) the Liquidator alleges that KPMG should have detected (as part of its review of GLG's audit of Bathon) that, as at 30th September 2007, the entirety (alternatively substantially all, or a very substantial part) of the loans made by Heather to Bathon were illegitimate and therefore irrecoverable because they formed part of the circular loans. It is also alleged that KPMG failed to detect that the sale of Bathon in February 2008 was not an arms-length transaction and the purported repayment of Bathon's debt of £72 million to Heather at that time was funded by further circular loans as part of the cover-up;

(2) KPMG also denies this allegation of negligence. However, in the light of the Liquidator's Voluntary Particulars, KPMG again accepts, for the purposes of this application only, that the Liquidator has pleaded a sufficient case of negligent conduct in respect of the Bathon Allegation, albeit that no complete cause of action results.

- The Mathon Allegation -

(1) the Liquidator alleges that KPMG should have detected (as part of its review of GLG's audit of Mathon) that, as at the end of the first audit period (31st December 2006), a very substantial part of the loans made by Mathon were "impaired" and therefore irrecoverable. The Liquidator also alleges that, after the first audit, KPMG should have detected (again, as part of its review of GLG's audits) that Mathon had made further "good", "impaired" and "illegitimate" loans funded by Heather (categorisations explained in Appendix A to the 23rd May 2014 letter);

(2) as set out below, KPMG submits that the claim based on the Mathon Allegation is not properly pleaded, such that there is no case to meet. Indeed, the Liquidator now accepts that he has not set out what would or could have been known to the parties at the time. In any event, the losses claimed also fail on the grounds of scope of duty and causation and the Mathon Allegation should be struck out for that further reason.

31. KPMG submits that the Heather Loans Claim should be struck out in whole or part because:

(1) the Liquidator's entire damages case is put on the basis that, "*but for*" KPMG's alleged negligence, Heather would have ceased to carry on business and avoided making any loans after the various Relevant Dates. It is well established by the authorities that "*but for*" causation is not sufficient to

establish liability against professional advisers for losses from continuing trading as claimed. Auditors are not underwriters of their clients' future business activities and losses that fall outside the scope of the auditors' duty are irrecoverable in law. The whole of the Heather Loans Claim should be struck out on grounds of absence of legal causation and scope of duty;

(2) alternatively, the individual allegations underpinning the Heather Loans Claim should be struck out because:

(a) the SPV and the Bathon Allegations (i.e. the fraud allegations) are irrelevant because (i) they are not alleged to have led directly to any loss recoverable from KPMG; and (ii) they cannot form the basis for an indirect claim for continuing trading losses; and

(b) the Liquidator has failed to plead a tenable case of negligence with regard to the Mathon loan book. In particular, there is no pleading of what KPMG (or GLG as the auditors of Mathon) ought to have found (without the benefit of the Liquidator's hindsight) in order to alert them to the alleged defects in the Mathon loan book at the time of conducting the audits. The Liquidator now recognises that he needs to identify the material misstatements based on the information available at the time but suggests that it is sufficient for him to do so at some point before trial, without amending his pleading. This is unacceptable.

32. KPMG submits that the A&L Investment Claim should be struck out both because it is a claim for losses from continuing trading advanced solely on the basis of "*but for*" causation and because it is a claim to recover shareholders' reflective losses that constitutes an inadmissible duplication of Heather's own claim for damages.

33. KPMG further submits that the Heather and A&L Fees and Investigation Costs Claims are also an impermissible attempt to recover losses on the basis of "*but for*" causation only and should be struck out. In addition, the fees claims depend upon establishing negligence by KPMG with regard to the state of the Mathon loan book (where, as pointed out above, there is no tenable pleading).

The Liquidator's Case

34. These are claims by audit clients against their own auditors, brought concurrently in contract and tort. No issue arises to potential duties to any third parties. The claims are (at the very least) strongly arguable on the merits. For example, KPMG's own working papers show that in the course of auditing Heather, Aarkad, and Lomond KPMG discovered that (a) they were being provided with information for the purpose of their audit that was known to be false; and (b) there was evidence which appeared to show that the executive management of Heather were operating the business of Heather in a dishonest manner and may have been perpetrating a fraud upon investors (something which turned out to be true). Indeed, so serious were KPMG's concerns that in mid-2007 they considered resigning as Heather's auditors and/or making a report to the Isle of Man Financial Supervision Commission ("FSC"). In the event, however, notwithstanding these "*red flags*", KPMG decided not to resign or to make a report to the FSC, but instead they proceeded to sign Heather's financial statements with only a limited qualification. The result was that Heather continued to

advance further loans which by their very nature were bound to be irrecoverable. Ultimately, Heather suspended its investment fund on 26th January 2009 and entered into insolvent liquidation on 7th July 2010.

35. Against this background, Heather submits that the claims are manifestly not suitable to be determined on a strike out application, especially not on the fact sensitive basis of an argument as to legal causation or an arid dispute as to what is or is not pleaded. It is submitted that these are very substantial professional negligence proceedings which raise a number of complex issues of fact and law.

36. Since issuing the Application KPMG have dropped a number of the grounds of challenge raised therein. KPMG were right to do so, but the parts of the Application which remain live are equally devoid of merit. In particular, much of KPMG's remaining attack rests upon their argument that the losses claimed by Heather fall outside the scope of the duties which KPMG owed to Heather, Aarkad, and Lomond. The question whether the losses claimed by Heather fall within the scope of KPMG's duties (as Heather contends that they do) is a complicated question of fact and law and one which is so fact-sensitive that it must be determined at trial. In support of their strike out application KPMG rely almost exclusively upon the decision of the English Court of Appeal in *Galoo v Bright Graeme Murray* [1994] 1 WLR 1360. Even if *Galoo* was rightly decided, however, it has always been distinguished rather than followed on strike out applications and the present claims are themselves readily distinguishable on their facts.

37. On the undisputed factual background for the Application the Liquidator claims that KPMG negligently failed to report significant fraudulent activity by Heather's management relating to the SPVs and Bathon. This failure was a cause of Heather continuing to make illegitimate and impaired loans to Mathon plc (which later became Mathon Limited). This is a sufficient basis for all the losses claimed.

38. Heather has also sufficiently pleaded a claim that KPMG negligently failed to report that Heather's loans to Mathon were impaired and substantially irrecoverable. This was also a cause of Heather continuing to make improper and impaired loans to Mathon and is a further sufficient basis for all of the losses claimed.

39. There is no fundamental defect or omission in Heather's statements of case.

40. Many of the points made by KPMG go to the assessment of loss, not to the existence of a cause of action and they are not suitable for determination on a strike out application.

41. The reflective loss argument fails because KPMG owed separate duties as auditor of the three companies who now make claims.

42. In brief summary, in the Heather Claim Heather alleges that KPMG was negligent in:

- failing to make a prompt report to the non-executive directors, the FSC, or the Isle of Man Financial Crime Unit;

- failing to take any or any adequate steps to assess the recoverability of the loans made by Heather, for example by failing properly to assess the adequacy of the security which the borrowers from Heather had purportedly obtained in respect of the onward loans that they made;

- relying upon, and not properly reviewing, the audit work carried out by GLG in respect of Mathon and Bathon; and/or

- signing Heather's accounts (which were materially misstated) with only a limited qualification.

43. Heather has pleaded a series of alternative dates on which KPMG were negligent between 10th August 2007 and 12th May 2009.

44. Heather alleges that as a result of KPMG's negligence, Heather continued to advance irrecoverable loans which it would not otherwise have done. The loans which Heather continued to advance constitute the main head of loss which Heather claims.

45. Heather claims further two other heads of loss, namely (a) certain administration fees which it paid to its administrators ("Abacus" and "Capita" respectively); and (b) the costs which the Liquidator has incurred in investigating the events that led to its insolvency.

46. The Aarkad and Lomond Claim proceeds on a similar basis. The documents on the audit file which Heather has seen to date show that KPMG did not carry out any additional or independent work in relation to the Aarkad and Lomond accounts. Instead, KPMG relied entirely upon the work which it had carried out in relation to Heather's accounts. That work was negligent for the reasons alleged by Heather in the Heather Claim. Again, three main heads of loss are being claimed in the Aarkad and Lomond Claim, the principal one of which represents the value of the investments made by Aarkad and Lomond in Heather after the earliest date on which KPMG are found to have been negligent. So far as fees are concerned, Heather claims qua assignee for administration, management, and promotion fees that were paid by Aarkad and Lomond to Sargon.

Strike Out – The Test to be Applied

47. The test which the court must apply to applications of this nature has been clearly stated. It has been the law for many years in this jurisdiction that claims will not be struck out unless they are effectively unarguable with no chance of succeeding (see *Davis v Radcliffe* [1987-89] MLR 341). There have been several judgments which have addressed the particular issue of the test which ought to be applied when the court is faced with issues of causation in the context of professional negligence claims. It may also be relevant to consider those judgments which address the test to be applied in cases where it is argued that the law is in a state of development or transition or where novel questions of law are raised. Further, there are judgments which deal with the test to be applied in "fact sensitive" scenarios.

48. I begin with the decision of the New Zealand Court of Appeal in *Sew Hoy & Sons Ltd v Coopers & Lybrand* [1996] 1 NZLR 392. McKay J at page 394 lines 1 – 13 sets out the general test to be applied in strike out applications:

> "*Both counsel accepted that the test to be applied on an application to strike out is well settled, and is conveniently summarised in South Pacific Manufacturing Co*

Ltd v New Zealand Security Consultations & Investigations Ltd [1992] 2 NZLR 282. The question is whether or not on the material before the Court and in the light of the present state of evolution of the common law, the case as pleaded is so clearly untenable that the plaintiff cannot possibly succeed. The jurisdiction is one to be sparingly exercised, and if the court is left in doubt the application must be dismissed. If disputed questions of fact arise, the case must go to trial. If the claim depends on a question of law capable of decision on the material before the court, the court should determine the question even though extensive argument may be necessary to resolve it. See per Richardson J at p305 and per Casey J at p311. It was also accepted that if a pleading is capable of being saved by amendment, a plaintiff should ordinarily be given an opportunity to amend."

49. Thomas J then dealt specifically with the issue of strike out applications where there are questions of causation in play (see page 407 lines 27 to 48):

> "*Questions of causation are probably particularly unsuitable for consideration on the basis of the pleading alone. As stated by Sir Anthony Mason CJ in March v E & M Stramare Pty Ltd (1991) 171 CLR 506, at p515; "The common law tradition is that what was the cause of a particular occurrence is a question of fact which 'must be determined by applying common sense to the facts of each particular case', in the words of Lord Reid: [Stapley v Gypsum Mines Ltd [1953] AC 663 at p681]. "A full grasp of the facts is imperative. Experience has demonstrated time and again that the answer to the question of whether there is a nexus between the breach of the defendant and the loss suffered by the plaintiff and, if so, what it is, then tends to fall into place. Indeed, if the question whether there is a casual connection between the wrong-doing and the damage is to be resolved by the application of common sense, it is difficult to see how that question properly can be approached in advance of the evidence. Common sense thrives on hard facts, not abstractions.*
>
> *This is not to say that a claim should not be struck out if it is clearly untenable on the pleadings and the question of law is one which can stand in isolation from the facts giving rise to it. In such circumstances it has always been accepted that the issue should be determined and the litigants spared the cost and inconvenience of a full trial. But, exercising the caution of which I have spoken, I am not satisfied that the company's claim in this case is one which is so clearly untenable on the pleading that it should be struck out or that the question of law can properly be determined in advance of the evidence."*

50. The next case chronologically is that of *Electra Private Equity Partners v KPMG* [2000] BCC 368 where the Court of Appeal per Auld LJ addressed the issue of strike out in the context of an area said to be "in a state of transition". See page 387 lines B to G:

> "*Actions of negligence against auditors and other professional advisers engaged by a third party are a notable example of facts-sensitive cases where the law is still in a state of transition and in which courts should normally take particular care before determining the matter against the plaintiff before the full facts are known. (See Peach Publishing Ltd v Slater as an example of the scope for difference of judicial views in this field even after full examinations of the facts at trial and on appeal) Chadwick LJ underlined this need for caution most recently in Coulthard v Neville Russell [1998] BCC 359 at p 369B-C:*

'the liability of professional advisers, including auditors, for failure to provide accurate information or correct advice can, truly, be said to be in a state of transition or development. As the House of Lords has pointed out, repeatedly, this is an area in which the law is developing pragmatically and incrementally. It is pre-eminently an area in which the legal result is sensitive to the facts. I am very far from persuaded that the claim in the present case is bound to fail whatever, within the reasonable confines of the pleaded case, the facts turn out to be. That is not to be taken as an expression of view that the claim will succeed; only as an expression of my conviction that this is not one of those plain and obvious cases in which it could be right to deny the plaintiffs the opportunity to attempt to establish their claim at a trial.'

It is true that a judge may reject pleaded allegations if he is satisfied that they are manifestly incapable of proof; see Morgan Crucible Co plc v Hill Samuel & Co Ltd [1991] BCC 82 at p87C; [1991] Ch 295 at p314B per Slade LJ and that he has some latitude as to inferences to be drawn from pleaded allegations of primary fact; see BCCI v Price Waterhouse, per Sir Brian Neill at [1998] BCC 617, p620B; [1998] PNLR 564, 567F-G. However, he should always beware of attempting to determine the issue solely on the evidence before him without regard to what other evidence might emerge when discovery has been given and the issues of fact are subjected to the rigorous scrutiny of a full trial. I believe that this is the error into which Carnwath J fell here, and which Master Moncaster with due and appropriate caution avoided. Even, allowing for the unsatisfactory nature of some of Electra's affidavit evidence before the judge, it was not such as could entitle him safely to reject it or to construe it against Electra as he did in advance of discovery from KPMG and SKC, oral evidence from Mr McConnell and Miss Farlow and cross-examination of Mr Lynch and Mr Gibbons."

51. In *Independents' Advantage Insurance Co v Cook* [2004] PNLR 3, it was said, in the context of an application to strike out the claim, that the law in respect of the liability of professional advisers, including auditors, for failure to provide accurate information or correct advice, was in a state of transition or development and the right course, unless on the facts the case was plainly and obviously within decided authority, was said to be to let the matter go to trial so that the principles in this field of law can be developed incrementally on the basis of a full appreciation of the actual facts (see page 53 para 17).

52. Similarly, in *Equitable Life Assurance Society v Ernst & Young* [2004] PNLR 16, it was held that not only was the power of summary disposal not intended for cases where there were issues which needed to be investigated at trial, but also that striking out was not appropriate in a claim concerning an area of developing jurisprudence.

53. The Court commented at page 300, paragraph 107 that the law relating to the limitation of the scope of the legal consequences of negligence or of legal responsibility for negligence "*is at present in a state of development and flux, and sensitive to the facts*".

54. Finally, in *Man v Freightliner* [2004] PNLR 19, Cooke J held that the authorities on the scope of an auditor's duties demonstrated the need for the determination of the facts

of any particular case before ascertaining how the questions of legal principle were to be applied.

55. I am assured by counsel that there are no later cases which have sought to vary this approach.

The Issues

56. This being a strike-out application, there is no dispute that for these present purposes the Claimant has an arguable case on negligence. Mr MacKenzie reminds us in his statement dated 21st August 2015 at paragraph 8 that KPMG is no longer pursuing the strike out application insofar as it concerns the alleged failure by the Liquidator to identify failings by KPMG in its conduct of the audit. The main dispute between the parties at this time centres on issues of causation. Furthermore, it seems to me that the essence of this application may be distilled to the court providing answers to the following questions.

- Firstly, is the Claimant's case that there is a casual link between the alleged negligence and the claimed heads of loss sufficiently pleaded as a matter of law?

- Secondly, if such a link is not sufficiently pleaded, might an amendment to the Claimant's pleadings suffice to remedy the situation?

- Thirdly, is the quantum claim in respect of the Mathon loan book so inadequately pleaded or particularised that it ought to be struck out?

- Fourthly, should the claim of the shareholders of Heather be struck out as being a claim for unsustainable reflective loss?

- Fifthly, is the quantum claim in respect of the Mathon loan book unsustainable and should thus be struck out insofar as it purports to claim for losses arising from the impact of market forces which it is said were causative of the Claimant's loss irrespective of the alleged negligence?

- Sixthly, is the claim for investigative fees so weak that it should be struck out?

- Seventhly, are the allegations relating to Bathon and the SPVs irrelevant to the claim, such that they should be struck out?

57. My answers to these questions may shortly be summarised as follows:

58. As to the first question I am satisfied that, on an examination of the Claimant's pleadings as a whole, there is a sufficient pleading of legal causation which goes beyond "but for" causation. If I am wrong on this point I am satisfied, in answer to the second question, that suitable amendments could readily be made to the Claimant's pleadings. I deal with these issues in more detail below.

59. As to the Mathon loan book claim, in brief summary Mr MacKenzie explains that in an earlier witness statement he had asserted that it was incorrect to claim, as had KPMG, that the assessment of the Mathon loan book had been "*with the benefit of hindsight*". He had asserted that this was incorrect because the Liquidator had sought to reconstruct the documentation and knowledge that was available to the company, and

therefore to the Defendant, at the time the lending was made. He now says that his assertion was inaccurate. He states (at paragraph 34):-

> "*The Liquidator has instructed my firm to undertake a valuation exercise of the Mathon loan book at relevant historic dates. The first stage of that exercise has been to instruct independent valuation experts to value the properties over which security was granted in favour of Mathon in respect of the lending advanced to the borrower. The second stage will be for independent accounting experts to assess, in light of the valuations obtained and all other relevant information, such as the ranking of that security and any other securities in place (such as personal guarantees), the value that should have been placed on each loan in the Mathon loan book. The outcome of this exercise will permit a more precise estimate to be made of the material misstatement to the accounts of Heather as a result at each relevant accounting date.*"

60. Therefore, as to the third question, while there is considerable uncertainty as to the pleading of quantum in respect of the Mathon loan book, I am satisfied by reference to Mr MacKenzie's statement dated 21st August 2015 that the Claimant is engaged in the process of remedying these deficiencies such that there will be a satisfactory pleading. A time limit should be placed on the date for this work to be completed. It is most important that definitive clarity be provided so that the Defendant knows the nature of the case it has to meet.

61. It is somewhat surprising to see the Heather Loans Claim pleaded in a lengthy letter, although Mr Davies did not strongly object to this method of proceeding. What is certainly unsatisfactory is to see the figures set out in the letter of 23rd May, 2014 (also known as the "quantum letter") substantially disclaimed and abandoned, principally it seems because the Liquidator had approached the exercise of valuing the properties in question with the benefit of hindsight, rather than as they were at the time the loans were made.

62. Related to this is the matter of whether there is a satisfactorily pleaded case that it was negligent for KPMG not to draw attention to the alleged fact that Heather was advancing loans to an insolvent company (Mathon). Mr Davies argued that the mere making of a loan does not cause a loss. There is, he submitted, no adequate explanation as to why and how the money was in fact lost. The pleading of fraud is, he submitted, entirely unsatisfactory. While I agree that the pleading of fraud seems on the face of it to be unsatisfactory, I am unable to say that the allegation of negligence resulting in continuing to lend to an insolvent borrower is so weak as to permit the Court to strike it out.

63. As to the fourth question, I am satisfied that the law on reflective loss is not such as to lead me to conclude that the A&L Proceedings are merely reflective of the Heather Claim and thus should be struck out. I deal with this issue in more detail below.

64. As to the fifth question, while I harbour doubts as to whether a claim encompassing losses sustained by the operation of the market will ultimately succeed, it seems to me that there is sufficient doubt on the issue as a matter of law as to prevent me from striking out this claim. I deal with this issue in more detail below.

65. As to the claim for investigative fees (question 6), I am in considerable doubt as to how fees incurred in investigating the SPV fraud could be the responsibility of KPMG.

It is also a point which is bound to, and has been, taken by KPMG that the figures for investigation costs appended to the respective Particulars of Claim are identical and seem to be the same regardless of the dates pleaded in the Particulars of Claim. However, I am not sufficiently convinced that this claim (which may result in part from aspects of the transactions in question other than the SPV fraud which led to Heather's insolvency) is so unsustainable that it should be struck out. This is in the end a matter for argument on quantum.

66. As to the seventh question, I am satisfied that the issues relating to Bathon and the SPVs are an integral part of the way in which the claim is pleaded. On that basis these allegations cannot be struck out. The frauds alleged in relation to the SPVs and Bathon are, it seems to me, the important backdrop to the Mathon allegations. It was pointed out during submissions that Mr McGarry of KPMG regarded the Aarkad/Lomond/Heather/Mathon/Bathon structure "*as one great big lending machine*" (see paragraph 47(34) of the Defence). I remind myself that the Liquidator puts his case on the basis that KPMG's negligence caused Heather to continue to trade in the same or similar fraudulent or improper manner which had occurred in respect of the SPVs and Bathon. Furthermore, it seems to me to be conceptually impossible to strike out the allegations relating to the SPVs and Bathon when it is accepted by the Liquidator that they do not give rise as such to any separate head of loss. They do however on the Liquidator's case represent an important evidential background.

67. I now proceed to analyse the issues set forth in what I have called the first, second, fourth and fifth questions in a little more detail.

The Pleadings

68. Attached to the applicant's skeleton argument is what is called the "But For" Schedule. This is designed to reveal that the Claimant has pleaded factual causation but not legal causation. It is common ground that, in order to succeed at trial, the Liquidator must prove both factual and legal causation. In other words, it does not suffice for a claimant to plead a duty of care, negligence and that "but for" the defendant's negligence, losses would not have been suffered. Such a plea is a necessary, but not a sufficient, basis for recovery.

69. As Laddie J said at para 25 of *BCCI (Overseas) v Price Waterhouse* (No 4) [1999] BCC 351:

> *"However [the Claimant] must do more than plead the existence of a duty of care. It must plead an arguable case that the duty is extensive enough to cover the types of loss for which it seeks compensation in this action, that the breach caused the loss and that the loss claimed is not too remote."*

70. While the "But For" Schedule concentrates on certain parts of the Particulars of Claim, it seems to me that, when looked at as a whole, the Claimant's pleadings do satisfactorily plead legal causation.

71. In the Claim Form itself it is said that:

> "... *as a result of the Defendant's negligence the Claimant continued to advance a number of illegitimate and irrecoverable loans which it would not otherwise*

have done; in the premises, the Claimant has incurred substantial losses which it now seeks to recover."

72. This plea is repeated in the final four lines of paragraph 8 of the Particulars of Claim. Whilst I accept that in the section of the Particulars of Claim specifically addressing causation and loss (paras 82 to 87), the words "*but for*" appear very often, there is also the pleading at paragraph 85 that:

> "... *as a result of KPMG's negligence as aforesaid Heather continued to advance loans to Mathon until 26 January 2009 (when it suspended its investment fund) and it did not enter into insolvent liquidation until 7 July 2010."*

I accept Mr Salzedo's submission that these paragraphs constitute a plea of legal, as opposed to merely factual, causation.

73. So far as administration fees are concerned, there is a plea at paragraph 86(b) that "*as a result of KPMG's negligence ... the NAV of Heather was overstated ...*", which caused it to pay a greater amount in administration fees than it would have done if the NAV had been correctly stated. Once again it seems to me that the issue of legal causation in this respect is properly pleaded.

74. When one turns to the Defence, it is clear that KPMG plead that neither Heather nor the FSC nor the FCU would have acted any differently if KPMG had provided the relevant information, and it is pleaded that the sole and/or primary and/or effective cause of Heather's loss was unsuccessful trading, adverse currency movements, adverse property price movements and/or the reduced availability of alternative finance for borrowers from Mathon. It is further pleaded that the losses resulted from the commercial decisions of Heather and that Heather's losses are outside the scope of KPMG's duty, it being no part of an auditor's duty to hold a company harmless from unsuccessful trading.

75. It is interesting to note that these matters are addressed in some detail in the Reply which, at paragraph 45 avers that, had KPMG promptly informed the FSC, the FCU and/or the non-executive directors of Heather of the matters which it had discovered during its audit, then an investigation would have been launched which would have resulted in the removal of Mr King as a director, and/or Heather ceasing to advance loans to Mathon and/or Bathon, and/or the winding-up of Heather.

76. It is further pleaded at paragraph 47 of the Reply that:-

> "*The principal cause (alternatively a very substantial cause) of Heather's losses after 10 August 2007 was its continued lending to Mathon in circumstances where:*
>
> *a. a very substantial part of the amounts advanced to Mathon by Heather were misappropriated (by Mr King and/or others) and/or were used to make loans which were either (i) illegitimate or (ii) impaired at the time they were made; and*
>
> *b. Mathon was insolvent and was unlikely to be able to repay such sums as were advanced to it by Heather."*

77. It is further pleaded at paragraph 50(2) of the Reply that "*KPMG's breaches of duty were an effective cause of the need for investigation by the Liquidator and of the investigation costs.*"

78. It is fair to say that the pleadings in the A&L Proceedings form a similar pattern and that similar arguments are in play.

79. In short, it seems to me on examination of the pleadings as a whole that the Claimant has adequately set forth a case of legal causation and has explained how, as a matter of law, the three heads of loss in the Heather Proceedings (loans advanced by Heather to Mathon; administration fees paid by Heather and investigation costs) have been caused by the alleged negligence. A similar argument applies to the A&L Proceedings.

80. If I am not correct in my analysis, I am satisfied that the Claimant could adequately amend its pleadings to ensure that legal causation and not merely "but for" or factual causation is pleaded.

81. The Claimant's case on causation is set forth at paragraph 80 of its skeleton argument:

> "*80. First, although the fraudulent conduct which KPMG discovered in mid 2007 related to the SPV lending, insofar as Heather continued to advance loans to Mathon which were either fraudulent or impaired (in the sense explained at paragraph 31 of MacKenzie 2, namely that it was lending carried out as part of the wider fraud or to conceal the fraud) Heather contends that those loans represent losses of the kind which KPMG had a duty to protect Heather against. Just as the Court of Appeal in Sasea v KPMG held that the funds misappropriated by the fraudulent employee and other losses in that case were (at least arguably) within the scope of the auditors' duty, so too here Heather's loans to Mathon represent losses which were brought about by the same course of fraudulent conduct which KPMG negligently failed to detect and/or report. Put differently, the present case is distinguishable from Galoo because, just as Tomlinson J held in Temseel, the complaint which Heather makes is not simply that KPMG's negligence caused it to continue to trade, but that KPMG's negligence caused it to continue to trade in a particular (i.e. fraudulent or improper) manner.*"

82. It is also set out in paragraph 56 of Mr MacKenzie's statement dated 21st August 2015:

> "*56. The Liquidator's pleaded case is that the loans advanced by Heather to Mathon (and the investments made by Aarkad and Lomond in Heather) were irrecoverable at the relevant audit dates as a result of the illegitimacy and/or impairment of Mathon's own lending (see for example Heather Particulars of Claim (Volume 1, Tab 4) paragraphs 81[31.12.06] (3)(e) and (f); 81 [30.09.07] (1)(d), (f) and (g); 81 [31.12.07] (1)(a), (f) and (g); 81 [30.06.08] 81 [31.12.08] (1)(a), (b) and (d); 83(4); 84; 86(a); Aarkad Particulars of Claim (Volume 1, Tab 9) paragraphs 37(9); 38(2)(c) and (d); 40 to 43). For this purpose, the degree of impairment to the Mathon loan book which requires to be demonstrated as to the relevant audit dates in order for the losses to fall within KPMG's scope of duty is only such impairment as would have made it clear to Heather that its own lending to Mathon was impaired such that further lending by Heather to Mathon would not be prudent. That would in turn have made it*

clear to Aarkad and Lomond that further investment in Heather would not be advantageous. Based on the investigations described in this witness statement I believe it is clear that at least this degree of impairment is likely to be established at trial."

83. It is also set out in paragraph 2.6 of the "quantum letter" dated 23rd May 2014:

> "*The natural and foreseeable result of that conclusion is that Heather should have ceased trading, and in all likelihood would have done so had the impairment of the value of its loan to Mathon been known to all the directors, or correctly recorded in the financial statements. Given the conclusion on the number of illegitimate and/or impaired loans, and the proportion of Mathon's loan book which these comprised, the Liquidator is seeking to recover all sums advanced to Mathon by Heather after the Relevant Date as loss which flows from the negligence of KPMG.*"

84. It is of course not for this court to tell the Claimant how to plead its case. The frequent references to "but for" causation in the Particulars of Claim have understandably caused the Defendant to challenge the pleading, based on the legal principles pertaining to auditors' liability.

85. In paragraph 41 of the Reply, the Liquidator pleads that "*Heather's primary case in both of these actions is that Mr King and Mr Volpe acted fraudulently.*" The issue is not very much, if at all, advanced by the Liquidator's response dated 23rd May 2014 to KPMG's Request for Further Information, by which it was said:-

> "*The results of the Liquidator's investigations, insofar as they relate to the fraudulent operation of Heather's business by Mr King, is already adequately pleaded in the Particulars of Claim and will be addressed in detail in witness statements in due course.*"

86. It is therefore correct to say that the allegations of fraud against Mr King "*and/or others*" are vestigial and in my view, as with any allegation of fraud, require to be pleaded with far greater particularity.

87. It is important that the pleadings are put into proper order as swiftly as possible in order that the parameters of the proceedings are established and so that the boundaries of, for example, disclosure and expert evidence are delineated. Nevertheless, I am satisfied by an examination of the pleadings as they stand and as they might reasonably and foreseeably be clarified (perhaps by reference to the matters set forth in the MacKenzie statement and the quantum letter) that this is not a case where the claim should be struck out on the grounds that the issue of legal causation has not been adequately pleaded.

<u>*Causation and Trading Losses*</u>

88. KPMG submit that the Liquidator is claiming the entire costs of the existence of Heather, Aarkad and Lomond after 10th August 2007 in the form of the net outflow of funds claimed in the loan claims, the fees paid to their administrators and promoters and the Liquidator's investigation costs, subject to an adjustment made in the fees claims for the effects of a market fall. KPMG submit that this type of claim is impermissible based on the principles set out by the Court of Appeal in the *Galoo* case

(which it is said establishes that trading losses incurred after an auditor's negligence which merely allow a company to continue to trade are irrecoverable) and further that losses incurred by reason of market fluctuations are not recoverable, as established by the House of Lords in the *SAAMCO* case [1997] AC 191. On these bases, KPMG submit that these claims should be struck out.

89. The Liquidator on the other hand says that the lending in question was part of a fraud or to conceal an earlier fraud and that those loans represent losses of precisely the kind which KPMG had a duty to protect Heather against. The Liquidator says that his complaint is not simply that KPMG's negligence caused Heather to continue to trade, but that KPMG's negligence caused it to continue to trade in a particular (i.e. fraudulent or improper) manner. As such the Liquidator says that his claim is readily distinguishable from *Galoo.* As to the issue of losses caused by falls in the property market, the Liquidator's submission is that as a matter of law these may be recoverable as a matter of principle and that whether they are or not will depend upon the evidence.

90. In *Galoo* a parent company made loans to its subsidiaries and claimed to have done so in reliance on the negligence of the subsidiary's auditor in failing to uncover the subsidiary's insolvency. Glidwell L. J. said that it was necessary to establish whether the negligence was the effective or dominant cause of the loss and that this was done "*by the application of the court's common sense.*" The court held that the negligent audit certificate merely created the opportunity for the subsidiaries to incur and continue to incur trading losses, the effective cause being the unsuccessful trading.

91. Upon examination of the way in which the case was pleaded in *Galoo* it is clear that it was alleged that, had the auditors performed their tasks correctly, the insolvency would have been revealed and the companies would have ceased to trade immediately. It is also clear that the claim was for the entire cost of the continuing existence of the company (see page 1368 lines C to H). Glidewell L.J. concludes his judgment on the issues of principle at page 1375B:-

> "*Doing my best to apply this test [the court's common sense], I have no doubt that the deputy judge arrived at a correct conclusion on this issue. The breach of duty by the defendants gave the opportunity to Galoo and Gamine to incur and to continue to incur trading losses; it did not cause those trading losses, in the sense in which the word "cause" is used in law.*"

92. *Galoo* sets forth the uncontentious proposition that the "but for" test is not sufficient to establish causation. It is an exclusionary test serving only to filter out non-causal occasions for the loss. The relevant breach must be held to have been an effective or dominant cause of the loss. However, what was said in *Galoo* about losses incurred from continuing to trade has proven to be more contentious. In *Sew Hoy,* the New Zealand Court of Appeal, per McKay J, observed that *Galoo* should not be regarded as deciding, as a matter of law, that a decision by a company trading at a loss that it will continue trading can never, without something more, be a cause of further loss. As McKay J said at page 400, line 44, "*The contrary is a familiar fact of commercial experience.*"

93. McKay J continued at page 404, line 10 that:

> *"The question which arises is whether a bare allegation that trading continued as a result of the breach is sufficient to link the breach with the trading loss subsequently incurred."*

And then at page 404 line 20:

> *"The factors which caused or contributed to that result are not asserted. What the appellant must allege in an informative way is that the loss suffered is to be attributed, not merely to having traded, but to the breach of contract or duty of care."*

And finally at page 404, line 32:

> *"It is the cause of the loss, and its relationship to the breach which is critical and which must be spelt out."*

94. Thomas J summarised the issue before the court as being:

> *"... whether a company which continued trading after its auditors negligently certified its accounts as true and fair without qualification can recover from the auditors the trading losses which it then incurred"* (page 404, line 49).

At page 409, line 44 he said this:

> *"If it can be said that the company not only continued to trade, but continued to trade in a certain way as a result of the auditor's breach and that the way in which it traded is responsible for the trading losses, it is at least arguable that a causal link is established."*

And at page 411, line 7:

> *"It is the absolute terms of the prohibition against the recovery of trading losses in* Galoo, *and the suggestion that the causal connection can never be established which is the most troubling feature of that decision. It is one thing to say that trading or trading losses are neutral; it is quite another to say that they can never be caused, in the sense that the law uses the word "cause", by a breach of the auditor's duty to properly verify the accounts".*

And finally at page 412:

> *"The critical question is whether that causal connection has been adequately pleaded."*

95. I respectfully agree that this is indeed the crucial question in this case also. I might comment that it does seem odd that an occasion was not sought or granted to permit the amendment of the pleadings in *Galoo.*

96. In *BCCI v Price Waterhouse*, Laddie J applied *Galoo* and decided on an application to strike out the claim that the losses claimed were simply losses occasioned by BCCI's continuing to trade. He said at page 365, line H to 366B:

> "*The losses are only the consequence of continued trading. In particular he points out that it has never been suggested that any of the guarantees relied on were touched by fraud, illegality, wrongdoing or any other imprudence. As far as the pleadings are concerned they are the sort of transactions which it was proper for Holdings to enter into. Similarly in relation to all the investments in and loans to the non-plaintiff subsidiaries, nowhere has it been pleaded or asserted that those subsidiaries' activities were tainted by imprudences or wrongdoing nor is it suggested that there was anything untoward in investing in the subsidiaries or in extending loans to them. There is nothing pleaded to suggest that any one of them was improper. Indeed, as far as the Holdings pleadings are concerned, they could have been commercially astute and laudable investments and guarantees. As para. 49.7 of the statement of claim asserts, all of these transactions 'proved loss making by reason of the insolvency' of BCCI. It is not asserted that they were in any sense improper.*"

And similarly, at page 371, paragraph 66:

> "*In my view there is no arguable case that the EW defendants' duty of care to Holdings, whether arising out of its appointment to audit the consolidated or unconsolidated accounts, extends as far as to cover a liability for deficits arising out of legitimate but loss-making business activities, such as investing in subsidiaries and guaranteeing loans. None of those activities was asserted as being either touched by fraud or imprudence. They are not pleaded as being a continuation of a type of business which was touched by fraud or imprudence which the EW defendants should have discovered and disclosed. They are simply losses occasioned by BCCI's continuing in trade. This conclusion can be expressed in alternative ways. The EW defendants' duty of care did not extend this far. This is not the kind of damage from which they had to take care to save Holdings harmless. Alternatively, the pleaded losses were not caused by the breaches alleged. They were caused by continued trading. The alleged negligence of the EW defendants, if proved at the trial, was just one of the factors which resulted in Holdings continuing to trade. Save in this respect it is not alleged to have played any part in generating the losses for which Holdings seeks compensation. This conclusion applies to investments in both the plaintiff subsidiaries and non-plaintiff subsidiaries. I do not understand Mr Powell to suggest that there is any difference in principle to be applied to these two groups nor any material difference in the facts.*"

The claim was struck out.

97. By way of contrast, in *Sasea Finance Ltd v KPMG* [2000] BCC 989, *Galoo* was distinguished on the basis that the four transactions in question were fraudulent or irregular:

> "*Each in its own way was the kind of transaction against the risk of which KPMG had a duty to warn.*" (page 995F).

98. *Galoo* was also distinguished in *Temseel Holdings Ltd v Beaumonts* [2002] EWHC 2642 (Comm) where Tomlinson J said at paragraph 52 that:

> *"The complaint made by the company is not simply that it was allowed to continue trading, but rather that in reliance upon the figures which had been supplied to it and represented to be correct it continued to trade in a particular manner."*

99. This approach seems to me (as one would expect to be the case) to be consistent with the landmark decision of the House of Lords in *Caparo plc v Dickman* [1990] 2 AC 605 in which Lord Bridge, at page 626C-E said this:

> *"No doubt these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the protection of his interest. But the crucial question concerns the extent of the shareholder's interest which the auditor has a duty to protect. The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders."*

100. Lord Oliver said this, at page 630C-G:

> *"My Lords, the primary purpose of the statutory requirement that a company's accounts shall be audited annually is almost self-evident. The structure of the corporate trading entity, at least in the case of public companies whose shares are dealt with on an authorised Stock Exchange, involves the concept of a more or less widely distributed holding of shares rendering the personal involvement of each individual shareholder in the day-to-day management of the enterprise impracticable, with the result that management is necessarily separated from ownership. The management is confined to a board of directors which operates in a fiduciary capacity and is answerable to and removable by the shareholders who can act, if they act at all, only collectively and only through the medium of a general meeting. Hence the legislative provisions requiring the board annually to give an account of its stewardship to a general meeting of the shareholders. This is the only occasion in each year upon which the general body of shareholders is given the opportunity to consider, to criticise and to comment upon the conduct by the board of the company's affairs, to vote upon the directors' recommendation as to dividends, to approve or disapprove the directors' remuneration and, if thought desirable, to remove and replace all or any of the directors. It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly,*

wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."

101. Their Lordships' references to misappropriation of funds by a director and wrongdoing are, it seems to me, particularly apposite in the context of the allegations pleaded in this claim. At the heart of the purpose of an audit is the detection of wrongdoing and fraud by the company's managers and directors.

102. It seems to me that the Liquidator's claim in respect of the lending to Mathon is comprehensible and consistent with the case law. While all the lending to Mathon is claimed by way of loss, this is not a claim where all the costs of the continuing existence of Heather are claimed. For the purposes of this application, I consider that the claim for monies lent to a particular debtor (being "*continuing to trade in a particular manner")* is sufficiently narrow as to bring the claim within the scope of the auditor's duties and is pleaded in such a way as to satisfy the test for pleading legal causation.

Market Losses

103. I accept Mr Davies' submission that, if it were clear at this strike out stage that losses attributable to a fall in the property market are not properly claimable, this would put the Liquidator's quantum claim in yet further doubt, as he would have to yet again recalibrate his figures to make appropriate allowances for market forces. However, I have concluded that as to the issue of the recoverability of losses occasioned by market fluctuations, the law lacks the necessary clarity to make the issue suitable for disposal on a strike out application.

104. On the one hand, the House of Lords in *South Australia Asset Management Corporation v Yale Montague* [1997] AC 191 (otherwise known as *Banque Bruxelles v Eagle Star* or "SAAMCO"), in the context of a claim against surveyors for negligently overvaluing properties, held that because a defendant will generally not be liable for all the consequences of supplying negligent information but only for the foreseeable consequences of the information being wrong, losses attributable to market falls in the property market will not generally be recoverable. This was contrary to the Court of Appeal's decision which was that the valuer should bear the whole risk of a transaction which, but for his negligence, would not have happened. He was therefore, according to the Court of Appeal, liable for all the loss attributable to a fall in the market.

105. That there may be exceptions to the general principle set out by their Lordships is apparent from Lord Hoffmann's reference at page 219 to *McElroy Milne v Commerical Electronics Ltd* [1993] 1 NZLR 39. Lord Hoffmann said this:

> *"I need mention by way of illustration only one such case. In McElroy Milne v Commercial Electronics Ltd [1993] 1 N.Z.L.R. 39, a solicitor negligently failed to ensure that a lease granted by his developer client contained a guarantee from the lessee's parent company. The result was that the developer, who had intended to sell the property with the benefit of the lease soon after completion, found himself in dispute with the parent company and was unable to market the property for more than two years, during which time the market fell. The New*

Zealand Court of Appeal held that the developer was entitled to the difference between what the property would have fetched if sold soon after its completion with a guaranteed lease and what it eventually fetched two years later. The solicitor's duty was to take reasonable care to ensure that his client got a properly guaranteed lease. He was therefore responsible for the consequences of his error, which was producing a situation in which the client had a lease which was not guaranteed. All the reasonably foreseeable consequences of that situation were therefore within the scope of the duty of care. The only issue was whether the client's delay in selling the property negatived the causal connection between that situation and the ultimate loss. The Court of Appeal decided this question on orthodox lines by asking whether the client had reacted reasonably to his predicament. County Personnel (Employment Agency) Ltd. v. Alan R. Pulver & Co. [1987] 1 W.L.R. 916 and Hayes v. James & Charles Dodd [1990] 22 All E.R. 815 are examples of similar principles of causation being applied by the Court of Appeal in England."

106. While KPMG submitted that *McElory* is distinguishable on the basis of the assumption there of an absolute contractual obligation and that the developer was "*locked into the market*", I note that the claim appears to have sounded in negligence.

107. I was also referred to *Supershield v Siemens Building Technologies* [2010] EWCA Civ 7 where Toulson L.J. said this at paragraph 43:

> "*Hadley v Baxendale remains a standard rule but it has been rationalised on the basis that it reflects the expectation to be imputed to the parties in the ordinary case, i.e. that a contract breaker should ordinarily be liable to the other party for damage resulting from his breach if, but only if, at the time of making the contract a reasonable person in his shoes would have had damage of that kind in mind as not unlikely to result from a breach. However, South Australia and Transfield Shipping are authority that there may be cases where the court, on examining the contract and the commercial background, decides that the standard approach would not reflect the expectation or intention reasonably to be imputed to the parties. In those two instances the effect was exclusionary; the contract breaker was held not to be liable for loss which resulted from its breach although some loss of the kind was not unlikely. But logically the same principle may have an inclusionary effect. If, on the proper analysis of the contract against its commercial background, the loss was within the scope of the duty, it cannot be regarded as too remote, even if it would not have occurred in ordinary circumstances.*"

108. I was also referred to *John Grimes Partnership Ltd v Gubbins* [2013] PNLR 301, a decision of the Court of Appeal in which at paragraphs 28 and 29 there is a discussion of claims based on falls in the property market:

> "*28. The appellant points to the fact that there are very few decided cases where a decline in the property market during a period of delay has been held to give rise to an actionable loss. That seems to be so. But nor are there cases from the property world deciding the other way. The case of SAAMCO, relied on by the appellant, was not a delay case, but one where the breach of contract was the giving of a negligently high valuation, and the discussion therein about the extent of the valuer's duty provides little guidance for present purposes. Indeed, in the course of his judgment, the only reasoned one in this case, Lord*

Hoffmann makes reference to the decision of the New Zealand (1993) 1 N.Z.L.R. 39, (sic) where a solicitor's negligence caused a two year delay in the sale of a property. The Court of Appeal held that the property owner was, in Lord Hoffmann's words,

> *"entitled to the difference between what the property would have fetched if sold soon after its completion with the guaranteed lease and what it eventually fetched two years later."*

There is no suggestion in Lord Hoffmann's speech that that was other than a proper conclusion.

29. There is also the case of T & S Contractors v Architectural Design Associates Unreported October 16, 1992, a decision of H.H. Judge Rich QC, sitting as an official referee, dated 16 October 1992. There the architect defendant had contracted to carry out a feasibility study and to seek planning permission on behalf of the plaintiff for a small housing development. As a result of the architect's negligence in surveying the site, a planning permission which was obtained proved incapable of implementation and a fresh permission had to be sought. The consequence of this was delay of some 14 months in the completion of the development. During that time the housing market suffered a decline, and the plaintiff sought damages (inter alia) for the loss in value. It was contended by the defendant that such loss was too remote. After referring to (1949) K.B. 528, to The Heron II and other authorities, the Judge held that the loss was reasonably foreseeable as a serious possibility if there was delay and was not too remote. It may well be that the reason for the absence of many cases of this kind is that the property market does not move as quickly as certain other types of market involving commodities and other goods, and it takes a very lengthy delay in breach of contract before a provable loss of value can occur. A few days or even a few weeks delay is unlikely to give rise to a demonstrable loss on the property market. It was the appellant's delay of 15 months, in the Judge's words an egregious delay, which in the present case gave rise to a quantifiable loss."

109. This line of cases was also referred to in the very recent judgment of Males J in *"MTM Hong Kong"* [2015] EWHC 2505 (Comm). It seems to me that these judgments recognise that, on examining the evidence, the contract and the commercial background, a claim for *"market losses"* may be permissible. In short, it seems to me that, on a strike-out application, it would be a mistake to hold that the Liquidator's claim, which encompasses losses due to a fall in the property market, is so ill-conceived as to justify its summary dismissal.

Claim for Alleged Reflective Loss

110. In simple terms, KPMG's case is that where a company and its shareholder have claims which duplicate each other, that of the shareholder must be surrendered or dismissed. In this claim it is said that the Claimant is suing in all the claims over the same loss. Mr Davies submitted that there is in this case only one loss, when the money *"left Heather"* and this money can accordingly be claimed only once.

111. He also submitted that the claim for investigation costs was identical in both sets of proceedings and as a matter of common sense could not be claimed twice.

112. The losses claimed in the A&L Proceedings are in the region of £51 million and, in light of the duplicative nature of this claim, it should be struck out.

113. In rather more detail, KPMG's skeleton argument sets out the matter in this way:

> *"82. In any event, the A&L Investment Claim is a pure claim for reflective loss, which is duplicative of Heather's damages claim and therefore inadmissible. It is well established that, if a duty is owed to both the shareholder and the company, the shareholder cannot recover for any loss that is not separate and distinct from a loss suffered by the company: see Johnson v Gore Wood [2002] 2 AC 1 at 35E-H per Lord Bingham and 62A-F, 63F, 66C-D per Lord Millett. As Lord Millett made clear, this is in part based on concerns about double recovery but also because, as a matter of policy, the claim by the company must always trump that of the shareholder.*
>
> *83. In this case, the Liquidator alleges (and KPMG admits) that it owed duties to both the shareholders (Aarkad and Lomond) and the company (Heather). The only question is therefore whether the loss claimed by Aarkad and Lomond is reflective of that claimed by Heather. It plainly is. The complaint by Aarkad and Lomond is (necessarily) that Heather, as the recipient of their fresh investments, was unable to repay its shareholders because it suffered fresh losses. However, those losses are being claimed by Heather and the loss claimed by Aarkad and Lomond is simply reflective of that claimed by Heather.*
>
> *84. That the loss claimed is essentially the same is demonstrated by A&L PoC/44 [1/9/196], which pleads that the Liquidator will give credit for sums recovered in the Heather Proceedings. However, the rule against reflective loss is not a pro tanto one. It is a complete bar to any claim by a shareholder to recover a loss which is reflective of a loss claimable by the company. Accordingly, the A&L Investment Claim is bound to fail on this additional ground."*

114. In response, Mr Salzedo submitted that Aarkad and Lomond should be permitted to sue their own auditor. If for example they had a different auditor to Heather they could surely not be prevented from suing that auditor. In his submission where the same Defendant is doing two separate pieces of work for two different clients the reflective loss doctrine does not apply.

115. Mr Salzedo's submissions are set out in more detail in his skeleton argument:

> *"94. Heather submits that KPMG's reliance upon the reflective loss principle is misconceived. In particular:*
>
> > *1. In Johnson v Gore Wood [2002] 2 AC 1 Lord Bingham summarised the relevant principles at page 35:*
> >
> > > *"... (1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and*

no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss. So much is clear from Prudential Assurance Co Ltd C v Newman Industries Ltd (No 2) [1982] Ch 204 , particularly at pp 222–223 ... (2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding. This is supported by Lee v Sheard [1956] 1 QB 192, 195–196, George Fischer and Gerber. (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other."

Lord Bingham went on to say at page 36:

"These principles do not resolve the crucial decision which a court must make on a strike-out application, whether on the facts pleaded a shareholder's claim is sustainable in principle, nor the decision which the trial court must make, whether on the facts proved the shareholder's claim should be upheld. On the one hand the court must respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders and ensure that a party does not recover compensation for a loss which another party has suffered. On the other, the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation. The problem can be resolved only by close scrutiny of the pleadings at the strike-out stage and all the proven facts at the trial stage: the object is to ascertain whether the loss claimed appears to be or is one which would be made good if the company had enforced its full rights against the party responsible, and whether (to use the language of Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204, 223) the loss claimed is "merely a reflection of the loss suffered by the company". In some cases the answer will be clear, as where the shareholder claims the loss of dividend or a diminution in the value of a shareholding attributable solely to depletion of the company's assets, or a loss unrelated to the business of the company. In other cases, inevitably, a finer judgment will be called for. At the strike-out stage any reasonable doubt must be resolved in favour of the claimant."

2. In Gardner v Parker [2005] BCC 46 Neuberger LJ said at [33]:

> *"I think that the effect of the speeches in Johnson can be taken as accurately summarised by Blackburne J. at first instance in Giles [2003] B.C.C. 79; [2003] Ch. 618 in a passage set out in para.57, subject to the qualifications expressed in paras 61 and 62, of the judgment of Chadwick L.J. in the Court of Appeal. As amended by those two qualifications, it seems to me that Blackburne J.'s formulation was approved by this court (Keene L.J. having agreed with Chadwick L.J.) in the following terms, so far as relevant:*
>
> *(1) a loss claimed by a shareholder which is merely reflective of a loss suffered by the company – i.e. a loss which would be made good if the company had enforced in full its rights against the defendant wrongdoer – is not recoverable by the shareholder; save in a case where, by reason of the wrong done to it, the company is unable to pursue its claim against the wrongdoer;*
>
> *(2) where there is no reasonable doubt that that is the case, the court can properly act, in advance of trial, to strike out the offending heads of claim;*
>
> *(3) the irrecoverable loss (being merely reflective of the company's loss) is not confined to the individual claimant's loss of dividends on his shares or diminution in the value of his shareholding in the company but extends ... to 'all other payments which the shareholder might have obtained from the company if it had not been deprived of its funds' and also (again in the words of Lord Millett) 'to other payments which the company would have made if it had had the necessary funds even if the plaintiff would have received them qua employee and not qua shareholder' save that this does not apply to the loss of future benefits to which the claimant had an expectation but no contractual entitlement;*
>
> *(4) the principle is not rooted simply in the avoidance of double recovery in fact; it extends to heads of loss which the company could have claimed but has chosen not to and therefore includes the case where the company has settled for less than it might ...;*
>
> *(5) provided the loss claimed by the shareholder is merely reflective of the company's loss and provided the defendant wrongdoer owed duties both to the company and to the shareholder, it is irrelevant that the duties so owed may be different in content." (emphasis added)*

The italicised text is taken from paras 61 and 62 of the judgment of Chadwick LJ."

3. In the light of these authorities, Heather submits that the reflective loss principle does not preclude the Aarkad and Lomond Claim. KPMG *owed separate duties of care to Heather, Aarkad, and Lomond. Therefore, even though Aarkad and Lomond were shareholders of Heather at all relevant times, they have their own cause of action against KPMG which is entirely distinct from that vested in Heather in its own right. Moreover, the losses suffered by Aarkad and Lomond on the one hand and Heather on the other hand are conceptually distinct: the principal heads of loss suffered by Aarkad and Lomond are the value of the investments which they continued to make in Heather after the date on which KPMG is held to have acted negligently and the fees paid to Sargon, whereas the principal heads of loss suffered by Heather are the value of the lending which it continued to advance to Mathon and the fees paid to Abacus and Capita. The Aarkad and Lomond Claim therefore falls within category 3 of the cases described by Lord Bingham in Johnson.*

4. Of course Heather accepts that it is not entitled to double recovery across the two claims. Hence at paragraph 44 of the Aarkad and Lomond Particulars of Claim Heather has pleaded that: "Heather (as assignee) will give credit to KPMG for any sums as Aarkad and Lomond may recover in due course as creditors in Heather's insolvency, including any sums thereby recovered as a result of success by Heather against KPMG in the Heather Action". At paragraph 84 of their skeleton KPMG seek to rely upon this acknowledgment as somehow demonstrating that the reflective loss principle must be engaged. But that is plainly wrong: the principle does not apply in every case where there is a prospect of double recovery by a claimant.

5. In any event, Heather submits that in line with the guidance provided by Lord Bingham and Neuberger LJ the answer to this issue is not sufficiently clear for this part of the Application to succeed and for the Aarkad and Lomond Claim to be struck out".

116. While it seems to me that there may well turn out to be a degree of overlap in the two sets of proceedings, I am persuaded that the matter is not so clear as to justify the striking out of the A&L Proceedings on this basis. I do however have a very substantial doubt as to the recoverability of two sets of investigation costs. As already observed, these are identical in both sets of proceedings. In the context of these particular proceedings the sums involved (£2.38 million) are almost de minimis. It is a matter of quantum and requires, in my view, to be given further attention by the Claimant.

117. It seems to me to be arguable that the remainder of the A&L Proceedings is not in Lord Bingham's first category because it is a claim brought in the capacity of an audit client, rather than in the capacity of a shareholder. Category two is clearly inapplicable. It is arguable that the claim falls within the third category, namely that Aarkad and Lomond have suffered a loss quite distinct from that of Heather, caused by a breach of duty independently owed to that shareholder. As Lord Bingham said, neither may recover loss caused to the other by breach of the duty owed to that other, and the Liquidator accepts that it is not entitled to double recovery across the two claims. For these reasons, I am unable to accede to Mr Davies' submission that this aspect of the claim be struck out.

Conclusion

118. For these reasons I conclude that KPMG have failed to persuade me that any of the three sets of proceedings should be struck out. It is now important that these proceedings are case managed appropriately in order that they may proceed to trial as expeditiously as possible. I trust that the parties can agree directions accordingly.

....
Deemster Corlett