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LEGAL UPDATE

Auditors' liability for whitewash report following the decision in Cook v Green

The recent case of Cook and another v Green and others ChD (Manchester) 02/05/2008, in which auditors were held liable for negligently preparing the statutory auditors' report required in connection with the financial assistance "whitewash" procedure, has highlighted the need for auditors to make a thorough enquiry into the financial affairs of a company before signing the statutory auditors' report stating that the company is in a position to give financial assistance for the acquisition of its own shares.

In Cook v Green, the target company made a loan to the purchaser (which was a newly incorporated company set up by the directors of the target to act as the acquisition vehicle) to assist in the acquisition of the shares of the target. This constituted financial assistance within the meaning of Section 151 of the Companies Act 1985 (the equivalent of Article 161 of the Companies (Northern Ireland) Order 1986) and so required to be "whitewashed" in accordance with Sections 155 and 156 of the Companies Act 1985 (the equivalent of Articles 165 and 166 of the Companies (Northern Ireland) Order 1986).

The judge found that the auditors in question, in preparing the statutory auditors' report required in connection with the whitewash procedure, had failed to make reasonable enquiry into the state of affairs of the target company. This constituted both a breach of contract and negligence on the part of the auditors and caused a loss to the target company since the directors of the target company would not have signed the statutory declarations as to the solvency of the target company if the inaccurate statutory auditors' report had not been provided by the auditors.

In Cook v Green, the loss to the company arose because the directors of the target company had overvalued the shares to be acquired – this resulted in the target company having to make a loan to the purchaser which it could not afford to make. In giving judgment, the judge held that the directors of the target company were liable for breach of their fiduciary duties as they had overvalued the shares in the target company which were to be acquired and that the auditors were liable for breach of contract and negligence. In apportioning damages between the directors and the auditors, the judge concluded that the auditors should compensate the target company for the real value of the shares at the date of completion (being the value of the shares that would have been determined had the audit been carried out competently) and that the directors would be liable for the payment that they had received in excess of the true value of the shares as a result of the overvaluation of the shares.

Among the investigations that the auditors failed to carry out in their audit of the target company, the following were highlighted by the judge as being essential to the requirements for a competent audit:

- **an analysis of the target company's aged debtors**

  Had the auditors carried out such an analysis, it would have revealed the performance of the target company's customers and the likelihood of further debts becoming owed to the target company.

- **the preparation of a consolidated profit and loss account, balance sheet or cash flow model**

  The judge remarked that this was probably the most important requirement for a competent audit as the balance sheet or cash flow model would show the ability of the target company to pay its debts immediately following and for the period of 12 months after the date on which financial assistance was given. As the statutory auditors' report certifies that the auditors have enquired into the affairs of the target company and that they are not aware of anything to indicate that the opinion of the directors expressed in their statutory declaration is unreasonable (including the directors' opinion that the company will be able to pay its debts for the period of 12 months following the date on which financial assistance is given), it is essential that the auditors carry out a thorough investigation of the target company's affairs, including the balance sheet, before signing the statutory auditors' report. The auditors in Cook v Green failed to properly enquire into the affairs of the Company and, accordingly, they were not in a position to be able to say whether the directors' opinion was reasonable or not. The opinion expressed in the statutory auditors' report was not therefore one which they could have reasonably and properly have expressed.

In preparing the statutory auditors' report, the task of an auditor is to examine the target company's financial affairs and then to report whether they are aware of anything that would render the directors' opinion set out in the statutory declaration unreasonable in the circumstances. The case of Cook v Green highlights the fact that auditors must make careful enquiry into the target company's affairs in order to be able to produce such a report. It goes without saying that if an auditor carries out the necessary enquiries and comes to the conclusion that the directors' opinion is unreasonable and that the target company will be unable to pay its debts following the provision of financial assistance, then the auditors should not sign the statutory auditors' report supporting the directors' opinion.

The prohibition on the provision of financial assistance by a private company in connection with the acquisition of its shares is to be abolished by the Companies Act 2006 (the prohibition will remain in place for public companies). Accordingly, with effect from 1 October 2008, private companies incorporated in Northern Ireland, England & Wales and Scotland will no longer be prohibited from giving such assistance and the 'whitewash' procedure will become obsolete. Nevertheless, any transactions which complete prior to 1 October 2008 will be subject to the existing "whitewash" regime.

Should you wish to discuss any aspects of our services in relation to whitewashing or other financial assistance matters please do not hesitate to contact us.

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