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# England and Wales Court of Appeal (Civil Division) Decisions

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**Neutral Citation Number: [2003] EWCA Civ 1114**

Case No: A3/2003/0372, A3/2003/0372A, A3/2003/0989

IN THE SUPREME COURT OF JUDICATURE  
COURT OF APPEAL (CIVIL DIVISION)  
ON APPEAL FROM QUEEN'S BENCH DIVISION  
COMMERCIAL COURT  
Langley J

Royal Courts of Justice  
Strand, London, WC2A 2LL  
25th July 2003

Before:

LORD JUSTICE BROOKE  
LORD JUSTICE RIX  
and  
LORD JUSTICE DYSON

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Between:

EQUITABLE LIFE ASSURANCE  
SOCIETY

- and -

ERNST & YOUNG

**Claimants/  
Appellants**

**Defendants/  
Respondents**

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**HTML VERSION OF JUDGMENT : APPROVED BY THE COURT FOR HANDING DOWN  
(SUBJECT TO EDITORIAL CORRECTIONS)**

**HTML VERSION OF DRAFT JUDGMENT**

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SUMMARY (Note: This summary forms no part of the judgment)

By this judgment the Court of Appeal has substantially allowed an appeal by Equitable Life Assurance Ltd ("Equitable") from a judgment by Mr Justice Langley in the Commercial Court on 10th February 2003. It has dismissed a cross-appeal by Equitable's former auditors Ernst and Young ("E&Y") against that judgment. It has also dismissed an appeal by E&Y against a later judgment in this case by Mr Justice Langley on 4th April 2003.

In this action Equitable claims damages from E&Y for negligence in its conduct of the audit of its statutory accounts for the financial years 1997, 1998 and 1999. It asserts that E&Y was negligent in two respects. First, they failed to ensure that the "technical provisions" in the accounts complied in each of these three years with the requirements of company law (paras 9-16). Equitable says that if its accounts had not been audited negligently, its directors would have appreciated that the Society's working capital was much lower than what was shown in the accounts (paras 17-21). Secondly, E&Y failed to ensure that the 1998 and 1999 accounts contained a note, prepared in accordance with standard accounting practice, which would have warned the directors of the scale of the untoward financial consequences that would ensue if Equitable lost the litigation relating to its differential terminal bonus policy, as indeed happened in July 2000 (paras 25-26).

Equitable advanced its claim in two different ways. By its "lost sale claims" or "loss of a chance of a sale claims" it asserted that if the directors had appreciated the true position they would probably have decided to raise more working capital by an orderly sale in 1998, or by an orderly sale soon after the House of Lords' decision in July 2000. Equitable claims the money that would probably have been achieved by such sales, boosted by the adoption of a more restrictive bonus declaration policy. Alternatively, it claims damages for the loss of the chance of achieving such sales (paras 27 and 35). It also claims as damages the sums which it would not have paid out as terminal bonuses, or to which it would not have committed itself by way of reversionary bonuses, as a result of the new bonus declaration policy the directors would have instituted if they had known the true position ("the bonus declaration claims") (paras 36-37).

The judge struck out the lost sales claims and the loss of a chance of a sale claims in their entirety (paras 42-47). By his first judgment he gave Equitable the opportunity to reformulate the bonus declarations claims, and by his second judgment he allowed it to advance them on a more restricted basis, with its maximum claim being reduced from £1.6 billion to £500 million (paras 48-55).

E&Y strongly dispute that they were negligent in any way, but for the purposes of their applications to strike out the claims or to be awarded summary judgment because the claims have no real prospect of success, it had to be assumed that negligence would be proved against them. Their arguments before the judge and in the Court of Appeal were based on their contentions that Equitable's claims were bound to fail on the facts (see in particular the four main elements of the factual issues in para 61), alternatively that they were bound to fail on the law (see in particular the main legal issues identified in para 105 and the subsidiary issues discussed in paras 89-101).

The Court of Appeal has restored the lost sale claims in principle, but it has ruled that they must be formulated in terms of the loss of a chance of a sale (see paras 87-88). It has restored the bonus declaration claims in their entirety, in each case subject to the qualification contained in para 81 of the judgment.

In the Conclusion at the end of the judgment (paras 136-138) the Court of Appeal has summarised its broad reasons. Although the court expressed some sympathy for E&Y's complaint that the sheer size of Equitable's claims represented an unwarranted burden for a litigant to have to bear in the particular circumstances of the present case, it did not see how on the material before it it could slice individual heads of claim and say they could not succeed for more than a given amount. There might still be other procedural opportunities for E&Y to capitalise on their scepticism about the size of Equitable's claims (para 136-137), but it was not appropriate to adopt the course which the judge took.

Part 4 of the judgment (paras 38-41) contains the court's approach to the complex factual material before it, and Parts 8 and 9 (paras 89-135) contain the analysis of the principal arguments of law the court had to resolve on these appeals.

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**Lord Justice Brooke** : This is the judgment of the court.

## Part 1 INTRODUCTION

### *Introductory*

1. This is an appeal by the claimants, the Equitable Life Assurance Society ("Equitable"), against an order of Langley J in the Commercial Court on 14<sup>th</sup> February 2003 which had the effect that paragraphs 7 to 98 of the Re-Amended Particulars of Claim were struck out as they then stood. The judge directed that if within 14 days Equitable sought permission to amend the Re-Amended Particulars of Claim, paragraphs 68-94A, 98(a)(i)-(ii), 98(b)(i) and 98(d) (which relate to what are described as the "lost sale claims") should nevertheless remain struck out, and that he should consider any outstanding matters at the same time as he considered the proposed amendments. In due course he made a further order on 4<sup>th</sup> April 2003 whereby he allowed the proposed amendments and made certain ancillary directions. The effect of his second order was to permit Equitable's alternative case, described as the "bonus declarations claims", to proceed to trial, but only in an amount limited to £500 million. The defendants Ernst & Young ("E&Y") appeal against that order and also cross-appeal against the judge's first order, in so far as he did not there and then strike out the whole of Equitable's claim. The judge delivered two judgments, reflecting his two orders.
2. At all material times E&Y acted as Equitable's auditors. By this action Equitable claims damages from E&Y for negligence in the performance of their audit duties in connection with the audit of its statutory accounts for 1997, 1998 and 1999. E&Y vigorously dispute that they were in any way negligent, but for the purposes of the present appeals, which arise out of their applications to the judge under both CPR 3.4 and CPR 24.2, they accept, as they did below, that a finding of liability is to be assumed. Nevertheless they say that Equitable's claims are both unrealistic in fact and unsustainable in law. The effect of the judgments below is that Langley J considered himself unable, sometimes with some hesitation or even reluctance, to say that all Equitable's allegations failed summarily as a matter of pure fact. Nevertheless, he limited the bonus declaration claims to the amount of £500 million repaid by Equitable after his first judgment and struck out the lost sale claims both

as a matter of fact and legal analysis. His reasons included a finding that these lost sale losses did not fall within the scope of E&Y's duty to Equitable.

3. On these appeals Equitable submits that the judge was wrong to limit its bonus declaration claims and wrong to regard its lost sale claims as unsustainable in law. E&Y for their part submit that the judge was wrong to regard either set of claims as realistic in fact or available in law.

*The background to Equitable's claim*

4. The story of the way in which Equitable got into severe financial difficulties in the summer of 2000 is set out in the judgments of the Court of Appeal and in the speeches of Lord Steyn and Lord Cooke of Thorndon in the House of Lords in *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408. The judge has also set out the history, with particular reference to the relationship between Equitable and E&Y, who were its auditors, in his first judgment under appeal ([2002] EWHC 112 (Comm)). For the purposes of this appeal we can take the matter more shortly.
5. Equitable's difficulties flowed from guarantees it offered to prospective policy-holders between 1957 and 1988. The owner of an Equitable Guaranteed Annuity Rate ("GAR") policy was entitled, if he wished, to exercise a Guaranteed Annuity Option ("GAO"), whereby he would receive an annual annuity calculated by applying the guaranteed rate contained in his policy to his policy value at the time of his retirement. A policyholder's policy value represented the total of the basic sum assured by his policy, the reversionary (or annual) bonuses he had accumulated over the years, and his terminal bonus. Whereas he had a vested right to a reversionary bonus once it was declared, he had no such vested right to a terminal bonus, although the amount of the terminal bonus (being effectively the amount of the additional bonus he would receive on his policy's maturity) was indicated annually. When the basic sum assured and the reversionary bonuses were added together, the resultant sum was known as the guaranteed fund value ("GFV") of the policy. Reversionary bonuses were declared each year retrospectively, so that when the directors considered the draft statutory accounts following the end of a financial year, they declared the reversionary bonus which was treated as vesting in each policy as at the followings 1<sup>st</sup> April. At the same time they would declare the non-guaranteed terminal bonuses for the past year, and the terminal bonus which would in fact be applied to policies maturing during the current year.
6. Although Equitable stopped issuing GAR policies in 1988 their existence caused no particular difficulty until about 1994 because current annuity rates ("CARs") prior to that date usually exceeded GARs, so that the GAO had no particular attraction. Once this situation changed the directors sought to preserve the assets of the Society by instituting in December 1993 what became known as the differential terminal bonus policy ("DTBP"). By this means a GAR policyholder who exercised his GAO became entitled to a lower terminal bonus than other policyholders. Except in a small minority of cases the implementation of the DTBP neutralised what would otherwise have been the adverse effect of the GAR policies (whereby Equitable would have been obliged to look to its assets for the money to pay GAR policyholders at a rate higher than the CAR).
7. By the autumn of 1998, however, indignation about the perceived unfairness of the DTBP was building up among GAR policyholders, and in due course the directors decided it would be best to test the legality of this policy in the courts. Mr Hyman was selected as a representative GAR policyholder, and Equitable undertook to pay his costs whatever the result of the litigation. In September 1999 Sir Richard Scott V-C granted Equitable declarations to the effect that the DTBP was lawful. In January 2000 his judgment was reversed by this court (Lord Woolf MR and Waller LJ, Morritt LJ dissenting). Waller LJ, however, indicated at the end of his judgment (see [2002] 1 AC 408, 444 at para 135) that he considered that there was a route ("ring-fencing") by

which in future the Society might so order its affairs as to mitigate the difficulties created by the GAR policies.

8. If that view had found favour with the House of Lords (even if it had otherwise upheld the majority judgments in the Court of Appeal) Equitable's eventual plight would have been very greatly reduced. In the event, however, on 20<sup>th</sup> July 2000 the House of Lords unanimously declared both the DTBP and the suggested ring-fencing expedient to be unlawful. An early calculation of the likely cost of this decision was that it would cost Equitable £200 million to compensate GAR policyholders who would have exercised their GAO in the past but for the DTBP, £200 million as compensation to other policyholders for mis-selling, and £1.3 billion to honour the effect of the GAO in the future.

## Part 2 THE ALLEGED NEGLIGENCE

### *E&Y's duty as auditors: the missing technical provision*

9. Equitable now has a new board of directors, and it claims damages from E&Y for negligence in the performance of their audit duties in connection with its statutory accounts for 1997-1999. It alleges that in all three years E&Y negligently failed to ensure that the accounts complied with company law in a manner which we will explain in detail below. With respect to 1998-1999, after the legality of the DTBP was put in question, Equitable complains that E&Y negligently failed to warn it that its accounts ought to have included a note disclosing the consequences of losing the *Hyman* litigation.
10. Equitable's main complaint against E&Y arises in this way. Because it is an insurance company, the form and content of its statutory accounts are governed by Schedule 9A of the Companies Act 1985. The balance sheet format required by that schedule includes among the liabilities to be shown on an insurance company's balance sheet a number of technical provisions. It was common ground that these provisions are described as "technical" only in the sense that they are calculated by reference to technical criteria. They include a "long term business provision" (Liabilities item C.2). Note (21) to the format explains that:

"This item shall comprise the actuarially estimated value of the company's liabilities ... including bonuses already declared."

11. Section D of Schedule 9A contains "Rules for Determining Provisions". Paragraph 43 provides that:

"The amount of technical provisions must at all times be sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen."

12. Chapter IV of the schedule is concerned with the interpretation of Part I (which includes the requirements for the balance sheet format). Paragraph 84(c) provides that:

"84. For the purposes of this Part of the Schedule and its interpretation –

(c) references in this Part to provisions for liabilities ... (other than provisions referred to in paragraphs 43 to 53 above) are to any amount retained as reasonably necessary for the purpose of providing for any liability ... which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise."

It appeared to be common ground that this language had the same general effect as the language of paragraph 43. Terminal bonuses (as opposed to reversionary bonuses) were not treated as liabilities because they conferred on policyholders no vested entitlement until they vested on actual maturity.

13. Paragraph 46 of the schedule refers expressly to long term business provision. So far as is material, it provides that:

"(1) The long term business provision shall in principle be computed separately for each long term contract ...

(3) The computation shall be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down in Council Directive 92/96/EEC."

14. Article 18 of that directive provides that the technical provisions must take account of:

"... all future liabilities ... including:

(a) all guaranteed benefits ...

(b) bonuses to which policy-holders are already ... entitled, however those bonuses are described – vested, declared or allotted.

(c) all options available to the policy-holder under the terms of the contract ..."

15. There are two other features of Schedule 9A which we must mention at this stage. The first is that although "Goodwill" is to be shown as an intangible asset in the balance sheet format (Assets item B.3), Note (3) makes it clear that amounts representing goodwill shall only be included to the extent that the goodwill was acquired for valuable consideration. This is important in the context of the present case because Equitable contends that it possessed "off balance sheet goodwill" of a very substantial value at the time the relevant accounts were audited.
16. The other is that Liabilities item Ba in the balance sheet format is described as "Fund for future appropriations" ("FFA"). In the case of a mutual insurance company Note (19) explains that:

"This item shall comprise all funds the allocation of which ... to policy holders ... has not been determined by the end of the financial year."

*The alleged effect of the missing technical provision*

17. Mr Michael Arnold, an actuary of immense experience who has made a witness statement on behalf of Equitable in these proceedings, explains (in para 52 of his statement):

"...[F]or a mutual company the FFA represents funds that are not yet allocated but are nevertheless for policyholders' benefit. It can only be allocated in future as bonus or, if derived from earlier generations of policyholders, be retained as an inherited estate. Therefore, other things being equal, the bigger (or smaller) the FFA, the more (or less) funds are available to enhance future benefits via bonuses, or to insulate bonus prospects from future adverse experience. Therefore the level of the FFA can be expected to be an indicator of the ability of the fund to continue to set bonuses at attractive levels in adverse conditions."

18. In paragraph 66 of his statement Mr Arnold added this:

"Since the FFA represents the available working capital of the Society, it must fulfil a number of functions including being a source of capital to meet terminal bonuses. It also provides a buffer to support the Society's high exposure to equity investments so that the Society's bonus policy could continue to operate, even in adverse investment conditions. It is also a source of finance for new business."

19. The effect of all these statutory requirements was, on Equitable's case, that Equitable was obliged to include technical provisions in its statutory accounts which embraced the basic sum assured and the reversionary bonuses attaching to each policy and also the additional sums it would be liable to pay under the GAOs (when GARs exceeded CARs) because they represented an option available to the policyholder within the meaning of Article 18(c) of the Council Directive. On the other hand it did not have to include in the technical provisions either the terminal bonuses they had indicated (since the policyholder had no vested right to receive them) nor the GAO liability on terminal bonuses.

20. We were furnished with coloured charts by Mr Thomson, who is now Equitable's chief executive, which illustrated what was described at the hearing as the "missing technical provision". Equitable contended that the statutory accounts ought to have included within the long term business provision a gross reserve for GAOs (over and above provisions for GFV) on an assumed take-up of approximately 75% (the remaining 25% being assumed to be taken as a lump sum by policyholders on their retirement). In the event no such provision was made in the 1997 accounts, and provision for only £200 million was made for this purpose for the later two years. After allowing for this provision, Equitable contends that additional provision should have been made for the GAR liability in the sums of £900 million (1997), £1.4 billion (1998) and £1.1 billion (1999).

21. Both Mr Thomson, who is another actuary with immense experience of life insurance business, and Mr Arnold say that this additional provision would have made such inroads into the FFA disclosed in the statutory accounts that the directors would have taken drastic steps to protect the Society if they had known the true position. The FFA (before adjustment) and the FFA (after the suggested adjustment) for these three years were:

1997 £2.176 billion £1.276 billion

1998 £3.025 billion £1.625 billion

1999 £4.841 billion £3.741 billion

22. The general effect of the evidence of these two witnesses can be gleaned from paragraphs 14-16 and 19 of Mr Thomson's first witness statement:

"14. I believe that one of the most important functions of the board of a life company is to monitor the continuing viability of the existing business model. By 'business model', in this context, I mean the essential factors which make up the operating philosophy of the company, such as its mutual status, the type and flexibility of the business it writes, the volume of new business it writes and its policy as regards distribution of surplus. In summary, the Society's business model at the relevant time was to distribute its available surplus to policyholders as fully as possible and thereby avoid building up an 'inherited estate'. In addition, the Society's mutual status (and the implications this has on capital raising) must be considered as part of its business model. Also, the quantity and nature (for example flexibility and proportion of GAR

policies) of the business written by the Society are relevant facets of its business model.

15. With the business model in mind, I believe that had the board of the Society been advised by the Appointed Actuary of the need to make a provision of £900 million in the 1997 accounts (and additional provisions of £1.4 billion in the 1998 accounts and £1.1 billion in the 1999 accounts) in respect of the GAR issue, the board would have had to question the continuing validity of the existing business model. The reason for this is that the need for such a provision in a company in the financial position of the Society (ie with limited free assets) and with its particular risk characteristics ... would have signalled a serious warning sign that the Society's solvency was at risk. In particular, the need for such a big provision (relative to the size of the fund and in particular the FFA) in respect of the GAR issue would have signalled that the Society was exposed to a serious interest rate risk, which in future years had the potential to worsen in the event that interest rates continued to fall (as they in fact did). I would add that increased longevity and decreasing mortality rates meant that GARs were becoming increasingly more expensive to provide.

16. In his witness statement, Mr Arnold identifies a number of options that he believes the Appointed Actuary would have considered to try and rectify the situation. Mr Arnold concludes that an attractive and viable option that should have been given serious consideration by the Society's board was to raise unencumbered capital by selling its undervalued assets, namely its goodwill, coupled with measured bonus cuts in the interim. From my knowledge of the Society, I believe that the likelihood is that the board would have concluded that the only workable long term solution was to raise fresh capital.

19. In summary, I believe that the Society's board, when faced with the need to make additional provisions in its 1997 to 1999 accounts (and disclose a contingent liability in its 1998 and 1999 accounts) in respect of the GAR liability, would in all likelihood have concluded that the only long term solution for the Society to address the problem would be to raise capital by demutualising or other sale of its assets. In addition, I believe that the board would have taken such appropriate mitigating action as it could in the meantime, which would have included immediate and measured (albeit significant) cuts to bonuses."

#### *Regulatory returns*

23. There is an important distinction which has to be made between a life insurance company's statutory accounts, which at all material times were required to show a true and fair view of its financial affairs, and the annual regulatory returns it was obliged to make to its regulator. The form and content of these returns were governed by the Insurance Companies (Accounts and Statements) Regulations 1996. Paragraph 64(1) of these regulations provides that:

"The determination of the amount of long term liabilities ... shall be made on actuarial principles which have due regard to the reasonable expectations of policy holders and shall make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors."

24. Mr Milligan QC, who appeared for Equitable, described this as "the reasonably foreseeable worst case scenario". The amounts identified as the missing technical provision were indeed included in the long term liabilities as shown in the regulatory returns for the years in question. Equitable's case is that they should also have been shown in the statutory accounts, and that if they had been their inclusion would have

alerted the directors to the weakness of the Society's overall position long before the House of Lords made their decision in the *Hyman* case. When making his recommendations to Equitable's board each year as to bonus declarations, Equitable's Appointed Actuary regularly said that:

"The Companies Act presentation can be regarded as the commercially realistic one, and it is on the office valuation within that presentation that the bonus decisions are based."

For that reason Mr Milligan submitted that Equitable's board would have had regard to the FFA figure derived in its statutory accounts, rather than to the worst case scenario reflected in its regulatory returns.

*The absence of a contingent liability note*

25. The part of Equitable's case which related to E&Y's failure to warn its clients that its 1998 and 1999 accounts ought to have included a note disclosing the consequences of losing the *Hyman* litigation was founded on SSAP 18 ("statement of standard accounting practice") issued by the Accounting Standards Board for the first of these years and on FRS 12 ("financial reporting standard") issued by the same board for the other year. It is suggested that these accounts should have included a Note in the following terms:

"The Society is presently engaged in litigation concerning the rights of policyholders with policies containing guaranteed annuity rate option clauses. Based on legal advice received to date, the Directors believe that the resolution of this litigation will not have a material adverse effect on the society's financial position. However, the outcome of litigation can never be predicted with certainty. In the event of an unfavourable outcome leading to a change in the Society's practice in setting levels of final bonus and a material transfer of economic benefits from non-GAR policyholders to GAR policyholders, the financial consequences could include the possible need for compensation to be paid to GAR policyholders affected by the Society's practice since 1994 and the possibility of policyholders bringing claims against the Society in respect of alleged mis-selling. An adverse outcome to the litigation may also have an impact on the decisions of policyholders in the future as to the extent to which they continue to pay future contributions. It is not possible to quantify the extent of these exposures."

26. Mr Milligan did not suggest that the assertion of negligence in this respect would necessarily have been robust enough if it had stood on its own: it was to be treated, however, for the last two years with which this action is concerned as giving important ancillary support to the assertions relating to the missing technical provisions.

Part 3 THE TWO TYPES OF CLAIM

*The lost sale claims*

27. Equitable's case is a simple one. In relation to the first audit year of which it makes complaint, viz 1997, it contends that if E&Y had ensured that the missing technical provision of £0.9 billion had been included in the 1997 accounts, the directors would have appreciated that the Society's working capital was now less than £1.3 billion and that they should take drastic action (see para 21 above). They would probably have put the Society up for sale and recouped an additional £2.6 billion by way of off-balance sheet good-will by concluding a sale before September 1998 (when GAR policyholders' unrest about the DTBP would have rendered the Society unsaleable until the legality of this policy had been resolved). Alternatively they would then have been poised for an orderly sale (as opposed to the "fire sale" that was attempted) as

soon as the *Hyman* litigation had been resolved, and would probably have recouped £1.7 billion in a sale taking place in the autumn of 2000.

28. For the 1998 and 1999 statutory accounts Equitable's case is founded on the proposition that if the directors had appreciated the true position (namely that the Society's working capital was in fact £1.4 billion and £1.1 billion less than was presented in the accounts) and had also read the contingent liability note, they would probably have achieved an orderly sale for £1.2 billion, alternatively £0.9 billion, after the *Hyman* litigation had been resolved.
29. In the alternative Equitable claims that it lost the chance of achieving such sales and that it is entitled to be compensated for the value of that lost chance.
30. Equitable's claim for £2.6 billion on the basis of a lost sale in 1998 was based on the total value of the four different items mentioned in paragraph 40 of the judgment which amounted to £2.9 billion, plus the lost investment income on that sum for two and a half years at 8% (£0.6 billion) less the value of certain of the Society's assets which were actually sold in February-March 2001 (£0.9 billion). The most contentious element in these calculations was the proposition, to which we will return, that if the directors had known the true position before they made the annual bonus declarations in February 1998, Equitable would not only have proceeded to a sale that year but would also have been able to make savings of £0.4 billion by reducing bonus payments without impairing policyholders' reasonable expectations ("PRE"). Equitable's case about these bonus reductions was explained by its solicitor Mr Plant in these terms:

"Between 1998 and 2000, policy payouts exceeded the underlying asset shares. Upon becoming aware of the true magnitude and impact of the risks being run in the management of the Society it is alleged that the board would have declared lesser bonuses. The figures shown for a sale in September 1998 accordingly assume a reduction in the level of bonus declaration consistent with reducing the ratio of policy values to assets backing with-profit business to 100%. These are calculated on the basis of the benefit payments that would have been saved up to 31 March 2002, assuming a purchaser continued to apply the same payout ratio target by adjusting policy values at each year end until the real life events of July 2001 actually occurred."

He then explains how the payout ratios were estimated.

31. PRE is a term of art in the life insurance world. It is a concept to which the managers of with profits business must have regard. It differs for each company and will be formed as a result of the way in which that company's business has been managed in the past, including consideration of the statements made in promotional materials or regular correspondence with clients. The Appointed Actuary of each with profits company is now required to make a statement about his interpretation of PRE for the purpose of valuing the company's liabilities. Mr Arnold describes how PRE has now been expanded to a more general concept of "treating customers fairly". He says that it is generally accepted to include the following expectations:
  - (i) Benefits will be paid as they fall due; and
  - (ii) Different classes and generations of with profits policyholders will be entitled to consistent and equitable treatment. Changes in the practices adopted by the company should reflect changes in the circumstances affecting the experiences of the policies.
32. Equitable's claim for £1.7 billion on the basis of a lost sale at the end of September 2000, starts with the total value of the same four items (see para 30 above) assessed

at £3.95 billion, against which would first have been set the following sums totalling £1.5 billion:

(i) the cost of capping GAO liabilities, estimated at £1.1 billion (being the value of benefit enhancements for GAO policies under the Society's compromise scheme);

(ii) the cost of GAO related mis-selling claims, estimated as £0.2 billion (being the value of benefit enhancements for non-GAR policies under the Society's compromise scheme);

(iii) the cost of a rectification scheme, namely £0.2 billion (being the provision for such a scheme included in the Society's 2000 annual report and accounts).

33. In addition to the resulting prospective sale value of about £2.4 billion, Equitable also claims lost investment income on that sum at 8% up to 1<sup>st</sup> March 2001 and gives credit against the resulting total for the £0.9 million actually obtained (see para 30 above), thus producing the claim for £1.7 billion.
34. Within the £3.95 billion there are included the value of very much larger savings of £1.6 billion for bonus cuts. Mr Plant explains that this sum was calculated on the assumption that bonuses would have been significantly reduced as soon as the Society became aware of its financial position. The assumed level of reduction was said to be consistent with the actions actually taken by Equitable in 2000 (when the total return was cut from 8% to 3.3%) and in 2001 (when policy values were cut by 16%). Mr Milligan told us that Equitable recognised that the much larger bonus cuts contained in this projection would damage PRE. He referred us, however, to the fact that there was no evidence from E&Y as to the impact which even these cuts would have had on goodwill. In contrast Mr Thomson said in his second witness statement that bonus cuts of the order of 80% would not have been commercial suicide, although it would plainly not have been desirable to make such cuts.
35. Because the suggested figure for bonus savings on this hypothesis (£1.6 billion) was so close to the suggested sale proceeds (£1.7 billion), Mr Hapgood QC, who appeared for E&Y, concentrated his arguments in this connection on the suggested lost sale in 1998 for which the value of the goodwill would have vastly exceeded the suggested bonus savings. The main reasons for this difference were said to be that in that scenario there would have been no need to make a £1.5 billion allowance for the "costs of *Hyman*", and the value of new business/goodwill would not have been reduced by £0.6 billion because of the effect of the assumed cuts in bonuses since 1998, although there were also adjustments in the opposite direction.

*The bonus declarations claims*

36. If the lost sale claims failed (for whatever reason) Equitable buttressed its claim for loss of the chance of a sale with the contention that in any event, if the directors had been alerted to the true position, they would have cut back the bonus declarations by £0.4 billion for each year between 1997 and 2000. Equitable's claims in this regard therefore taper down from £1.6 billion (if negligence is established in connection with the 1997 audit) to £1.2 billion (negligence in the 1998 audit) and £0.8 billion (negligence in the 1999 audit).
37. As indicated above, the combined effect of the two judgments in the court below is that the claims based on a lost sale or the loss of a chance of a sale have been struck out and the size of the bonus declarations claims has been cut back to £500 million, for reasons we will explain in due course.

#### Part 4 THE LEGAL APPROACH

38. In *Three Rivers District Council v Bank of England (No 3)* [2001] UKHL 16; [2001] 2 All ER 513 the House of Lords gave useful guidance to courts in their task of deciding whether to grant summary judgment in favour of a defendant in a claim as complex as this. It endorsed the authority of the earlier judgments in this court in *Wenlock v Moloney* [1965] 1 WLR 1238 and *Swain v Hillman* [2001] 1 All ER 91. Important guidance is contained in the speech of Lord Hope of Craighead at paras 91-96 and 103, supported by Lord Hutton, particularly at paras 111 and 147, and by Lord Steyn's agreement. The following general principles can be derived from those speeches and the prior authorities. The overriding concern is the interests of justice. So far as facts are concerned, the simpler the case is the easier it is likely for a court to be able to take a view that the basis of a claim is fanciful or contradicted by all the documentary material on which it is founded. More complex cases are unlikely to be capable of being resolved in that way. There is a danger of injustice in seeking to try such cases summarily on the documents and thus without disclosure and oral evidence tested by cross-examination. It should not be done unless the court can be confident that all the relevant facts had already been satisfactorily investigated. The power of summary disposal is not intended for cases where there are issues which need to be investigated at trial.
39. The factual material in this case is undoubtedly complex and difficult, and has led on this appeal to different analyses in the persuasive submissions of opposing counsel. The facts cover changing situations over a number of years, and raise issues as to what was known, or ought to have been appreciated, at various times by the parties, by the directors as well as by the auditors. Submissions have also been made as to the directors' policies, and as to what they would or might have been willing or unwilling to do, out of choice, expediency or necessity.
40. As for issues of law, it has been said by this court that it is not appropriate to strike out a claim in an area of developing jurisprudence since decisions as to novel points of law should be based on actual findings of fact (*Farah v. British Airways plc* (CAT 6<sup>th</sup> December 1999)). Complex issues of law have been debated on this appeal, as will appear below. To some extent, for example E&Y's submission that the losses claimed by Equitable do not fall within the scope of their duty as auditors, recent decisions canvassed in the course of counsels' argument, such as the decisions of the House of Lords in *South Australian Asset Management Corporation v York Montague Ltd* [1997] AC 191 ("*SAAMCO*") and *Aneco Reinsurance Underwriting Ltd v Johnson & Higgins Ltd* [2002] 1 Lloyd's Rep 157, indicate that novel questions of law in a developing area are involved. Moreover, these and other issues, such as causation and mitigation, are also peculiarly fact sensitive. If it be the case that the relevant facts require investigation at trial, it may not be possible with safety to form a view on a summary basis as to the application of such principles of law.
41. In this context a word is also necessary about the material which was before the judge and again before this court. Apart from the evidence of the relevant audit partner, Mr Paul McNamara, in support of E&Y's original application, the only evidence in the form of witness statements has come from Equitable. This has not been answered by evidence on the part of E&Y. All that E&Y have done, and it is a matter of complaint by Mr Milligan, is to place before the court a mass of documentary material which has been available to them about the affairs of Equitable. Mr Hapgood has sought to draw factual support from such material or from inferences said to be derivable from it, and to fashion points of law which are themselves derived from those inferences. Mr Milligan has complained that this approach to the case prejudiced him in front of the judge in as much as he could not always anticipate the direction of E&Y's arguments.

#### Part 5 THE JUDGMENTS

42. It is not possible to understand the submissions on appeal without first setting out the judge's conclusions as to Equitable's two claims. A convenient place to begin is with paragraphs 75-77 of his first judgment where he collects E&Y's reasons for striking out those claims:

*"The Lost Sale Claims*

75. Mr Hapgood submitted that Equitable does not have reasonable grounds for bringing the lost sale claims or has no real prospect of succeeding in those claims because:

- i) Equitable suffered no loss in consequence of failing to effect a sale;
- ii) The lost sale claims are not within the scope of E&Y's duty of care;
- iii) The alleged loss was not caused by E&Y;
- iv) Any amounts properly recoverable under the lost sale claims are claimed in the bonus declaration claims;
- v) The board would not have resolved to attempt a sale in 1998 or at any time before a final ruling in the *Hyman* litigation and after the decision of the House of Lords no one would have bought Equitable.

*The Loss of Chance of a Sale Claims*

76. Mr Hapgood relies on the same submissions and also submits that such claims are unsustainable in principle.

*The Bonus Declaration Claims*

77. Mr Hapgood submitted that Equitable does not have reasonable grounds for bringing the bonus declaration claims or has no real prospect of succeeding in those claims because:

- i) The amount claimed is "utterly unrealistic" in two respects
  - a) There can be no claim in respect of reversionary bonuses declared or terminal bonuses announced after 20 July 2000 (the date of the decision of the House of Lords) because Equitable then knew the DTBP could not be used to depress demand for GARs; and
  - b) There can be no claim in respect of policies which had not matured before 20 July 2000 as regards reversionary bonuses because the *Hyman* decision entitled Equitable to re-address them and as regards terminal bonuses because they could be withdrawn at any time.
- ii) The decisions as to the amount of bonuses were beyond the scope of E&Y's duty of care;
- iii) The loss alleged was not caused by E&Y;
- iv) Equitable has not suffered the loss claimed or has in fact mitigated the loss."

43. The judge then turned in an extended passage headed "The Law" to discuss the legal issues generated by those submissions under headings such as "Scope of duty and SAAMCO", "Causation and *Galoo*" (ie *Galoo Ltd v Bright Grahame Murray* [1994] 1 WLR 1360), and "Loss of a Chance". He reverted (at para 95) to Mr Hapgood's specific submissions, beginning with the lost sale claims. He analysed those claims as being made up essentially of the £1.6 billion of bonus declarations which Equitable alleged could have been saved over the four years from 1997 to 2000 plus £1 billion of goodwill, most of which had been lost by September 2000, hence the fall from £2.6 billion for the lost sale in 1998 to £1.7 billion for the lost sale in 2000. He said (at para 97) that "On that basis the loss is at least intelligible". He therefore appears to have considered the lost sale claims as being identical to the bonus declarations claims with the added element of lost goodwill. He then concluded, as a matter of law, that such claims to lost goodwill could not be within the scope of E&Y's duty as auditors. He said (at para 99):

"In my judgment a fall in the value of Equitable's assets and in particular goodwill even if proved is not a consequence which properly falls within the general scope of an auditor's duty the breach of which has led to a failure to require provisions to be made in the accounts, however large."

44. He considered (at para 103, quoted in full at para 132 below) that the same result followed also as a matter of causation, on the ground that the causes of loss had not been identified by Equitable but must include matters (Mr Hapgood had mentioned falling markets and interest rates) for which E&Y could only be responsible, if at all, on a "but for" basis "such as both SAAMCO and *Galoo* outlaw".

45. The judge gave an additional factual reason (at para 106) for concluding that the claim for lost goodwill (and indeed the bonus declaration claims themselves) were incoherent: in that the £0.4 billion to be saved in 1998 would have been unachievable, or would itself have destroyed Equitable's goodwill, since it would all have to have been saved from terminal bonuses paid in that year, thereby reducing such terminal bonuses by 80%. The judge said (at para 107):

". Mr Milligan's response to these submissions was to point to the statements of Mr Thomson and Mr Arnold and to submit that it would be wrong to conclude on issues of fact necessarily addressing a hypothetical situation that Equitable had no real prospect of success in the claim. But neither Mr Thomson nor Mr Arnold have provided any detail to support their views nor have they sought to address the points made by Mr Hapgood."

46. Finally, on the subject of the lost sale claims, the judge turned to another of Mr Hapgood's submissions on the facts, namely that on the showing of the documents in the case the directors were so committed to the concept of mutuality that Equitable had no real prospect of establishing that the directors would ever have resolved to have sold the business unless and until the *Hyman* litigation was lost. On that point, however, the judge briefly said (at para 109) that whereas he thought that there was considerable force in this point, it would not of itself have provided a sufficient basis for striking out these claims.

47. The judge then accepted (at paras 110-111) Mr Hapgood's submission that for similar reasons the alternative claim for loss of the chance of sales was unsustainable. He added as a further reason his view of the law (expressed in para 94 of his judgment), namely that if the lost sale claim failed on the balance of probability, they could not be resurrected on the basis of a loss of a chance to try and effect a sale "which probably would not have been achieved".

48. The judge next dealt with the bonus declaration claims. He immediately pointed out that these claims were in effect for the same "savings" (of £1.6 billion, or £0.4 billion per year) as had formed part of the lost sale claims. They were therefore open to the

same factual objections (the destruction of goodwill point) that had already undone those claims (see para 45 above). However, since this was a point which ultimately went to the allowable amount of the bonus declaration claims, the judge returned to it in a subsequent passage (at paras 125-126, albeit under the heading of causation), where he was prepared to accept that, despite what he called Mr Hapgood's powerful submissions, Equitable had a real prospect of establishing at least "some loss". He therefore gave it the opportunity to consider if it wished to present these claims differently.

49. The judge went on to consider the further submission that there could in any event be no claim after 20 July 2000. He said that, if that point had stood alone, he would have given Equitable a limited opportunity to spell out its claims in further detail.
50. The judge next considered the submission that Equitable had in any event mitigated its loss, by recouping post-*Hyman* the amounts which it now claimed. The judge accepted those submissions on the then current pleading, but he again said (at para 121) that he would give Equitable a further opportunity to address these issues in a "proper pleading or claim". He rejected (at para 127) Mr Hapgood's submission that Equitable had suffered no loss because it had merely discharged a liability.
51. As for the legal submissions that the bonus declaration claims were not within the scope of E&Y's duty, or had not been caused by any breach of their duty, he accepted (at para 122), in contrast to the lost sale claims, that Equitable had a realistic prospect of showing otherwise, on the ground that the FFA in the statutory accounts played a real part in the decisions as to bonus declarations, so that, as in the case of dividends, an auditor's duty may extend to the consequences of payments made in reliance on the accuracy of his report.
52. The judge finally (at paras 128-129) expressed his conclusion as follows:

"128. In my judgment, Equitable should not be permitted to pursue the lost sale claims and the loss of chance of sales claims. I also think that the bonus declaration claims as pleaded and explained for the purposes of these applications can fairly be described as fanciful in approach and amount. There may be proper claims that could be advanced on this or a related basis but not, I think, those which are made, and I do not think it is right or consistent with the CPR that defendants should face claims of the magnitude of these bonus declaration claims which can be shown to have so many basic flaws.

"129. Equitable should be given an opportunity albeit within a defined timescale to consider the declaration claims and decide whether or not it wishes to present them in any way differently. In my judgment if they are not pursued E&Y is entitled to have them presented with a rigour and reality which is presently lacking. If Equitable declines to accept that invitation, I will grant E&Y's application in respect of those claims also."

53. In sum, the judge struck out the loss of sale claims (and the loss of chance of sales claims) both on the facts and the law. He was also prepared to strike out the bonus declaration claims, as then pleaded, on the facts (but not on the law), subject to the opportunity which he gave to Equitable to replead these claims.
54. Equitable availed itself of that chance, but subject to its appeal. It reduced its bonus declaration claims to £500 million in its re-re-amended particulars of claim. It did so on the basis of two "scenarios", the first that the bonus cuts should not be so large as to destroy the DTPB, the second that the bonus cuts should in addition remain consistent with the PRE, which produced a figure of £399 million. In any event, it limited its claims in these respects to savings prior to 20 July 2000. The pleadings

make it clear that the savings were to be made from both reversionary and terminal bonuses.

55. There was then a further hearing at which E&Y sought to gain the judge's confirmation that he would strike out the bonus declaration claims as well as the loss of sale claims. Mr Hapgood took essentially three points. The first was a return to the submission which the judge had accepted in principle, subject to Equitable's repleading of its case, that following the *Hyman* debacle there had been mitigation by Equitable of its loss. The second was that in any event Equitable's estimate at that time was that only £200 million was necessary to compensate GAO holders whose policies had matured prior to 20 July 2000. The third was that the *Hyman* disclosure complaint added nothing to the erroneous FFA complaint. The judge, however, declined to accede to these submissions and he gave permission for the amendments. He thought that at their reduced level Equitable's claims were no longer unrealistic. As to the point on mitigation, he appears to have changed his mind, reasoning (at para 12):

"The fact that a dividend is overpaid by a company in one year which then decided that less should be paid out in the next has not been determined to be preclusive of a claim for loss and I think the contrary is arguable. The actual loss by over-payment of bonuses in the claim period is itself irrecoverable from the payees. Cutting bonuses later does not, I think, necessarily extinguish that loss nor 'save' it."

#### Part 6 THE FACTUAL ISSUES

56. It is convenient to start with factual issues, or the factual basis of Equitable's claims, since if it is plain that the judge was right to say to the extent that he did that Equitable has no real prospect of success on the facts of the case, then issues of law may well be irrelevant. In any event it may only be safe to say that Equitable's claims cannot succeed in law if the court is sufficiently confident that it knows the facts to which it seeks to apply the principles of law which are invoked to strike out those claims.
57. Because this is a matter which tends to be obscured by detailed argument on those matters which are in dispute, it is well to begin by restating what is not in dispute, *at this stage*. Thus, it is not in dispute for the purposes of this strike out application that E&Y were negligent in the performance of their auditing responsibilities. It is worth pausing for a moment to consider the significance of this common ground. It is tempting to say that on this basis Equitable has established its right to proceed to trial on the issue of liability, leaving over its right to do so as a matter of quantum. This may not be analytically quite correct, because it may be that the issues of scope of duty or of causation which are debated in this case are themselves issues which go to liability as well as to quantum. This is, however, a refined debate into which it is not profitable to enter for the purposes of an application which seeks the summary disposal of Equitable's claims. In any event the claims are brought in contract, and prima facie negligence in the performance of E&Y's duties of care owed in contract are breaches of contract. In essence, to the extent that the judge has struck out those claims, or, as E&Y now submit on this appeal, were this court to go further and strike out the whole action, that has been or would be done on the basis that Equitable has no reasonable prospect of proving that the heads of damage which it puts forward are losses which it could have suffered in fact, or which have been caused by E&Y's negligence, or for which E&Y is responsible in law. These are all essentially issues of quantum.
58. Nowhere is this clearer than in respect of the judge's conclusion that Equitable is entitled to proceed to trial on its bonus declaration claims, but only to the extent of a maximum of £500 million, rather than to the extent of the full claim of £1.6 billion. Moreover, since on the judge's own analysis the lost sale claims themselves partake

in large part of the elements of the bonus declaration claims, and since the judge has accepted at this stage that the directors might have considered selling the Society's business, it is in essence only his view that E&Y are not legally responsible for any loss flowing from a failure to sell the business (whether expressed as a matter of scope of duty or as a matter of causation) that has caused him to strike out the loss of sale claims in their entirety.

59. There may of course be cases where, even at a preliminary stage, and even though an assumption of negligence or breach of contract is made in favour of the claimant, it is nevertheless obvious that the claim as a whole, or some distinct aspect of it, cannot succeed. In such a case, the right to bring such proceedings, in whole or part, to an efficient close, without any risk of unfairness or injustice, is a valuable adjunct of the court's powers. However, in our judgment a court should be cautious, particularly in a complex case, about claiming to foresee, especially at the very outset of proceedings, a clear path to the summary dismissal of a case on the ground that, even though the issue of liability needs to go to trial, all issues of quantum must go against the claimant. This is particularly so when one considers that there are other mechanisms available, such as the ordering of preliminary issues, for judging whether a case, or part of a case must fail so far as matters of quantum are concerned. There are cases whose structure may make it sensible to reverse the normal order of things and to take an issue or issues of quantum first. This may either be because the argument on quantum is relatively brief and, if decided against the claimant, determinative of the case; or it may be because such an issue or issues will determine whether the case is worth a great deal or comparatively little, and that may assist the parties to know whether it requires litigation at all, or can be mediated or settled.

60. Into which category does the present case fall?

61. The purely factual issues fall across both main claims, the loss of sale claims and the bonus declaration claims. A consideration of the judgments below and the arguments in this court suggest that there are perhaps four main elements to such factual issues. They are:

(1) Whether the judge was right to say that the issue of whether the directors would ever have contemplated selling the Society should go for trial, or whether in truth they were so committed to mutuality that they would have acted as they did whatever had been in the statutory accounts.

(2) Whether the judge was right to say that bonus cuts of as much as £0.4 billion each year were not feasible without destroying the goodwill of the Society and/or the DTBP and thus to limit Equitable's claim to £0.5 billion.

(3) Whether the judge was wrong in effect to curtail Equitable's claims to the period before 20 July 2000 on the basis that the directors then knew all that had to be known.

(4) Whether the judge was right in effect to place on Equitable the obligation to show positively what the value of the Society probably was in 1998 and/or (in the absence of a fire-sale) in September 2000, and that the difference between those amounts and the sums actually obtained in 2001 was not due to extraneous factors such as declining markets, declining interest rates, and bonus cuts which could never have been achieved.

62. As for (1), Mr Hapgood was able to point powerfully to passages in the documents which were testament to the directors' commitment to mutuality. There were however some straws in the wind in the opposite direction, and in any event the world of affairs is replete with situations where favoured policies have had to be changed or abandoned in the face of hard facts. We think we can take this issue quite shortly, for,

if the judge was not able to see his way to shutting Equitable out on this point, we see no reason for departing from that judgment.

63. Element (2) was at the heart of the judge's attitude on the facts to Equitable's claims. There are undoubtedly obscurities and complexities about the calculation, and the feasibility of the calculation, of Equitable's claim to have been able, with proper forewarning of its financial situation and the implications and dangers of its GAO policies and DTBP, to save £0.4 billion over each of the four years from 1997 to 2000. Those complexities and obscurities are inherent in the hypothetical exercise of considering how any alteration to the declaration and payment of bonuses would have affected PRE, the exercise of GAOs, the Society's goodwill and its overall business structure. However, in our judgment the judge erred in his understanding that such savings had to come solely from *terminal* bonuses paid on policies maturing in those years (see his para 106). In principle those savings could also have come from the reversionary bonuses declared for the years in question, as Equitable's detailed calculations in its re-re-amended pleadings indicate (albeit on lower amounts).
64. It is true that the evidence of Mr Plant on behalf of Equitable records that the "bulk" of the alleged savings would have come from cuts in terminal bonus (see para 73(iii) of the first judgment referring to paras 10 and 100 of Mr Plant's statement; the judge cannot be faulted for being guided by this evidence). But Equitable's pleadings before the judge at the time of his first judgment did not commit it in the same way, and, as has just been stated, its amended pleadings show cuts in both reversionary and terminal bonuses. It would seem from this (and Mr Arnold's and Mr Thomson's evidence, see para 68 below) that Mr Plant was mistaken in this comment, as the actual figures for the years in question and the period following the *Hyman* decision in the House of Lords indicate. As it is, the post-*Hyman* bonus allocations necessarily reflect the fact that the reversionary bonus declarations for the previous three years could not be undone, whereas the claims assume, *ex hypothesi*, that those declarations could have been subject to a new understanding from the 1997 year onwards.
65. The actual figures for reversionary and terminal bonus commitments were available below both in the evidence scheduled in para 65 of Mr Arnold's statement and, most fully and conveniently, in Schedule 1 to the statement of Ms Clare Louise Canning, E&Y's solicitor. The following figures can be extracted from the latter schedule, and show (in £million) (a) the cost of reversionary bonuses in fact declared for the relevant years and (b) the terminal bonuses in fact paid in the relevant years:
- | 1997             | 1998         | 1999         | 2000         | 2001         |
|------------------|--------------|--------------|--------------|--------------|
| (a) 508.1        | 363.4        | 422.6        | 0.2          | 0.1          |
| (b) <u>387.5</u> | <u>467.0</u> | <u>508.6</u> | <u>543.5</u> | <u>965.5</u> |
| 895.6            | 838.4        | 931.2        | 543.7        | 965.6        |
66. It will be remembered that the figures in the first row reflect decisions taken retrospectively by the directors in the first quarter of the following year, when they had access to the draft statutory accounts for the previous year. The figures in the second row reflect the decisions as to terminal bonus for policies maturing during the course of a year which were taken at the start of each of the years of the maturing policies' lives, although, as happened in 2000 and 2001, corrective action might be taken at any time during the year.
67. The 2000 figure for terminal bonuses paid reflected the fact that in that year the Society did not alter its policies (which incorporated the DTBP) on the payment of

terminal bonus until July, when the *Hyman* decision was announced. Payment of terminal bonus thereafter reflected, among other things, the cost of remedying *Hyman*. Hidden beneath these figures is the fact that apart from the terminal bonuses paid on policies which actually matured prior to 20<sup>th</sup> July 2000 the directors retrospectively allocated no bonuses at all for the first seven months of 2000. They thereafter declared terminal bonuses only (on the basis of policy growth of 8%), so that they did not increase the GFV of any of the policies. When their initial remedial measures did not work effectively, to a great extent because the Society's investments did not perform as well as had been hoped, the new board cut bonuses drastically with effect from July 2001 (see para 34 above) so that all policy values were cut by 16%.

68. We referred (at para 64 above) to the evidence of Mr Arnold and Mr Thomson. In his statement Mr Arnold said this about the subject of cutting bonuses:

*"Reducing Reversionary or Terminal Bonus Rates*

79. In the case of the Society, there was no inherited estate. Therefore, it would be inevitable that the cost of the GAR problem could only be met from the undistributed surplus represented by the FFA. An immediate consequence of recognising an additional liability of £900 million in 1997 would thus have been that future bonus prospects would be substantially impaired.

80. It is difficult to determine with precision how the cost of GAR would have been reflected in bonus rates and, in particular, the extent to which reversionary and terminal bonus rates would have needed to be cut. However, while precise calculations are impossible, it is clear, in my opinion, that significant cuts would have been required. The reductions would have had to have reflected the immediate outflow that would occur as a result of GAR being 'in the money' and policyholders exercising GAO on policies maturing in that year. In my opinion this suggests that immediate reductions in terminal bonus rates would have been needed...

84. In respect of reversionary bonuses, any cuts (which it must be noted would have been in addition to the required cuts which other life offices were applying to reflect the lower interest rate environment) would have seriously affected the Society's future business prospects."

Mr Thomson's evidence in this connection (see para 17 of his statement) in general supported that of Mr Arnold.

69. We recognise that Mr Arnold's and Mr Thomson's evidence was directed not so much to proving any particular level of bonus cuts as to substantiating the argument that cuts by themselves were not the solution, and that the directors, if properly informed of the Society's true situation, would have had to contemplate a sale of its business in order to raise fresh capital. Nevertheless their evidence seems to us to go far to support Mr Milligan's submissions on this appeal in relation to this element of the case.
70. There is another set of figures to which it would also be helpful to refer. Between 1995 and 1999 the policy values for with-profit policies always exceeded the underlying assets supporting those policies. The respective rounded figures as at the end of each year and the proportion by which policy values exceeded assets, were as follows (in £million):

1995 14,962 13,366 111.9%

1996 17,424 15,699 111%

1997 20,597 19,240 107%

1998 23,587 22,387 105%

1999 26,873 26,139 102.8%

71. Underlying these figures is the operation of a smoothing policy adopted by Equitable (and other life companies). 1994 had been a bad year for the company's investments, but the directors did not react by cutting back severely on policy values. Instead they restricted the growth in policy values during the ensuing years until the figures were restored to equilibrium. Mr Hapgood has shown us that there was no evidence of any cash flow crisis during any of these years. The DTBP appeared to be working and the directors had no reason to suppose that it would ultimately be held to be invalid. Indeed, it was working so well that although 11,000 GAR policies matured in 1998, only 97 (or less than 1%) of these GAR policyholders exercised the GAO option.
72. E&Y's case, which the judge accepted in part, was that against this background the directors would not have made drastic bonus cuts (with the effect of paring down the value of maturing policies to a sum not much greater than their GFV) even if the statutory accounts had shown them a much smaller figure for FFA than appeared on the figures presented to them. Mr Hapgood showed us features of the 1997-9 evidence (examples appear on pages 600-602, 660-661, 698-699, 828-830 and 939-941 of the bundles before us) which, he suggested, provided powerful support for his clients' case that the directors would not have been thrown off course in the manner suggested.
73. Mr Hapgood also reminded us that Equitable was suing its former directors, so that it was unlikely to be able to call any witnesses to say how the directors would have behaved if the true import of the missing technical provision had been explained to them. He added that they had received such confident advice from leading counsel about the prospects of winning the *Hyman* litigation that they would have been unlikely to have been stopped in their tracks (and therefore taken the measures now being suggested) by a note in the accounts which would have spelled out the position they might face if the auditors had warned them how low their working capital had sunk.
74. In sum, as to this factual element (2), in both its aspects, viz first in its role as the subject matter of the bonus declaration claims and secondly as the largest and most critical component of the loss of sale claims (if the judge's analysis in this regard is correct), while we are sceptical about the size of Equitable's claim it seems to us that it would be wrong to stop it pursuing its claim to trial if that is its wish. In reaching the conclusions set out in paragraph 106 of his judgment the judge was endeavouring to try the action on the documents. It was unreasonable for him, in our judgment, to criticise Mr Thomson and Mr Arnold for not addressing points made by Mr Hapgood at the hearing, particularly as E&Y had filed no evidence at all in answer to the points they had made in their witness statements. If two witnesses with their track record of experience make assertions as powerful as those contained in their witness statements it would in our judgment be wrong to dismiss them unheard, as the judge did, without any of the forensic processes described by Lord Hope and Lord Hutton in the *Three Rivers* case being permitted to Equitable.
75. Equitable's case, in short, was that if the directors had realised the true effect of the missing technical provision when they came to consider the 1997 statutory accounts they would have taken the same drastic action as they were in fact to take in July 2001. As was put in argument, "beggars can't be choosers". Although their policy would have had the effect of inducing more GAR policyholders to opt for the GAO,

they could have achieved massive savings whether or not they were able to sell the Society in an orderly manner post-*Hyman*. Their evidence was to the effect that they would have had no real choice and that this would not have been commercial suicide. This case should be allowed to proceed to trial on the facts, so long as it is not put out of court by the considerations of law to which we will refer below.

76. In relation to element (2), therefore, we do not consider it appropriate to order summary judgment in favour of E&Y on the facts. Even if we may have serious doubts about the size of the claim, E&Y's remedy properly lies in an order for the trial of a well-crafted issue or issues, and not in an order under CPR 3.4 or 24.2. In our judgment the judge was wrong to cut Equitable's claim down in the way he did. He was only able to achieve that end by rejecting the evidence of two highly qualified witnesses as fanciful without hearing them give evidence at all, and this the rules do not allow him to do.
77. As for element (3), Mr Milligan said that his clients' claim should not be pegged as at 20<sup>th</sup> July 2000 because all that they then knew was the likely cost of putting the DTBP in reverse. They did not at that stage realise the true effect of the missing technical provision. If they had, they would not have acted as they did in relation to bonus declarations between July 2000 and July 2001. Even when they introduced a much larger technical provision of £1.7 billion for the purposes of the 2000 statutory accounts, they were still allowing for an uptake of only 57.5% of GAOs instead of the more realistic 75% contended for in their claim.
78. We have had the advantage, denied to the judge, of a fourth witness statement from Mr Thomson in which he tried to clear up some of the confusion which existed at the time of the hearing in the court below. We have already noted (see para 5 above) how terminal bonuses were not guaranteed. They did not therefore feature at all in the statutory accounts, except when they formed part of the policy value paid out to a policyholder when his policy matured. The future "cost of remedying *Hyman*" simply consisted of the economic transfer of £1.3 billion from non-GAR holders to GAR holders, who were in future to receive the same terminal bonus as the non-GAR holders, with the GAR biting on the increment as well.
79. The increase in the technical provision of £1.7 billion, on the other hand, related to the perception that the GAO take-up would be much greater than the Society had previously anticipated. This resulted in a substantial reduction in the FFA (which in fact fell from £4.8 billion in the 1999 accounts to £2.3 billion in the 2000 accounts). Mr Thomson, who joined Equitable in January 2001, just before the 2000 accounts were finalised, says it is not clear to him when the need or the basis for the provision which was included in the 2000 accounts was first appreciated, and that E&Y's working papers are likely to shed light on this.
80. This part of the case caused us concern. It is of course correct that from 20<sup>th</sup> July 2000 the directors realised that they would have to replace the DTBP with policies which did not treat GAR policy-holders differentially with reference to terminal bonus, but the remedy for this ("the cost of *Hyman*") had nothing to do with the missing technical provision. Mr Hapgood points to the fact that Equitable was evidently aware of the need to make a much larger technical provision when the statutory accounts for the year 2000 came to be prepared, and it is difficult to see how Equitable could contend that it did not have access to all the material facts when it came to take its decisions on bonus declarations at the beginning of 2001. Mr Milligan, however, referred to the sum of £543.5 million in fact paid out as terminal bonuses during 2000, and he argued that there was a live question as to how much of these payments could have been prevented if the directors had been better informed between 20<sup>th</sup> July 2000 and the end of the year.
81. To that extent it appears to us that the judge was wrong to cut short the bonus declaration claim as at 20<sup>th</sup> July 2000. The claim ought to be permitted to extend for

another six months, a period which ends at about the time Mr Thomson, newly in office, made his first report to the board on these matters on 19<sup>th</sup> January 2001. By that time the board was in a position to know all the matters that influenced its decision to cut bonuses six months later (apart from any deterioration in stock market values or reduction in interest rates, for which E&Y cannot of course be held responsible).

82. As for element (4), having got this far, we think that the judge erred at this early stage of the proceedings by in effect requiring Equitable to prove its case as a condition of being allowed to run it. We are not convinced that the right way to analyse the loss of sale claims is in terms of £1.6 billion of bonus savings plus £1 billion of goodwill, since a new and more powerful owner may have had all kinds of options open to it which Equitable did not possess, and could therefore have valued the business in a way which Equitable could not take advantage of, while maintaining a more generous bonus policy than Equitable was in a position to sustain on its own. In any event, to the extent that the bonus declaration claims are an element in the makeup of the loss of sale claims, it follows from what we have said above that we do not see in these factual issues grounds for summary disposal. As for goodwill, this is in effect a premium which the market may or may not grant to a business from time to time. If, as the judge himself thought, he should not, subject to questions of law, shut Equitable out from a case that the directors would have sold the business if they had known the true position, it seems to us to be a misuse of at present merely speculative possibilities to complain that Equitable could not at that early stage show, even to a low standard, that the loss of goodwill between 1998 and 2001 was not due to market forces but rather to mismanagement of the Society's affairs as a result of E&Y's negligence. It was perhaps open to E&Y to show that in truth any additional value in Equitable in September 1998 or September 2000 was merely the product of temporary market forces, a difficult enough case to sustain on a strike-out application. It hardly seems just, however, to complain that Equitable cannot at present prove the contrary.

#### Part 7: LOSS OF SALE OR LOSS OF A CHANCE OF SALE? THE CORRECT APPROACH

83. Mr Hapgood sought to maintain the judge's conclusions on the facts (quite apart from his views on scope of duty and causation) to the effect that no case worthy of trial had been demonstrated in respect of the loss of sale or loss of chance of sale claims. Mr Milligan for his part sought to persuade us that both those claims should be allowed to go to trial. In the course of these submissions, however, a number of matters became clear. First, in as much as it is necessary to a loss of chance claim that a claimant should first be able to prove on the balance of probabilities that he would have at least attempted to secure the advantage the loss of which is the subject matter of complaint, Equitable is entitled to point to the judge's own finding, from which we would not dissent, that Equitable's claim that the directors would have tried to sell the business of the Society had some real prospect of success. Secondly, that once a situation is reached where a claim depends on the hypothetical reactions of a third party, as here the willingness of a potential buyer to buy Equitable's business at an acceptable price, the test is not what would have happened on the balance of probabilities, but whether the claimant has lost a real or substantial as distinct from a merely speculative or fanciful chance. If the former is substantiated, it is then for the court to evaluate that chance, which can in theory range across the whole spectrum from some non-fanciful albeit rather meagre chance to something approaching certainty. See *Kitchen v Royal Air Force Association* [1958] 1 WLR 563, 575-6 and *Allied Maples Group v Simmons & Simmons* [1995] 1 WLR 1602, 1611-1614. Thirdly, in these circumstances we are unable to agree with the judge (at para 94 of his judgment) that Equitable's loss of a chance of sale claim fails because it had only lost a chance "to effect a sale which probably would not have been achieved" (at para 94).

84. Mr Hapgood submitted that it was a necessary element in a loss of a chance case that the defendant's wrongful act had irrevocably deprived the claimant of an opportunity, for instance because of the passing of a period of limitation, and that nothing of that kind had happened in the present case. We do not, however, think that the doctrine is subject to so schematic an approach. It rather raises the question whether, in all the circumstances, a real opportunity has been lost.

85. Mr Hapgood also said that he was unaware of any case in which the loss of an opportunity to sell had been the subject matter of a loss of a chance claim. However, among a number of examples of the application of this principle in *McGregor on Damages* (16<sup>th</sup> Edition and Fourth Supplement), at paras 382-385, a particularly apposite example (which was not cited to us) is the decision of this court in *First Interstate Bank of California v Cohen Arnold* [1996] PNLR 45, a case mentioned in *McGregor* in para 384. If a guarantor's negligent accountant had not misled the bank by misrepresenting his client's wealth, the bank would have demanded repayment of its secured loan on 30<sup>th</sup> June 1990. In the event it did not realise the true position until 17<sup>th</sup> August. The judge held that if it had not been misled the bank would probably have achieved a satisfactory sale of the secured property in a falling market by the end of September in the sum of £2.7 billion, and he awarded the whole of that sum by way of damages (subject to giving credit for the much lower sale price actually achieved). This court held that he had adopted the wrong approach. Ward LJ said (at p 29E):

"... [T]here was a confusion between causation and damages and a failure to separate out those matters which had to be proved on the balance of probabilities, those which depended upon finding that chances were substantial, and finally the evaluation of the chance itself."

86. In the event the court evaluated the chance of a sale at 66.66%. It adopted the judge's assessment of the best result that could reasonably have been achieved and then substituted two thirds of that sum as representing the chance of selling the property at that price in a falling market.

87. We therefore consider, subject to the questions of law we discuss below, such as scope of duty and causation, that the judge was wrong to eliminate the loss of a chance of sale as a feasible and realistic claim. We also think, however, in the light of the authorities and principles we have just discussed, that if Equitable has any viable claim on the basis that if E&Y had not been negligent it would have realised the sums it mentions on an orderly sale in 1998 or in the late summer or early autumn of 2000, its claim should be advanced on the basis that it lost the chance of selling on one or other of those occasions. Unless the court were to dismiss this chance as speculative as distinct from substantial (and we do not consider it open to do this at this summary stage) its chances of a sale would depend on the likelihood of a purchaser being willing to buy at an acceptable price. This is not a case in which one can assume a readily available market like a commodity market or a well-developed property market (see *Skipton Building Society v Stott* [2001] QB 261), where a sale is assured and the only possible issue is as to the market level.

88. In the present case, so far as a prospective sale in 1998 is concerned (which is the only scenario on which we need to dwell for the reasons given in para 35 above), Equitable's case could only properly be put on the basis of the chance it would realise the sums suggested before the early autumn of 1998 when disquiet about the DTBP blew up and there was then no prospect of a successful sale until the validity of the DTBP was determined.

#### Part 8 NO LOSS OF BONUS DECLARED

89. Under this heading we consider two separate points of law raised by Mr Hapgood as part of E&Y's defence to the bonus declaration claims. He said that in truth Equitable

had suffered no loss at all. Alternatively it had taken reasonable steps to mitigate the whole of its loss, and had thus avoided making a loss at all.

*The bonus declaration claims: no loss*

90. The first of these arguments ran along the following lines. The FFA simply represented a pot of money which had not been allocated to policyholders following the end of a financial year. No individual member of the Society had a contractual claim to any part of it, and the Society could not dispose of it except by way of distributing it to the members. There were always going to be winners and losers whenever a decision was made to cut policy values. In the events that happened, the Society's non-GAR policyholders whose policies matured in 1998 did rather better than they would have done if there had been cuts in all non-guaranteed policy values in February 1998, as the Society now suggested would have happened if E&Y had not been negligent. Those whose policies matured in 1998-2000 received more than they would otherwise have received, and policyholders in the future would receive less, but the Society as a whole would be unaffected. The same was true in terms of reversionary bonuses declared in 1997-2000, the value of which was thus not available in future years.
91. Mr Hapgood did not challenge, in theory at any rate, the viability of a claim for loss of the investment income the Society would have generated until the cuts were eventually made, but he submitted strongly that it had suffered no overall loss for which it could claim. He said that the cases on the recovery of unlawful dividends fell into a different category, because in those cases it was the illegality of the dividend payment out of a company's capital which formed the basis of the right of recovery. Similarly, if a negligent auditor prepared accounts which purported to show, wrongly, that there were surplus monies out of which a dividend might lawfully be paid, the auditor could be required to make good what had unlawfully been paid out. In the present case there was no question of any unlawful payments. The bonuses had all been paid or committed lawfully. The only question was whether one generation of policyholder was to benefit rather than another.
92. Mr Milligan submitted that the Society had indeed suffered a loss. It had paid out or committed all these bonuses which it was quite unable to recover from those whose policies had matured or those whose reversionary bonuses were guaranteed. As a result of E&Y's negligence, the Society had no money left from which to pay the next generation of policyholders. They could not sue the Society. Nor could they sue E&Y. Only the Society had the appropriate standing to recover this loss from its negligent auditors.
93. He said that the sums in the FFA did not have to be distributed. They could be seen as a source of capital to invest in profit-earning assets or to discharge onerous liabilities. The law should not draw a radical distinction, as Mr Hapgood suggested should be done, between the payment of unlawful dividends and the payment of lawful dividends which would not have been declared if the accounts had shown a correct figure for profit. A company could recover other payments from a negligent auditor, such as tax or bonuses, which it had expended on the basis of falsely stated profits.
94. Mr Milligan drew comfort for his approach from the decided cases. In *Leeds Estate, Building and Investment Company v Shepherd* (1887) 36 Ch D 787 Stirling J ordered a negligent auditor to repay to a company not only directors' fees but also the bonuses paid to a manager which were only properly payable if the company paid a dividend of 5% (which it would not have done if the accounts had been prepared accurately). In *re The Westminster Road Construction & Engineering Co Ltd* (1932) Acct LT 38 Bennett J held that a company was entitled to recover from a negligent auditor commissions it had paid on the basis of a wrongly stated profit figure. In *In re Thomas Gerrard & Son Ltd* [1968] 1 Ch 455 Pennycuik J awarded a company as

against its negligent auditor both the cost of recovering excessive tax paid on wrongly stated profits and also any tax not in the event recovered.

95. Mr Milligan said that an even clearer case in support of the proposition he was advancing was *Segenhoe Ltd v Akins* [2002] Lloyd's Rep PN 435, an action against negligent auditors decided by Giles J in the Supreme Court of New South Wales in March 1990. The defendants in that case had similarly argued that the company had suffered no loss after paying out an unlawful dividend to shareholders. In particular, it contended that the fact that the company was still solvent made all the difference, as did the fact that the dividends represented sums paid to shareholders rather than to third parties. Giles J dismissed both these arguments. Of the first, he said (at p 442 RHC):

"In either case the company as a separate entity is out of pocket to the extent of the money paid away."

Of the second he said (at p 443 LHC):

"Equally, it does not seem to me that in principle the company is unable to recover the money so paid away because it was paid to shareholders rather than to a third party or third parties. That would negate the company's status as a legal entity separate from its shareholders and the shareholders' lack of any proprietary interest in the company's assets. Further, recovery of the money paid away does not necessarily mean that shareholders will be paid twice over. Even if the shareholders remain the same, the company may or may not distribute the amount recovered by way of further dividend; it may or may not make profits from the use of that amount; it may have suffered in its trading between payment out and recovery such that the recovery only restores its position. Inquiry into these matters would be akin to the *never-ending* process to which I previously referred. Changes in shareholding may mean that there is a real loss to shareholders occasioned by the company being out of pocket which is not matched by receipt of the dividend wrongly paid. An incoming shareholder will not necessarily pay a price for his shares discounted so as to reflect the company being out of pocket, and thus will not necessarily receive a benefit, or the equivalent of a benefit, twice over if the company recovers the money paid away. If the submission for DHS were to be accepted incoming shareholders may be disadvantaged, and it can not be that the result should differ according to when in relation to changes in shareholding the proceedings were brought to a successful conclusion, or according to an investigation of the position of each of the shareholders."

96. Langley J decided this issue by saying (at para 88) that he did not see why in the context of a negligent audit the law should in principle draw so radical a distinction between payment of unlawful dividends and lawful dividends which would not have been declared had the accounts shown a correct profit figure. Profits usually do not have to be distributed either at all or at any particular date or rate. He considered the cases cited on both sides and concluded that Mr Hapgood's submission was not established by them, at least at this summary stage. We agree.

97. Mr Hapgood also submitted that there was no loss because the declaration and payment of bonuses discharged a liability of the Society. The judge's response (at para 127) was that the contrary argument had some real prospect of success. The "liability" represented by the FFA was not an obligation like a commercial debt, but a balancing figure (we would add, analogous to "shareholders' funds"). Equitable was entitled to declare and announce bonuses in such amounts and at such times as it chose and they only became commitments following declaration or on maturity. We again agree.

*The bonus declaration claims: mitigation*

98. In the alternative, Mr Hapgood said that it was evident that Equitable had calculated its claim on the basis that the cuts of 3.7% in total policy values represented by the bonus freeze for the first seven months of 2000, and of 16% made in July 2001, had all been put in place with effect from 1<sup>st</sup> January 1998. He accepted that Equitable might properly claim (on the disputed hypothesis that his clients had been negligent) the loss of investment income arising out of the facts that these cuts had not been put in place in 1998. But if its claim centred round its loss of working capital, it had mitigated its loss by putting in place, albeit three years late, the necessary remedial measures. If the court asks itself whether Equitable had taken steps which in fact mitigated its loss, Mr Hapgood said that the answer was inevitably "yes".
99. So far as the bonus freeze was concerned, Mr Milligan said that it was introduced as part of the cost of remedying *Hyman*: it had nothing to do with remedying the dilemma created by Equitable's ignorance of the missing technical provision. He then treated the court to a number of analogies to rebut the suggestion that his clients should give credit for the effect of the cuts it in fact made in July 2001. One such analogy was the man who recoups the £500 he lost as the result of his auditor's negligence by walking to work and saving the cost of his £500 season ticket. He said that the fact that the Society, in its needlessly impoverished state, had to take prudent measures for the future did not mean that it was not entitled to recover from E&Y the reversionary bonuses it would not have declared in 1998 and 1999 or the terminal bonuses it would not have paid in 1998-2000 if it had known about the missing technical provision.
100. In his second judgment under appeal the judge said (at para 12) of Mr Hapgood's argument:

"In my judgment, however, this is not a point which is so obviously right that it justifies shutting Equitable out from arguing the contrary. It would, in its ultimate logic, mean a company in the same business as Equitable could never suffer a loss from over-payment of policy values at least, perhaps, so long as it was solvent. The fact that a dividend is overpaid by a company in one year which then decided that less should be paid out in the next has not been determined to be preclusive of a claim for loss and I think the contrary is arguable. The actual loss by over-payment of bonuses in the claim period is itself irrecoverable from the payees. Cutting bonuses later does not, I think, necessarily extinguish that loss nor 'save' it."

101. Again we agree with the judge's approach. In essence this alternative way of putting Mr Hapgood's point comes very close to his first "no loss" argument. These matters will need to be looked at in the round when the facts are clear. They do not in any event apply to the potential bonus declaration savings as an element in the loss of chance of sale claim. Although it may be that after hearing all the evidence the trial judge may favour Mr Hapgood's submissions it cannot possibly be said at this stage that Equitable's arguments have no real prospects of success.

#### Part 9 THE SCOPE OF E&Y'S DUTY OF CARE, AND CAUSATION

##### *Issues relating to the scope of E&Y's duty of care and causation*

102. We turn finally to issues relating to the scope of E&Y's duty of care and to causation. So far as the lost sale claims are concerned, the reason why the judge struck them out as a matter of law can be readily gleaned from paragraphs 101 and 102 of his judgment:

"101. It should be noted that:

(i) It is not alleged that Equitable contemplated a sale or that E&Y knew that a sale was in contemplation or would have been had the provisions been made;

(ii) It is not alleged that E&Y owed a duty to protect Equitable from an erosion in the value of goodwill. Goodwill was not even included in the audited accounts as an asset;

(iii) It is not alleged that the purpose or one of the purposes of the provisions was in any way related to whether or not the business and assets should be sold or goodwill preserved;

(iv) It is not alleged that E&Y did nor should have given any advice on sale or raising capital or preserving goodwill or how otherwise to address the provisions;

(v) Mr Milligan was concerned not to identify (and it is not pleaded) what it was that did cause the alleged loss in the value of goodwill between September 1998 and early 2001. Mr Hapgood submitted that the causes were not difficult to identify: the *Hyman* decision; falls in interest rates and equity values. None of those are matters for which E&Y bears any responsibility, nor were any of them caused by a want of provision.

102. The lost sale claims are therefore not expressed in terms of the specific transaction cases. Moreover on analysis they are in my judgment analogous to claims for the type of loss which *SAAMCO* and *Galoo* determined to be irrecoverable. In effect the claims are for all the losses which it is said Equitable suffered for whatever reasons after the dates when the supposed sales would have been effected. That is (at most) 'but for' and no more. It is also (at most) foreseeability and no more. As I understand the law such a claim is unsustainable and should not be permitted to proceed."

103. It was for this reason that he struck out the paragraphs in the Re-Amended Particulars of Claim which are mentioned in paragraph 1 above.

104. In contrast, the judge permitted the bonus declaration claims to proceed, while significantly curtailing their scope (for which see paras 52-54 above). The reasons for his different approach are evident from paragraphs 122 and 123 of his judgment:

"122. In contrast to the lost sale claims I do think it is open to Equitable to pursue with some real prospect of success a claim that the decisions as to the level of bonuses fell within the scope of E&Y duties. The analogy with dividends, tax and commissions payable out of or by reference to profits seems to me to be a real one... There is evidence that the DTBP and FFA in the statutory accounts played a real part in the decisions. There is also evidence that E&Y understood and appreciated as much in carrying out their audits. The potential or arguable rationale, as it seems to me, is that the scope of duty of an auditor whose duty includes a duty to report on a statement of surplus (or profit) may extend to the usual consequences of the surplus being paid away to members in reliance of the accuracy of the amount reported upon.

123. I decline therefore to strike out the claims or to give judgment for E&Y on this basis."

105. It is now well established that in a case like this a court needs to ask itself five questions:

(i) Does a legally enforceable duty of care exist?

(ii) If so, what is the scope of that duty?

(iii) What is the prospective harm, or kind of harm, from which the person to whom the duty is owed falls to be protected?

(iv) Has there been a breach of that duty?

(v) If so, was the loss complained of caused by that breach, or was it caused by some other event or events unconnected with the breach?

106. Because this is an application under CPR 24.2, all the claimant needs to show at each stage is that it has a real, as opposed to a fanciful, prospect of establishing its case. And since this is a developing field of law, the well-known advice of Sir Thomas Bingham MR in *E (A Minor) v Dorset CC* [1995] 2 AC 633, 693-4 needs to be borne in mind, with appropriate modifications for the fact that this is not only a strike out application. In particular, Sir Thomas Bingham said (at p 694B):

"This must mean that where the legal viability of a cause of action is unclear (perhaps because the law is in a state of transition), or is in any way sensitive to the facts, an order to strike out should not be made."

107. In the present case, it is not as though a cause of action for negligence arising in contract is unknown, or even unclear; and for present purposes E&Y's negligence is assumed. The debate is rather about concepts used to limit the scope of the legal consequences of negligence or of legal responsibility for negligence, where, as will appear below, the law is at present in a state of development and flux, and sensitive to the facts.

*(i) The duty of care arises in contract*

108. There is no difficulty in answering question (i). This is a claim in contract, and like all who render professional services for reward, E&Y owed Equitable an implied duty of care in and about the manner in which they performed those services.

*(ii) The scope of E&Y's duty of care: the contractual documents*

109. There is similarly little difficulty in answering question (ii), since the scope of E&Y's duties can be gleaned from their written letters of engagement and the various documents in which they set out what their services would be. Once the scope of their services is identified, it was not in issue that E&Y owed Equitable a duty of care in relation to the manner in which they performed them.

110. Their duties in connection with the 1997 audit were embraced by a letter of engagement dated 15<sup>th</sup> November 1995. This letter described the familiar duties of auditors (including the duty to state whether in their opinion the accounts gave a true and fair view of the state of the company's affairs at the balance sheet date). It also contained the following two passages:

"As directors of the company, you are responsible for the maintenance of the accounting records and the preparation of accounts which give a true and fair view and comply with the Companies Act, However, should we have any

comments on matters affecting the form and content of the accounts, we shall discuss them with you, as and when they arise.

...

We also have a professional responsibility to report if the accounts do not comply in any material respect with accounting standards as issued or adopted by the Accounting Standards Board."

111. Relevant standards included:

"When the auditors become aware of, or suspect that there may be, instances of error ... they should document their findings and ... discuss them with the appropriate level of management (SAS 110.5).

The auditors should as soon as practicable communicate their findings to the appropriate level of management, the board of directors or the audit committee if ...

(b) material error is actually found to exist (SAS 110.7)."

112. The nature of E&Y's services to Equitable in connection with the 1997 audit was filled out by its Client Service Memorandum 1997, which referred in turn to a Service Charter for Equitable which they had developed in conjunction with Equitable's senior management. The memorandum contained the following relevant passages:

"In determining the scope of audit work we seek to obtain reasonable assurance that each company's accounts are free from material error. [Overall materiality for the purposes of the group accounts was said to be £40m].

Our audit approach has been developed after discussing the Society's business goals and its strengths, weaknesses, opportunities and threats with a number of the Society's senior management.

The Charter summarises the Society's medium term expectations of our service. It also confirms the key business issues and risks which form the background against which our audit approach has been developed."

113. The Charter contains the following features:

(i) Under the headings "Your Needs: Assurance" appear the words "Audit opinions" and "Audit Committee comfort".

(ii) Under the headings "Aligning audit to business needs: Key business goals: SWOT," the "Weaknesses" include "Thin solvency margin" and "Strain due to high volumes of business", and the "Threats" include "Stock Market Collapse".

(iii) Under the headings "Understanding your business and financial risks: Risk Assessment: Key Financial Statement Risks" appear the words "Technical reserves".

(iv) Audit opinions, Audit Committee papers and Management letter are included among "Deliverables", and "Assurance received on key risk areas" is one of the value measures to be used for measuring delivered value.

114. An engagement letter dated 21<sup>st</sup> October 1998 covered the 1998 audit work. E&Y were now issuing formal terms of business which were to dictate the essential elements of the terms of engagement. They also prepared an audit committee report which was said to form the basis on which their programme of audit work would be carried out and the agreed deliverables provided. We were shown passages on which Mr Milligan relied, which appeared on pages 2-4, 9, 20 and 23 of this report. It is unnecessary to summarise these passages for the purposes of this judgment, since they followed the pattern of the previous year. The same weaknesses and threats were identified, and the strains on statutory solvency, which were fully analysed on page 9, constituted one of the key risk areas on which E&Y's "efficient audit strategy" was to be focused.

115. So far as the Terms of Business were concerned, "Our Responsibilities" included the following passages:

"We will provide the services described in our engagement letter ... with reasonable skill and care in accordance with the professional standard expected of us, and in a timely manner.

...

Whilst our reports and advice may be a factor to be taken into account when deciding whether or not to proceed with a particular course of action, you remain responsible for any commercial decision that you make, and regard must be had to the restrictions on the scope of our work and the large number of other factors, commercial and otherwise, of which you and your other advisers are, or should be, aware by means other than our work."

116. It is unnecessary to add very much in relation to the engagement letter and the other documentation relevant to the 1999 audit. Suffice it to say that the Audit Committee Report referred to the ongoing *Hyman* litigation, and Mr Milligan invited us to pay particular attention to passages on pages 2, 4 and 5. In particular, E&Y referred to the public concern over the Society's ability to cope with severe adverse experience.

117. From all this it can readily be concluded that the scope of E&Y's duties of care included the following:

(i) Preparing a report on the accounts which was free from material error (as defined);

(ii) Reporting to Equitable at the appropriate level as soon as they found an actual material error;

(iii) Paying particular attention to Equitable's thin solvency margin, the strain caused by high volumes of business, and the risk of stock market collapse;

(iv) In carrying out its risk assessment, paying attention to the level of the technical reserves;

(v) Giving assurance to Equitable on the key risk areas.

*(iii) The harm, or kind of harm, from which Equitable was to be protected*

118. In relation to the third main question we received sharply differing submissions. Mr Hapgood's approach was to argue that Equitable had never sought any advice at all from E&Y about the desirability of a sale of the type now being

suggested: indeed, the directors were adamantly opposed to the loss of the independence which the Society's mutual status carried with it. Similarly, Equitable had never sought any advice about the bonus declarations they would make. In these circumstances the Society could not now say that E&Y owed it any duty to protect it from the harm now alleged, whether of the loss of a timely sale or the loss caused by making inappropriate bonus declarations.

119. Mr Milligan, on the other hand, said that after identifying the scope of E&Y's duties in the manner suggested, it inevitably followed that Equitable was entitled to be protected from making inappropriate decisions or failing to take appropriate decisions in relation to its corporate management because they relied on statutory accounts which showed that the FFA appeared to be far larger than ought to have been shown. In the two later years E&Y's misleading errors were compounded by the failure to spell out what would be the consequences of losing the *Hyman* litigation. He submitted that it was reasonably foreseeable that Equitable would rely on these accounts when it made strategic corporate management submissions during the ensuing year. The auditors owed the Society a duty to protect it from making ill-informed decisions, whether as to bonus declarations or as to demutualisation, in the belief that the statutory accounts were at any rate free from material error (for which see para 111 in relation to the 1997 audit).

120. In this connection, we were addressed at length by Mr Milligan and Mr Haggood about the effect of the decisions of the House of Lords in *SAAMCO* and *Aneco*. Those two cases were very different from the present case, because the scope of the defendants' services were not stated in a number of detailed documents, as they are here. They were both claims in which there were concurrent duties in contract and tort. In *SAAMCO* it was important to identify the precise nature of a valuer's duty, namely to provide the plaintiffs with a correct valuation. In *Aneco* the majority of the members of the House of Lords concluded that the insurance brokers' duty extended beyond obtaining the excess of loss protection they were instructed to obtain, and included a duty to inform their clients whether or not the relevant reinsurance cover was available on the market at all.

121. It is worth pausing on the difference of judicial opinion in the *Aneco* case. Lord Millett, who dissented, thought that the brokers did not owe the second of those duties because their clients never expressly asked them whether they were seeking a cover which was not available on the market. Lord Lloyd and Lord Steyn, however, with whom Lord Slynn and Lord Browne-Wilkinson agreed, distinguished the duty in the *SAAMCO* case to provide specific information from the duty to advise generally. Once the scope of the broker's duty to advise was identified, then the usual rule followed that foreseeable loss could be recovered as compensation for any breach, provided that the loss fell within the scope of the duty that had been identified.

122. The parties sought to support their submissions by references to, or reliance on distinctions from, a number of other cases relating to issues of auditors' negligence. Thus a leading case in this area is *Caparo Industries Plc v Dickman* [1990] 2 AC 605, where it was held that auditors owe no duty of care in tort to investors or potential investors in their client's shares, even when it was foreseeable that their client would be susceptible to an attempted takeover. That was decided on a preliminary issue on assumed facts. The case was really concerned with the familiar, but often difficult, question in tort of *Duty of care to whom?* There was no contractual nexus between the auditors and the plaintiffs in that case. Mr Milligan, nevertheless, relied on the statement by Lord Bridge of Harwich that in practice the shareholders' interests can be protected by the company, which will have a claim against its auditors (at 626D-F). Mr Haggood, on the other hand, relied on passages, for instance at p 627 (in the speech of Lord Bridge) or at pp 660-662 (in the speech of Lord Jauncey of Tullichettle) which address the separate question of identifying the scope of any duty owed. Thus Lord Bridge said (at p 627D):

"It is never sufficient to ask simply whether A owes B a duty. It is always necessary to determine the scope of the duty by reference to the kind of damage from which A must take care to save B harmless."

123. In this connection, however, we think that remarks at pp 630G and 662A which contemplate that the auditors' reports are intended to enable shareholders (and thus we would infer the directors themselves) to question the management of the company are not unfavourable, at any rate at this summary stage, to Equitable.

124. Mr Milligan also relied on *Coulthard v Neville Russell* [1998] 1 BCLC 143, where the directors of a company sued the company's auditors for failure to warn them that a loan made by the company might constitute a breach of section 151 of the Companies Act 1985 and thus should have led to a qualified audit report: their claim was for the loss which disqualification proceedings consequent upon the breach of section 151 had caused them. The auditors sought to strike out the claim on the ground that it was no part of auditors' duties to protect directors personally from the consequences of their mistakes and wrongdoing. The auditors' application was initially successful, but this court allowed the directors' appeal. That was another claim in tort. Chadwick LJ pointed out that the complaint involved an allegation that the existence of the loan should have led to a qualified report. He considered many of the leading cases on auditors' negligence, as well as *SAAMCO*, and concluded (at pp 154-155):

"I remind myself that this is an application to strike out...In my view 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 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 view that this is not one of those plain and obvious cases in which it could be right to deny the plaintiffs the opportunity to establish their claim at trial."

125. Mr Hapgood on the other hand relied on *Bank of Credit and Commerce International (Overseas) Ltd (in liquidation) v Price Waterhouse* [1999] BCC 351, where Laddie J did strike out BCCI's claims against its auditors in contract and tort to recover losses made on bad investments. The essence of the complaint made against the auditors was that they had failed to detect and warn the directors against fraud and imprudence in the company's affairs. However, the particular claims struck out related to activities which were not alleged either to have been touched by fraud or imprudence themselves or to have been a continuation of a type of business which had been touched by the fraud or imprudence which the auditors should have discovered. It was in these circumstances that Laddie J said (at para 57):

"The skill [the auditor] offers and for which he is paid is the skill in looking at the company's accounts and the underlying information on which they are or should be based and telling the shareholders whether the accounts give a true and fair view of the company's financial position. He is not in possession of facts nor qualified to express a view as to how the business should be run, in the sense of what investments to make, what business to undertake, what prices to charge, what lines of credit to extend and so on. Not only does he not normally have the necessary expertise but those are areas in respect of which his advice is not sought. When the company engages an auditor, it is not seeking his help in steering the management into making better management decisions."

126. Although Mr Hapgood submitted that that passage applied with equal force to the present claims, we would observe that in the present case (1) there is assumed negligence which goes to the actual status and accuracy of the audit report itself; (2) the bonus declaration claims are closely connected with the question of the Society's available resources rather than its day to day business or investments; (3) the loss of a chance of sale claims go to a fundamental question of the Society's viability, rather than to day to day management.
127. *Sasea Finance Ltd (in liquidation) v KPMG* [2000] 1 All ER 676 concerned another application to strike out certain heads of claim in an action brought by a company against its auditors for negligence. This case, like *BCCI*, centred round a complaint that the auditors had failed timeously to warn the company of fraud by a senior employee. The application succeeded in part at first instance, but this court allowed the company's appeal. It was submitted that the auditors' duty did not extend to the losses claimed because the transactions from which they flowed arose in the normal course of business and were part of the ordinary risks associated with the carrying on of that business. This court disagreed. In any event, that submission hardly seems to be an appropriate basis for striking out the present claims.
128. In seeking to demonstrate that Mr Milligan's submissions as to the scope of E&Y's duties were flawed Mr Hapgood relied heavily on the approach taken in *SAAMCO*. However, as the cases cited above demonstrate, all of which, with the exception naturally of *Caparo* itself, referred to and considered *SAAMCO* in the course of their reasoning, the issue is one which turns on the particular facts of each and has rarely been found suitable for summary disposal. Neither *SAAMCO* nor *Aneco* were striking out cases. In referring to *Aneco*, Mr Hapgood acknowledged, for instance by reference to the last paragraph of Lord Steyn's speech (para 43), that ultimately the question was one of fact as to "which side of the line drawn in *SAAMCO* the present case falls", and he also acknowledged that such a question can be a difficult one. He submitted nevertheless that in the present case the line-drawing exercise was easy, on the basis that E&Y had never been asked to advise on issues regarding working capital or the merits of selling the business. However, even Langley J ultimately drew a line between the two classes of claims made by Equitable, for although he struck out the loss of sale claims he allowed the bonus distribution claims (in reduced form) to go through. The evidence before the court from Mr Thomson and Mr Arnold, moreover, (at this stage uncontradicted) is that if the directors had known what it is alleged E&Y should have drawn to their attention, and even though with that knowledge they would probably have cut bonuses, they could not by that means alone have secured the safety of the Society's business without raising more capital and thus without selling it. Given this uncontradicted evidence we consider that the line drawn by the judge is a fine one and too fine for summary disposal.
129. Mr Hapgood's solution was to strike out everything. We think that is to compound the mischief. Ultimately, we consider that it cannot be said that Equitable has no real prospect of persuading a court that E&Y owed it a duty to protect it from the harm identified by Mr Milligan. When auditors undertake for reward to perform services such as those listed in paragraph 111 above and are found to be negligent in the way they perform those services we do not understand the law to require the client to ask for specific advice before it can recover damages for the foreseeable losses it later suffers. The answer to the matters set out in paragraph 101 (i) and (ii) of the judgment (see para 102 above), which so strongly influenced the judge, is that because E&Y must be taken to have failed in their duty of care to report to Equitable on material errors in its accounts, the directors of Equitable did not think that it needed to seek advice from E&Y about the advisability of a sale. If, however, they had known what it is said they would have known had E&Y performed their duty, it is well arguable that the consequences, not only for bonus distribution, but also for the factors affecting the Society's capital base generally, would have had to have been discussed with the auditors and considered at large and as a whole.

(iv) *The breach of duty is assumed*

130. As to item (iv), it is to be assumed for the purposes of E&Y's application, although it will be hotly disputed at the trial, that E&Y acted in breach of its duty.

(v) *Was the loss complained of caused by the breach?*

131. Finally, the Society's first claim, as it must now be reformulated, is for the loss of the chance of achieving an orderly sale during the second and third quarters of 1998 (alternatively, during the last five months of 2000, following the fierce retrenchment on bonuses in the meantime which has been suggested). Mr Haggood continued to rely on *Galoo* and on the judge's additional finding that the lost sale claims had not been caused by E&Y's assumed negligence. However, the judge considered that his ruling on causation followed from the analysis which had led to his decision on scope of duty, and might in fact be in essence the same question. He said:

"92. The claim in *Galoo* alleged that negligent audits were carried out in the years 1985 to 1990; non-negligent audits would have revealed insolvency; the company would have ceased to trade, and so subsequent trading losses would not have occurred. The Court of Appeal distinguished between a breach of contract which was the dominant or effective cause of a loss and one which had 'merely given the opportunity for the loss to be sustained' and said the answer to which it was depended on the court applying commonsense to the facts of each case. The claim for trading losses was struck out.

93. As I have already indicated, I find it easier to analyse *Galoo* in terms of scope of duty. But it also serves to demonstrate that to establish causation a claimant must establish some feature beyond 'but for'. It also follows, in my judgment, that it is at least necessary for a claimant to identify the losses claimed and attribute a cause to them which can then be assessed by the application of the scope of duty and commonsense."

132. Thus it was that having struck out the loss of sale claims on the ground of scope of duty, the judge immediately went on to say:

"103. I think the result is the same if the submissions are approached as a matter of causation. The causal link between a loss of goodwill and the want of provisions is said to be that the provisions would have shown (not caused) a lack of working capital and so led to a decision to sell. But the loss claimed is not a lack of working capital but a loss of the value of goodwill in an amount approaching £1 bn over the period September 1998 and February/March 2001. As I have said, the causes of that loss are not identified by *Equitable* but must include matters for which E&Y could only be responsible if at all on a 'but for' basis such as both *SAAMCO* and *Galoo* outlaw."

133. We think that once the judge's analysis and decision in terms of *SAAMCO* have been departed from then the support for his decision on causation also fails. Although *Galoo* was a case of summary disposal, the facts of the case were idiosyncratic. Since, *ex hypothesi*, the company was insolvent, the losses suffered by continuing to trade were really suffered by the creditors (or by the company's parent), and so, although the case was not argued in that way, the real question may well have been whether the auditors owed any duty to the creditors (see Lord Hoffmann's lecture to the Chancery Bar Association, 15 June 1999, *Common Sense and Causing Loss*, at pp 22-23). In any event, we consider that in the passage cited above the judge was in effect trying the case on the facts before they had been established (see

at para 82 above). If the loss of a chance of sale claims are within the scope of E&Y's duties, then the quantum of those claims becomes a matter of fact. We do not therefore consider that such claims should be shut out at this stage. It was suggested that a significant part of the alleged loss flowed from causes quite separate from E&Y's breach of duty, but if the Society had a significant chance of achieving the sales for which it contends, then it would be entitled to recover an appropriate proportion of the price it would have achieved at the time of the relevant sales. We would therefore allow Equitable's appeal in relation to the lost sale claims, provided that they are restricted to a claim for damages for the loss of a chance of achieving such sales. We cannot address issues of quantum at this summary stage.

134. For similar reasons, we consider that the judge was right to allow the bonus declarations claims to stand. We have already stated our reasons for concluding that they should not have been curtailed in the manner suggested by the judge.

135. We were addressed by counsel at great length on the law, and many of the recent leading cases were drawn to our attention, to some of which we have referred. We have crafted the five questions contained in paragraph 105 of this judgment from a careful study of the caselaw cited to us.

#### Part 10. CONCLUSION

136. Mr Hapgood pressed us with the sheer size of Equitable's claims and submitted that, against the uncertain background of the support for them to be found in Equitable's pleadings, they are an unwarranted burden for a litigant to carry down to trial. He put this point in a number of ways, for instance by comparing the £1.6 billion bonus declaration claims to the considerably smaller figure of £0.9 billion which was the missing technical provision for 1997 with which Equitable's complaints commence; or by contrasting Equitable's amended and at least detailed pleading of £0.5 billion for the bonus declaration claims with the much more general sweep of Equitable's previous £1.6 billion claim; or by emphasising the "lost" £1 billion for goodwill.

137. We have some sympathy for this submission. However, having concluded that Equitable's claims cannot be struck down summarily either on the ground that they are unsustainable in law or on the ground that there is no realistic prospect of success at trial, we do not see how on the material before us we can slice individual heads of claim and say that they cannot succeed for more than £x or £y.

138. The judge's first order in effect compelled Equitable to try to replead a minimum figure for the bonus distribution claims which would get past his analysis: but that pleading was made under threat of complete striking out and was always subject to Equitable's appeal. We asked Mr Hapgood if he could cite any authority to illustrate his submission that the court could slice a single head of claim as a matter of summary disposal, but he was unable to do so. In any event, and even if the bonus declaration claims were to survive for only a reduced figure of, say, £0.5 billion, there would still need to be a full trial process to consider all matters of liability and quantum. Moreover, there may still be opportunities, through the processes of requests for clarification of the statement of case or for more information, proper disclosure, and by means of preliminary issues, for E&Y to capitalise on their scepticism about the size of Equitable's claims. That, however, will be a matter for the application of general principles of case management.

139. For these reasons we would allow Equitable's appeal to the extent set out in this judgment and dismiss E&Y's appeal and cross-appeal. The court will hear counsel as to the terms of the order which must be drawn up to reflect the terms of this judgment.

