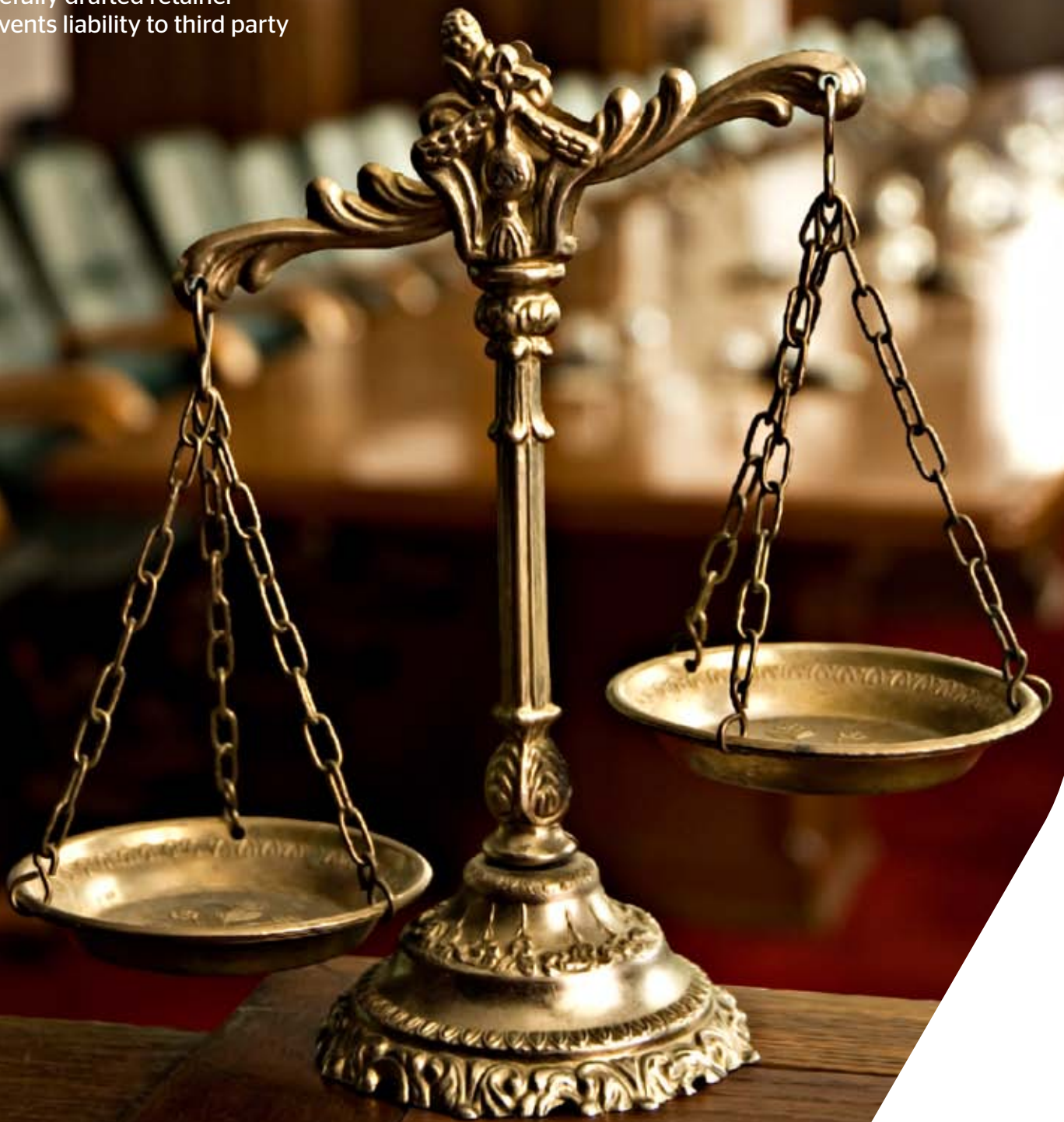


QBE European Operations

Professional liability

Carefully drafted retainer prevents liability to third party



Carefully drafted retainer prevents liability to third party

KPMG has recently been successful in striking out a claim in the High Court when an investor in a failed company tried to recoup substantial losses from the firm after the company collapsed (*Arrowhead Capital Finance Ltd v KPMG LLP*). This matter serves as a reminder of the benefits of appropriately drafted terms of engagement and the law on tortious duties of care.

Facts

KPMG's client was Dragon Futures Limited ('Dragon'). In 2003, Dragon decided to trade in the 'grey market' in mobile telephones, a grey market being a trade in branded goods outside of the normal distribution channels authorised by the brand's owners. A typical transaction would involve Dragon buying a consignment of mobile telephones from one party and then selling them on to another party for a profit. This would require Dragon to pay VAT on the purchase price, which it subsequently reclaimed from HM Customs and Excise (HMCE) (as it then was). It was critical to Dragon's business plan therefore that it would be able to recover VAT. Dragon engaged the services of KPMG to advise on the recovery of VAT. KPMG's engagement letter dated 17 September 2003 provided as follows:

"We will deliver services to you in connection with the implementation of a due diligence strategy to address the threat posed by HMCE and its approach to companies dealing in the mobile telephone industry."

Scope of services

KPMG will provide the following services:

- Review the existing business records to identify areas for attention
- Analyse the current measures Dragon Futures takes to protect itself from fraudulent traders
- Update the existing procedures to take into account the recent Budget measures

- Provide a regular review of systems and documentation, dates to be agreed with yourself
- We will agree with you, in advance, the scope of any further work that you require us to do over and above that detail"

In addition, the engagement letter referred to the associated Terms of Business which contained various provisions limiting KPMG's liability. Although not specifically referred to in the engagement letter itself, the Terms of Business provided that the contract between Dragon and KPMG would not create or give rise to any third party rights, and excluded the application of any legislation conferring any contractual or other rights on third parties.

In January 2004, the Claimant, Arrowhead, loaned money to Dragon through an intermediary. As part of the loan negotiations, Arrowhead was shown documents referring to the due diligence exercise undertaken by KPMG for Dragon. HMCE began investigating Dragon's transactions. In March 2004, Dragon arranged a conference call with Arrowhead, which was attended by an individual from KPMG, to discuss the investigations. By November 2004, HMCE had rejected all of Dragon's claims for input tax on the basis of missing trader fraud. Dragon appealed HMCE's decision, but the appeal was dismissed by consent because Dragon had to accept that it should have known that the transactions were connected to fraud and would have known if it had made sufficient enquiries. Dragon was subsequently ordered to be wound up and was dissolved with no distribution to creditors. Dragon had made some repayments to the intermediary through which Arrowhead had made the loans, but US\$52 million remained outstanding. Arrowhead claimed against KPMG.



The claim

Arrowhead's claim against KPMG was in tort, as there was no contractual relationship between the parties. It was Arrowhead's case that KPMG owed a duty of care not only to Dragon as its client but also to Arrowhead as an indirect investor in Dragon. It was said that KPMG should have understood the relationship between Dragon and its investors, and that the business success of Dragon and its ability to repay its loans was wholly dependant on the success of its VAT repayment claims.

It was Arrowhead's case that KPMG performed its services negligently by failing to uncover fraud within Dragon's supply chains or to provide Dragon (and in turn Arrowhead as an investor in Dragon) with warnings as to the former hallmarks of fraudulent trading and that it failed to carry out sufficiently stringent checks on Dragon's proposed counterparties so as to meet HMCE's requirements for a VAT refund. The allegations of negligence were denied by KPMG.

KPMG applied to have Arrowhead's claim struck out on the basis that it owed no duty to Arrowhead as it was not the client and that the claim was out of time.

Judgment

In this decision, Stephen Males QC (sitting as a deputy High Court Judge) accepted, at least for the purposes of the application, that KPMG would have fully understood the critical nature of the success of Dragon's VAT repayment claims to its success, and that it would have been readily apparent to KPMG that the recoverability of VAT would be of great importance to any investor providing finance to Dragon as Dragon was unlikely to be able to offer any security other than its VAT repayment claims. In addition, KPMG was aware that Dragon was seeking to raise finance in order to expand its business and that loan finance was one of the options being considered.

The Court considered both the well known 'assumption of responsibility' test and the 'threefold' test (foreseeability, proximity, and whether it is fair, just and reasonable to impose a duty) set out

in *Customs & Excise Commissioners v Barclays* (2006) in order to determine whether a duty of care could be established by Arrowhead.

Assumption of responsibility

It was held that it was "inconceivable" that any reasonable businessman would have considered that KPMG was voluntarily assuming an unlimited responsibility towards potential investors in Dragon, even more so towards a sophisticated investor such as Arrowhead, who was investing in Dragon at several removes. Whilst Arrowhead had probably not known of the express exclusion in KPMG's terms of business of liability to third parties, this was not an unusual term and a reasonable businessman would expect to find it there.

Three-fold test

Applying the threefold test, the court was prepared to assume for the purposes of the application that Arrowhead would be able to satisfy the requirements for foreseeability and, with some hesitation, proximity. However, it was the Court's view that it would not be fair, just, and reasonable to impose a duty of care on KPMG resulting in unlimited liability (for essentially the same reasons that there was no assumption of responsibility) as several factors had been obvious to all concerned: KPMG's relationship with its client, Dragon, was governed by an engagement letter which was likely to contain limitations on the extent of KPMG's liability and very possibly an exclusion of liability to third parties; that the business in which Dragon proposed to engage was a high risk business; and that KPMG would not have been prepared to accept such a responsibility to Arrowhead had it been asked to do so.

Arrowhead therefore failed to establish that it was owed a duty of care by KPMG. The court also found that the claim had been made out of time and it was struck out.

Conclusion

Whilst this case represents an application of established legal principles, it does serve as a reminder of the protection that appropriately drafted terms of engagement can provide.

Further advice should be taken before relying on the contents of this summary.

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