Man Nutzfahrzeuge AG v Freightliner Ltd

[2005] EWHC 2347 (Comm)
High Court of Justice Queen's Bench Division Commercial Court

The Right Honourable Lord Justice Moore-Bick

Date: 28th October 2005

Mr. Dominic Kendrick Q.C. and Mr. Timothy Kenefick (instructed by Slaughter and May) for the claimants.
Mr. Geoffrey Vos Q.C. and Mr. Andrew Twigger (instructed by Clifford Chance) for the defendant.
Mr. Justin Fenwick Q.C. and Mr. Simon Salzedo (instructed by Linklaters) for the Part 20 defendants.

JudgmentThe Rt. Hon. Lord Justice Moore-BickA.Introduction and Background1.The parties

In 1933 Edwin Richard Foden began building motor lorries at Sandbach in Cheshire. That business eventually developed into the ERF group of companies of which ERF Holdings Plc was the parent and ERF Limited the principal trading company which continued to build a range of trucks sold under the ‘ERF’ badge, mainly to buyers in this country. (References in this judgment to “ERF” generally refer to ERF Holdings Ltd and thus to the group as a whole, but where the production of trucks is under discussion it should be understood to refer to either or both of the companies as the context requires.) ERF did not produce its own components, but assembled trucks using components obtained from suppliers in this country and abroad. One of the most popular features of ERF trucks was the Cummins engine produced in the United States which was highly regarded for its reliability and fuel efficiency. Although it did produce a standard range of vehicles, ERF specialised in making trucks to meet the particular requirements of individual customers and was to that extent producing a bespoke product. As a result the brand commanded a high degree of loyalty among customers, many of whom also liked to buy trucks made in Britain.

For some years the truck manufacturing industry has been undergoing a period of consolidation as manufacturers have sought to obtain the benefits of economies of scale. Margins on the sale of new trucks have been low and many smaller manufacturers have been taken over by larger groups as they have come under intense financial pressure. In June 1996 ERF was acquired by a Canadian truck manufacturer, Western Star Trucks Holdings Ltd (“Western Star”), whose operations were directed by its chairman, Mr. Terence Peabody. Western Star's operations were based in Kelowna, British Columbia, but its subsidiaries included a company called Orion Bus Industries Inc. (“Orion”) based in Toronto. Following the take-over of ERF by Western Star Mr. John Bryant, who had been managing director of ERF since November 1991, was appointed to the board of Western Star and at the same time also became managing director of Orion, dividing his time between that company and ERF.

In July 2000 Freightliner LLC, an American subsidiary of Daimler-Chrysler AG, acquired the whole of the share capital of Western Star. Western Star's Canadian operations were merged into Freightliner Ltd, the defendant in this action. It is common ground that as a result of the merger Freightliner is the successor in title to Western Star and responsible for any liabilities incurred by Western Star prior to the merger.

MAN AG (“MAN”) is the holding company at the head of a large German industrial group whose operations range from the development and production of diesel engines (including the well-known marine engines), through the manufacture and sale of printing presses and a wide range of other industrial machinery to the provision of commercial and financial services. The first claimant, MAN Nutzfahrzeuge AG (“MN”), is a subsidiary of MAN and is responsible for the operation of the group's commercial vehicle division. As such it is a manufacturer of heavy trucks and was one of ERF's competitors in the European market. It carried on business in the UK through its subsidiary MAN Truck & Bus UK Ltd.

Ernst & Young are well-known accountants with a world-wide practice which is carried on through associated partnerships established in different jurisdictions. This case concerns two of those partnerships, Ernst & Young, a limited liability partnership practising in Canada (“E&Y (Canada)”) and the firm of Ernst & Young that is established and practises in this country ("E&Y (UK)"). E&Y (Canada) were appointed auditors to the Western Star group in March 1991. At the time with which this case is concerned Mr. Edward Kendrick was the partner with principal responsibility for Western Star's affairs.

Following the acquisition of ERF in June 1996 E&Y (UK) were appointed auditors of ERF. Miss Alison Cunningham (later to become Mrs. Sinderson) was responsible for the group's affairs. For convenience I shall refer to her throughout this judgment as Mrs. Sinderson.2.The origins of the dispute(a)Fraudulent manipulation of ERF's accounts and false VAT claims

This is an unusual case, not so much because it has its roots in fraud, but because the existence and general nature of that fraud is accepted and recognised by all parties to the action. It is common ground that from about the middle of 1997 the accounts of ERF, both the monthly management accounts and the year-end statutory accounts, were persistently manipulated by its financial controller, Mr. Stephen Ellis, who from around the same time was also responsible for systematic frauds on H.M. Customs and Excise by means of false claims for the repayment of VAT.

Mr. Ellis joined ERF in August 1976 and was subsequently employed in various positions in its finance department until July 2001 when his activities were discovered. He was not a qualified accountant, but had learnt his accountancy and bookkeeping skills in the course of his employment, rising by 1998 to a senior position within the department as deputy to the then financial controller, Mr. Andrew Williamson.

Confronted with the results of the investigations into ERF's financial affairs, Mr. Ellis admitted at one time or another falsifying ERF's VAT returns over the period from March 1996 to July 2001 and falsifying the financial information provided to management and to the group's auditors. At the trial he was called as a witness by MN and was therefore able to provide his own explanation of what he had done and the motives behind his actions. He was put forward by MN as a witness of truth whose purpose in giving evidence was to complete the difficult task of coming to terms with his own wrongdoing and to assist the parties to this action in discovering the truth. Other parties have submitted, however, that he has shown himself to be dishonest to the point where little weight can be attached to his evidence except where it is supported by contemporary documents which are themselves clearly reliable. Given the nature of his admissions, I think it is right to approach his evidence with a significant degree of caution, but I think one should also recognise that it takes a certain amount of courage to confess publicly to persistent wrongdoing and deception of the kind that went on in this case, particularly when there is no personal benefit to be gained from doing so other than peace of mind. It is right to make it clear at the outset that there is nothing to suggest that Mr. Ellis or anyone connected to him benefited financially from his activities. However, lest it be thought that Mr. Ellis made a clean breast of all his activities as soon as he was challenged, it is right to point out that he did not confess to the VAT frauds immediately and did not admit to the dishonest practice of early invoicing, which I describe later in this judgment, until he was under cross-examination.

In March 1996 Mr. Ellis falsified ERF's VAT return to show that the company was in a repayment position, that is, that it was entitled to claim repayment of VAT from H.M. Customs and Excise. The evidence suggests that at the time that may have been an isolated event, but by his own admission from the middle of 1997 onwards he falsified the VAT returns month by month, thereby enabling ERF to receive regular repayments of tax to which it was not entitled. He said that he did so in order to relieve the group's financial problems by obtaining regular injections of cash from Customs & Excise and I am satisfied that that was so. In most cases he did not sign the VAT returns himself, but he was responsible for preparing the figures that went into them and for submitting the returns to senior management for signature.

Following its take-over by Western Star ERF's financial year was changed to expire on 30th June instead of 31st March. Accordingly, a year-end balance was struck as at that date which was in turn adopted as the opening balance for the following year. Shortly afterwards the management of Western Star decided to introduce a new accounting and materials management system produced by BaaN Information Systems B.V. ("BaaN") throughout the group. ERF was the first company within the Western Star group to transfer to this new system, although at the outset only the finance module was introduced and the existing materials recording system was retained. The introduction of the finance module of the BaaN system proved to be disastrous for ERF. It went live on 1st

July 1997 replacing the previous J.D. Edwards system without any period of parallel running. It produced endless headaches for the accounts staff who for many months were unable to obtain a trial balance from the system. Difficulties in operating the BaaN system meant, among other things, that it was not possible, as it had been in the past, to produce monthly management accounts based on recorded figures for the benefit of ERF's own managers and Western Star. To overcome the difficulty Mr. Ellis produced monthly profit and loss accounts which, instead of containing figures drawn directly from the financial records, contained estimated figures based on his assessment of the group's performance derived from conversations with the Sales, Costs, Payroll and other relevant departments. In the case of the balance sheet he obtained basic information on items such as fixed assets, stock, and debtors, but used trade creditors as a balancing figure. Mr. Ellis failed to inform Western Star or indeed the management of ERF that the figures he was reporting were estimates and had not been drawn directly from the records.

In May 1998 Mr. Ellis was appointed financial controller of ERF when the group accountant, Mr. Andrew Williamson, moved to take up a position with Western Star in Canada. Although not a director, he thus became the most senior member of staff responsible for ERF's financial affairs. He was also appointed company secretary. Shortly afterwards E&Y (UK) were appointed auditors of ERF on the recommendation of E&Y (Canada).

Following the end of the financial year at 30th June 1998 Mr. Ellis and his staff began the preparation of the statutory accounts. By that time it was possible to transfer figures from the BaaN system to a spreadsheet which could be used to produce a profit and loss account and balance sheet. However, when he came to produce the balance sheet Mr. Ellis found that there was a discrepancy of about £18 million between the figures derived from the BaaN system and the figures he had reported in the monthly management accounts during the course of the year. In order to bring the general ledger into line with the figures he had previously reported, Mr. Ellis made a number of false journal entries in the purchase ledger control account, but these in turn gave rise to a discrepancy of about £18 million between the purchase ledger itself and the purchase ledger control account. In order to reconcile the two for the benefit of the auditors Mr. Ellis produced a reconciliation showing that various amounts totalling £18 million had been paid to suppliers before the end of the year but had not yet been entered into the purchase ledger. The payments to which he referred had indeed been made to suppliers, but in July 1998, the month following the year end. The reconciliation was therefore invalid and indeed false inasmuch as none of the payments was properly referable to the financial year ending 30th June 1998, as he was well aware. Unfortunately, E&Y (UK) failed to verify the reconciliation by reference to the underlying documents and therefore failed to detect that it was invalid.

In the course of carrying out the audit of ERF Mrs. Sinderson began to form her own view of Mr. Ellis and his abilities. The impression she formed was not particularly favourable. On 24th November she wrote a memorandum headed ‘ERF Concerns’ in which she set out a number of matters which troubled her. It will be necessary to return to the so-called ‘ERF Concerns memorandum’ at a later stage, but it is worth mentioning at this point that she had already begun to question whether Mr. Ellis was as frank with Mr. Bryant about problems within ERF as he should have been and was certainly of the view that he was not as frank with her as she would have expected. His apparent unwillingness to give bad news made her nervous. Mrs. Sinderson sent Mr. Kendrick a copy of the memorandum by fax and discussed it with him in a telephone conversation that evening.

In their draft Audit Observations produced towards the end of November 1998 following the audit of the Western Star group's consolidated accounts E&Y (Canada) commented on the absence of standard monthly closing procedures at ERF and the unavailability of a monthly trial balance from the general ledger. Mr. Ellis was asked to provide a response on behalf of the ERF management and on 10th December he replied saying that monthly figures were generated from reports produced by other systems within ERF which had proved reliable in the past and that at the year end every line item had been reconciled to give both ERF and E&Y (UK) “total comfort” in the result. That was clearly something of an over-statement, but Mrs. Sinderson did not take issue with it when she was asked for her comments. The Audit Observations were finally delivered to Western Star's audit committee on 25th January 1999. It was not until 4th May 1999 that E&Y (UK) was able to sign its audit report on

ERF.(b)Events leading to the purchase of ERF by MN

At the beginning of 1999 ERF had about 8% of the UK truck market and appeared to be making a small operating profit, mainly from the supply of parts and servicing through a network of distributors. Traditionally profit margins on the sale of new trucks throughout the industry have been small (and in lean years non-existent), but good returns have been made in what is known as the ‘after-market’, that is, parts and servicing. Although ERF had become part of the Western Star group, differences between the European and American regulations governing truck construction, as well as different market requirements, meant that there were few opportunities for practical co-operation between ERF and other companies in the group. Under Western Star's ownership, therefore, ERF continued largely as an independent operation. As such it faced increasing difficulty in competing with larger, more productive manufacturers who could benefit from economies of scale, but its share of the market in the United Kingdom made it potentially attractive to a big manufacturer which could obtain increased profits through ‘synergies’, that is, by supplying its own components for use in ERF trucks and by using its greater purchasing power to enable ERF to obtain more cheaply those components that it could not supply itself.

In early 1999 Daimler-Chrysler expressed an interest in acquiring ERF from Western Star. Negotiations made some progress, but collapsed after Daimler-Chrysler had undertaken some preliminary due diligence work. Soon after, however, in April 1999 MN learnt that Mr. Peabody might be willing to dispose of his family's controlling interest in Western Star. MN was not interested in buying Western Star itself, but it was interested in acquiring ERF in order to obtain its share of the UK market and to realise the benefits of the synergies available to two European truck producers. Accordingly, on 22nd April 1999 the MN executive board under its chairman Dr. Klaus Schubert instructed Mr. Klaus Wagner, then head of strategic planning, to find out whether it might be possible for MN to take over ERF, and if so on what terms.

The first meeting between the parties took place on 4th June 1999 when Mr. Peabody and Mr. Bryant met Dr. Schubert at Hanover airport. Mr. Peabody confirmed that he might be willing to sell ERF and produced a brief statement of the group's financial position for the previous year (1998) and forecasts for the years ending 30th June 1999 and 2000. This showed the group's earnings before interest, tax, depreciation and amortisation (“EBITDA”) to be £11.1 million for the financial year ending June 1998, £9.7 million for the year ending June 1999 and £12.8 million for the year ending June 2000. He also provided an indication of the price for which he was looking expressed as a multiple of EBITDA.

On 7th July the parties met again at ERF's premises at Sandbach. This time Western Star was represented by Mr. Bryant and by Mr. David Harrison of Warburg Dillon Read (“Warburgs”), the investment bankers instructed by Mr. Peabody to advise on the sale. MN was represented by Mr. Wagner and Dr. Jurgen Knorpp, the managing director of MAN Truck & Bus UK Ltd. The primary purpose of the meeting was to explore in greater detail the terms of a possible sale to enable Mr. Wagner and Dr. Knorpp to report back to the board of MN and for that purpose they were provided with copies of ERF's audited accounts for the years ending June 1997 and 1998, the management accounts for May 1999 and a document produced by Warburgs containing a presentation on ERF and its operations. In the course of their discussions Mr. Wagner asked a number of questions about the accounts which Mr. Bryant did not feel competent to answer. There was a difference of recollection between Mr. Wagner and Mr. Bryant over whether Mr. Bryant had suggested at the meeting that he should ask Mr. Peabody to bring Mr. Ellis into the team for the purposes of any future discussions, but it is not one of any significance since it was common ground that a few days after their meeting Mr. Bryant telephoned Mr. Wagner to tell him that Mr. Peabody had agreed that Mr. Ellis should take part in any future discussions.

MN then set about evaluating the proposal for the acquisition of ERF and at a meeting of the executive board on 27th July decided to move forward despite the fact that it thought Mr. Peabody was asking too high a price. On 28th July there was a telephone conversation involving Dr. Schubert, Mr. Wagner, Mr. Peabody and Mr. Harrison in the course of which Dr. Schubert confirmed that MN was seriously interested in acquiring ERF and was willing to start detailed negotiations. That led in due course to the next significant meeting between the parties which was held at The Belfry golf course hotel near Birmingham on 19th and 20th August. On that occasion MN was represented by Dr. Ulf Hülbert, the director responsible for its Controlling department, Mr. Wagner, Mrs. Sabine Drzisga, a member of the MAN Planning department, and Dr. Knorpp. Western Star was represented by Mr. Bryant, Mr. Harrison and Mr. Stewart Smith, a director of Western Star and a close associate of Mr. Peabody. The meeting was also attended by Mr. Ellis, the nature of whose involvement in this and subsequent meetings was the subject of considerable debate during the course of the trial. MN said that he was present at this and later meetings to speak on Western Star's behalf when questions were asked about ERF's accounts. Freightliner said, however, that he was present to answer questions about the accounts of ERF only in his capacity as its financial controller and that he spoke only on behalf of ERF and not on behalf of Western Star. This is a question to which it will be necessary to return at a later stage.

The main topics of discussion at the Belfry meeting were the method of establishing a price for ERF, the manner in which the EBITDA of the group should be calculated, the range within which it should fall for the year ending June 2000 and the detailed figures disclosed in the accounts provided to the MN representatives. For the purposes of the discussions they had been provided with a package of financial documents prepared by Mr. Ellis, including a profit and loss account for the year ending 30th June 1999 for ERF (Holdings) Plc, a balance sheet as at 30th June 1999 for ERF (Holdings) Plc, a comparison between ERF's actual profit and loss figures for the year ending June 1999 and its budget for the year ending June 2000, a comparison between ERF's actual profit and loss figures for the year ending June 1999 and the forecast figures for the year ending June 1999, a business plan and five year forecast and details of ERF's parts and vehicle sales margins. During the meeting Western Star also provided at MN's request a copy of ERF's profit and loss account and balance sheet for the year ending June 1999 which included budget figures for the year ending June 2000 which Mr. Ellis's assistant, Mr. Ian Marsh, sent by fax to the hotel on the afternoon of 19th August. During the meeting various representatives of MN asked detailed questions about these documents, some of which were answered by Mr. Bryant, but many of which were answered by Mr. Ellis himself.

Following the meeting Mr. Wagner and Mrs. Drzisga prepared a report which was considered by the MN board at a meeting held on 30th August and 1st September 1999. The board reviewed the figures in the various accounts discussed at the Belfry meeting and concluded that a purchase price of about £57 million would be appropriate, whereas Western Star was looking for a purchase price of between £85 and £90 million. In those circumstances the board decided not to make a firm offer at that stage but to clarify some aspects of the transaction first.

On 14th September the parties met again briefly at the Hilton hotel at Heathrow. Once again Mr. Ellis attended together with Mr. Bryant, Mr. Harrison and Mr. Stewart Smith. Discussions centred on various specific aspects of ERF's accounts. Mr. Harrison was keen for MN to make a firm offer, but Dr. Hülbert preferred to concentrate on specific issues arising out of the accounts and little progress was made on the larger question.

The board of MN considered the matter again on 21st September. It approved the acquisition in principle and decided that Dr. Schubert should find out whether Mr. Peabody would accept £65 million for ERF. It also agreed that he should put forward the possibility of including MN's Australian subsidiary, MAN Automotive (Australia) Pty Ltd (“MAN Australia”) in the transaction in order to assist the negotiations. MN's attempt to break into the Australian market had not proved successful and its Australian subsidiary had been something of a problem child. The acquisition of the company held some attractions for Western Star, however, because it had existing businesses in Australia into which it could be incorporated. On 24th September Dr. Schubert wrote to Mr. Peabody confirming MN's interest in taking over ERF at a price of not more than £65 million and offering to include MAN Australia in the deal.

The negotiations moved a stage further on 8th October when Mr. Wagner and Mr. Klaus Helm, a member of MN's department responsible for monitoring foreign subsidiaries (Department Z), met Mr. Bryant, Mr. Stewart Smith and Mr. Harrison in Toronto. There was discussion about including MAN Australia in the agreement and about the purchase price. In the end a compromise was agreed under which the price to be paid for ERF would be adjusted to reflect changes in the inter-company indebtedness and bank debts at closing from that shown in the accounts at 30th June 1999. A protocol was signed recording the terms agreed at the meeting, but as it later turned out the agreement reached in Toronto had unfortunate repercussions which nearly led to the negotiations being broken off entirely.

On 12th October MAN's executive board considered the acquisition of ERF. It thought that taken on its own the price being asked was too high, but that the proposal was worth pursuing because it offered an elegant way to dispose of MAN Australia. The board also decided that one of its own members, Dr. Philipp Zahn, should take over primary responsibility for the negotiations with Western Star.

A further meeting between the parties was arranged to take place at the Hilton Hotel, Heathrow on 20th October with a view to discussing the proposal to include MAN Australia in the transaction and reaching agreement on the price to be paid for ERF. On this occasion MN was represented by Dr. Zahn, Mr. Wagner, Mr. Helm, Dr. Hülbert and Mr. Schussler. Mr. Bryant, Mr. Harrison and Mr. John Anderson, a partner in the Canadian law firm of Stikeman Elliot, represented Western Star. The meeting was short and such discussion as there was revolved around the protocol signed in Toronto. Dr. Zahn had come to the view, somewhat belatedly, that an agreement to adjust the purchase price by reference to the amount of the inter-company debt owed by ERF to Western Star would enable Western Star to manipulate that debt, and thus the purchase price, to its advantage. He was therefore unwilling to proceed on that basis. Mr. Bryant and Mr. Harrison, who had come to the meeting thinking that the terms agreed at Toronto represented a firm understanding about the financial basis of the transaction, reacted strongly to what they saw as an attempt to renege on the deal and the meeting broke up in acrimony. The negotiations were only salvaged by a series of exchanges between Dr. Schubert and Mr. Peabody which led to a compromise reflected in a term sheet dated 26th October 1999 signed on behalf of both parties.

In the meantime E&Y (UK) had been carrying out their audit of ERF's accounts for the year ending 30th June 1999. The fieldwork which began in August had already been completed when on 20th September Mrs. Sinderson received an unexpected telephone call from a Mr. Frederick Pointon, a retired bank executive. He told her that he had received information from his daughter, who worked at ERF, that information of a misleading nature that might be supplied to the auditors was being produced at the behest of senior management. The precise terms of the tip-off are in dispute and it will be necessary to consider the evidence relating to it in greater detail at a later stage because there is an issue between Freightliner and both E&Y (Canada) and E&Y (UK) whether as auditors or advisers to Western Star they responded to it in an appropriate manner. What is clear, however, is that on 21st September Mrs. Sinderson reported her conversation with Mr. Pointon to Mr. Kendrick who in turn reported it to Western Star's chief financial officer Mr. David Burke. It was at that time that Mrs. Sinderson became aware for the first time that negotiations were going on between Western Star and MN for the sale of ERF.

Throughout the financial year ending 30th June 1999 ERF had continued to experience difficulties in operating the BaaN system and Mr. Ellis had continued to produce monthly management accounts based in part on estimates of the group's performance. When the time came to draw up the statutory accounts he found that there was once again a discrepancy between the results he had reported during the year and the balance sheet produced by the BaaN system. This time it had risen to about £21.4 million and once again he made false entries in the purchase ledger control account in order to bring the two into line. Again he provided a false reconciliation to satisfy the auditors based on a combination of alleged timing differences and posting errors and once again E&Y (UK) failed to verify the reconciliation to the underlying documents. It was common ground that as a result the audited accounts for the year ending 30th June 1999 which were signed on 4th November 1999 failed to give a true and fair view of ERF's financial position.

The next step in the negotiations between MN and Western Star was for MN to undertake its due diligence investigation of ERF and its affairs. Mr. Peabody was anxious to ensure that the negotiations did not come to the attention of any of ERF's employees and it was therefore agreed that the process should take place away from ERF's premises at the Cottons hotel in Knutsford. The Working Group list provided by Mr. Harrison to Dr. Zahn in preparation for the exercise identified Mr. Ellis as one of the key participants in relation to accounting matters. MN was advised in connection with the due diligence by the accountants Deloitte & Touche who asked to be given access to E&Y (UK)'s working papers. That was provided on terms set out in a ‘hold harmless’ letter dated 19th October 1999 to which it will be necessary to refer at a later stage.

The due diligence exercise began on 2nd November 1999 with an introductory meeting at which the various participants were introduced to each other and the MN team outlined the areas which they wished to investigate. Mr. Bryant explained that he would deal with questions relating to commercial matters and that Mr. Ellis would deal with questions relating to the accounts and other financial matters. Various documents had been brought to the hotel for examination by the MN team and further documents were made available during the due diligence exercise from time to time at their request. One of the documents that the MN representatives were most anxious to receive was a copy of ERF's audited accounts for the year ending June 1999. These had not been completed when the exercise began, but following a certain amount of pressure the audit certificate and the accounts were signed on 4th November and a copy of the audited accounts was immediately made available to the MN representatives. The due diligence investigation continued at Knutsford until 19th November when Dr. Raab and Mr. Ziegler finally returned to Munich. Throughout its course Mr. Ellis provided copies of financial documents to the MN representatives at their request and answered questions arising out of them. He did so without at any time informing the management of ERF or Western Star, much less those representing MN, that the accounts had been falsified in the manner described earlier. Based on the information obtained in the course of the due diligence MN concluded that ERF was operating at about break-even level but that the potential financial benefits to be derived from synergies were of the order of DM40 million a year.

As soon as the due diligence exercise had been completed MN and its advisers evaluated their findings to assess their significance for the purchase price. Although a number of matters had come to light, Dr. Schubert decided that it would be inappropriate for MN to seek a reduction of the price by reference to matters of which it had already been aware before the due diligence exercise began. Further negotiations therefore concentrated on matters that had come to light in the course of that exercise. One such matter was ERF's approach to accounting. The MAN group adopted a conservative approach to accounting based on International Accounting Standards (IAS). ERF applied United Kingdom Generally Applicable Accounting Principles (UK GAAP). Not only did MN regard UK GAAP as less conservative than IAS, it regarded ERF's application of those principles as too optimistic in some respects. As a result Deloitte & Touche, who had been advising MN in connection with due diligence, recalculated the profitability of ERF on what they considered to be a more prudent application of UK GAAP, leading to a suggested reduction in net assets of about £10 million and a reduction in EBITDA of about £5.6 million. That had obvious implications for a price based on a multiple of EBITDA.

On 30th November 1999 Dr. Schubert wrote to Mr. Peabody telling him that information obtained through due diligence, in particular ERF's audited accounts for the year ending June 1999, showed a significantly different picture from that previously provided by Western Star and that the purchase price would therefore have to be renegotiated. The parties met for further discussions at the offices of Shearman & Sterling in London on 2nd and 3rd December 1999. On this occasion the principal representatives of MN were Dr. Zahn, Dr. Hülbert, Dr. Raab and Mr. Wagner. Western Star was represented by Mr. Bryant, Mr. Stewart Smith and Mr. Harrison. Mr. Ellis was also present and took part in the discussions; the precise nature of his involvement is a matter of dispute to which I shall return. Mr. Anderson of Stikeman Elliot was also present, but does not appear to have taken a prominent part. Discussions at the meeting were directed to MN's analysis of ERF's financial results as disclosed in the audited accounts for the year ending June 1999 and the management accounts for the quarter ending 30th September 1999. At the end of the meeting Dr. Zahn indicated a provisional offer of £55–£60 million which the Western Star representatives rejected as too low.

Following further consideration of the proposal by the executive and supervisory boards of MAN, each of which gave its approval for the acquisition to be pursued, Dr. Schubert wrote to Mr. Peabody on 9th December putting forward an offer from MN to buy ERF for £65 million plus the whole of the shares in MAN Australia. The offer was expressly based on the audited accounts for the year ending June 1999 and was subject to adjustment in the light of a stocktaking of spare parts and fixed assets after take-over. On the same day Mr. Peabody responded to the effect that the offer was generally acceptable, subject to certain relatively minor modifications.

The parties and their advisers met again on 20th December in London to discuss the wording of the proposed sale agreement and certain other matters, including the ERF pension scheme. Once again, Mr. Ellis was present and took part in discussions relating to the accounting treatment of the pension fund. It was not possible to resolve all outstanding issues on that occasion and negotiations in relation to the substance and the mechanics of the transaction continued into the new year until they were finally resolved in a telephone conversation between Dr. Schubert and Mr. Peabody on 14th January 2000.

At that stage preparations were being made for the signature of a formal agreement. On 18th January Mr. Ellis sent MN a copy of ERF's management accounts for the period ending 31st December 1999 which showed net assets of £26.3 million and an EBITDA of £4.834 million, both generally in line with earlier forecasts. Although an analysis of the accounts suggested that ERF's financial position had deteriorated slightly since June 1999, the change was not regarded as significant in the context of the negotiations as a whole.

On 30th January 2000 a formal Share Purchase Agreement was concluded by an exchange of faxes between Dr. Schubert and Dr. Zahn on behalf of MN and Mr. Peabody on behalf of Western Star under which MN agreed to purchase the whole of the share capital of ERF (Holdings) Plc for the sum of £65.3 million, subject to certain adjustments. MN also agreed to take over a number of guarantees that Western Star had given in support of ERF and to take over responsibility for ERF's bank overdraft. The Share Purchase Agreement contained a large number of representations and warranties relating to the state of ERF's business.

Closing took place on 8th March 2000 when Mr. Peabody and Mr. Stewart Smith resigned as directors of the ERF companies and Dr. Schubert, Dr. Hülbert, Mr. Dietz and Dr. Breun, all of whom were members of MN's executive board, and Mr. Wagner were appointed to the board of ERF Holdings. Mr. Wagner was also appointed to the board of ERF Ltd where he became an executive director with Mr. Bryant as managing director. A week later Western Star paid gratuities to Mr. Ellis and two other employees of ERF who had provided assistance with the due diligence, Mrs. Dorothy Allcock and Mr. John Pinney. In the case of Mr. Ellis the sum involved was £15,000.(c)Events following the purchase

MN had three main priorities following completion of the sale: the undertaking of a limited internal audit; the integration of ERF into MN's accounting and reporting procedures, in particular by bringing ERF's accounting into line with that of the rest of the MAN group by adopting IAS in place of UK GAAP; and the realisation of the projected synergies. The executive management team consisted of Mr. Bryant, Mr. Wagner and a newly appointed director of ERF Ltd, Mr. David Smith, who was recruited to take charge of sales. Mr. Wagner, who had considerable experience in the field of purchasing and materials management, directed much of his energies to realising the synergies. Mr. Bryant, who was a very experienced production engineer, concentrated on production operations. The task of integrating ERF into MAN's accounting and reporting procedures largely fell to Mr. Ellis, although he and the members of his department received a considerable amount of support from MN. No one was appointed at board level to take separate charge of ERF's finances, despite the fact that neither Mr. Bryant nor Mr. Wagner regarded himself as much of a financial expert. It is ironic in the light of what was subsequently discovered that Mr. Ellis was kept on as head of the Finance department precisely because he had made a good impression on the MN representatives during the due diligence exercise. He continued to act as financial controller reporting to Mr. Wagner.

The MAN group operated an elaborate system of monthly and quarterly reporting. Each month ERF was required to send MN's Department Z a report on the number of vehicles sold, units produced, revenues, margins, overhead costs, stocks and receivables, personnel employed and other matters affecting the profit and loss account. It was also required to provide operating accounts in a form known as a *Betriebsergebnisrechnung* or "BER" showing revenue from all sources, expenses and various margin calculations. It was also required to report indebtedness for the relevant month and to provide a prediction of its future cash needs which was used by MAN's Treasury department to manage the group's cash funding requirements. Each quarter the company also had to provide a detailed financial report in what was known as the 'Hyperion' format. MN was aware that these demanding new reporting requirements imposed a significant burden on ERF's Finance department. It provided advice and assistance by sending accountants from Munich to assist in preparing the reports and was tolerant of early failures to produce reports on time.

One of the more striking features of ERF's operations following its take-over by MN was its constant need for additional working capital. Under Western Star ERF had obtained the finance required for its operations from a variety of sources. Apart from the usual bank overdraft and a loan from Western Star itself, it had factoring agreements with a company called ERF Financing Ltd, a subsidiary of Newcourt Credit of Canada Ltd, under which it could obtain payment for trucks as soon as they were delivered to customers. (Throughout this litigation the parties referred to ERF Finance Ltd as "Newcourt" and for convenience I shall do the same.) ERF retained a contingent liability to Newcourt in respect of invoices that were not settled by customers within an agreed time. At the time MN acquired ERF the total amount of financing provided by Newcourt amounted to about £40 million. The factoring facility was terminated soon after MN acquired ERF and by the end of the year all financial support from that quarter had ceased.

The MAN group operated a pooled cash facility known as the inter-company account ("ICA") through which its subsidiaries' needs for cash were met. In effect MAN's Treasury department operated as a central bank for all its subsidiaries. ERF joined the ICA immediately after the completion of the acquisition. After MN had paid off its inter-company loan from Western Star and the overdraft with the bank ERF's opening balance with the ICA reflected its inherited debt of about £37.5 million. By June 2001 it had risen nearly every month to stand at just under £135 million, despite frequent forecasts that it would be brought under control and despite the fact that on 30th June 2000 MN had capitalised £18 million of the company's indebtedness. Part of that increase was due to changes in the way the group's working capital was financed, in particular the decision to wind down the factoring arrangements with Newcourt, but with the benefit of hindsight it is now possible to see that this apparently insatiable demand for additional funds was largely attributable to the fact that ERF was not breaking even but was trading at a loss. It is less clear, however, whether that should have been apparent at the time, and indeed this was one of the matters in dispute between the parties at the trial. The period of 16 months between the completion of the take-over and the discovery of Mr. Ellis's fraud was one in which there were major changes to the way in which ERF was funded, in which two new models, the ECS and ECX, were introduced in accordance with plans that had already been put in place during Western Star's ownership and in which production was transferred from two sites at Sandbach to a single new set of factory premises at Middlewich, again in accordance with arrangements set in motion by Western Star, with the inevitable disruption to its operations. Explanations could therefore be given for the drawdown of additional working capital which could be supported by reference to the various circumstances affecting ERF's operations and were indeed partly justified by them.

Following the take-over ERF's financial year was changed again, this time to end on 31st December to coincide with that of the other companies in the MAN group. Deloitte & Touche, the auditors to the MAN group, were appointed to act as its auditors. Mr. Ellis continued reporting false figures to his own management and to MN and continued to manipulate the purchase ledger control account to ensure that the figures in the general ledger matched those he was reporting. Once again he concocted a false reconciliation between the purchase ledger and the purchase ledger control account. Deloitte & Touche audited ERF's accounts twice within a period of about six months, once following the old year end of 30th June 2000 and once following the new year end of 31st December 2000. On the first occasion the auditors failed to identify the discrepancy between the purchase ledger and the purchase ledger control account, but in the course of their audit of the 31st December 2000 accounts they did note the discrepancy which then stood at about £19 million.

Since Deloitte & Touche could not certify the accounts until a satisfactory reconciliation of that discrepancy had been produced, it became essential to investigate the position and a member of MN's internal audit department, Mr. Jung, was deputed to carry it out. Initially he sought to resolve the problem through Mr. Ellis, but after a certain amount of prevarication on his part Mr. Jung eventually visited ERF in April 2001 to investigate the position at first hand. His attempt to verify the purchase ledger by reference to supplier statements led to the realisation that the purchase ledger itself was in disarray and had to be sorted out before any attempt could be made to reconcile it with the purchase ledger control account.

Mr. Jung reported his findings to Mr. Wagner who decided that the time had come to strengthen ERF's accounting operations by employing a qualified accountant in a senior position. As a result on 1st June 2001 Mrs. Stephanie Frobisher started work with ERF as a senior accounting manager assisting Mr. Ellis. She had previously been employed by Deloitte & Touche and had been involved in the most recent audits of ERF, so she was already familiar with its systems. One of her first tasks was to sort out the problems with the purchase ledger. By early July she had brought that ledger under control and was in a position to begin reconciling the purchase ledger and the purchase ledger control account as at 31st March 2001. She soon found that it was impossible to produce a valid reconciliation and Mr. Ellis was unable to provide an explanation for the discrepancy. On 12th July Mr. Wagner reported to MN that while preparing the quarterly accounts for 30th June Mrs. Frobisher had found unexplained discrepancies in the quarterly accounts for 31st March 2001 and that the year-end accounts at 31st December 2000 might also be wrong. A week later on 18th July he was writing to the new head of Department Z, Mr. Weinmann, to warn him that the discrepancies discovered so far were only the tip of the iceberg and to request assistance from MAN's internal audit department in investigating the position. A special investigation was launched to determine the nature and extent of the problem and on 23rd July Mr. Ellis was suspended. Shortly afterwards Mr. Bryant and Mr. Wagner were also suspended on the grounds that as the two most senior managers they were accountable for the manner in which ERF, including its accounting function, had been run. By the beginning of August it had become apparent that there was a deficiency of approximately £100 million in the balance sheet of ERF as at 30th June.(d)Developments following the discovery of the fraud

Following the discovery of the deficiency in ERF's balance sheet MAN and MN were faced with two main tasks: to ascertain its effect on the equity and reserves of the MAN group as a whole; and to decide what to do with ERF, which was clearly insolvent. Although substantial, the amount of the deficiency was not such as to pose a serious financial problem for the MAN group. Of greater importance was the damage that might be caused to its commercial reputation. The most pressing questions, therefore, were those surrounding the future of ERF. Should it be put into liquidation or should it be restructured in some way involving closer integration into MN's operations?

MN was strongly predisposed to favour a restructuring of some kind. Apart from the fact that it had never previously allowed a subsidiary to go into liquidation, it was concerned that to do so in this case would result in a loss of confidence among its customers and have a damaging effect on its reputation that could not be confined to its commercial vehicle division. Decisions had to be taken quickly, but they also had to be carefully considered.

On 16th August MAN issued a brief press release stating that as a result of the discovery of irregularities in the accounts of ERF Mr. Bryant and Mr. Wagner had been suspended from their posts and that Dr. Raab had been appointed chief financial officer to oversee the continued operations of ERF. Dr. Raab was appointed to the board of ERF the same day.

On 27th August the executive board of MN met to consider the next step. In practical terms there were two possible courses of action: close down production altogether, or produce MN's new model (known as the "TGA") under the ERF badge at Middlewich and merge ERF's operations with those of MAN Truck & Bus UK. However, before any decision could be taken the board thought that a number of technical, production and marketing questions needed to be answered.

It appears that by this time some customers of ERF were already expressing concern about after-sales support in the form of spare parts, servicing and the ability to sell their trucks back to ERF at a guaranteed return (the so-called "buy-back" arrangements which represented an important feature of the sale of every new vehicle). In order to allay these fears MAN issued separate press releases in English and German on 29th August confirming its intention to strengthen ERF's activities in the UK by speeding up the introduction of new models at Middlewich and improving the efficiency of its administration. It also made it clear that ERF and MAN would retain their separate sales and distribution networks. The German version placed somewhat greater emphasis on the integration of ERF into MN's operations than did the English version, but both made it clear that ERF would continue to exist as a separate brand within the UK. However, the need for radical changes resulting in the loss of about 370 jobs was recognised by another press release issued on 11th September.

On 18th September a special meeting of the MN board was convened to discuss how to proceed. Calculations produced by Dr. Raab suggested that an operating profit could be made from assembling ‘ERF’ TGA trucks at Middlewich and the board agreed to adopt that strategy while recognising that, if it were not successful, it might be necessary to stop producing trucks at Middlewich altogether. However, since the ERF version of the TGA model could not be made available for some months, the board agreed that production of the existing ECS and ECX models should continue until it became available in the summer or autumn of 2002. The board also approved an injection of capital into ERF to make good the lost equity and operating losses incurred in 2001.

On 1st October 2001 a new chief executive, Mr. Arnd Löttgen, was appointed to run ERF in conjunction with Dr. Raab and Mr. David Smith. Mr. Löttgen was chosen for the position because he had a good deal of experience in restructuring ailing companies. On 8th October MAN held a press conference at a hotel near Heathrow at which its plans for the future were explained to the financial and trade press. Later a conference for dealers and distributors was held in Nottingham. Over the next three months Dr. Raab carried out detailed evaluations of various restructuring arrangements based either on continuing the assembly of trucks at Middlewich or on moving all aspects of production to Munich and retaining only minor finishing work at Middlewich. During that period the continuing investigation into ERF's financial position brought to light the fraudulent claims for repayment of VAT.

Eventually it became apparent from the work carried out by Dr. Raab that the cost of continuing production at Middlewich substantially exceeded that of concentrating all production at MN's factory in Munich and could only be justified if it would have a marked effect on sales. Since existing market research had already shown that that was unlikely to be the case, all indications pointed in favour of concentrating production in Munich and an informal decision to that effect was taken by those members of the boards of MAN and MN who had been most closely involved in the exercise.

Some two months later on 28th February 2002 MN issued a press release setting out its strategy for the future. It emphasised its intention to retain the ERF brand and to continue offering Cummins engines. The decision to discontinue production at Middlewich was hinted at, without being given any prominence, but there was a clear statement of its intention to continue producing the current models and to amalgamate ERF's distributorships and support services with those of MAN Truck & Bus under the overall direction of Dr. Knorpp. The briefing given to employees did, however, make it clear that in the longer term production at Middlewich would be limited to the modification of standard vehicles in accordance with the requirements of individual customers with a consequent loss of about 200 more jobs.

In March 2002 the marketing, sales and support functions of ERF were integrated with those of Man Truck & Bus in a new organisation called MTB-ERF. A separate manufacturing company was maintained alongside this organisation to carry on the engineering and vehicle modification side of ERF's business. Production of the ECS and ECX models at Middlewich finally came to an end in September 2002 and thereafter the Middlewich site was used only for the purposes of carrying out bespoke modifications to trucks manufactured by MN in Munich. On 1st April 2003 ERF Ltd and Man Truck & Bus were formally merged to become the fifth claimant, MAN ERF UK Ltd. A separate manufacturing company was maintained alongside this organisation to carry on the engineering and vehicle modification side of ERF's business. The various agreements necessary to transfer ERF's business and operating assets and liabilities were finally executed on 24th September 2003.3.The Share Purchase Agreement

It is convenient at this stage to refer briefly to some of the provisions of the Share Purchase Agreement. Copies of ERF's audited accounts for the year ending 30th June 1999 ("the June accounts") and ERF's management accounts for the six months ending 31st December 1999 ("the December accounts") were annexed to the Agreement and formed the basis for a number of representations and warranties. Article 4 of the Agreement contained the following (among other) provisions: "4.1Representations and Warranties of WS Holdings

WS Holdings represents and warrants as follows to each of MAN and MAN AG and acknowledges and confirms that each of MAN and MAN AG is relying upon such representations and warranties in connection with the purchase by MAN of the ERF Shares:(i)

Conduct of Business in Ordinary Course . Except as disclosed in Section 4.1(i) of the ERF Disclosure Schedule, since the date of the ERF Financial Statements, the ERF Business has been carried on in the Ordinary Course. (k)

No Material Adverse Change . Except as disclosed in the ERF December Financial Statements, since the date of the ERF Financial Statements, there has not been any change in the affairs, prospects, operations or condition of the ERF Companies, the ERF Assets or the ERF Business which would have a Material Adverse Effect and to the knowledge of WS Holdings no event has occurred or circumstances exist which may have a Material Adverse Effect;

…(cc)

Books and records . All accounting and financial Books and Records have been fully, properly and accurately kept and completed in all material respects …; (dd)

ERF Financial Statements . The ERF Financial Statements [the June accounts] … ave been prepared in accordance with the provisions of the Companies Act 1985 … and give a true and fair view of (i)

the consolidated assets, liabilities … and financial position of ERF and the ERF Companies at the date of the ERF Financial Statements;(ee)

ERF December Financial Statements . The ERF December Financial Statements [the December accounts] … have been prepared in accordance with the ERF Accounting Policies on a basis consistent with [the June accounts] and in accordance with such policies fairly represent: (i)

the consolidated assets, liabilities … and the financial position of ERF as at 31st December 1999;

…(oo)

Taxes . The ERF Companies have filed or caused to be filed, within the times and in the manner prescribed by Law, all tax reports which are required to be filed by or with respect to the ERF Companies … The information contained in such returns is correct and complete in all material respects … and except as disclosed in Section (oo) of the ERF Disclosure Schedule:

…(ii)

there has not been any transaction, arrangement, event or omission either occurring after 30th June 1999 or occurring before 30 June 1999 but relating to expenditure to be incurred after 30 June 1999 ….(B)

the taxation treatment of which is as far as WS Holdings are aware or may become the subject of any dispute with any taxation authority

…(xiii)

the ERF Companies have properly and punctually paid all taxation which they have become liable to pay …;(pp)

Full Disclosure . Neither this Agreement nor any Ancillary ment to which WS Holdings is a party (i) contains any untrue statement of a material fact in respect of WS Holdings, the affairs, operations or condition of the ERF Companies, the ERF Assets or the ERF Business, or (ii) to the knowledge of WS Holdings omits any statement of a material fact necessary in order to make the statements in respect of WS Holdings, the affairs, operations or condition of the ERF Companies, the ERF Assets or the ERF Business contained herein or therein not misleading."

Section 5.1 dealt with the conduct of ERF's business between the date of the agreement and the date of completion. It provided as follows: "(1)

During the Interim Period, WS Holdings will cause the ERF Companies to conduct the ERF Business in the Ordinary Course or otherwise as specifically contemplated in this Agreement.(3)

… WS Holdings shall … cause the ERF Companies to:(g)

conduct the ERF Business in such a manner that on the Closing Date the representations and warranties of WS Holdings contained in this Agreement shall be true, correct and complete as if such representations and warranties were made on and as of such date."

Section 5.8 provided that Western Star would promptly notify MAN upon any representation or warranty becoming known to it as untrue or incorrect during the period between the date of the agreement and closing.

Article 12 contained the following (among other) provisions: "12.1Indemnification in Favour of MAN

Subject to Section 12.3, Section 12.4 and Section 12.5, WS Holdings shall indemnify and hold each of MAN AG, its Affiliates, the ERF Companies and the Other ERF Subsidiaries (collectively, "MAN Indemnified Persons") harmless of and from any Damages suffered by, imposed or asserted against any of the MAN Indemnified Persons as a result of, in respect of, connected with, or arising out of, under or pursuant to:(a)

any failure of WS Holdings … to perform or fulfil any of their respective covenants under this agreement;(b)

any breach or inaccuracy of any representation or warranty given by WS Holdings … contained in this Agreement;12.3Time Limitations

…(2)

The representations and warranties of WS Holdings … contained in this Agreement … shall survive the Closing and … shall continue for a period of 12 months after the Closing Date, save for the representations and warranties relating to … taxation in Section 4.1(oo) (tax) [which] shall continue for a period of six years after Closing and any claim in respect thereof shall be made in writing during such time period.

…(5)

For the avoidance of doubt the time limits referred to in this Section 12.3 shall not apply to any claim (whether made by way of representation, warranty or indemnity) in respect of fraud or fraudulent misrepresentation.

…12.7Exclusion of Other Remedies

No Party shall have the right to bring any proceedings against any other Party for a breach of any representation, warranty, covenant or agreement contained in this Agreement, except for a proceeding brought in accordance with the provisions of this Article. This provision is not intended to preclude any proceeding by any Party against any other Party based on fraud or on a cause of action or right, including any statutory right, other than a cause of action in contract or tort for breach of a representation, warranty, covenant or agreement contained in this Agreement."

Since some of the representations and warranties on which MN rely were qualified by Western Star's state of knowledge, it is relevant to note that Article 1.6 provided as follows: "1.6Knowledge

Where any representation or warranty … is expressly qualified by reference to the knowledge of a Party, it shall be deemed to refer to the actual knowledge (without further enquiry) of those Persons listed in Section 1.6 of the ERF Disclosure Schedule in the case of WS Holdings …" Mr. Ellis was one of the people listed in section 1.6 of the ERF Disclosure Schedule.

In view of the scope of the argument as to the measure of damages that MN was entitled to recover if it were successful in its claims it is also relevant to note at this stage that the word "Damages" as used in the Agreement was given an extended meaning, being defined as

"any loss, liability, claim, damage (including incidental and consequential damage) or expense (whether or not involving a third party claim) including legal expenses."

The representations and warranties in the Share Purchase Agreement play a prominent part in the dispute. Not only did they form an essential part of the Agreement, but there was also a requirement for them to be repeated and confirmed at the time of closing. Thus, Article 6.1 provided as follows: "6.1Conditions for the Benefit of MAN

The purchase and sale of the ERF Shares is subject to the following conditions to be fulfilled or performed prior to the Closing, …(a)

Truth of Representations and Warranties . Other than as required by any action specified in or as otherwise contemplated in Article 5, the representations and warranties of WS Holdings contained in Section 4.1 shall be true and correct in all material respects as of the Closing date with the same force and effect as if such representations and warranties had been made on and as of such date and WS Holdings shall have executed and delivered a certificate of a senior officer to that effect. Upon the delivery of such a certificate, the representations and warranties of the WS Holdings in Section 4.1 shall be deemed to have been made in all material respects on and as of the Closing Date with the same force and effect as if made on and as of such date."

A certificate signed by Mr. Stewart Smith confirming the truth of the representations and warranties was duly provided by Western Star at closing.4.The claims and defences being advanced in these proceedings

The issues between the parties were numerous and complex and in many cases closely inter-related. Some receded in importance during the course of the trial, as often occurs and others emerged more strongly. I do not think it would be helpful, therefore, to attempt to identify all the issues at this stage, but it may be helpful to summarise briefly the main areas of dispute.(a)MN's claims against Freightliner

The June and December accounts lie at the heart of these proceedings. It is accepted by all parties that as a result of Mr. Ellis's manipulations of ERF's books neither of them gave a true and fair view of ERF's financial position as at the date to which they were drawn up. It follows that there were breaches of the representations and warranties contained in sections 4.1(cc), 4.1(dd), 4.1(oo) and 4.1(pp)(i) of the Share Purchase Agreement, all of which were admitted by Freightliner. In these proceedings MN sought to recover from Freightliner all the losses it had incurred arising out of the purchase of ERF on the basis that Western Star was liable in deceit at common law and liable for fraudulent misrepresentation under the Share Purchase Agreement. It is necessary to explain in a little more detail the bases of these different claims.(i)Claims in deceit

MN's primary case was that it was induced to purchase ERF by false representations on the part of Mr. Ellis that the June and December accounts provided a true and fair picture of ERF's financial position. It sought to hold Freightliner liable for that deception on the grounds that from the time of his attendance at The Belfry in August 1999 Mr. Ellis was speaking on behalf of Western Star whenever he provided MN with information about ERF's accounts or its financial position generally. It contended that in the course of that meeting and the various meetings and discussions that followed (including the due diligence exercise) Mr. Ellis made a series of representations, both explicit and implicit, to the effect that the accounts of ERF which formed the basis for the parties' discussions had been prepared in good faith and that as far as he was aware they gave a true and fair picture of ERF's financial position, whereas to his knowledge that was far from the truth. It therefore sought to recover by way of damages for deceit at common law the whole of the amount that it paid to acquire ERF together with the amount that it had spent to keep it going until the completion of its ultimate reorganisation in April 2003, less its value as a going concern at that date. The total amount claimed is in the order of £350 million.

MN also said that by putting forward Mr. Ellis to answer questions about ERF's financial position Western Star itself implicitly represented that he was an honest, professional and trustworthy employee and that it was induced by that representation to retain him as financial controller of ERF, thereby enabling him to continue falsifying the accounts long after it had acquired ownership of the company.

Freightliner did not go quite so far as to accept that Mr. Ellis had made any representation about the view of ERF's affairs given by the accounts, but it did admit that in his dealings with MN he had implicitly represented that the accounts had been prepared honestly. It denied, however, that MN relied on any representation of that kind in purchasing ERF. Moreover, Freightliner argued that as a matter of law it was not liable for any dishonest statements made by Mr. Ellis about the accounts or anything else. It also denied that it could be held liable for any representation that Mr. Ellis may have made about his own honesty and said that in any event MN had formed its own view about him and had relied on that alone when deciding to keep him on as financial controller of ERF.

As to the allegation that it dishonestly held Mr. Ellis out to MN as being an honest and trustworthy employee, Freightliner said that it did nothing of the kind, but that even if it had it had done so, it had no reason to think that he was in fact dishonest. It could only be held liable on these grounds, therefore, if it were fixed with Mr. Ellis's knowledge of his own dishonesty, which would be contrary to well established principles.(ii)Claims under the Share Purchase Agreement

As an alternative to its claim in deceit MN argued that it was entitled to recover damages in the same amount under one or more of the provisions of the Share Purchase Agreement on the grounds that the representations made by Western Star about the conduct of ERF's business, its accounts and its tax position had been false and that the warranties given in respect of them had been broken. Recognising that Article 12 imposes restrictions on the right to recover for simple misrepresentation or breach of warranty, MN contended that its claim was a claim for fraud because in each case the knowledge of Mr. Ellis was to be attributed to Western Star. However, since the time allowed for making a claim in respect of the representations and warranties in section 4.1(oo) relating to ERF's tax position had not expired, MN argued that it was entitled to recover a full indemnity under that provision even if it failed to establish fraud.

Freightliner accepted that there had been breaches of many (though not all) of the warranties on which MN relied, but it did not accept that it was affected by Mr. Ellis's knowledge except in those cases where the agreement expressly so provided. Its primary response to the claims under the Share Purchase Agreement depended in part on the true extent of the information about ERF and its financial affairs that had been made available to MN prior to completion and partly on a detailed analysis of the terms of the agreement itself. In particular, it argued that Article 12 was intended to provide an exhaustive code regulating MN's right to recover for breaches of the agreement and although it accepted that claims for fraud could be made outside the 12 month time limit, it contended that the remedy for a breach of any kind was limited to the indemnity provided in Article 12.1 which provided a more limited measure of recovery than that available at common law in respect of the tort of deceit.(iii)Quantum

One of the main areas of dispute in this case concerned the amount that MN is entitled to recover if it is successful in its claim. The primary way in which MN put its case was that since its claim sounded in fraud it was entitled to recover the whole of the amount it had spent in buying, operating and restructuring ERF, although it accepted that it must give credit for the value of the business as it finally emerged from that process. That was said to reflect the established rules governing damages for fraud to be found in a series of cases from Doyle v Olby (Ironmongers) Ltd [1969] 2 Q.B. 158 onwards. Both Freightliner and E&Y took issue with that on a number of grounds. First, they contended that MN's right of recovery was limited to the indemnity provided by section 12.1 which was intended to put MN in the position in which it would have been if the representations had been true in every respect. In the alternative they argued that even if MN was entitled to recover damages for fraud in accordance with the principles of common law, the manner in which it conducted the business of ERF after the take-over was such as to break the chain of causation. In effect, they said that MN had managed ERF in an extraordinary way and was to a very large extent the author of its own misfortune. They also submitted that Freightliner could not be held liable for the continued manipulation of the books by Mr. Ellis between March 2000 and July 2001, which was sufficient to break the chain of causation in any event. Finally, they said that MN had failed to mitigate its loss once the fraud was discovered by failing to integrate ERF into MAN Truck & Bus without delay.

Although I had originally intended to determine all matters in issue between the parties, including all issues of quantum, at this trial, it became clear as time went on that even if MN were successful, the different factual bases on which damages might fall to be assessed were too numerous and complex to enable the parties to make detailed submissions in advance of my findings. Accordingly, I decided with the parties' agreement to make such findings of fact as I could at this stage and to defer the assessment of damages to a later hearing, if that should prove necessary.(b)ERF's claim against Freightliner

The fifth claimant, MAN ERF UK Ltd, made a claim in its own right as assignee of the rights of ERF (Holdings) Ltd and ERF Ltd to recover an indemnity under Article 12 of the Share Purchase Agreement. Freightliner accepted that Article 12 extended to ERF but maintained that ERF had no relevant cause of action to assign. I found it difficult to see under what circumstances ERF might be entitled to succeed in a claim against Freightliner if MN itself could not do so and after I had raised the question it was eventually agreed that this claim would not be pursued. I shall therefore say no more about it.(c)Freightliner's claims against E&Y (UK)

Using the Part 20 procedure Freightliner sought to recover from E&Y (UK) an indemnity against any liability it might be held to have incurred to MN. The claim was put on four distinct grounds:

(i) breach of a common law duty of care owed to Western Star in carrying out the audits of ERF's accounts for the years ending 30th June 1998 and 30th June 1999;

(ii) breach of contractual and common law duties of care owed to Western Star in connection with the due diligence exercise;

(iii) the right to a contribution under section 1 of the Civil Liability (Contribution) Act 1978 on the grounds that if Freightliner was liable to MN, E&Y (UK) was also liable to MN at common law in respect of the same damage, having negligently provided misleading information to MN in connection with the purchase of ERF (this became known as the “MN contribution claim”); and

(iv) a similar right to a contribution under the 1978 Act on the grounds that if Freightliner was liable to ERF, E&Y (UK) was in breach of contractual and common law duties to ERF in auditing its accounts for the 1998 and 1999 financial years (the “ERF contribution claim”).

Since the claim by ERF was not pursued, the ERF contribution claim inevitably fell by the wayside. The other three heads of claim, however, gave rise to numerous issues of fact and law which are described in more detail at a later stage. (d)Freightliner's claims against E&Y (Canada)

Freightliner also sought to obtain an indemnity from E&Y (Canada) and certain named partners in the firm against any liability it might be held to have incurred to MN on two grounds:

(i) breach of a contractual and a common law duty of care in carrying out the audits of the Western Star group's accounts for the years ending 30th June 1998 and 30th June 1999, in particular in failing to ensure that misleading management comments incorporated in the 1998 Audit Observations Report were not corrected and in failing properly to respond to the tip-off about ERF received from Mr. Pointon; and

(ii) breach of contractual and common law duties of care owed to Western Star in advising on and assisting in the sale of ERF to MN.

Again, each of these has given rise to issues of fact and law, both in relation to the nature and extent of an auditor's duty and the consequences of any breach of duty in the circumstances of this case. B.MN's claims against Freightliner1.MN's claim in deceit

I begin by considering MN's claim in deceit. It is not suggested that anyone other than Mr. Ellis was aware that he had been manipulating the accounts of ERF or that he had been systematically falsifying its VAT returns. Nor is it suggested that anyone other than Mr. Ellis made any representations to MN in the course of the negotiations for the sale of ERF which he did not believe to be true. The first question, therefore, is whether Mr. Ellis did make any or all of the representations alleged by MN.(a)Did Mr. Ellis make false and dishonest representations about ERF's accounts and financial statements?

For the moment I propose to concentrate on whether Mr. Ellis made false and dishonest representations about ERF's accounts and its financial statements. For reasons which will become apparent it may be necessary for some purposes to distinguish between what was said in the course of negotiation meetings and what was said in the course of the due diligence exercise, but for present purposes the distinction may not matter greatly. It is plain, in my view, that in the course of the various meetings which he attended with representatives of MN Mr. Ellis did indeed make numerous statements, explicit and implicit, about ERF's accounts and financial statements that he knew to be false. It is unnecessary to attempt to identify each such statement and probably impossible to do so since he attended many meetings and answered many questions arising out of the accounts. Implicit in all his answers was the statement that, as far as he was aware, the books of account had been honestly maintained and the financial statements based upon them had been honestly drawn and that therefore they could be relied upon to provide a true and fair picture of ERF's financial position. The implied representation that the accounts had been prepared honestly was fundamental to MN's (and for that matter Western Star's) understanding of ERF's position and dictated their approach to the negotiations.

The most prominent sets of accounts which formed the basis for the parties' initial discussions were the audited financial statements for the year ending 30th June 1998, the draft accounts for the year ending 30th June 1999 and the budget for the year ending June 2000, all of which were provided to MN at the Sandbach meeting on 7th July 1999 and formed the basis for the parties' discussions of ERF's EBITDA at the Belfry meeting in August which Mr. Ellis attended. Although the 1998 accounts had been audited, all those involved must have been aware that fraud can sometimes escape the auditors' notice and that there was a small risk of that having happened in this case, as in all cases. Accuracy and honesty are quite different things. MN no doubt did rely on the auditors to detect material errors in the accounts (and no doubt hoped that they would have detected any fraud as well), but I am quite satisfied that they also relied on Mr. Ellis's implicit assertions that those accounts had been prepared honestly and that he was not aware of anything that prevented them from giving a true and fair view of the group's financial position.

The draft accounts for 1999 were superseded by the audited accounts for that year when they became available early in November and I have no doubt that in the ensuing discussions with MN's representatives Mr. Ellis again represented (by implication, because it is not a matter that was, or normally would be, raised explicitly) that they had been prepared honestly on the basis of accounting records which had themselves been honestly maintained and that as far as he knew they gave a true and fair picture of ERF's financial position. The same must have been the case for the September management accounts and the budget for 1999–2000, both of which were made available to MN in the course of due diligence.

After the completion of the due diligence exercise negotiations between the parties resumed. Mr. Ellis attended the meeting in London at the beginning of December at which there were vigorous discussions about the EBITDA to be derived from the average of the accounts for the 1998 and 1999 years and the budget for 2000. Mr. Ellis took an active part in those discussions and by implication represented once again that the accounts and the budget had been prepared honestly.

During January 2000 Mr. Ellis prepared the management accounts for the six months to 31st December 1999 on the same basis as he had prepared the previous accounts and sent a copy to MN. Mr. Ziegler said that Mr. Ellis spoke to him shortly afterwards by telephone to tell him that a few changes needed to be made. That evidence was not challenged and I accept what he said. I think it inevitable that in discussing the accounts with Mr. Ziegler, even in that limited manner, Mr. Ellis again implicitly represented that they had been honestly drawn.

Having regard to the nature and extent of his involvement in the discussions with MN, therefore, I am satisfied that Mr. Ellis did make false and dishonest representations to MN before, during and after the due diligence exercise that the accounts of ERF on which those discussions were based had been honestly drawn and that as far as he knew they gave a true and fair view of ERF's financial position at the various times to which they related.(b)Is Freightliner liable for Mr. Ellis's false representations?

The main area of dispute between MN and

Freightliner in relation to this aspect of the claim was whether Western Star (and hence Freightliner itself) could be held liable for dishonest statements of that kind made by Mr. Ellis. I am indebted to Mr. Geoffrey Vos Q.C. for his helpful analysis of the authorities relating to vicarious liability for fraudulent statements made by servants or agents. The starting point is generally taken to be the judgment of Willes J. in Barwick v English Joint Stock Bank (1867) L.R. 2 Exch. 259 . In that case the plaintiff gave credit to a customer on the strength of an assurance from the manager of one of the defendant bank's branches that on the receipt of certain funds the customer's cheque would be paid in priority to any other payment “except to this bank”. However, as the manager knew, the customer already owed the bank a greater sum than that which he expected to receive. The court held that there was sufficient evidence of fraud on the part of the manager to go to the jury and that, if the jury found fraud on his part, the bank as his employer was liable for it. Giving the judgment of the court Willes J. said at page 265

“But with respect to the question, whether a principal is answerable for the act of his agent in the course of his master's business, and for his master's benefit, no sensible distinction can be drawn between the case of fraud and the case of any other wrong. The general rule is, that the master is answerable for every such wrong of the servant or agent as is committed in the course of the service and for the master's benefit, though no express command or privity of the master be proved. That principle is acted upon every day in running down cases. It has been applied also to direct trespass to goods, as in the case of holding the owners of ships liable for the act of masters abroad, improperly selling the cargo. It has been held applicable to actions of false imprisonment, in cases where officers of railway companies, intrusted with the execution of bye laws relating to imprisonment, and intending to act in the course of their duty, improperly imprison persons who are supposed to come within the terms of the bye laws. It has been acted upon where persons employed by the owners of boats to navigate them and to take fares, have committed an infringement of a ferry, or such like wrong. In all these cases it may be said, as it was said here, that the master has not authorized the act. It is true, he has not authorized the particular act, but he has put the agent in his place to do that class of acts, and he must be answerable for the manner in which the agent has conducted himself in doing the business which it was the act of his master to place him in.”

That decision was applied and in some respects clarified in Lloyd v Grace, Smith & Co. [1912] A.C. 716 in which the House of Lords made it clear that vicarious liability for the acts of servants or agents depends not on whether in committing the tort the agent acted for the principal's benefit, but on whether the agent was performing an act of a kind that he was held out as having authority to do. Thus in the words of Lord Loreburn at page 725:

“If the agent commits the fraud purporting to act in the course of business such as he was authorized, or held out as authorized, to transact on account of his principal, then the latter may be held liable for it.” Similar expressions of opinion can be found in the speeches of Lord Macnaghten at page 736 and Lord Shaw of Dunfermline at page 740.

Where the employee's wrongful act consists in making a fraudulent representation the essential question for decision, as these cases show, is whether the defendant is to be regarded as having authorised the wrongdoer to speak on his behalf in relation to the matter in hand. However, the decision in Armagas Ltd v Mundogas S.A. [1986] 1 A.C. 717 , in which Lloyd v Grace, Smith was applied, serves to emphasise that the principal will not be liable for the tort of his agent unless he is responsible for leading the third party to believe that the agent had authority to perform the act in question, either by placing him in a position in which he would ordinarily have such authority, or by representing to the third party in some other way that he is authorised to carry out the transaction in question on his behalf. In that case the defendants' chartering manager, Mr. Magelssen, fraudulently purported to enter into a three year time charter with the plaintiffs on behalf of the defendants. A person in Mr. Magelssen's position would not ordinarily have had authority to make a contract of that kind, but he had misled the plaintiffs into thinking that he did have such authority. The fact that the defendants had not themselves held Mr. Magelssen out as having authority to do an act of that kind was fatal to the claim. Lord Keith put the matter in this way at page 782:

“At the end of the day the question is whether the circumstances under which a servant has made the fraudulent misrepresentation which has caused loss to an innocent party contracting with him are such as to make it just for the employer to bear the loss. Such circumstances exist where the employer by words or conduct has induced the injured party to believe that the servant was acting in the lawful course of the employer's business. They do not exist where such belief, although it is present, has been brought about through misguided reliance on the servant himself, when the servant is not authorised to do what he is purporting to do, when what he is purporting to do is not within the class of acts that an employee in his position is usually authorised to do, and when the employer has done nothing to represent that he is authorised to do it."

In Crédit Lyonnais Bank Nederland N.V. v Export Credits Guarantee Department [2000] 1 A.C. 486 P, an employee of the defendant, authorised the issue of export credit guarantees as part of a scheme to mislead the claimant into making payments to a third party, C. The guarantees were presented by C to the claimant in support of bills of exchange with forged acceptances in the names of fictitious buyers of goods. The claimant brought an action against the defendant on the grounds, among others, that it was vicariously liable for the wider deceit committed by P within the course of his employment as part of a joint enterprise with C. The claim failed, however. Although P was acting in the course of his employment when he authorised the issue of the guarantees, that was not in itself a wrongful act and although he knew of the use to which C intended to put them, it was not his act but the acts of C which misled the claimant. Lord Woolf M.R. explained the position as follows at page 495:

"The conduct for which the servant is responsible must constitute an actionable tort and to make the employer responsible for that tort the conduct necessary to establish the employee's liability must have occurred within the course of the employment. If the tort is committed jointly, then it is conduct which is within the course of the employment sufficient to constitute the tort, irrespective of which tortfeasor performed the acts, which is necessary. As both tortfeasors are responsible for the tortious conduct as a whole in the case of joint torts it is not necessary to distinguish between the actions of the different tortfeasors. For vicarious liability what is critical, as long as one of the joint tortfeasors is an employee, is that the combined conduct of both tortfeasors is sufficient to constitute a tort in the course of the employee's employment.

… before there can be vicarious liability, all the features of the wrong which are necessary to make the employee liable have to have occurred in the course of the employment. Otherwise there is no liability. You cannot therefore combine the actions of Mr. Pillai in the course of his employment with actions of Mr. Chong, which if done by Mr. Pillai would be outside the course of Mr. Pillai's employment, and say E.C.G.D. is vicariously liable for the consequence of Mr. Pillai's and Mr. Chong's combined conduct."

At one point Mr. Vos sought to argue that in the present case Mr. Ellis was doing nothing more during the negotiations with MN than attempting to cover up the fraud he had committed as an employee of ERF and that a crucial feature of the wrong in this case was the original fabrication of the accounts which had nothing to do with Western Star. However, I am unable to accept that. The deceit said to have been committed by Mr. Ellis consisted in dishonestly making false representations about ERF's accounts. It is quite true that in order for him to do so the accounts must to his knowledge have been falsified in some material respect, but it was not necessary that they should have been falsified by him. His knowledge of the fact was a state of mind which, although acquired earlier, existed at the time the false statements were made. If one leaves aside for a moment the question of inducement, the essential elements of deceit were present as soon as he made a representation which he knew to be false with the intention that it be accepted as true by MN and acted upon.

Finally in this context it is necessary to mention two further decisions of the House of Lords in which their Lordships considered the circumstances in which a person can properly be said to have been acting in the course of his employment or within the scope of his authority so as to render his employer or principal vicariously liable for his intentional wrongdoing. The first is Lister v Helsey Hall Ltd [2001] UKHL 22; [2002] 1 A.C. 215 which concerned the liability of a school for abuse committed against pupils by the warden of a boarding house. Clearly it was no part of the warden's duties to abuse children in his care; the question was whether acts of abuse were to be regarded as having been committed within the course of his employment so as to render his employers liable for them. Lord Steyn expressed his conclusion as follows at page 230: "28.

Employing the traditional methodology of English law, I am satisfied that in the case of the appeals under consideration the evidence showed that the employers entrusted the care of the children in Axeholme House to the warden. The question is whether the warden's torts were so closely connected with his employment that it would be fair and just to hold the employers vicariously liable."

This approach was applied in the later case of Dubai Aluminium Co. v Salaam [2003] 2 A.C. 366 which concerned the liability of a firm of solicitors for the alleged wrongdoing of one of its partners. Their Lordships emphasised that the issue of vicarious liability could not be determined simply by asking whether the employee or partner was authorised to do the very act in question; it was necessary to ask whether the wrongful act was so closely connected with the acts the partner or employee was authorised to do that it might fairly and properly be regarded as done by him while acting in the ordinary course of the firm's business or of his employment: see per Lord Nicholls at page 377, paragraph 23.

In the light of the authorities it is necessary, therefore, to enquire in more detail into the role played by Mr. Ellis in the various meetings which he attended between July 1999 and March 2000. The critical question in my view is whether Western Star put him forward to speak about the accounts and financial position of ERF in such a way as to hold him out as having authority to speak about such maters on its behalf.(i)Representations about ERF's accounts

The parties' positions on this issue can be summarised as follows: Mr. Dominic Kendrick Q.C. submitted that Western Star brought Mr. Ellis into the meetings to explain the accounts and to answer questions about ERF's financial position in such a way as to make it clear that he was speaking on its behalf. Mr. Vos, on the other hand, submitted that Mr. Ellis was asked to attend those meetings simply as financial controller of ERF in order to answer questions about the group's accounts in that capacity. He was not put forward to speak on behalf of Western Star at all and was not held out as having authority to do so.

Before considering this question it is convenient to deal with a submission made by Mr. Vos that Mr. Ellis could not, as a matter of law, have been acting as agent for Western Star in making statements about ERF's accounts because throughout the period during which the negotiations took place he remained at all times in the employment of ERF. The argument rested on two decisions under the Road Traffic Acts, Sykes v Millington [1953] 1 Q.B. 770 and Interlink Express Parcels Ltd v Night Trunkers Ltd [2001] EWCA Civ 360; [2001] R.T.R. 338 .

In Sykes v ton the court was concerned with whether there had been a breach of the statutory provisions relating to the licensing and use of road haulage vehicles. Section 1(3) of the Road and Rail Traffic Act 1933 provided as follows:

"When a goods vehicle is being used on a road for the carriage of goods, … the person whose agent or servant the driver is, shall, for the purposes of this Part of this Act, be deemed to be the person by whom the vehicle is being used."

The respondent owned three lorries in respect of which he held a licence under which their use was restricted to a certain area. On various occasions he hired one or other of the lorries together with a driver to a third party for use in the carriage of its own goods. The third party held an unlimited licence allowing it to operate lorries without any restriction on the area of their operations. The respondent was prosecuted for an offence under the Act and the question arose whether the drivers, who at all times remained in the respondent's employment, were to be regarded as the servants of the respondent or the agents of the third party. The justices held that, whether or not the drivers were the respondent's servants, they were the agents of the third party and that no offence had therefore been committed. The Divisional Court (Lord Goddard C.J. and Lynskey J.) allowed the prosecutor's appeal, Lord Goddard saying at page 775 that

"With all respect to the justices, a man cannot be the servant of A and the agent of B in performing the same piece of work. He is either the servant of A or the servant of B."

In Interlink Express Parcels Ltd v Night Trunkers Ltd the issue was whether an agreement between the claimant and the defendant was void for illegality because it involved the contravention of section 2 of the Goods Vehicles (Licensing of Operators) Act 1995 which prohibits the use of a goods vehicle on a road for the carriage of goods for hire or reward except under an operator's licence issued under the Act. The facts of the case were similar in many respects to those of Sykes v Millington in that lorries owned by Night Trunkers were hired with drivers to Interlink for the purposes of enabling Interlink to carry goods in the course of their own business.

Section 58(2) of the Act provides as follows:

"For the purposes of the Act, the driver of a vehicle, if it belongs to him or is in his possession under an agreement for hire, hire-purchase or loan, and in any other case the person whose servant or agent the driver is, shall be deemed to be the person using the vehicle; and references to using a vehicle shall be construed accordingly." Night Trunkers did not hold the appropriate licence, but Interlink did, so again the question arose whether the drivers of the lorries were to be regarded as the servants of Night Trunkers.

The judge held that while driving the lorries under the contract the drivers remained the servants of Night Trunkers with the result that there was a contravention of the Act. The Court of Appeal took a different view, concluding that they were in the temporary employment of Interlink, so it became unnecessary to decide whether they could also be the agents of Interlink. In the course of her judgment, however, Arden L.J. referred to the judgments in Sykes v Millington and expressed the view that the proposition that a person cannot be the servant of A and the agent of B in performing the same piece of work was part of the ratio of that decision. Hale L.J. preferred to express no view on what she described as a "difficult issue". Butler-Sloss P. expressed no view on the question.

In my view the decisions in both these cases, and the comment of Lord Goddard C.J. in Sykes v Millington to which I have referred, must be understood in the context of the legislation to which they were directed. As Lynskey J. pointed out in Sykes v Millington at page 776, under section 1(3) of the Road Traffic Act only one person was to be deemed to be using the vehicle, which made it impossible to conclude that the drivers were acting both as servants of the respondent and as the agents of the third party for the purposes of the Act. The same is true in the case of the Goods Vehicles (Licensing of Operators) Act 1995 and I do not think that either of these decisions can be regarded as laying down a general principle of law. Indeed, insofar as it is suggested that an employee of one person cannot, while he continues to be so employed, act as the agent of another for any purpose, the proposition is in my view too wide. As examples discussed in argument demonstrate, it is not difficult to imagine circumstances in which the employee of A can act as agent of B for certain purposes while remaining in the employment of A throughout. It may be that as a general rule a person will not be both the employee of A and the agent of B *at the same time and in relation to the same act*, although even that ought in principle to be possible where the act is done in relation to a matter in which A and B are both directly interested. In the present case I accept that throughout the period of the negotiations between Western Star and MN Mr. Ellis was employed by ERF as its financial controller, but in my view that did not as a matter of law prevent him from speaking to MN on behalf of Western Star if he was authorised, or held out by it as being authorised, to do so. It is to this question that I now turn.

Most of those who attended the negotiation meetings and the due diligence exercise were called to give evidence and all of those who gave evidence were asked about the part played by Mr. Ellis. Although many of them were inevitably drawn into expressing their own opinions about his role, what matters most for present purposes is how Western Star put him forward to MN, both at the time he was first brought into the meetings and subsequently as the negotiations developed.

It became obvious in the course of the meeting at Sandbach in July 1999 that Mr. Bryant did not consider himself capable of dealing with detailed questions about ERF's accounts and financial statements and it was for precisely that reason that he suggested that Mr. Ellis should be brought into future meetings. According to Mr. Wagner, Mr. Bryant said at that meeting that he would ask Mr. Peabody to bring Mr. Ellis "into the team", or something to that effect, and two or three days later had telephoned him to tell him that he had suggested to Mr. Peabody that Mr. Ellis be included in the discussions and that Mr. Peabody had agreed. Although this part of his evidence was challenged by Mr. Vos, Mr. Wagner remained confident in his recollection of what had been said.

Mr. Bryant's recollection was a little different in that he did not think he had suggested to Mr. Wagner at the meeting itself that Mr. Ellis should become involved. He recalled that after the meeting Mr. Harrison had said that they needed to have someone at future meetings who had more detailed knowledge of the accounts. Someone (he did not remember who it was) had subsequently spoken to Mr. Peabody to obtain his approval and he had spoken to Mr. Wagner a few days later to tell him that Mr. Peabody had agreed that Mr. Ellis would be available at future meetings to answer questions about the finances.

As I have already indicated, in my view nothing turns on whether the involvement of Mr. Ellis was raised in the course of the Sandbach meeting or not. What is significant is what Mr. Bryant told Mr. Wagner a few days later about the purpose for which he would be attending future meetings. Mr. Wagner was quite clear that whatever precise words Mr. Bryant had used, they had signified that Mr. Ellis would be attending subsequent meetings with Mr. Peabody's approval to answer questions and provide explanations on behalf of Western Star. In that sense he would be part of the Western Star team. That appears to accord with Mr. Bryant's understanding at the time since he accepted in cross-examination that Mr. Ellis would attend meetings to take over part of his role in speaking for Western Star on financial matters under his general supervision.

Mr. Ellis was introduced to the MN representatives for the first time when the two sides met at The Belfry in August 1999. In common with all those present he handed out copies of his business card which described him as Financial Controller of ERF and I am satisfied that is how Mr. Bryant introduced him to those present. I also think it likely that Mr. Bryant explained that he was present in order to answer questions about ERF's financial position. Moreover, Mr. Wagner knew from earlier conversations with Mr. Bryant that Mr. Peabody himself had agreed to the inclusion of Mr. Ellis in what were at that stage still very much negotiation meetings. At the start of the meeting MN's questions were generally directed to Mr. Bryant, who seems to have been acting as leader of the Western Star team. He invited Mr. Ellis to respond if the question was one that called for financial knowledge, but as the meeting progressed it became more informal and questions were directed to Mr. Ellis who responded without waiting for an invitation from Mr. Bryant. Others on both sides who attended the Belfry meeting, including Mr. Ellis himself, described his participation in broadly similar terms.

Mr. Ellis did not attend the meeting in Toronto on 8th October 1999 or the second Heathrow meeting on 20th October, but he did play an important role in the due diligence exercise, answering MN's questions and producing additional documents in response to various requests. Moreover, he attended all the meetings between the two sides that followed the completion of the due diligence exercise. These included the important meeting at Shearman & Sterling's offices on 2nd and 3rd December in the course of which he vigorously defended ERF's accounts and Western Star's calculation of the EBITDA derived from them which was one of the principal matters around which the negotiations then revolved.

Mr. Vos submitted that Mr. Ellis remained an employee of ERF throughout and that even if it were possible for him to be Western Star's agent for certain purposes, MN bore the burden of showing that there was a temporary transfer of employment to Western Star of the kind contemplated in Mersey Docks and Harbour Board v Coggins & Griffith (Liverpool) Ltd [1947] A.C. 1 . He submitted that the burden was a heavy one which MN was unable to discharge in this case. Mr. Kendrick submitted, however, that the problems which arise in a case where one person lends an employee to another for certain limited purposes do not really arise in the present case, but he was prepared to submit, if necessary, that there was in this case a temporary transfer of Mr. Ellis's employment from ERF to Western Star for the purposes of his participation in the negotiations.

In the Mersey Docks case the House of Lords considered at some length the problems that arise in determining who should be vicariously liable for the torts of an employee when a person makes one of his workmen available to another for the purposes of carrying out certain operations. The House concluded that the correct approach, which is not always easy to apply in practice, is to determine, on the facts of the case, whether the workman remains in the employment of his original employer or has been temporarily transferred to another. Given the nature and incidents of a contract of employment, as well as the likelihood in many cases that the general employer will have given the workman the training and instructions necessary to enable him to perform his task (both matters that were adverted to by Lord Porter at pages 15–17), one can understand why it will often be difficult to show that there has been a temporary transfer of employment. In a case such as the present, however, where all that is alleged is that the employee of one person was authorised to speak about certain matters on behalf of another, the same difficulties do not arise. There is in my view no obvious reason why Western Star should not have authorised Mr. Ellis to speak on its behalf despite the fact that he remained an employee of ERF at the time. If that was indeed the case, it would be right to regard him as speaking only for Western Star at the meetings in question and to that extent it could be said that there was a transfer of functions (albeit not of employment), but that is simply another way of saying that in those meetings he was speaking in his capacity as agent of Western Star rather than in his capacity as an employee of ERF. One comes back, therefore, to the question whether Mr. Ellis purported to speak for Western Star at the meetings in question and was authorised (or at least was held out by Western Star as being authorised) to do so.

In deciding this issue considerable importance is in my view to be attached to the circumstances in which Mr. Ellis came to be involved in the negotiations and the manner in which he was introduced at the Belfry meeting because, although it is possible that the nature of his participation could have changed significantly over the course of time, the way in which it was explained and the manner in which he was invited or allowed to become involved in discussions at that first meeting must inevitably have made the most lasting impression on those who represented MN. Mr. Vos laid some emphasis on the fact that Mr. Ellis was, and was known to be, financial controller of ERF, that he was introduced as such and that he handed round business cards which described him in that way, but I am unable to attach much significance to any of those matters. What I consider to be more important is that fact that Mr. Bryant had previously indicated that he would seek to involve Mr. Ellis in the discussions to make up for his own lack of familiarity with the financial matters and that he had given Mr. Wagner to understand that he had obtained Mr. Peabody's approval to that course. Moreover, these factors have to be considered in the context of negotiations involving Western Star and MN alone. There was, as Mr. Kendrick submitted, only one conversation going on at that time, namely, a conversation between Western Star and MN to which ERF was not a party. That is not determinative of the issue because it would still be possible for one or other of the participants to invite a third party to attend their meetings in order to provide information without making him an agent to speak on its behalf, and indeed that is what Mr. Vos submitted had occurred in this case. However, the fact that there was a conversation going on between MN and Western Star does force one to consider carefully whether any such third party, in this case Mr. Ellis, was in fact independent of the party introducing him. The nature of his participation, if nothing else, is likely to make the position clear.

Whether or not ERF had an interest in its potential sale to MN, it is clear that it was not itself directly involved in the negotiations. Mr. Peabody was keen to ensure that none of the employees of ERF with the exception of Mr. Ellis, Mr. Pinney and Mrs Allcock, whose involvement was necessary in order to make essential information available to MN, became aware of the negotiations and there is no evidence that the board of ERF ever considered them. Nor is there any evidence of what it thought the group's attitude to a take-over should be. I find it impossible, therefore, to conclude that Mr. Ellis was invited to attend the meetings in order to represent ERF's own interests; nor do I find it possible to conclude that he was invited to attend as a neutral representative of ERF with a view to sharing with Western Star and MN indifferently his knowledge of ERF's accounts and financial position. Mr. Vos submitted that his position was at best ambiguous because he had been brought to the meeting as financial controller of ERF in order to speak about matters which he had learnt as an employee of ERF and that it was necessary for any doubt on the matter to be removed before he could be regarded as speaking on behalf of Western Star. I am not sure that in a situation of the present kind there is a strong presumption that an employee continues to act for his general employer; it very much depends on the particular circumstances of the case. However, I am in any event quite satisfied that when he took part in negotiation meetings Mr. Ellis was not acting on behalf of ERF. His participation in the Belfry meeting took the form of answering questions and entering into discussions on matters that would have been handled by Mr. Bryant himself if he had felt competent to do so. All that took place in the presence of Mr. Bryant and others representing Western Star without any suggestion that Mr. Ellis did not have authority to speak on its behalf. The nature of his participation in the meeting in early December, again in the presence of Mr. Bryant and Mr. Stewart Smith, was likewise consistent only with representing the interests of Western Star. Mr. Ellis himself believed that when he spoke about financial matters he was representing Western Star and I am satisfied that Mr. Peabody intended that he should. More importantly perhaps, although no one on MN's side thought Mr. Ellis's authority extended to concluding an agreement, formal or informal on its behalf, they did believe that he was speaking on Western Star's behalf when they discussed such matters with him. The fact that (unbeknown to MN) Mr. Ellis later received a gratuity from Western Star tends to confirm that it also considered him to have been acting on its behalf, but coming, as it does, after the event, it does not really take the matter any further and in any event has no direct bearing on the way in which he was held out to MN by those acting for Western Star.

Thus far I have concentrated on Mr. Ellis's involvement in what I have described as negotiation meetings, but Mr. Kendrick submitted that even during the due diligence exercise Mr. Ellis continued to act on behalf of Western Star so as to render it vicariously liable for any dishonest statements he made in the course of his discussions at the Cottons hotel. However, I find that a more difficult proposition to accept. Whereas the negotiation meetings by their very nature involved direct communications between Western Star and MN, the due diligence exercise involved an investigation by MN into ERF and its operations. Although a data room due diligence of the kind that took place in this case is not unusual, it is a modified version of the classic exercise in which the seller opens the target company up to inspection by the purchaser and the purchaser visits the company to examine its books and records and to talk to key members of staff, if it wishes to do so. If such an exercise had been carried out in this case, representatives of MN would undoubtedly have examined the books and records at Sandbach and would have obtained from Mr. Ellis exactly the same kind of explanations and assistance as they obtained from him at the Cottons hotel. Although the company's co-operation in an exercise of that kind is provided for the benefit of its shareholder, I do not think that the employees who provide explanations and assistance to the purchaser can normally be regarded as speaking on the seller's behalf rather than on behalf of the company itself. If the due diligence exercise had taken that form, therefore, I think there is little doubt that Mr. Ellis would have been acting in the course of his employment as financial controller of ERF and not as an agent for Western Star when answering MN's questions.

Mr. Kendrick submitted, however, that the way in which the due diligence exercise was carried out in this case meant that Mr. Ellis continued to speak on behalf of Western Star throughout. He relied in particular on the fact that the exercise was carried out off-site and on the fact that it was attended and monitored by representatives of Western Star, in particular Mr. Stewart Smith and (for part of the time) Mr. Bryant. In effect, he said that it was closely controlled by Western Star which was in reality the party answering questions and supplying information and documents to MN.

It is quite true that MN was not given as free a hand as it might have liked in carrying out its due diligence and that the process at the Cottons hotel was monitored by representatives of Western Star, but the exercise was lengthy and detailed and the evidence does not indicate that it was organised in that way to enable Western Star to filter the material provided to MN by deciding what documents or information should be disclosed by ERF, or that it did so. Nor is there any evidence that Mr. Ellis was in fact told what he could or could not disclose or what he should or should not say when answering MN's questions. Western Star obviously wanted to know what material MN had requested and what it had received, what questions it had asked and what answers it had been given, and Mr. Stewart Smith and Mr. Ingrassia of Warburgs, who was also present, were there to observe and report back. However, I do not think that Western Star can be said to have conducted the due diligence itself so as to remove it from the sphere of ERF.

In my view Mr. Ellis was acting for ERF not Western Star when he attended the due diligence meetings, but on the two other important occasions when he met representatives of MN, namely, at the Belfry meeting and at the meeting in London in December 1999, and also when he discussed the December management accounts with Mr. Ziegler, he did so as a representative of Western Star. No one suggested, of course, that Western Star authorised Mr. Ellis to make false and dishonest representations to MN, but he was brought into the meetings specifically to deal with ERF's accounts and its financial position more generally and the representations he made could scarcely have been more closely connected to the task he was authorised to perform on its behalf. In those circumstances I am satisfied that it is fair and just that Western Star should be held vicariously liable for his fraud.

In these circumstances it is unnecessary to deal at any length with Mr. Kendrick's alternative submission that Mr. Ellis acted dishonestly in concealing ERF's true financial position and his own dishonest manipulation of the accounts. I think Mr. Vos was right in saying that there is no general duty of disclosure at common law in the context of the sale of a company, but in reality these allegations seem to me to be little more than a reflection of Mr. Ellis's dishonesty in relation to the accounts. By suppressing what he knew he quite deliberately led MN to believe that ERF's accounts had been honestly maintained and that the financial statements based on them had been honestly drawn. Thus his concealment of the true position was nothing more than the means by which he made the false statements to which I have already referred.(ii)Representations about his own honesty

It is necessary, however, to say something further about another false statement that Mr. Ellis is said to have made on behalf of Western Star, namely, that he was an honest and trustworthy employee of ERF. This representation is not said to have induced MN to enter into the Share Purchase Agreement, but it is said to have induced MN to retain Mr. Ellis as financial controller of ERF and so in a position to cause further harm and in view of the nature of the representation he is said to have made it is convenient to consider the argument at this point.

I think it is helpful to begin by considering in a little more detail exactly what Mr. Ellis is supposed to have said about himself in the course of these meetings. It is not suggested that he made any particular claims to honesty or trustworthiness or that he said anything about how he was regarded by ERF or Western Star. Any representations he made about himself were purely implicit. Herein, it seems to me, lies much of the difficulty. All those who attended the meetings at which Mr. Ellis was present put themselves forward as honest and trustworthy persons; that went without saying. Equally, it was assumed on both sides that the people Western Star and MN put forward to represent them were considered by their respective principals to be honest and trustworthy; again, it went without saying. No one was interested in whether Western Star had a particularly high opinion of Mr. Ellis, however, and no one asked Western Star for its views about him. In those circumstances I do not think that it can fairly be said that Mr. Ellis made any statement about himself, other than that he was as honest and trustworthy as the next man.

That statement was, of course, false and dishonest, but I find it more difficult to accept that he was authorised to make it on behalf of Western Star or that it was so closely connected with the task he was put forward to carry out that it would be fair and just to hold Western Star liable for what he said about himself. By bringing him into the meetings to speak on its behalf Western Star itself had put him forward as an honest and trustworthy person —it had no reason to do otherwise — and in doing so had said all that it was necessary for it to say about him. There was no reason for it to have wanted Mr. Ellis to say anything about himself on its behalf. In those circumstances I am unable to accept that Western Star could reasonably be thought to have put him forward to make any statement on its behalf about his own character. Anything he said about himself, therefore, was not said on behalf of Western Star and was not sufficiently closely connected with what he had been put forward to do to make it fair and just to hold Western Star liable for it.(c)Did Mr. Ellis's representations about ERF's accounts induce MN to enter into the Share Purchase Agreement?

Since the performance of ERF as reflected in the accounts played such a large part in the negotiations, it would be surprising if MN had not relied on their fundamental honesty in entering into the Share Purchase Agreement. Indeed, Mr. Vos was prepared to accept that MN did rely on the accounts themselves, but he did not accept that it had relied on anything that Mr. Ellis might have said about them. What it really relied on, he said, was the certification of the 1998 and 1999 accounts by E&Y (UK), the work carried out by Deloitte & Touche during the due diligence exercise and the representations and warranties given by Western Star in the Share Purchase Agreement. Moreover, he submitted that MN had failed to establish that either its own executive board, which took the decision to enter into the agreement, or the executive board of MAN, which approved it, had placed any reliance on anything said or done by Mr. Ellis.

The effective decision to buy ERF was taken by the executive board of MN, although it was approved by its supervisory board and by the executive and supervisory boards of MAN. Of the members of the MN board, only Dr. Schubert and Dr. Hülbert had been directly involved in the negotiations with Western Star and Dr. Schubert had not attended any of the meetings in which Mr. Ellis took part. Dr. Zahn, who had become involved at the time of the second Heathrow meeting, was a member of the executive board of MAN and was not a director of MN. Mr. Vos submitted that there was nothing in the board papers to suggest that the executive board of MN had been aware of the nature or extent of Mr. Ellis's involvement in the negotiations or that anything that he had said had influenced its decision in any way.

It is true that none of the papers produced for the MN executive board relating to the acquisition of ERF referred in any detail to the involvement of Mr. Ellis, though his presence at meetings was noted where appropriate. Nonetheless, one member of the board, Dr. Hülbert, had taken part in all the negotiation meetings at which Mr. Ellis had been present and he at least must have been aware of the nature and extent of his involvement. However, in my view Mr. Vos's submission takes far too narrow a view of the negotiation process and of the significance to be attached to important, though apparently uncontroversial, statements made in the course of it. Mr. Wagner as leader of the MN negotiating team made it quite clear to Western Star that although he and his team were authorised to conduct negotiations, the final decision lay with the board of MN from which they obtained their authority and to which they would have to report. Western Star must have been aware, therefore, that anything said in the course of negotiations that was liable to influence the views of the MN representatives was liable to influence the decisions of the MN board, whether they were expressly reported to it or not. There was nothing unusual about that; it is the normal position when negotiations are conducted in that way, as they frequently are. It follows that any representation made on behalf of Western Star which was intended to influence the way in which Mr. Wagner and his team reported to the board was equally intended to influence the board's decision and was likely to do so. In this case the essential honesty of the accounts was fundamental to the negotiations, so much so that it was unnecessary for Western Star to state in terms that, as far as it was aware, that was the case and equally unnecessary for Mr. Wagner to confirm it to his board. It was a statement implicitly made by everyone who took part in the discussions on behalf of Western Star, but particularly by Mr. Ellis because he had been responsible for drawing the accounts and had been brought into the meetings expressly to deal with them. Mr. Wagner and the other MN representatives who attended the meetings with Mr. Ellis were intended to, and did, rely on his implied representations that the accounts had been honestly drawn. They relied on those representations when making their reports to the board and in that way the representations played an important part in inducing the board of MN to enter into the Share Purchase Agreement. The same is true of the MN supervisory board and the boards of MAN.

Similarly, I have no doubt that MN relied on the investigations carried out on its behalf by Deloitte & Touche as part of the due diligence exercise, but again it does not follow that Mr. Ellis's representations played no part in inducing MN to buy ERF. An understanding that the accounts had been honestly prepared must have affected the way in which MN regarded the work done on its behalf by Deloitte & Touche whose main function was to confirm that the audit carried out by E&Y (UK) had been properly performed. They were not expected to duplicate that work, much less to carry out a searching investigation into all aspects of ERF's financial affairs.

Mr. Vos also submitted that MN, particularly in the person of Dr. Schubert, had been so keen to acquire ERF in order to obtain its share of the UK truck market that it was not greatly concerned about the honesty of its accounts and would have been happy to buy the company in any event. Accordingly, he submitted, Mr. Ellis's fraud did not induce it to enter into the Share Purchase Agreement.

I am unable to accept that argument for a number of reasons. In the first place, it is not appropriate to ask what MN would have done if it had known the truth (see Downs v Chappell [1997] 1 W.L.R. 426, 433 per Hobhouse L.J.), but in any event in the light of the evidence about the discussions within MN which preceded the decision to go ahead with the acquisition of ERF I find it inconceivable that Dr. Schubert or anyone else would have been willing to pay £63.5 million or indeed any sum for a company which was not only heavily insolvent but probably trading at a fairly substantial loss as well. Leaving that on one side, however, I think it is clear that the essential honesty of the accounts was fundamental to the discussions between the parties. Dr. Schubert said that MN would have withdrawn from the negotiations immediately if it had discovered that Mr. Ellis had been deliberately manipulating ERF's books in any material respect, and one can well see why. Once an instance of fraud of that kind has been detected in the accounts it casts doubt on the accounts as a whole and calls for a full investigation. It would have been impossible for MN to consider resuming discussions until such an investigation had been completed. It is now possible to see that the manipulation of the accounts was concealing not only a substantial deficit in ERF's balance sheet but also serious frauds on Customs & Excise by way of false claims for the repayment of VAT.

The inclusion in the Share Purchase Agreement of the various representations and warranties was an important form of protection for MN and was no doubt one of the factors which induced it to enter into that agreement, but it does not follow that Mr. Ellis's fraud ceased to have any influence on MN's decision. The evidence of Mr. Wagner, Dr. Schubert and others amply supports the conclusion that MN was induced to buy ERF in part by the implied representation that the accounts by reference to which the sale had been negotiated had been honestly drawn. I therefore reject Mr. Vos's submission to the contrary.(d)Section 14.10 of the Share Purchase Agreement

It is relevant at this point to consider the effect of Section 14.10 of the Share Purchase Agreement since Mr. Vos submitted that its purpose was to make it clear that MN did not rely on representations of any kind made prior to the signature of the agreement.

Section 14.10 provided as follows:

"This Agreement together with the Ancillary Agreements constitutes the entire agreement between the Parties and supersedes all prior agreements, understandings, negotiations and discussions, whether oral or written, of the Parties. There are no representations, warranties, covenants, conditions or other agreements, express or implied, collateral, statutory or otherwise, between the Parties in connection with the subject matter of this Agreement except as specifically set forth herein and none of the Parties has relied or is relying on any other information, discussion or understanding in entering into and completing the transactions contemplated in this Agreement and the Ancillary Agreements … Nothing in this Section 14.10 shall affect any Party's liability for fraud or fraudulent misrepresentation."

While recognising that this clause specifically excludes fraud from the scope of its operation, Mr. Vos submitted that it clearly was intended to prevent the purchaser from seeking relief of any kind based on innocent or negligent misrepresentations. He argued that either MN relied on representations or it did not. It made no sense to say that MN did not rely on representations if they were made innocently or negligently, but did rely on representations if they were made fraudulently.

I can see the logic of that submission, but in my view it fails to have sufficient regard to the parties' intentions in including this provision in the agreement. The first two sentences are in my view intended to make it clear that the agreement contains the definitive statement of the parties' rights and liabilities arising out of the negotiations. Although the second sentence is worded in terms of an absence of any representations etc. outside the agreement itself, it does in fact operate as a contractual renunciation of the right to rely on anything said or done in the course of the negotiations as giving rise to a ground of complaint, or indeed for any other purpose. To that extent the clause does alter the parties' positions, but it is subject to the exception in the final sentence which makes it clear that they did not intend to give up the right to hold each other liable for fraud or fraudulent misrepresentations made before entering into the agreement. For these reasons I am satisfied that Section 14.10 does not prevent MN from holding Freightliner liable for the fraud of Mr. Ellis.(e)Was MN fraudulently induced to retain the services of Mr. Ellis?

For the reasons given earlier I do not think that Mr. Ellis made any representations about his own character other than that he was as honest and trustworthy as the next person. Nor am I persuaded that he made any such representation on behalf of Western Star or in such circumstances as to render Western Star liable for this aspect of his dishonesty. Insofar as MN formed any view of his character it did so on the basis of what it saw of him in the meetings. In deciding to retain his services as financial controller of ERF it may well have relied to some extent on what he had implicitly said about himself, but that is not a matter that can be laid at the door of Western Star.(f)Conclusions

For these reasons I am satisfied that MN was induced to enter into the Share Purchase Agreement by fraudulent statements made by Mr. Ellis about ERF's accounts and financial statements and that as a result it is entitled to recover from Freightliner damages for deceit at common law. It is not, however, entitled to recover damages in respect of any false statements that Mr. Ellis made about his own honesty.2.MN's claim under the Share Purchase Agreement

As an alternative to its claim in deceit at common law MN sought to recover damages for fraudulent misrepresentation under the terms of the Share Purchase Agreement. It contended that several of the representations made in the agreement were false and that, since they were to be treated as having induced it to enter into the agreement, it was entitled under section 12.1 to obtain from Western Star an indemnity against the whole of the loss it had suffered as a result of doing so. MN accepted that, because section 12.3 of the agreement limited the period in which claims for misrepresentation and breach of warranty could ordinarily be brought to 12 months from the date of completion, it was necessary (except in the case of the representation in Section 4.1(oo) relating to taxation which was subject to a separate six year time limit) for it to establish that the representations in question had been made fraudulently so as to bring itself with the exception contained in the last sentence of section 12.3(5).(a)The representations on which MN relied

Mr. Kendrick identified eight separate representations which he submitted were false and which induced MN to enter into the Share Purchase Agreement and to complete the transaction. They are to be found in Sections 4.1(i) (conduct of business in the ordinary course), 4.1(k) (no material adverse change in the company's affairs since the June 1999 accounts), 4.1(l) (compliance with applicable laws), 4.1(cc) (books and records have been properly kept), 4.1(dd) (the June 1999 accounts give a true and fair view of the company's financial position), 4.1(ee) (the December accounts fairly represent the company's financial position), 4.1(oo) (compliance with the requirements of the tax authorities), and 4.1(pp) (no untrue statements and no omission of material facts), all of which I have cited at length earlier in this judgment. Some of the representations are unqualified and some qualified by reference to Western Star's knowledge.

Although MN was able to point to so many representations which it maintained were untrue, all the misrepresentations on which it relied, with the sole exception of the representation contained in Section 4.1(oo) relating to tax, are in reality reflections of the same fundamental complaint that ERF's accounts did not provide a true and fair view of its financial position because Mr. Ellis had dishonestly manipulated its books and financial statements. That much was not in dispute and indeed Freightliner accepted that the key representations contained in sections 4.1(cc) and (dd) were false, though it denied that they had been made fraudulently. In those circumstances I do not think that there is anything to be gained by considering each representation individually and I therefore propose to concentrate on those representations which, for one reason or another, give rise to issues of fact or principle that were debated in argument before me.(b)The nature of Article 4

The first issue to which I turn concerns the nature of the representations themselves. Section 4.1 contained a large number of representations and warranties on the part of Western Star. (Corresponding representations and warranties on the part of MAN in relation to the sale of MAN Australia were contained in section 4.3.) In each case the same statement was expressed in terms of both a representation and a warranty.

It was accepted that insofar as these statements were expressed as warranties they involved a promise on the part of the maker that they were correct and that if shown to be incorrect for whatever reason the promisee would be entitled to obtain an indemnity under section 12.1(b) which would be measured primarily by reference to the value of the promise. This was referred to for convenience as a ‘contractual’ measure of damages, though it should be noted that the definition of 'Damages' in section 1.1 may enable the promisee to recover a wider range of losses for a breach of warranty than he would be entitled to under the general law. The statements were also expressed as representations, however, and it is inherent in the nature of a representation that it is liable to induce the person to whom it is made to take some action on the faith of it. If the representation is false, therefore, any loss suffered by the representee is likely to have been caused by his acting in reliance on it. In principle, therefore, one would expect him to be entitled to recover what was described as a 'reliance' measure of loss rather than a contractual measure of loss: see Royscot Trust Ltd v Rogerson [1991] 2 Q.B. 297, a decision under section 2(1) of the Misrepresentation Act 1967. This reflects the essential distinction between a representation and a warranty.

MN's claim under the Share Purchase Agreement depends on its being entitled to treat the representations in Section 4 as statements which induced it to enter into the contract. Mr. Kendrick submitted that the position in this respect was clear, both because the agreement itself characterises them as representations as well as warranties and because the opening language of section 4.1 contains an express acknowledgment by Western Star of MN's reliance on them in connection with the purchase of ERF. In response to that submission Mr. Vos drew my attention to the decision of the Court of Appeal in Eurocopy Plc v Teesdale [1992] BCLC 1067 which he submitted sheds some light on the significance to be attached to the parties' decision to give each of these various statements the status of representations as well as warranties and to include the acknowledgment of reliance in the opening part of section 4.1.

In Eurocopy v dale the purchaser of a company claimed damages from the sellers for breach of warranty. In their defence the sellers alleged that although the disclosure letters did not mention the matters that were said to constitute the breach, they were in fact known to the purchaser before it entered into the agreement. The agreement itself provided that no information other than that contained in the disclosure letters was to affect a claim for breach of warranty and the purchaser therefore sought to strike out that part of the sellers' defence. The judge at first instance dismissed the application because he accepted that as a matter of construction it was arguable that the terms in question, although expressed as warranties, were no more than representations and so would not support a claim for damages unless the purchaser could show that he had relied on them. The Court of Appeal dismissed the purchaser's appeal. Nourse L.J., who gave the leading judgment, agreed with the judge that it was not a case for striking out, but it is not at all clear that he agreed with that particular part of the judge's reasoning and I do not think that the case can be regarded as authority for any general proposition of that kind. I reject any suggestion that this decision lends support to the conclusion that the statements in question were not intended to have a life of their own as representations separate from their life as warranties.

However, as the argument developed Mr. Vos did not seek to put his case quite as high as that. He accepted not only that the representations were intended to retain the character of representations (i.e., statements rather than promises) but that they were to be regarded as statements inducing the contract for the purposes of giving rise to a right to rescind if they turned out to be false. He submitted, however, that the only remedy for misrepresentation allowed by the agreement was rescission and that, if the purchaser did not rescind the agreement, it was left with a claim for breach of warranty and the right to obtain an indemnity under section 12.1 based on the contractual measure of damages.

There is nothing in the Share Purchase Agreement that expressly limits MN's remedy for misrepresentation to rescission of the agreement. Moreover, section 12.1 expressly provides an indemnity against loss caused by misrepresentation in the following terms:

"… WS Holdings shall indemnify and hold [MN] harmless of and from any loss … suffered by … [MN] as a result of, in respect of, connected with, or arising out of, under or pursuant to any breach or inaccuracy of any representation or warranty … contained in this Agreement."

Mr. Vos submitted that it was clear from this that the parties did not intend that in the event of a misrepresentation MN should be entitled to obtain an indemnity against losses flowing from its having entered into the agreement. His argument, as it seems to me, really involved the proposition that by using the compendious expression "breach or inaccuracy of any representation or warranty" the parties demonstrated an intention to provide for a single measure of loss based on breach of warranty, but it is difficult to see why that should be so in view of the very wide terms in which sectidon 12.1 is drafted. Moreover, Mr. Vos was willing to accept that MN could recover losses incurred in reliance on a false representation after entering into the agreement on the basis that the representations could be relied on for the future. If that is correct, it is difficult to see on what basis MN is to be prevented from recovering losses caused by entering into the agreement.

In my view the only safe course is to construe the words of the agreement as they stand, making the assumption that the parties (both of whom were advised by lawyers) intentionally drew a distinction between representations and warranties in the knowledge of their different characteristics. The decision to make statements about ERF in the form of representations together with the express acknowledgment in section 4.1 that MN was relying on them in connection with the purchase of ERF in my view amounts to a contractual recognition that the representations were to be taken as having induced MN to enter into the agreement. One then looks at the other terms of the agreement, including section 12.1, to see what consequences flow from that. I can see nothing in the language of that section, nor indeed any other part of the agreement, to indicate that the parties did not intend to provide an indemnity against loss caused by misrepresentation. In my view, therefore, MN is entitled to obtain an indemnity under section 12.1 against loss caused as a result of entering into the agreement, but it does not necessarily follow that the indemnity is to be construed as extending to all the consequences of entering into the transaction. I shall deal later with the parties' submissions concerning the scope of the indemnity afforded by section 12.1 against loss caused by misrepresentation.(c)The unqualified representations and warranties

In order to succeed on this part of its case it is necessary, as I explained earlier, for MN not merely to show that there was a misrepresentation which induced it to enter into the Share Purchase Agreement but to show that it was made fraudulently. It is convenient to consider first the position in relation to the unqualified representations, the most significant of which are to be found in sections 4.1(cc), 4.1(dd), 4.1(ee), 4.1(oo) and 4.1(i).

It has not been suggested at any stage in these proceedings that anyone at Western Star had any inkling of what had been going on in the finance department of ERF. There is no question, therefore, of any impropriety on its part. However, Mr. Kendrick submitted that Mr. Ellis's knowledge of his own manipulation of ERF's accounts and the falsity of the financial statements based on them, as well as his knowledge of the VAT frauds, was to be attributed to Western Star when it made the unqualified representations contained in the Share Purchase Agreement. Accordingly, he submitted, those representations are to be treated as having been made fraudulently so that the time limit in section 12.3(2) does not apply to the claim. This raises the question as to the circumstances in which knowledge held by one person can properly be attributed to another, or in this case to a company, a question which is governed by principles which are quite distinct from those which govern the vicarious liability of a principal for torts committed by his employee or agent.

Once again, I am indebted to Mr. Vos for his careful exposition of the authorities in this area beginning with the judgment of Vaughan Williams J. in In re Hampshire Land Co. [1896] 2 Ch. 743. In that case the directors of a company had power to borrow money, but not beyond a certain amount without the consent of the shareholders. A general meeting called to approve a loan to the company by a building society had given its approval to the transaction, but the notice summoning the meeting had not stated that there would be a proposal before it to approve borrowing beyond the limit of the directors' powers, as was required by the company's articles. On the winding up of the company the liquidator sought to prevent the lender from proving in the liquidation on the grounds that since the notice calling the meeting did not comply with the company's articles, the loan was outside the directors' powers and therefore unenforceable. It was accepted that the company's failure to comply with that provision of its articles could not prejudice the building society unless it had notice of it, but the liquidator argued that since the secretary of the company, Wills, was also the secretary of the building society, his knowledge of the irregularity was to be imputed to the society. The argument was rejected at page 748 on the grounds that

"… the knowledge which has been acquired by the officer of one company will not be imputed to the other company, unless the common officer had some duty imposed upon him to communicate that knowledge to the other company, and had some duty imposed on him by the company which is alleged to be affected by the notice to receive the notice."

The judge did not think that the test was satisfied in the case before him which he regarded as more akin to a case of fraud. At page 749 he said:

"The case is very much more like the one which both Mr Bramwell Davis and Mr Jenkins had to admit was an exception to the general rule that they sought to lay down, for they admitted that if Wills had been guilty of a fraud, the personal knowledge of Wills of the fraud that he had committed upon the company would not have been knowledge of the society of the facts constituting that fraud; because common sense at once leads one to the conclusion that it would be impossible to infer that the duty, either of giving or receiving notice, will be fulfilled where the common agent is himself guilty of fraud. It seems to me that if you assume here that Mr Wills was guilty of irregularity — a breach of duty in respect of these transactions, the same inference is to be drawn as if he had been guilty of fraud. I do not know, I am sure, whether he was guilty of actual fraud; but whether his conduct amounted to fraud or breach of duty, I decline to hold that his knowledge of his own fraud or of his own breach of duty is, under the circumstances, the knowledge of the company."

These principles were later approved and applied by the House of Lords in J.C. Houghton & Co. v Nothard, Lowe and Wills [1928] A.C. 1 .

In Belmont Finance Corporation Ltd v Williams Furniture Ltd [1979] 1 Ch. 250 there was an issue as to whether a company was party to a conspiracy to commit an unlawful act in the form of providing financial assistance for the purchase of its own shares. Certain of the directors were alleged to have been parties to the conspiracy and therefore to have known that the transaction was illegal. It was said that their knowledge as directors was to be attributed to the company which thus became a party to the conspiracy. The Court of Appeal held that even if the directors did have knowledge of the conspiracy, their knowledge was not to be attributed to the company which was itself the victim of the conspiracy. Buckley L.J. put the matter in the following way at page 261G:

"… if the allegations in the statement of claim are made good, the directors of the plaintiff company must then have known that the transaction was an illegal transaction.

But in my view such knowledge should not be imputed to the company, for the essence of the arrangement was to deprive the company improperly of a large part of its assets. As I have said, the company was a victim of the conspiracy. I think it would be irrational to treat the directors, who were allegedly parties to the conspiracy, notionally as having transmitted this knowledge to the company; and indeed it is a well-recognised exception from the general rule that a principal is affected by notice received by his agent that, if the agent is acting in fraud of his principal and the matter of which he has notice is relevant to the fraud, that knowledge is not to be imputed to the principal."

The next case to consider is El Ajou v Dollar Land Holdings Plc [1994] 2 All E.R. 685 which provides some particularly helpful insights into the principles governing the attribution of knowledge. By the time the matter reached the Court of Appeal the central question in the case was whether the knowledge of the defendant's chairman, F, that certain funds received by the company by way of investment represented the proceeds of fraud was to be attributed to the company itself. The claimant argued that it should, either because F was the directing mind and will of the company in relation to the receipt of the funds, or because he acted as the company's agent in the transaction. The court held that although F was a non-executive director who generally played no part in the company's business, he was its directing mind and will in relation to the transaction by which the company received the funds and that his knowledge of the fraud was to be attributed to the company on those grounds.

In his judgment Nourse L.J., having referred to the well-known dictum of Viscount Haldane L.C. in Lennard's Carrying Co. Ltd v Asiatic

Petroleum Co. Ltd [1915] A.C. 705 at page 713, pointed out that management and control is not something to be considered generally or in the round. Rather, it is necessary to identify the natural person who has management and control in relation to the particular act or omission in question (page 696a). Similarly, Rose L.J. considered it implicit in the speeches of their Lordships in the Lennard's case that a company's directing mind and will may be found in different persons for different activities (page 699h). Hoffmann L.J. made the same point at page 706d. All members of the court were satisfied on the facts of the case that F was the directing mind and will of the company for the purposes of the transaction in question so that his knowledge was also that of the company.

The court also held, however, that F's knowledge could not be imputed to the defendant on the grounds that he had acted as its agent in the transaction, either because he acquired his knowledge as director of another company and owed that company no duty to communicate it to the defendant (per Nourse L.J. at page 698h); or because F owed no obligation to the defendant to communicate the information to it because the defendant itself had no duty to enquire into the source of the funds (per Rose L.J. at page 700e); or because, in the absence of a duty on the part of the defendant to make enquiry, the presumption of communication raised by F's duty to communicate his knowledge to the defendant as his principal could be, and on the facts of the case had been, rebutted (per Hoffmann L.J. at page 703h). I have found the judgments in this case particularly helpful, both for the distinction they draw between the attribution of knowledge to a company by virtue of its being held by the person who represents its directing mind and will and the attribution of knowledge to a principal by virtue of its being acquired by his agent and for the penetrating analysis in the judgment of Hoffmann L.J. of the different circumstances under which a principal will be affected by knowledge acquired by his agent.

Finally, it is necessary in this context to refer to the decision of the Privy Council in Meridian Global Funds Management Asia Ltd v Securities Commission [1995] 2 A.C. 500 which was concerned with the failure of Meridian to give notice of its acquisition of an interest in the shares in a public company in New Zealand in accordance with the relevant legislation. The interest had been acquired on behalf of Meridian by two of its investment managers acting within the scope of their trading authority but without the knowledge of the board. The question was whether their knowledge of the acquisition was to be attributed to Meridian so as to impose on it a duty to give notice.

At page 507D–F Lord Hoffmann delivering the opinion of the Board pointed out that the rules by which the acts and omissions of natural persons are attributed to a company depend on the proper interpretation of the policy underlying the substantive rules of law to which they relate. At page 507B–F he put the matter in this way:

"The company's primary rules of attribution together with the general principles of agency, vicarious liability and so forth are usually sufficient to enable one to determine its rights and obligations. In exceptional cases, however, they will not provide an answer. This will be the case when a rule of law, either expressly or by implication, excludes attribution on the basis of the general principles of agency or vicarious liability. For example, a rule may be stated in language primarily applicable to a natural person and require some act or state of mind on the part of that person "himself," as opposed to his servants or agents. This is generally true of rules of the criminal law, which ordinarily impose liability only for the actus reus and mens rea of the defendant himself. How is such a rule to be applied to a company?

One possibility is that the court may come to the conclusion that the rule was not intended to apply to companies at all; for example, a law which created an offence for which the only penalty was community service. Another possibility is that the court might interpret the law as meaning that it could apply to a company only on the basis of its primary rules of attribution, i.e. if the act giving rise to liability was specifically authorised by a resolution of the board or an unanimous agreement of the shareholders. But there will be many cases in which neither of these solutions is satisfactory; in which the court considers that the law was intended to apply to companies and that, although it excludes ordinary vicarious liability, insistence on the primary rules of attribution would in practice defeat that intention. In such a case, the court must fashion a special rule of attribution for the particular substantive rule. This is always a matter of interpretation: given that it was intended to apply to a company, how was it intended to apply? Whose act (or knowledge, or state of mind) was *for this purpose* intended to count as the act etc. of the company? One finds the answer to this question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy."

Having discussed a number of authorities Lord Hoffmann concluded at page 511 that

"It is a question of construction in each case as to whether the particular rule requires that the knowledge that an act has been done, or the state of mind with which it was done, should be attributed to the company. Sometimes, as in In re Supply of Ready Mixed Concrete (No. 2) [1995] 1 A.C. 456 and this case, it will be appropriate. Likewise in a case in which a company was required to make a return for revenue purposes and the statute made it an offence to make a false return with intent to deceive, the Divisional Court held that the mens rea of the servant authorised to discharge the duty to make the return should be attributed to the company: see Moore v. I. Bresler Ltd. [1944] 2 All E.R. 515 . On the other hand, the fact that a company's employee is authorised to drive a lorry does not in itself lead to the conclusion that if he kills someone by reckless driving, the company will be guilty of manslaughter. There is no inconsistency. Each is an example of an attribution rule for a particular purpose, tailored as it always must be to the terms and policies of the substantive rule."

One point of importance which emerges clearly from these authorities, perhaps most clearly from El Ajou v Dollar Land Holdings Plc , is the need to distinguish between several quite distinct sets of rules. The first, to which Lord Hoffmann adverted briefly in the Meridian case, are the rules which relate to vicarious liability under which a person may be held liable for the acts and omissions of those he engages to act on his behalf. Liability in such cases depends on the wrongful act or omission of the agent or employee himself for which his principal or employer is held responsible. It does not depend on the attribution to the employer of another's state of mind. The second set of rules concerns the attribution to one person (natural or juridical) of the state of mind of another whom he has appointed to act as his agent. It is with that question that cases such as In re Hampshire Land Co., Belmont Finance v Williams and El Ajou v Dollar Land Holdings (insofar as it turned on the relationship between principal and agent) are concerned. A third set of rules which governs the attribution of the acts and omission of natural persons to juridical persons such as companies was the subject of discussion in the Meridian case. These rules do not involve so much the attribution of one person's state of mind to another as the identification of the natural person or persons who are to be regarded as representing the juridical person for the purposes of the substantive rule in question.

Mr. Kendrick submitted that since Mr. Ellis was put forward by Western Star in the negotiation meetings to explain ERF's accounts and speak about its financial position, he was the person whose knowledge counted as the knowledge of Western Star for the purposes of making representations about ERF's accounts in the Share Purchase Agreement, as was confirmed by his identification in section 1.6 of the ERF disclosure schedule as one of those whose knowledge was to be regarded as the knowledge of Western Star itself. Whether that is the effect of the agreement is a matter to which I shall return in a moment, but insofar as it was suggested that it follows from the application of general principles of law I am unable to accept that it is correct.

It is obvious that, because it is a fictitious person, a company can only act through one or more natural persons and therefore, as the decisions in El Ajou v Dollar Land Holdings Plc and dian case show, in order to determine whether the company is liable in respect of any particular act or omission it is necessary to identify the natural person who represented the company for that particular purpose and who can therefore can be regarded as embodying for that purpose what is sometimes called its controlling mind and will. When seeking to identify the person who is to count as the company for the purposes of a substantive rule of law it is necessary to consider the nature and policy of that rule. The essence of fraudulent misrepresentation, so far as is relevant for this case, is making a statement that is known to be untrue intending that the person to whom it is made will rely on it. Liability therefore depends on the conjunction of a false statement and a dishonest state of mind. In a case where it is said that a company has made a fraudulent misrepresentation the first step must be to see whether a false statement has been made by someone who is authorised to speak on the company's behalf. Once that has been established the starting point in deciding whether the company acted dishonestly must be to enquire into the state of mind of the person who made the statement. However, if that person was unaware that the statement was false, it may be necessary to enquire into the state of mind of other persons who directed him to make it or who allowed it to be made.

There are two particular difficulties facing Mr. Kendrick in this case. The first is that all the representations on which MN relies are contained in a single agreement. The second is that Mr. Ellis, whose knowledge he seeks to attribute to Western Star for this purpose, was neither a director nor an employee of the company.

Entering into an entire contract of the kind represented by the Share Purchase Agreement in this case represents a single indivisible act of will, despite the fact that the contract itself may contain many different provisions. Therefore, although the agreement in this case contains many different representations, they were all made at the same time by the same legal person at the direction of the same natural person or persons. In these circumstances although several persons may together be regarded as representing the company's controlling mind and will for the purpose of entering into the contract (for example, the various members of the board of directors), it is not possible, in my view, for different persons to represent its controlling mind and will in respect of different parts of that contract. The fact that the state of knowledge of those who represent the company for the purpose of a complex transaction of this kind may be different does not present any difficulties, however, since the knowledge of all those who can be regarded as representing the company will be attributed to it in relation to each part of the contract. In the present case I am prepared to assume that Mr. Peabody, Mr. Stewart Smith, Mr. Burke and Mr. Bryant as directors of the company all counted as Western Star for the purposes of the Share Purchase Agreement and that the knowledge of each of them is to be regarded as the knowledge of Western Star for the purposes of each of the representations made in it. However, that does not help MN since it was accepted that none of them was aware of what Mr. Ellis had been doing.

Mr. Kendrick submitted that Mr. Ellis was also one of those who counted as Western Star, at least for the limited purposes of making the representations and warranties relating to ERF's finances, but in my view it is difficult to accept that he can be identified with Western Star for that purpose at all. Although he was involved on its behalf in the negotiations, Mr. Ellis was not a director or even an employee of Western Star and there is no evidence that he was involved in the decision to commit Western Star to the Share Purchase Agreement or in deciding the price or terms on which ERF should be sold. Those decisions were taken by Mr. Peabody, perhaps in conjunction with all or some of Mr. Stewart Smith, Mr. Burke and Mr. Bryant. The agreement itself was signed by Mr. Burke.

The proposition that Mr. Ellis is to be regarded as Western Star for the purposes of the representations in the Share Purchase Agreement relating to ERF's finances ultimately rests on the fact that he spoke about those matters on behalf of Western Star in the course of the negotiations. However, that is not enough in my view to support the conclusion that he is to be regarded as the person whose state of mind counts as that of Western Star for the purposes of those representations, even if they could properly be viewed separately from the rest of the agreement. One cannot get away from the fact that the representations derive their existence from the contract itself and nothing else or from the fact that Mr. Ellis took no part in deciding whether Western Star should sign up to them. I do not think that much assistance is to be gained from the decision in Odyssey Re (London) Ltd v OIC Run-Off Ltd [2000] EWCA Civ 71; [2001] 1 Lloyd's Rep. 1 to which Mr. Kendrick referred me which turned on its own very unusual facts.

Applying the general principles of law identified by the Privy Council in the Meridian case, I am unable to accept that the knowledge of Mr. Ellis counts as the knowledge of Western Star for the purposes of deciding whether the representations contained in the Share Purchase Agreement were made fraudulently. If Mr. Ellis's knowledge of ERF's accounts is to be attributed to

Western Star, therefore, it can only be because the Share Purchase Agreement, properly understood, contains an agreement between that parties to that effect.

To his credit Mr. Kendrick did not shrink from grasping that nettle. He submitted that in the light of section 1.6 it was implicit in the Share Purchase Agreement, read in the light of the preceding negotiations, that Mr. Ellis's knowledge of ERF's accounts was to be treated as the knowledge of Western Star for all purposes of the agreement, or at any rate for the purposes of the unqualified representations. In effect his argument was that section 1.6 reflected the fact that Mr. Ellis had been responsible for explaining ERF's accounts and since his knowledge was to be treated as the knowledge of Western Star for the purposes of the qualified representations and warranties, the parties must have intended that his knowledge should be attributed to Western Star for the purposes of the unqualified representations and warranties as well. If that were not the case, he submitted, there would be a serious imbalance between the different kinds of provisions.

I have a number of difficulties with that argument. The first is that it depends on attaching to section 1.6 a wider meaning than its language will reasonably bear. If the parties had intended that the knowledge of those persons identified in section 1.6 of the ERF Disclosure Schedule should be deemed to be the knowledge of Western Star for all purposes in connection with the agreement, they could easily have said that and if they had done so it would have been open to MN to say that any representation made by Western Star, whether qualified or unqualified, which was false to the knowledge of Mr. Ellis was to be treated as having been made fraudulently. However, the parties did not word the agreement in that way and in the absence of clear language I am unable to accept that they intended that result since it would expose Western Star to a potential liability for fraud without any dishonesty on the part of those who could properly be regarded as having responsibility for the agreement.

Section 1.6, which by its own terms is intended to be read in conjunction with the clauses containing the qualified representations and warranties, cannot be properly construed in isolation from them. Although Mr. Kendrick suggested that it provides that the knowledge of the persons identified in the ERF Disclosure Schedule is to be treated as if it were the knowledge of Western Star, it does not in fact say that. What it actually says is that where a representation or warranty is qualified by reference to the knowledge of Western Star it shall be deemed to refer to the knowledge of the persons listed in section 1.6 of the ERF Disclosure Schedule, of whom the only one of any relevance for present purposes is Mr. Ellis. The distinction is important because in each case the representation is made, and the warranty given, by Western Star as the contracting party, *not* by any of the persons named in the Schedule.

The meaning and effect of section 1.6 can best be ascertained by considering it in conjunction with one of the clauses that contains a qualified representation. Taking section 4.1(k) as an example for this purpose, one can see that when read in conjunction with Section 1.6 it provides as follows:

“WS Holdings represents and warrants that

… since the date of the ERF Financial Statements, there has not been any change in the affairs, prospects, operations or condition of the ERF Companies, the ERF Assets or the ERF Business which would have a Material Adverse Effect and to the knowledge of [Stephen Ellis] no event has occurred or circumstances exist which may have a Material Adverse Effect;” There are minor differences in the wording of the various qualified representations, but they do not materially affect matters for this purpose.

The precise effect of any individual representation will no doubt depend on its own language, but the effect of section 1.6 is that each of the qualified representations contains a representation by Western Star about the state of knowledge of the individuals named in the section 1.6 of the ERF Disclosure Schedule, *not* a representation by the company about its own knowledge, that is, the knowledge of the natural persons who could properly be regarded as representing the company for the purpose of making the agreement. (The other persons named in section 1.6 of the ERF Disclosure Schedule were all directors of Western Star and their knowledge is attributable to the company in any event in accordance with ordinary principles.) I do not think that is surprising. When a company, particularly a group holding company, makes a representation or gives a warranty in a contract of this kind qualified simply by reference to its own knowledge there may be considerable uncertainty about whose knowledge is relevant for that purpose. Difficulties of that kind can be avoided by identifying the natural persons to whose knowledge it is intended to refer and that seems to me to be the obvious purpose of section 1.6 of the Share Purchase Agreement. Western Star was clearly willing, for whatever reasons, to make unqualified representations and to give unqualified undertakings about some matters; it was clearly unwilling to do so about others, but in relation to those other matters it was willing to represent and warrant that, as far as those who were most likely to have knowledge of them were aware, the position was as stated. That makes perfectly good sense, but a statement of that kind (even if untrue) will not have been made dishonestly unless the company itself knew at the time of making it that the person in question did know that the position was not as stated, or was reckless as to that matter. This means that in the context of the present case Western Star cannot be held to have made a fraudulent statement unless it knew of, or was reckless as to, Mr. Ellis's fraud, neither of which was suggested to be the case. I can see nothing in the agreement to indicate that the parties intended that Western Star should be treated as having been fraudulent in circumstances of the kind that occurred in this case.

The second difficulty I have with Mr. Kendrick's argument, which is related to the previous point, arises from the distinction which the agreement itself draws between unqualified and qualified representations and warranties, the latter being expressed by reference to Western Star's knowledge. One would normally expect that qualified statements and undertakings would not be as far-reaching as absolute ones and would be intended to limit the degree of risk to which the party making them was exposing itself. If Mr. Kendrick's argument were correct, however, the qualified representations would expose Western Star to a much greater risk of liability for fraud than the unqualified representations. I find it difficult to accept that that is what the parties intended and it is not a result to which the language of the agreement naturally leads. That being so, it would be wholly at odds with the rest of the agreement to construe section 1.6 in such way as to attribute to Western Star for all purposes, including the unqualified warranties, the knowledge that Mr. Ellis had of his own fraud and I am unable to accept that the parties intended to do so.(d)The qualified representations and warranties

MN contended that the qualified representations were not only false but were to be regarded as having been made fraudulently by Western Star by virtue of the fact that the knowledge that Mr. Ellis had of his own frauds was to be attributed to it.

To a large extent I have already addressed this question, but it is necessary to consider in a little more detail the particular sections of the Share Purchase Agreement on which MN relies. I have already considered the construction of section 4.1(k) in conjunction with section 1.6. The relevant part of section 4.1(oo) is worded slightly differently: instead of using the expression “to the knowledge of WS Holdings” it uses the expression “as far as WS Holdings are aware”. However, as I have already indicated, I do not think that this difference of language is significant since in this case the clause must be read as if it said “(ii)

… there has not been any transaction … (B) the taxation treatment of which is, as far as Mr. Ellis is aware, or may become the subject of any dispute with any taxation authority.” That representation on the part of Western Star was undoubtedly false, but it was not made dishonestly since none of those who represented Western Star for the purposes of making it was aware of the fact.

For the same reasons, I am unable to accept that MN can succeed in a claim in deceit against Freightliner based on any of the other qualified representations in the Share Purchase Agreement. It follows that this limb of MN's claim must fail, save for its claim based on section 4.1(oo).(e)The representations relating to ERF's tax position — Section 4.1(oo)

By virtue of section 12.3(2) a claim for misrepresentation based on section 4.1(oo) can be made within six years after closing and it is unnecessary, therefore, for MN to establish fraud in order to avoid the operation of a time bar. Section 4.1(oo) contains many separate representations relating to ERF's tax position of which three are particularly relevant for present purposes: first, that ERF had filed all necessary tax returns and that they were correct and complete in all material respects; second, that nothing had occurred since 30th June 1999 that was likely as far as Western Star was aware to give rise to a dispute with the tax authorities; third, that ERF had properly and punctually paid all taxes which it had become liable to pay.

Mr. Kendrick submitted that since on his own admission Mr. Ellis had been systematically defrauding Customs & Excise by causing ERF to submit false claims for the repayment of VAT since at least the middle of 1997, there could be no doubt that the first and third of those representations were false. Mr. Vos submitted, however, that the effect of paragraph 5(e) of the ERF Disclosure Schedule was that MN was deemed to be aware of that fact and so could not make a claim for misrepresentation on those grounds.

The ERF Disclosure Schedule provided as follows: "General Disclosures2.

The representations and warranties contained in Section 4.1 of the Agreement are made and given subject to the disclosures in this ERF Disclosure Schedule. Neither WS Holdings nor any of the ERF Companies shall be or be deemed to be in breach of any such representations and warranties in respect of matters disclosed in this ERF Disclosure Schedule.5.

The following are also disclosed:

…(e)

any matter which is or should be revealed by inspection of the statutory registers and books and minutes of each of the ERF Companies which would have been revealed by the making of such inspection as would have been made by a prudent purchaser and its professional advisers."

The first thing to note is that, unlike many of the financial representations contained in section 4.1, and unlike those contained in the subsequent numbered paragraphs of the section, the representations in the opening part of section 4.1(oo) are not expressly qualified by any reference to the ERF Disclosure Schedule. That might suggest that those particular representations were not intended to be qualified by anything contained in that Schedule, but the language of paragraph 2 of the Disclosure Schedule is perfectly general and cannot easily be read as being intended to apply only to the specific sections of the Schedule that follow to the exclusion of paragraph 5. To read it in that way would deprive paragraph 5 of most of its content. Mr. Kendrick submitted that since section 4.1(oo) only refers to section (oo) of the Disclosure Schedule, the provisions of paragraph 5 of the General Disclosures were not meant to apply to it, but a brief glance at the rest of section 4.1 shows that each of the paragraphs to which a specific section of the Disclosure Schedule relates is worded in a similar way and I do not think that the parties can have intended the general disclosures not to apply in any of those cases. Taking the general disclosures as a whole, I think it is reasonably clear that the parties intended that a claim for misrepresentation should not be made on the basis of anything that by virtue of paragraph 5(e) was to be treated as having been disclosed.

That raises the question as to what is to be treated as having been disclosed. Paragraph 5(e) refers to "the statutory registers and books and minutes of each of the ERF Companies". Mr. Vos submitted that that expression was wide enough to cover ERF's VAT ledger which a prudent purchaser would wish to inspect and was not limited, as Mr. Kendrick suggested, to formal records such as registers and minutes of board meetings. It is necessary to bear in mind when construing this provision that the general disclosures of which it forms part are followed by a number of self-contained sections, each of which gives disclosure of matters that have specific relevance to a particular paragraph of section 4.1. If it had been the parties' intention to treat as disclosed anything that would be revealed by an inspection of the company's accounting records, the obvious course would have been to include some appropriate language in section (oo), but they did not choose to do so. Paragraph 5(e) is of more general application. In the preceding sub-paragraphs one finds reference to documents attached to the disclosure letter, to matters or information disclosed or noted in the financial statements and management accounts (but not to all the information contained in the accounts themselves) and to matters contained in the companies' constitutions. This all suggests that the reference to statutory registers and books and minutes was intended to refer to formal company documents and was not intended to encompass the whole of ERF's accounting books and records. In my view the clause does not extend to the monthly VAT files kept by ERF which were the only records from which the pattern of its monthly VAT returns could be discerned.

The matter does not end there, however. Mr. Vos's argument depends on the proposition that the "matters” disclosed in this way include not only the information contained in the documents themselves but inferences to be drawn from it. Thus, he submitted that Western Star must be taken to have disclosed not simply ERF's repeated claims for repayment of VAT but also the fact that the information contained in its VAT returns was not correct and complete in all material respects. In order to reach that conclusion, however, it would be necessary to have a good deal of other information about ERF's trading activities of a kind that does not appear in the VAT records. In my view an analysis of that kind is not what is contemplated by paragraph 5. If that had been the parties' intention, it could have been achieved more easily by providing that any information that could be derived from a reasonably thorough examination of the company's accounting records was to be treated as having been disclosed.

In this context my attention was drawn to three cases in which the scope of disclosure letters has been considered, Levison v Farin [1978] 2 All E.R. 1149 , New Hearts Ltd v Cosmopolitan Investments Ltd [1997] BCLC 249 and Infiniteland Ltd v Artisan Contracting Ltd (unreported) [2005] EWCA Civ 758 . In Levison v rin the seller of a company warranted that “save as disclosed” its overall financial position would not have changed adversely in any material way between the balance sheet date and the date of completion. Gibson J. held that protection from breach of warranty by making disclosure will not normally be achieved by merely providing in the course of negotiations the means of knowledge which may, or do, enable the other party to work out certain facts and conclusions (page 1157h). That observation was adopted and applied by Lord Penrose in the Court of Session in New Hearts v Cosmopolitan Investments when holding that

“Mere reference in a disclosure letter to a source of information, which is itself a complex document, within which a diligent enquirer might find relevant information will not satisfy the requirements of a clause providing for fair disclosure with sufficient details to identify the nature and scope of the matter disclosed” (page 259c).

However, it would be dangerous to draw from these two cases a general principle that provisions relating to disclosure are to be construed in a restrictive way. Each contract has to be considered on its own terms, as was emphasised in the third of these cases, Infiniteland Ltd v Artisan Contracting Ltd , in which the contract referred to “the contents of the Disclosure Letter and of all accompanying documents” and the disclosure letter was accompanied by several files of material. In my view paragraph 5(e) of the ERF Disclosure Schedule in this case will not bear the construction that Mr. Vos seeks to place on it. The natural meaning of the words the parties have chosen to use is that only matters that can be directly ascertained from an inspection of the relevant documents are to be treated as having been disclosed. Accordingly, Western Star is not protected by that paragraph from liability for the inaccuracy of the representations contained in section 4.1(oo).

However, even if the construction which Mr. Vos sought to put on paragraph 5(e) of the ERF Disclosure Schedule were correct, I do not think that the VAT frauds could be treated as having been disclosed in this case. I accept, as is apparent from an appendix to the letter in which they reported their key findings to MN, that Deloitte & Touche did in fact examine ERF's VAT returns and did become aware that they showed a continuous repayment position, but Mr. Ellis explained that away by saying that the company had a significant amount of export business. That was untrue and his deception might have been discovered if those with whom he was dealing had examined the sales records to see whether it was true, but at the time they had no reason to disbelieve him and did not consider it necessary to obtain corroboration of what he had told them. They did not, therefore, become aware of the true position. Mr. Vos submitted that MN itself knew from other sources that ERF had virtually no current business abroad and that any competent businessman would have realised as a result that there was a problem with the VAT position, but that calls for a greater degree of detective work than I think can reasonably be expected of a purchaser in MN's position.

I am satisfied, therefore, that ERF's tax position was seriously misrepresented in the opening part of section 4.1(oo) and I am also satisfied that MN was induced by that misrepresentation to enter into and complete the Share Purchase Agreement. The acknowledgment in the opening paragraph of section 4.1 that MN was relying on the representations in connection with the purchase of ERF makes that conclusion inevitable, but in any event I am satisfied that the representations did influence the minds of those who were responsible for committing MN to the transaction. Whatever may be said about Dr. Schubert's enthusiasm for the acquisition, I am quite satisfied that neither he nor anyone else at MN would have been willing to countenance the purchase of a company which had been persistently defrauding the tax authorities. Had MN known the true position, the purchase would undoubtedly have been abandoned.

Mr. Kendrick submitted that on this basis alone MN was entitled to obtain a full indemnity under section 12.1 against all the loss it had incurred as a result of being induced to purchase ERF. However, that conclusion was challenged by Mr. Vos who submitted that the scope of the indemnity provided by that section was far narrower than that. It is necessary, therefore, to consider the meaning and effect of Article 12 as a whole.(f)The construction of Article 12

I have already discussed many of the issues surrounding the construction of Article 12 of the Share Purchase Agreement. Mr. Vos submitted that the effect of section 12.7 was to make the indemnity provided by section 12.1 the exclusive remedy for any misrepresentation or breach of warranty arising under the Share Purchase Agreement, whether fraudulent, negligent or innocent. The measure of the indemnity, he submitted, must be the same in all cases and was one that reflected a contractual measure of damages. It therefore provided a far more limited measure of recovery than would be available under the general law in respect of the tort of deceit.

As I have already observed, in the opening lines of section 4.1 Western Star expressly recognised that MN was relying on the representations and warranties in connection with the purchase of ERF and Mr. Vos accepted that one purpose of so doing was to preserve MN's right to rescind the agreement if any of the representations turned out to be false. However, once it is accepted that the representations induced MN to enter into the agreement with potentially damaging consequences, the scope of any indemnity is to be determined by the terms of the contract.

In my view Mr. Vos was right in submitting that Article 12 was intended to provide an exclusive remedy for the matters to which it relates. Indeed, that much is clear from the terms of section 12.7 and was not in dispute. However, it leaves open two questions: to what claims does Article 12 apply, and what is the measure of indemnity provided for misrepresentation?

The first of these questions arises out of the last sentence of section 12.7 which excludes from its operation

“proceedings … based on fraud or on a cause of action or right, including any statutory right, other than a cause of action in contract or tort for breach of a representation, warranty, covenant or agreement contained in this Agreement.”

Mr. Kendrick submitted that those words enabled MN to pursue a claim for fraudulent misrepresentation without being subject to the limitations on the scope of the indemnity, if there were any, contained in section 12.1. Mr. Vos, on the other hand, submitted that the effect of section 12.7, properly understood, was to deprive MN of the right to claim in deceit for misrepresentations contained in the agreement save as provided for in Article 12 which provided a limited indemnity in accordance with its terms.

The issue between the parties ultimately comes down to the question whether the words

“other than a cause of action in contract or tort for breach of a representation, warranty, covenant or agreement contained in this Agreement” at the end of the last sentence of section 12.7 refer only to the preceding expression (“a cause of action or right”) or are intended to refer to “fraud” as well so as to prevent any claim for fraud based on a representation contained in the agreement from being pursued otherwise than in accordance with, and subject to any restrictions contained in, Article 12. In my view the former construction is clearly to be preferred, both because it better reflects the natural meaning of the language used in the sentence as a whole (the words “or on” in the expression “based on fraud or on a cause of action” are naturally disjunctive and tend to limit the scope of the later reference to a cause of action) and because it is supported by indications elsewhere in the same Article, for example in sections 12.3(5) and 12.4(5), that the parties intended to treat fraud as an exceptional case. The scheme of section 12.7 seems to me reasonably clear: it is intended to limit the parties' remedies for breaches of the agreement to those provided in Article 12, but it expressly excludes from that limitation claims based on fraud generally and claims arising outside the terms of the agreement. In my view, therefore, Mr. Kendrick was right in saying that a claim for fraudulent misrepresentation based on the representations contained in the agreement is not subject to any limitations imposed by Article 12. However, MN's claim under section 4.1(oo) is not one for fraudulent misrepresentation and therefore it is restricted to obtaining an indemnity in accordance with the terms of section 12.1

I am unable to accept that the indemnity provided by section 12.1 is limited to a purely contractual measure of loss as Mr. Vos submitted, although it does not necessarily follow that it is as extensive as Mr. Kendrick submitted. Once it is accepted that the parties are to be treated as having relied on the representations in entering into the contract, it would not be surprising to find that they had contemplated the possibility that they might suffer loss as a result if any of the representations turned out to have been false and had fashioned the indemnity to provide an appropriate remedy. In fact it is noticeable that the language of section 12.1 itself is cast in wide terms and is made even more extensive by the way in which the expression “Damages” is defined in section 1.1. Reading these two provisions together section 12.1(b) provided that Western Star should

“… indemnify [MN] against and hold it harmless of and from any loss … damage (including incidental and consequential damage) or expense … suffered by … [MN] as a result of or arising out of or under or pursuant to … any breach or inaccuracy of any representation or warranty given by WS Holdings … contained in this agreement.”

Mr. Vos submitted that the indemnity that MN was entitled to obtain was limited to the loss flowing from a breach of warranty, that is, to the sum of money required to make good the promise in question, and did not extend to losses flowing from the claimant's having relied on its truth as a representation. In support of that argument he submitted that it would be very odd for the parties to have intended that in a case such as the present MN should be entitled to recover the whole of its trading losses simply because it could show that one of the representations had been inaccurate in a minor respect. In support of his argument he referred me to a passage in the judgment of May J. in Senate Electrical v STC (unreported, 20th December 1996).

Although I agree with the latter part of Mr. Vos's argument, I am unable to accept his submission that the indemnity provided by section 12.1 altogether excludes ‘reliance’ losses, that is, losses suffered by the injured party as a result of relying on the truth of the representations contained in Article 4, including losses suffered as a result of entering into the Share Purchase Agreement itself. In the first place it pays insufficient regard to the fact that section 12.1 allows the injured party to recover wide-ranging consequential losses even in the case of a breach of warranty. More importantly, however, I think it fails to give adequate recognition to the fact that the injured party will only be able to obtain an indemnity against losses suffered as a result of entering into the agreement if it can show that it was induced to do so by misrepresentation and that even then the scope of the losses it can recover will be determined by the agreement between the parties contained in section 12.1 itself.

The decision in Senate Electrical v STC does not in my view add anything to the strength of the argument. The case concerned a claim under a contract for the sale of a company which, like the Share Purchase Agreement in this case, contained a number of representations and warranties relating to the accounts. It also contained a provision requiring notice of a claim for breach of warranty to be given within 18 months of the date of closing. The purchaser made a claim for breach of warranty which was disputed in part on the grounds that it had not been made within the required period. To circumvent that objection the purchaser also made a claim for negligent misrepresentation. It was conceded in the course of an interlocutory hearing that the notice requirement applied as much to a claim for misrepresentation as to a claim for breach of warranty, but the allegation of negligence was not struck out. At trial the claimant applied for leave to withdraw that concession and to serve particulars of negligence, but the application was refused. The claimant applied for permission to appeal against the judge's order, but that was also refused. In his judgment May J. cited a passage from the judgment of Sir Thomas Bingham M.R. dismissing the plaintiff's application for leave to appeal in which he expressed the view that the claim in tort added nothing to the claim in contract. However, the issues before the court were not the same as those which arise in this case and did not receive any extended discussion in what was a brief extempore judgment. I do not think that any assistance is to be derived from that case.

For his part Mr. Kendrick submitted that where it can be shown that any of the statements in Article 4 was untrue the agreement allows the injured party to choose whether to claim for misrepresentation or breach of warranty and thereby to elect between the contractual and reliance measures of damages. Although I would not put it in quite that way, I think that is broadly the effect of the agreement as a whole. By drafting the clauses in question as both representations and warranties the parties have attached different characteristics to the statements they contain which, depending on the circumstances, may give rise to different consequences and different measures of loss. Far from suggesting that the indemnity available to the injured party is restricted in every case to the measure of loss appropriate to a breach of warranty, section 12.1(b) makes it clear that it extends to any loss flowing from the inaccuracy of a representation.

Since the agreement expressly recognises that MN relied on the representations in connection with the purchase of ERF, I think it must be accepted that they played some part in inducing it to enter into the Share Purchase Agreement. It does not necessarily follow, however, that the indemnity provided by section 12 extends to losses of every kind flowing from entering into the agreement. In South Australia Asset Management Corporation v York Montague Ltd [1997] A.C. 191 at page 214 Lord Hoffmann suggested that, if a person who is under a duty to take care in providing information on which he knows that another will decide upon a course of action is negligent and as a result provides inaccurate information, he is not generally regarded as responsible for all the consequences of that course of action, but only for those consequences attributable to the fact that the information he provided was wrong. The reason, he suggested, is because it is necessary to find a sufficient causal connection between the breach of duty and the loss in question before it is possible to regard the maker of the statement as responsible for it. Although these comments were made in the context of determining the scope of a duty of care at common law, they do in my view reflect the response of a reasonable person to the provision of inaccurate information under a contract of this kind and are therefore factors that are properly to be taken into account when construing the indemnity provided by section 12.1. The critical distinction for this purpose is, as Lord Steyn later described it in Smith New Court Securities Ltd v Citibank N.A. [1997] A.C. 254 at page 283C, between losses flowing from the *misrepresentation* and losses flowing from the *transaction*.

This distinction was emphasised by Mr. Vos when he submitted that it would be very odd if a minor, albeit material, misrepresentation made honestly and without any want of due care were to expose Western Star to liability for any losses suffered by MN as a result of entering into the Share Purchase Agreement. I agree and I find it difficult to accept that that is what the parties really intended. I have so far concentrated my attention on the terms of section 12.1(b) because it contains the provisions dealing with breach of warranty and misrepresentation, but it is important to note that the list of circumstances giving rise to losses against which Western Star must indemnify MN is quite extensive and that in some cases specific losses have been identified. For example, paragraph (g) provides an indemnity against certain VAT liabilities, costs, interest and penalties. The general structure and wording of section 12.1 lends some support, therefore, to the suggestion that the parties were directing their minds to losses that could be linked directly to the circumstances mentioned in the individual paragraphs rather than to more remote consequences.

The construction for which Mr. Kendrick contended would have the effect of rendering Western Star liable to indemnify MN (and, in respect of the sale of MAN Australia, MAN to indemnify Western Star) on a fraud basis even in cases where it had been neither fraudulent nor negligent. However, as I have already observed, there are indications elsewhere in Article 12 that the parties intended to treat fraud and fraudulent misrepresentation quite separately and I regard that as a further indication that section 12.1 was not intended to provide an indemnity against all the consequences of entering into the agreement in reliance on a representation that later turned out to be untrue.

If it is right, as I think it is, to regard section 12.1 as being directed to circumstances arising otherwise than as a result of fraud, many of the difficulties disappear.

In my view the parties clearly did intend to impose on Western Star an obligation to indemnify MN against all the costs and expenses arising out of the inaccuracy of any of the representations, including losses incurred as a result of taking steps in reliance on their accuracy, but not against the entire consequences of entering into the agreement insofar as they could not be said to flow from the inaccuracy of the particular representation.

Accordingly, I am unable to accept Mr. Kendrick's submission that MN is entitled to recover under section 4.1(oo) the whole of the losses it has suffered as a result of having entered into the Share Purchase Agreement. The indemnity available under section 12.1 is limited to the losses that flow from the inaccuracy of that particular representation, namely, the amounts that ERF is liable to pay by way of arrears of VAT, penalty and expenses incurred in connection with the proceedings that have since been brought by Customs & Excise.(g)The Settlement Agreement

Finally under this head it is necessary to consider the effect of an agreement embodied in a letter from Western Star to MN dated 17th January 2001 which Freightliner contended operated as a compromise of some or all of the claims being made by MN in this action.

After the takeover had been completed MN found that ERF had incurred a liability in connection with the export of a number of trucks to a South African buyer, CTC Holdings, which had gone into receivership and later went into liquidation. It also learnt that a number of trucks that had apparently been sold to ERF's Spanish subsidiary, ERF España S.A. ("ERF Spain"), had in fact been supplied on terms that made it unlikely that they would be paid for. It will be necessary to describe the circumstances giving rise to these circumstances in a little detail later on in connection with another issue, but for present purposes it is enough to say that they were such as to cause MN to make a claim under the Share Purchase Agreement for breach of warranty in an amount of about £1.9 million.

Attempts to reach a compromise with Western Star came to nothing, partly, it seems, because Western Star was itself in the throes of being taken over by Freightliner. However, in November 2000 when that takeover had been completed Mr. Wagner flew to Portland to discuss the claim with Mr. Hubler and Mr. Desloges of Western Star. Those discussions led to an agreement in principle to settle the claim for £1.45 million which was recorded in a memorandum of understanding and later formally embodied in an exchange of letters in January 2001.

The memorandum of understanding provides part of the background to the letter agreement. It included the following paragraphs:

"In consideration of the payment in the aggregate amount of £1,450,000 by Western Star to MAN or MAN designee MAN and Western Star agree

…

2. MAN's outstanding claims against Western Star are satisfied in full.

3. MAN waives and will not assert any further claim against Western Star based on the covenants, representations and warranties under the Share Purchase Agreement.

…

6. This memorandum is not legally binding and is subject to a definitive agreement which must provide for the payment of £1,450,000."

The letter of 17th January 2001 from Western Star to MN setting out the formal terms of the agreement, which was counter-signed by MN and MAN to indicate their agreement, contained the following terms:

"2. Subject to paragraph 4 below, all current, past and future claims including claims for interest and/or costs that MAN may have, or may otherwise have had, against Western Star in connection with (whether directly or indirectly) the indemnities, the covenants, representations and warranties of Western Star Trucks Holdings Ltd in the Share Purchase Agreement and any Ancillary Agreement will be fully and finally settled, waived and discharged.

…

4. This agreement does not apply to any claims that MAN may have against Western Star arising out of the environmental and taxation representations and warranties …"

Mr. Vos submitted that the effect of that agreement was that MN abandoned any claims it might otherwise have had based on the representations and warranties in the Share Purchase Agreement, except for claims based on representations and warranties relating to environmental matters and taxation, whether based on fraud or otherwise. Mr. Kendrick submitted, however, that the agreement should not be construed as extending to claims of which MN was unaware at the time the agreement was made and that the parties did not intend that it should apply to claims based on fraud. In any event, he submitted, it did not apply to claims based on representations made outside the Share Purchase Agreement.

On this last point, at least, there was agreement between the parties because Mr. Vos quite properly recognised that the letter makes no reference to claims based on representations outside the Share Purchase Agreement. The only question for decision, therefore, is whether it operated as a waiver of claims arising under the agreement (other than tax and environmental liability claims), including claims based on fraud.

In the light of the conclusions I have already reached on the construction of the Share Purchase Agreement this question is no longer of any relevance. MN's claim for fraudulent misrepresentation fails on other grounds and its claim for misrepresentation of ERF's tax position is expressly excluded from the operation of the agreement. However, the point is a short one and since it was fully argued I shall express my views on it.

In support of his submissions Mr. Kendrick drew my attention to the case of Bank of Credit and Commerce International S.A. v Ali [2001] UKHL 8; [2002] 1 A.C. 251 in which the House of Lords considered the proper approach to the construction of a general release of this kind. The case concerned the construction of an agreement between B.C.C.I. and certain employees who were being made redundant which provided that they accepted its terms in full and final settlement of "all or any claims … of whatsoever nature that exist or may exist" against the bank. Some time later the bank went into liquidation. The liquidators sought to recover loans made to the defendant employees who sought by way of counterclaim damages for misrepresentation and breach of their contracts of employment which they said had caused them to be at a disadvantage in the labour market. The House of Lords, while holding that no special rules applied to the construction of general releases, nonetheless held that, since the parties could not have contemplated that it might be possible in the circumstances of that case to claim damages for disadvantage in the labour market, they could not be held to have intended the releases to apply to claims of that kind.

Two points of particular importance on which all of their Lordships were agreed emerge from the speeches. The first is an insistence that the same approach is to be adopted when construing a general release as when construing a contract of any other kind. No special rules apply. The second is the emphasis which all their Lordships placed on the importance of the context in which the release is given. However wide the language in which it is cast, it is always necessary to understand the context in which a release was agreed in order to decide what the parties intended its true scope to be.

The context in which the release is given will inevitably vary from case to case. I accept that the court should be cautious in coming to the conclusion that a person has given up rights of which he was not and could not have been aware, but it may be clear having regard to language used and the context in which the agreement was made that that is indeed what was intended. The release in this case was part of an agreement by which the parties compromised two specific claims under section 4.1 of the Share Purchase Agreement and the language of the letter reflects that. The release is not worded in very general terms or in terms which suggest that the parties intended to waive all claims of any kind that might subsequently be discovered. On the contrary, paragraph 2 of the letter makes it clear that it only extends to claims in connection with the indemnities, covenants, representations and warranties of Western Star in the Share Purchase Agreement. On the other hand, the expression "current, past and future claims … that MAN may have, or may otherwise have had", together with the exclusion in paragraph 4 of environmental and taxation claims, strongly suggests that the parties did intend to compromise claims of which MN was still unaware.

Mr. Kendrick submitted that the parties cannot have intended to compromise claims for misrepresentation or breach of warranty based on fraud, both because of the fact that they were grounded in fraud and because they were claims whose existence was unknown at the time. In my view, having regard to the context in which the parties entered into the settlement agreement and the language in which they expressed themselves, it was their intention that Western Star should be discharged from any further liability under section 4.1 of the Share Purchase Agreement, whether the possibility of a claim was known to MN at the time or not. I find it more difficult to say that they intended to release Western Star from liability for claims arising out of its own fraud, however. I am satisfied that neither party had the possibility of fraud in mind. As Rix L.J. said in HIH Casualty and General Insurance Ltd v Chase Manhattan Bank [2001] EWCA Civ 1250; [2001] 2 Lloyd's Rep. 483 at page 512, fraud is a thing apart because parties contract with one another in the expectation of honest dealing. Moreover, the manner in which fraud is treated in Article 12 of the Share Purchase Agreement reinforces the conclusion that the parties in this case regarded it as giving rise to fundamentally different considerations. If, therefore, Mr. Ellis's knowledge is to be imputed to Western Star so as to render any of the representations not only false but fraudulent, I do not think that the settlement agreement was intended to deprive MN of its right to pursue a claim in respect of them. (h)Conclusions

For the reasons given earlier I have reached the conclusion that although some of the representations made by Western Star in the Share Purchase Agreement were false, they were not made fraudulently and that therefore, apart from a claim under section 4.1(oo), it is now too late for MN to pursue a claim for an indemnity under Article 12. However, its right to pursue a claim in deceit in respect of statements made outside the Share Purchase Agreement is unaffected by the terms of the agreement.

Section 12.1 is limited in its application to breach of warranty and innocent or negligent misrepresentation; it has no application in the case of fraudulent misrepresentation. MN is entitled to pursue a claim for misrepresentation based on section 4.1(oo), but since the misrepresentation was not made fraudulently, it can only obtain an indemnity in accordance with the terms of section 12.1 which is limited to losses caused by the inaccuracy of the representation.

The settlement agreement had no effect on claims arising outside the Share Purchase Agreement or on claims in fraud arising under the agreement. By its own terms it has no effect on the claim under section 4.1(oo).3.Causation and remoteness of damage(a)The relevant principles

MN is seeking to recover the whole of the loss it has suffered as a result of its purchase of ERF, either by way of its claim in deceit or by way of its claim for fraudulent misrepresentation under the Share Purchase Agreement. In either case, therefore, it is necessary to consider the principles governing the measure of damage recoverable for fraud and the circumstances giving rise to the loss in this case. It is right to say, however, that the dispute between the parties was not so much about the principles themselves as about their application in the particular circumstances of this case.(i)The measure of damages for fraud

In Doyle v Olby (Ironmongers) Ltd [1969] 2 Q.B. 158 the Court of peal recognised that a person who has been induced by a fraudulent misrepresentation to act in a certain way is entitled to recover by way of damages the whole of the loss he has suffered as a result of the fraud. The starting point, therefore, as all three members of the court accepted, is to compare the claimant's position before the misrepresentation was made with that which has been brought about by the misrepresentation. Although it is sometimes said that the injured party is entitled to recover the whole of his loss, however, the issue of causation may assume considerable importance. For example, both Winn L.J. and Sachs L.J. expressly recognised that a claimant is not entitled to recover losses that have been caused by his failure to act with reasonable prudence and common sense.

The principles set out in Doyle v Olby (Ironmongers) Ltd were approved and followed in the cases of East v Maurer [1991] 1 W.L.R. 461 and Downs v Chappell [1997] 1 W.L.R. 426 . In Downs v Chappell Hobhouse L.J. said at page 444B that the appropriate course when assessing damages is to compare the loss suffered by the claimant consequent upon entering into the transaction with what would have been the position had the represented or supposed state of affairs actually existed, but that statement of principle was doubted by Lord Hoffmann in South Australia Asset Management Corporation v York Montague Ltd since he understood it as being intended to exclude from recovery losses which would have been a consequence of the transaction even if the representation had been true. He considered that to be contrary to the usual understanding of the position applicable in cases of fraud, but he declined to express a concluded view since the issue was not before the House. He did, however, point out at page 216C that

"… even if the maker of the fraudulent misrepresentation is liable for all the consequences of the plaintiff having entered into the transaction, the identification of those consequences may involve difficult questions of causation. The defendant is clearly not liable for losses which the plaintiff would have suffered even if he had not entered into the transaction or for losses attributable to causes which negative the causal effect of the misrepresentation."

The position in relation to fraudulent misrepresentation was eventually considered by their Lordships in Smith New Court Securities Ltd v Citibank N.A. [1997] A.C. 254 . In July 1989 the claimant was induced to buy a block of shares in a publicly quoted company from the defendant as a market-making risk at a price of 82¼ pence each by a fraudulent representation on the part of the defendant's brokers that two other purchasers were interested in them. In September 1989 it became known that a fraud had been perpetrated on the company as a result of which its shares fell sharply. Over the next seven months the claimant sold the shares at a substantial loss which it sought to recover from the defendant. The judge held that the true value of the shares at the date of the purchase was 44 pence each, that if there had been no misrepresentation the claimant would have offered at most 78 pence each for them and that it would not have acquired them at that price.

Lord Browne-Wilkinson and Lord Steyn, with whom the rest of their Lordships agreed, both approved the principles applied by the Court of Appeal in Doyle v Olby (Ironmongers) Ltd . At page 264H Lord Browne-Wilkinson identified the following four propositions as emerging from the decision in that case:

"First, that the measure of damages where a contract has been induced by fraudulent misrepresentation is reparation for all the actual damage directly flowing from (i.e. caused by) entering into the transaction. Second, that in assessing such damages it is not an inflexible rule that the plaintiff must bring into account the value as at the transaction date of the asset acquired: although the point is not adverted to in the judgments, the basis on which the damages were computed shows that there can be circumstances in which it is proper to require a defendant only to bring into account the actual proceeds of the asset provided that he has acted reasonably in retaining it. Third, damages for deceit are not limited to those which were reasonably foreseeable. Fourth, the damages recoverable can include consequential loss suffered by reason of having acquired the set." Moreover, in the next paragraph he recognised that the defendant's fraud may continue to have an effect after the transaction has been completed and that the acquisition of an asset may itself lock the purchaser into continuing to hold it until an opportunity to sell it arises. In a later passage, however, he confirmed that the claimant is under a duty to mitigate his loss once he is aware of the fraud.

At pages 266h–267C Lord Browne-Wilkinson summarised the principles relating to the assessment of damages in deceit cases as follows:

"In sum, in my judgment the following principles apply in assessing the damages payable where the plaintiff has been induced by a fraudulent misrepresentation to buy property: (1) the defendant is bound to make reparation for all the damage directly flowing from the transaction; (2) although such damage need not have been foreseeable, it must have been directly caused by the transaction; (3) is assessing such damage, the plaintiff is entitled to recover by way of damages the full price paid by him, but he must give credit for any benefits which he has received as a result of the transaction; (4) as a general rule, the benefits received by him include the market value of the property acquired as at the date of acquisition; but such general rule is not to be inflexibly applied where to do so would prevent him obtaining full compensation for the wrong suffered; (5) although the circumstances in which the general rule should not apply cannot be comprehensively stated, it will normally not apply where either (a) the misrepresentation has continued to operate after the date of the acquisition of the asset so as to induce the plaintiff to retain the asset or (b) the circumstances of the case are such that the plaintiff is, by reason of the fraud, locked into the property. (6) In addition, the plaintiff is entitled to recover consequential losses caused by the transaction; (7) the plaintiff must take all reasonable steps to mitigate his loss once he has discovered the fraud."

Lord Steyn, explaining the significance of the decision in Doyle v Olby (Ironmongers) Ltd , pointed out at page 282C–E that the victim of fraud is entitled to compensation for all the actual loss directly flowing from the transaction induced by the wrongdoer, including heads of consequential loss, and is not tied to any process of valuation at the date of the transaction. The rule is based on the overriding compensatory principle, widened in view of the fraud to cover all direct consequences, so that it is necessary to compare the position of the plaintiff as it was before the fraudulent statement was made to him with his position as it became as a result of his reliance on it. Lord Steyn specifically disapproved the statement of Hobhouse L.J. in Downs v Chappell mentioned above on the grounds that

"the orthodox and settled rule that the plaintiff is entitled to all losses directly flowing from the transaction caused by the deceit does not require revision."

The principle that the claimant is entitled to recover the whole of the loss suffered as a result of his being induced to enter into the transaction was not in issue in the present case. What was in issue, however, was whether all the losses which MN sought to recover were in fact caused by its having entered into the transaction and how the losses that were caused in that way should be assessed. In particular Mr. Vos submitted that much of MN's loss was caused by events or decisions that were wholly independent of the fraud.

The following colourful illustration of the distinction between what might be called a flawed asset and the operation of an independent cause, much discussed in the course of argument, was provided by Cockburn C.J. in Twycross v Grant (1877) 2 C.P.D. 469 at page 544:

"If a man buys a horse, as a racehorse, on the false representation that it has won some great race, while in reality it is a horse of very inferior speed, and he pays ten or twenty times as much as the horse is worth, and after the buyer has got the animal home it dies of some latent disease inherent in its system at the time he bought it, he may claim the entire price he gave; the horse was by reason of the latent mischief worthless when he bought; but if it catches some disease and dies, the buyer cannot claim the entire value of the horse, which he is no longer in a condition to restore, but only the difference between the price he gave and the real value at the time he bought."

It is interesting to note that in this example the latent defect which rendered the horse worthless had nothing to do with the representation which had induced the purchaser to buy it. The consequence of entering into the transaction, however, was that he lost the whole of the value he had given. Moreover, I think it follows from the principles stated by Lord Browne-Wilkinson and Lord Steyn in Smith New Court v Citibank that, since the defect was not discoverable at the time of the sale, the purchaser would be entitled to recover the cost of the horse's keep as well as the price he originally paid for it.

The principle that in cases of deceit the claimant can recover the whole of the loss caused by entering into the transaction, but not loss caused by extraneous events, has assumed considerable importance in the present case. Mr. Vos submitted that even if Freightliner was liable for fraudulent statements made by Mr. Ellis which induced MN to enter into the transaction, the chain of causation was broken by further fraudulent acts on his part for which Western Star could not be held responsible and by MN's own conduct in its management of ERF. It is therefore necessary to consider in a little more detail the approach that the law takes when assessing the effects of fraudulent statements and the kind of behaviour on the part of the victim of fraud that will suffice to break the chain of causation.(ii)The effect of fraudulent statements

The claimant will not succeed in establishing a right to recover damages for fraud at all unless he can show that he was induced by the defendant's misrepresentation to act in a way that caused him to suffer harm and I have already said that I am satisfied that Mr.

Ellis's representations that ERF's accounts had been honestly drawn played a significant part in inducing MN to enter into and complete the Share Purchase Agreement. However, it does not follow that the influence of his misrepresentations entirely evaporated at the moment that the purchase was completed. It is necessary, therefore, to consider whether they continued to affect MN's understanding of the position and the extent to which it can be said that their influence was overshadowed by other events.

In Edgington v Fitzmaurice (1885) 29 Ch. D. 459 the plaintiff was induced to buy certain bonds issued by a company partly by a belief that they were secured on the company's assets and partly by a fraudulent statement in the prospectus as to the purposes for which the money was being raised. His belief that the bonds were secured on the company's assets was a mistake on his part for which the defendants bore no responsibility. The Court of Appeal held that, if the statement in the prospectus influenced the plaintiff's mind in deciding to buy the bonds, the defendants were liable in deceit despite the fact that his mind was also influenced by his mistaken view that the bonds were secured. Cotton L.J. said at page 481

“It is true that if he had not supposed he would have a charge he would not have taken the debentures; but if he also relied on the misstatement in the prospectus, his loss none the less resulted from that misstatement. It is not necessary to show that the misstatement was the sole cause of his acting as he did. If he acted on that misstatement, though he was also influenced by an erroneous supposition, the defendants will still be liable.”

Fry L.J. put the matter similarly as follows at page 485:

“Then this question has been raised: the Plaintiff admits that he was induced to make the advance not merely by this false statement, but by the belief that the debentures would give him a charge on the company's property, and it is admitted that this was a mistake of the Plaintiff. Therefore it is said that the Plaintiff was the author of his own injury. It is quite true that the Plaintiff was influenced by his own mistake, but that does not benefit the Defendants' case. The Plaintiff says: I had two inducements, one my own mistake, the other the false statement of the Defendants. The two together induced me to advance the money. But in my opinion if the false statement of fact actually influenced the Plaintiff, the Defendants are liable, even though the Plaintiff may have been also influenced by other motives.”

In Standard Chartered Bank v Pakistan National Shipping Corporation [2003] 1 A.C. 959 the House of Lords reaffirmed and applied the principles set out in Edgington v Fitzmaurice (1885) 29 Ch. D. 459 when holding that contributory negligence does not provide a defence to claim in deceit. In that case the claimant bank had accepted a bill of lading under a letter of credit after the period of validity of the credit had expired. It was induced to do so partly by the fact that the bill of lading itself had been falsely dated and partly by the fact that it had negligently overlooked the expiry date of the credit and wrongly believed that it was entitled to obtain payment from the issuing bank. Commenting on the decision in Edgington v Fitzmaurice Lord Hoffmann at page 967 said

“This case seems to me to show that if a fraudulent representation is relied upon, in the sense that the claimant would not have parted with his money if he had known it was false, it does not matter that he also held some other negligent or irrational belief about another matter and, but for that belief, would not have parted with his money either. The law simply ignores the other reasons why he paid.” He considered the rule to be based upon sound policy because it would not be just for a fraudulent defendant's liability to be reduced on the grounds that the victim should not have made the payment which the defendant successfully induced him to make.

In each of these cases the court was concerned with the significance of fraudulent statements acting in conjunction with other causes to induce the claimant to enter into the transaction which caused the loss. However, the same principles are equally applicable in cases where the defendant's fraud continues to operate on the mind of the claimant's mind after he has entered into the transaction. In such cases the original fraudulent statement may induce the claimant to act in ways that exacerbate the loss flowing from the transaction. It follows that the defendant will be liable for any further losses resulting from steps which the claimant was induced to take, even in part, by the original fraudulent statement and that actions taken in response to subsequent events cannot be regarded as truly independent of the fraud unless it played no significant part in inducing them.(iii)New intervening events

Mr. Kendrick submitted that the threshold for a new intervening event is very high. In Clerk & Lindsell on Torts, 18th ed, paragraph 2–36 it is said that, whatever its form, the intervening event must have such an impact that it obliterates the wrongdoing of the defendant, a test which Mr. Vos did not seek to challenge. Indeed, it was implicit in his submission that MN's handling of ERF was commercially reckless, irresponsible and irrational that the event would have to be of that character. These are very strong criticisms to make of directors and senior managers of what was accepted to be a substantial and well-respected commercial organisation, but they reflect the nature of the task facing Freightliner in this case. Mr. Vos accepted that the burden was on Freightliner to establish that there had been a break in the chain of causation and did not at any stage seek to argue that mere negligence on the part of MN would suffice for that purpose. (b)The facts

Before turning to consider the application of these principles to the facts of the present case, it is necessary to say a little more about the way in which Mr. Vos put this part of his case. He submitted that I should follow rigorously the approach indicated by Lord Browne-Wilkinson in Smith New Court v Citibank, starting from the presumption that the loss was to be assessed at the date of closing unless there were good reasons for concluding that that would not provide fair compensation to the injured party. He contended that to assess damages as at the date of completion would provide fair compensation to MN because neither of the situations envisaged by Lord Browne-Wilkinson as justifying a departure from the normal rule applied in this case: the fraudulent statements made by Mr. Ellis during the negotiations did not continue to be operative after closing and MN was not locked into the transaction in a way that made it impossible for it to avoid incurring further loss.

Mr. Vos identified six separate matters which he said, acting together, broke the link between the original misrepresentations and the loss suffered by MN. The first was the continuing fraudulent conduct of Mr. Ellis who went on producing monthly and quarterly management accounts, as well as year-end statutory accounts, which incorporated manipulated figures and which he knew to be false and misleading. The other five matters all concerned the way in which MN acted in its oversight or management of ERF after the takeover. They comprised (i) advancing a substantial amount of money to ERF each month without imposing proper controls on how it was used; (ii) failing to investigate the causes of ERF's inability to forecast cash usage with a reasonable degree of accuracy; (iii) accepting implausible explanations for ERF's increasing need for funds; (iv) relying too heavily on the auditors' reports; and (v) allowing ERF to spend money on what were known to be loss-making activities. Because these matters were inter-connected Mr. Vos developed his submissions on this part of the case by reference to various specific occasions on which he said MN should have taken decisive action to put a stop to the increase in ERF's borrowing and it is convenient to consider the evidence with those occasions particularly in mind. Before doing so, however, I propose to consider the effect of Mr. Ellis's continuing fraudulent mis-reporting of ERF's results.(i)Mr. Ellis's continuing dishonesty

Mr. Ellis provided MN with false information about ERF's financial position from the very day after closing, when he attended the first audit planning meeting with Dr. Raab and representatives of Deloitte & Touche, until he was suspended in July 2001. Inevitably he provided Mr. Wagner and Mr. Bryant with the information on which they took decisions about the management of ERF and the Controlling departments of MN and MAN with the information they used to monitor its performance. Mr. Vos submitted that the effect of his actions was so serious and so pervasive that it wholly eclipsed his earlier misrepresentations insofar as they had induced MN to undertake the purchase of ERF. In support of that conclusion he drew my attention to the following passage in the speech of Lord Steyn in Smith New Court v Citibank at page 285 in which he explained why the particular facts of that case justified a departure from the normal rule that damages are to assessed at the date of the transaction:

"In these circumstances Smith was truly locked into the transaction by reason of the fraud perpetrated on it. And the causative influence of the fraud is not significantly attenuated or diluted by other causative factors acting simultaneously with or subsequent to the fraud. The position would have been different if the loss suffered by Smith arose from a subsequent fraud. That would be a case like the misrepresented horse in Cockburn C.J.'s example in Twycross v. Grant, 2 C.P.D. 469, 544–545, where the buyer plainly cannot recover the entire value of the horse if it subsequently catches a disease and dies."

Mr. Vos submitted that Mr. Ellis's continued mis-reporting of ERF's financial position was equivalent to the subsequent fraud to which Lord Steyn referred or the supervening disease envisaged by Cockburn C.J. in Twycross v Grant, but in my view the position in this case is rather different. What both Lord Steyn and Cockburn C.J. clearly had in mind was a new event, unrelated to the original fraud, whose effect would be to destroy in whole or in part whatever benefit the victim of the original fraud had obtained from the transaction. The present case is not quite like that inasmuch as Mr. Ellis's continued dishonesty was in substance a continuation of the very conduct that had given rise to the fraud in the first place, namely, falsely representing that the accounts provided to management were to the best of his knowledge and belief accurate.

Mr. Vos submitted that each time Mr. Ellis made a false statement of that kind he chose to commit a new fraudulent act separate and distinct from what had gone before, and in one sense that is true inasmuch as he could at any time have decided to stop manipulating the figures. If Mr. Ellis had begun providing accurate accounts to MN on 9th March 2000, his earlier fraud would have come to light at once and MN's loss would not have exceeded the amount of the purchase price and a small amount of additional losses. The argument that his further acts of dishonesty broke the chain of causation can only succeed, however, if the earlier frauds had lost substantially all their potency. If they continued to influence to any significant effect the minds of those at MN who were responsible for ERF's operations, they would properly be regarded as one cause, albeit not the sole cause, of the losses flowing from the continued operation of the group. That seems to me to be consistent with the decisions in Edgington v rice and Standard Chartered Bank v Pakistan National Shipping Corp as well as the general principles of law relating to causation.

Shortly after closing ERF's balance sheet was restated as at 31st March 2000 on the basis of the IAS principles and a new budget was prepared. Mr. Vos submitted that from that point onward no one was concerned with the previous accounts and that therefore the effect of Mr. Ellis's original frauds was wholly eclipsed by what came later.

This argument necessarily makes the assumption that, having restated the accounts, MN gave no further thought to what it had learnt about ERF's finances in the course of the negotiations. In my view that fails to recognise the fundamental importance of the belief engendered by the original frauds that the June and December accounts contained a true and fair view of the group's financial position. Although the accounts provided by Mr. Ellis to management after closing were false, they were accepted as correct largely because they were broadly consistent with the June and December accounts. They had to be, otherwise the earlier frauds would have come to light. In that way the statement that June and December accounts were honestly drawn and the consequent belief that they were broadly reliable continued to operate on the minds of those whose job it was to evaluate ERF's operations and its developing financial position as disclosed in the monthly and quarterly management accounts; and that in turn conditioned MN's assessment of the developing ICA debt. The explanations provided by Mr. Ellis for the increase in debt gained much of their plausibility, particularly during the summer and autumn of 2000, from the fact that the accounts provided no reason for thinking that ERF was operating at a substantial loss.

Mr. Ellis was acutely aware that his fraud could best be kept hidden by ensuring that on the face of the accounts there was no sudden alteration in ERF's practices (for example in paying or reclaiming VAT) and no sudden changes in its performance. That reflects the fact that each successive set of accounts is intended to be read as part of a continuous record of performance over a period of time rather than in isolation. The difficulty facing Mr. Vos is to identify the point at which Mr. Ellis's continuing dishonesty wholly eclipsed his original frauds so as to become the sole cause of MN's loss. The discrepancy in the accounts that eventually led to the discovery of the fraud was identified by Deloitte & Touche early in 2001 in the course of their audit of the accounts for the year ending 31st December 2000 and even then the problem was thought to be of a technical nature. No one realised that there was a massive discrepancy between the position shown in the accounts and the true position, largely because there was no serious discrepancy between those accounts and the accounts for previous years. In the light of the way in which matters developed over the period between March 2000 and July 2001 I am not satisfied that the original frauds ever completely lost their potency or that they ceased to have any influence over the way in which MN ran ERF.(ii)Mr. Ellis as the 'bad apple'

Mr. Kendrick submitted that losses flowing from Mr. Ellis's later dishonesty were recoverable as losses flowing from entering into the transaction because they were the result of what could properly be regarded as an inherent defect in the business that MN acquired. This is what became known as the 'bad apple' point. In Smith New Court v Citibank the collapse in the price of the shares the claimant had been induced to buy was caused by a fraud on the company which had taken place before the claimant had acquired them but which came to light some time afterwards. The claimant was held to be entitled to recover the resulting loss because it was a consequence of matters that already affected the company at the time of the purchase. As Lord Browne-Wilkinson observed, the shares were already "pregnant with loss". The example given by Cockburn C.J. in Twycross v Grant of the racehorse with a latent disease is very much in point.

Mr. Kendrick submitted that in the present case ERF suffered from a latent defect in the form of a dishonest financial controller and that therefore any loss suffered by MN as a result of his continuing employment was a loss which flowed from entering into the transaction. Mr. Vos put forward three arguments in opposition to that. The first was that MN had chosen to employ Mr. Ellis on the strength of its own assessment of his character and abilities. It is certainly true that the representatives of MN who met Mr. Ellis in the course of the negotiations and due diligence meetings were favourably impressed by his knowledge of ERF's financial affairs and by his apparent integrity. They judged to him be a hardworking, loyal and reasonably capable employee who was doing a good job in the face of the difficulties arising from the failure of the BaaN system to provide all the information required of it and they thought it sufficiently important to retain his services to insist on his remaining with ERF after the take-over. However, there is nothing to indicate that Western Star was thinking of offering Mr. Ellis a job elsewhere in the group and it would have been surprising in my view if his services had not been retained, whether or not MN had decided to appoint a finance director to take responsibility for his department at board level. Mr. Ellis was a senior member of the existing staff of ERF and as such could be expected to remain in his position within the company.

Mr. Vos's second point was that since Mr. Ellis was free to decide whether to continue or cease being dishonest, each subsequent decision to provide dishonest accounts was to be regarded as a new intervening act unrelated to anything that had gone before. However, this seems to me to ignore two things. The first is that Mr. Ellis had embarked on a course of dishonesty of a kind which, as he himself recognised, he had to continue in order to avoid detection. If he had produced an honest set of accounts his fraud would have been discovered immediately. In that sense each new act of dishonesty was an integral part of one continuous course of conduct. The second is that by the time the takeover was complete Mr. Ellis had become fundamentally dishonest as far as reporting to management was concerned and had ceased to have any reservations about providing the directors and others within MN with false information. Moreover, in meetings with MN he had been willing to give the impression that the figures in the accounts were to the best of his knowledge reliable, when he knew that was not the case, and was willing to do so despite the fact that he knew that MN was relying on them in making its bid for the company. In those circumstances it was inevitable that he would continue to deceive MN once the take-over was complete.

Finally Mr Vos submitted that although the loss caused by Mr. Ellis's continued dishonesty might be said in a general way to flow from the transaction, they could not be said to flow from the deception on which the claim is based. In fact, as I have already explained, the original deception did continue to operate long after MN had acquired ERF, but quite apart from that it is clear from the decision in Smith New Court v bank that the injured party is entitled to recover losses flowing from the *transac-*

tion . Once the court is satisfied that the fraudulent misrepresentation induced the claimant to enter into the transaction, the claimant is entitled to recover the whole of the loss sustained as a result of entering into the transaction. He is not entitled to recover losses attributable to other causes, but that is a different point altogether.

Having regard to these matters I think Mr. Kendrick was right in saying that Mr. Ellis's presence within ERF amounted to a latent defect in the company's staff of a kind that make it appropriate to regard losses flowing from his continuation in the same course of dishonesty as losses flowing from the transaction.(iii)MN's response to ERF's use of cash

The other matters on which Mr. Vos relied as breaking the chain of causation all arise out of MN's response to ERF's use of cash. To that extent they are, as he suggested, inter-connected, but MN could not do more than respond to the position as it developed from time to time in the light of the information then available to it. It would not be right, therefore, as Mr. Vos accepted, to treat these various matters as other than different aspects of the same complaint, namely, that MN behaved in a reckless, irresponsible and commercially irrational manner in allowing ERF to draw substantial quantities of cash from the ICA.(A)Recklessness, irresponsibility and commercial irrationality

Before going any further it is necessary to consider a little more closely what Mr. Vos meant by recklessness, irresponsibility or commercial irrationality. He accepted that it must involve something more than ordinary negligence, but he did not define with any precision what it did involve. The real thrust of his argument was that MN's conduct overall was simply unjustifiable by any rational standards, but that of itself tells one nothing because conduct of that kind may result from negligently overlooking or failing to appreciate the significance of one or more pieces of information which, if properly understood, would have led to quite different decisions being made. If Freightliner is to succeed on this part of its case, therefore, it must in my view persuade the court that, despite being fully aware of all the information available to it and its significance, MN pursued a course of conduct in relation to ERF which could not be commercially justified on any rational basis.

This part of Freightliner's case depended heavily on the evidence of its expert witness, Mr. Stephen Johnson, who had a long and distinguished career in the motor manufacturing industry, much of which was spent as a member of the senior management of Volvo both in this country and, for a short time, at the company's headquarters in Sweden. He was an impressive and engaging witness whose experience included working with businesses that had themselves undergone mergers and made acquisitions. Mr. Kendrick criticised Mr. Johnson's evidence on the grounds that many of his judgments were made with the benefit of hindsight and failed to make adequate allowance for the difficulties facing MN at the time, but in the main I do not think that criticism is justified. In my view Mr. Johnson was aware of the dangers of hindsight and took care not to allow it to colour his views as far as he could do so. Occasionally he was unsuccessful, but not to a degree which undermined the whole of his evidence.

Another criticism made of Mr. Johnson was that his experience lay mainly in the fields of sales and promotion rather than production. In my view there is more force to that point. Mr. Johnson's early career was mainly in the after-market, particularly in the sale of spare parts. He then moved into truck and bus sales with Volvo and eventually became responsible for its worldwide marketing activities. He admitted that he had little or no direct experience of running a truck manufacturing or assembly business. Moreover, at the end of his evidence I was left with the impression that there were some significant differences of commercial philosophy between Mr. Johnson and the senior management of MN which in part reflected significantly different attitudes to corporate growth and development. That does not necessarily detract from the value of his evidence, but it does make it necessary to consider carefully whether his judgments were to some extent coloured by his own particular experience.(B)The background to the acquisition

Mr. Vos submitted that MN's response to the increasing demand by ERF for more cash was largely conditioned by its own very particular objectives in acquiring ERF and that these led it to allow the company to draw unlimited amounts of money from the ICA regardless of how that money was being used or the returns that could be expected. He argued that ERF's share (then about 8%) of the UK truck market represented the last opportunity for any truck manufacturer to increase its share of the total European market by acquisition as opposed to organic growth and that Dr. Schubert was determined to obtain that share for MN regardless of cost. According to Mr. Vos, Dr. Schubert was driven by three considerations: personal prestige, an over-optimistic view of the profits that could be realised from synergies and a desire to reduce the risk of a take-over of MN itself. These, he submitted, had led MN to pay significantly more for ERF than it knew it was worth.

I can deal with the first and third of those matters quite shortly. I accept that Dr. Schubert was enthusiastic about the acquisition of ERF, but not out of a desire to enhance his personal standing within the MAN group, nor out of any concern that MN itself might be the target of a takeover bid if it failed to grow. There is no evidence to support the suggestion that Dr. Schubert was motivated by personal vanity and the only grounds for suggesting that he might be concerned about the risk of a takeover were some rather speculative press articles. Neither of these calls for any further consideration.

The suggestion that MN over-estimated the value of the potential synergies deserves more detailed consideration. From the outset Mr. Wagner had realised that one of the factors critical to the success of the proposed acquisition was the amount that could be realised through synergies. Early in September 1999 he produced a preliminary estimate of their value which he put at DM50 million (about £17 million) which, after allowing a 25% margin for contingencies, provided a working figure of DM37 (about £12.5 million). The ability to produce synergies at that level was regarded by the board of MAN as essential if MN was to pay as much as £65 million for ERF and had therefore to be fully substantiated in the course of due diligence. In the course of due diligence Mr. Rettig and Mr. Setzmüller carried out a more detailed evaluation of the potential synergies on behalf of MN. They concluded that they should be worth DM52.87 million or DM39.7 million after allowing 25% for contingencies. Dr. Zahn expressed the view that at full value and using a multiple of seven for the purposes of capitalisation they could be valued at about £120 million.

Mr. Johnson expressed the view that MN should have paused to think again whether synergies could produce as much as £15 million profit a year. It represented a 7.5% return on ERF's current annual turnover of about £200 million which was more than many successful truck producers were able to achieve. He thought that the inherent inefficiencies of ERF's operations and the need to avoid harmful competition between the two brands would reduce considerably the amount of profit that could be generated in that way. On the other hand, he recognised that if MN had spare capacity it could produce additional components for ERF without adding to its existing costs which would add to their profitability. It has never been disputed that the value of the synergies was an important factor driving the acquisition of ERF. However, the evidence does not in my view bear out the suggestion that MN's assessment of their potential value was unrealistic and its experience following the takeover suggests that it was not.

The suggestion that MN was determined to acquire ERF at any price and knew at the end of the day that it was paying more than the group was worth is rather surprising. It is quite true that MN believed ERF to be currently operating at no more than break-even level, but that was acceptable if it could provide a significant share of the market from which MN could generate long term profits through synergies. In the course of the negotiations and the due diligence exercise various departments within MN sought to work out the true value of ERF in terms of its EBITDA. However, since that depended on a combination of the choice of accounting principles, the application of those principles and on the view taken of different items in the balance sheet, the exercise was not entirely straightforward.

Mr. Vos pointed out that at the Belfry meeting the parties' discussions were based on an EBITDA of £10 million, being the average of the figures for the years ending June 1998 and June 1999 and the budget predictions for the year ending June 2000. Applying a multiple of 10 based on a debt-free value gave a total price of £100 million, which, after allowing for about £40 million debt, suggested an equity value of £60 million.

About a week after the Belfry meeting Mrs. Drzisga produced a different calculation which took account of a recent acquisition within the industry and suggested a purchase price of £57.3 million. Her paper was put before the MN executive board on 30th August 1999 which decided that no offer should be made at that stage given that Western Star was understood to be looking for a price in the order of £85–90 million. Some time later Mr. Wagner and Mrs. Drzisga produced a revised version of a profitability study for consideration by the board which showed that if MN paid DM210 million (roughly £70 million) for ERF, the acquisition should produce an investment return before tax of 16%. On 21st September the board considered the paper and agreed that it would be sensible to pursue the acquisition based on MN's current knowledge. It authorised Dr. Schubert to see whether Mr. Peabody would accept an offer of £65 million for ERF and also agreed that he could raise the possibility of including MAN Australia as part of the package. In those circumstances, although Dr. Schubert and Mr. Wagner may well have been the driving force behind the board's decision, I do not think there are grounds for suggesting that they overrode all opposition, much less for any suggestion that Dr. Schubert made the offer of £65 million to Mr. Peabody on 24th September without the board's full knowledge and approval.

Once Dr. Schubert and Mr. Peabody had reached agreement in principle the matter came before the executive board of MAN on 12th October 1999. Although the board considered £65 million to be too much for ERF taken on its own, it regarded the price as acceptable, provided the synergies could be verified in the course of due diligence, because of the opportunity the proposed transaction provided of disposing of MAN Australia. In the end, after the parties had fallen out at the second Heathrow meeting, agreement was finally reached on a price of £67.5 million. Although an agreement which enabled it to dispose of MAN Australia had real commercial value to the MAN group, MN had at that stage agreed to pay a very full price for ERF.

On the basis of information obtained during due diligence Dr. Raab produced an analysis of the budget for the year ending June 2000 which indicated that the EBITDA of the ERF group would be only £6.5 million leading to a net loss of over £1 million. However, Dr. Zahn said that Dr. Raab had failed to take proper account of the margin on the supply of parts and that the correct figure was somewhat higher. On 24th November Dr. Raab and Mr. Ziegler produced a memorandum for the board setting out their conclusions in which they described ERF as “anything but an autonomous runner”. There was a certain amount of debate about whether that was intended to mean that ERF just required careful monitoring and management or that it was incapable of surviving as an independent self-contained business. The emphasis in the memorandum on the financial difficulties facing ERF and the need to complete a successful restructuring tend to support the former, as does the comment that the company could be made profitable. In my view the main purpose of the memorandum was to make the board aware that ERF would need a lot of attention to ensure that the restructuring was completed successfully if the acquisition was to be worthwhile.

On 26th November 1999 Deloitte & Touche sent MN an adjusted EBITDA calculation for the year ending June 1999 which suggested that after increasing the provision for buy-backs to £4 million the figure on a more prudent UK GAAP basis should be only £3.2 million. According to Dr. Zahn, he and others had been pressing the argument that ERF's accounting was too optimistic and that the accounts should be based on a more conservative application of UK GAAP. Western Star had never accepted that and the term sheet recording the agreement referred to a closing balance sheet based on ERF's current accounting policies continuously applied. Nonetheless, ERF's approach seems to have rankled with Dr. Zahn who wanted to bring it back into the discussions if he could and I accept his explanation that Deloitte and Touche produced these calculations to give MN a clearer idea of how far a more conservative application of UK GAAP might affect the picture.

Mr. Vos submitted that Dr. Schubert simply overrode the advice of his due diligence team by instructing those who were responsible for the negotiations to concentrate simply on matters which had come to light since the term sheet had been signed. He did that, so it was said, because he did not want them to insist on an EBITDA that would produce a price lower than that which he knew Mr. Peabody would accept. The different approaches reflected in the documents do suggest that Dr. Raab and Mr. Ziegler took a more pessimistic view than Mr. Wagner and Dr. Schubert, but the differences between them turned to a large extent on the treatment of various items in the financial statements such as the capitalisation of research and development costs and the provision for buy-backs. Another memorandum produced by Mr. Ziegler on 30th November 1999 also referred to the possibility that the price of trucks might have to be reduced in response to market pressures which would lead to a further reduction in EBITDA.

Dr. Schubert wrote to Mr. Peabody on 30th November giving MN's considered response to the information provided in the course of due diligence and attaching a paper prepared by Department Z which concluded that the EBITDA would have to be reduced from £10 million to £8.2 million based on ERF's audited accounts for the years ending June 1998 and June 1999 and its budget forecast for 1999–2000 with corresponding adjustments. That was consistent with his earlier instructions to the team that they should only seek to renegotiate the price by reference to matters discovered in due diligence.

One can see in the documents, as was indeed confirmed by various witnesses in the course of their evidence, that there was a certain amount of tension between the commercial men in the shape of Dr. Schubert, Mr. Wagner and Dr. Zahn and the controllers in the shape of Dr. Raab and Mr. Ziegler. Having reached agreement with Mr. Peabody on the basis of ERF's existing financial statements, Dr. Schubert did not want to go behind it by challenging the way in which ERF applied UK GAAP. He appears to have been afraid that the discussions might run into the sand if MN did not take a larger view and was clearly concerned about any attempt to re-open one of the important aspects of the agreement that had already been reached. Dr. Zahn, who was always looking for an opportunity to make capital out of what he regarded as ERF's rather cavalier approach to accounting, accepted that he could not do so head on without crossing Dr. Schubert. As controllers Dr. Raab and Mr. Ziegler saw their function rather differently. It was their job to scrutinise the calculations and to ensure that the commercial men were aware of all the possible pitfalls. In my view the evidence as a whole does not support the conclusion that Dr. Schubert simply overrode his advisors.

At the meeting with Western Star in early December at which MN's figures were discussed in some detail Dr. Zahn made an initial offer of £53 million for ERF on behalf of MN which he later increased to £60 million. Over the next few days Mr. Ziegler produced more studies showing the returns that could be expected from the acquisition of ERF on various assumptions. Mr. Wagner prepared a paper for the MAN board which pointed out that ERF would not produce an operating profit unless its costs were reduced by integration into MN, but against that there were the substantial profits to be realised through synergies and the opportunity to dispose of MAN Australia. In the end MN agreed to pay £63.5 million in order to reach agreement with Western Star.

Mr. Vos pointed to the fact that, despite the negative information that had emerged in the course of due diligence, in the end MN agreed to pay more for ERF than it had originally estimated the company was worth following the Belfry meeting. That is true and it is also true that, if the value had been calculated by reference to some of the lower EBITDA figures put forward by Mr. Ziegler and others, it would have been possible to justify a much lower price than £65 million. However, the fact of the matter is that Mr. Peabody would not have agreed to sell ERF for much less. In the end MN and its parent, MAN, had to decide whether the group was worth buying at the price at which it could be obtained.

Given the different functions played by those who contributed to the ultimate decision, I do not think it is right to treat Dr. Raab and Mr. Ziegler as putting forward the right answers and Dr. Schubert and Mr. Wagner as determined to pursue a course which they knew to be wrong. MN's response following the due diligence depended both on an assessment of ERF's accounts, which involved certain matters of judgment, and what could be achieved in negotiations and also on an assessment of what the long term value of ERF to MN would be. If a price of £65 million based on the information available before due diligence was thought to be acceptable, a modest reduction by reference to matters discovered during due diligence ought not to have been commercially unacceptable, even though there were arguments that a lower figure could be justified.

All those involved were well aware that ERF was unlikely to make much, if anything, in the way of operating profits, but they thought it was worth buying at the price given the value of the synergies and the benefits to be derived from disposing of MAN Australia. In my view MN cannot be criticised for taking a long-term strategic view of the acquisition. The suggestion that Dr. Schubert aided by Mr. Wagner drove through an acquisition which he knew could not be justified in financial terms is one which I am unable to accept. Whatever their enthusiasm for the venture, neither Dr. Schubert nor Mr. Wagner struck me as irresponsible when dealing with the use of group funds; quite the contrary. It may well be, as Mr. Johnson suggested, that MN underestimated the cost of integrating ERF into its financial reporting systems, but that does not take the matter any further.

I have dealt with this aspect of the matter at some length because Mr. Vos laid some emphasis on what he said was Dr. Schubert's determination to buy ERF whatever the cost. As I have said, I do not think that is a fair description of the position, but even if it were, it would have had no legal significance, as he accepted. At best it would only have provided evidence of a cavalier approach to financial matters which might have shed some light on the way in which MN responded to ERF's use of cash after the takeover. In the end, therefore, its significance was never more than evidential.

Freightliner identified a number of specific occasions on which it said MN had acted in such a way as to break the chain of causation and it is helpful in my view to consider the position as it developed by reference to those particular occasions. Before doing so, however, it is necessary to consider a number of criticisms made by Mr. Vos of the way in which MN addressed the task of integrating ERF into the MAN group.(C)The integration of ERF into the MAN group

Mr. Vos submitted that MN made a number of serious errors in the way it went about incorporating ERF into the MAN group. The first was that it failed to undertake a thorough investigation of ERF immediately after closing in order to find out exactly how the group worked and to discover any problems that called for immediate attention. Mr. Johnson expressed the view that a prudent purchaser of a newly acquired company would mount a vigorous investigation into its operations and reporting systems immediately after completion of the purchase in order to ensure that within about three months it knew the business inside out. He considered that MN had not been sufficiently willing to challenge what it was told, to criticise what it found or to ask awkward questions.

Within a few weeks of completion MN did initiate an internal audit to investigate those areas of the accounts that had been found in the course of due diligence to be potentially unreliable and it also instructed Deloitte & Touche to start work on auditing the accounts for the year ending 30th June 2000. It did not, however, initiate the kind of challenging investigation into ERF that Mr. Johnson had in mind, partly because no one at MN thought that it was necessary in the aftermath of the recent due diligence exercise and partly because senior management at MN, who had complete confidence in the abilities of Mr. Bryant and Mr. Wagner, was anxious not to overwhelm ERF with German managers. Their philosophy was to provide practical support to ERF to assist its integration into the MN reporting systems without disrupting its operations more than necessary.

This desire not to overwhelm ERF with German management also goes some way to explain why MN did not take another step that Mr. Johnson thought necessary, namely, the appointment of a finance director from within its own ranks to take overall responsibility for ERF's financial affairs. Mr. Johnson thought that the management team at ERF was unbalanced because both Mr. Bryant and Mr. Wagner were essentially experts in engineering and production rather than financial management. MN had confidence in Mr. Ellis and with him at the head of the finance department it considered Mr. Wagner to be competent to take responsibility at board level for the company's financial affairs.

The main difference between the approach advocated by Mr. Johnson and that adopted by MN seemed to me to be one of commercial philosophy. I accept that in many cases it does make very good sense to undertake a searching investigation into all aspects of a company following its acquisition, but circumstances may differ and each case has to be judged on its merits. MN had conducted a detailed due diligence and had reason to follow a different path in this case. However, the failure to appoint a finance director was in my view a mistake. Although at that time MN had no reason to think that its confidence in Mr. Ellis was misplaced, it did fail to recognise that if Mr. Wagner was to ensure that the synergies were realised as quickly as possible he would be unable to devote more than a moderate amount of his energies to ERF's financial affairs. A director devoting the whole of his time to ERF's finances could be expected to have maintained a tighter grip on the use of resources and to have been in a better position to identify where the money was going. Whether the appointment of a finance director would have led to the discovery of Mr. Ellis's frauds much sooner is questionable, however. Although they were uncovered by Mrs. Frobisher within about six weeks of her appointment, she had the advantage of knowing that Deloitte & Touche had identified a specific problem with the accounts. On balance I think it likely that the ERF's increasing need for working capital and the unreliability of forecasts prepared by Mr. Ellis would have led a finance director to make enquiries of the kind that eventually brought it to light, although it is impossible to say how soon that would have happened. That does not mean, however, that MN's failure to appoint a separate finance director can be regarded as the real cause of MN's subsequent loss or any part of it. In my view the decision to place responsibility for financial matters in the hands of Mr. Wagner might be described as imprudent but cannot be described as irrational or commercially irresponsible in the light of what MN knew at the time.

Mr. Vos also criticised what he submitted was MN's decision to allow ERF to continue operating as an independent business. Mr. Johnson said that he would have expected MN to integrate ERF into its existing operation in this country in order to reduce administrative overheads, but that was essentially a matter of commercial judgment. MN was well aware that ERF was not really viable as a wholly independent business, but that is not how it envisaged it would be run. Although MN did not have in mind the kind of integration that Mr. Johnson described, it did envisage that ERF would obtain the benefits of operating within the framework of the MAN group. Once again, the difference between Mr. Johnson and MN was essentially a matter of commercial judgment.

Finally, I should say that I am unable to accept Mr. Vos's suggestion that MN's strategy was to increase market share at any cost. Of course market share is important, as all the senior managers who gave evidence on behalf of MN agreed, because it provides a platform for increasing profits, in particular through the realisation of synergies, but it is not an end in itself. It is worth mentioning, however, that the truck manufacturing industry is cyclical in nature and from time to time goes through periods when it is difficult to make profits. At the time MN bought ERF prices, and therefore profits, were coming under increasing pressure. However, it took a long view of the market and embarked on the acquisition of ERF with a view to making profits in the longer term and that inevitably had an influence on its attitude to the provision of funds to ERF in the short term.(D)The ERF Holdings board meeting on 2nd May 2000

ERF's account with the ICA on joining the MAN group was about £37 million, mainly as a result of paying off the inter-company loan from Western Star and the bank overdraft. By the end of March 2000 it had risen by £15.5 million. On 4th April Mr. Wagner sent a fax message to Dr. Raab explaining this rise in indebtedness. About £6.2 million could be accounted for by specific extraordinary items of expenditure. The explanation for the balance included low revenues coinciding with high levels of payments for components (£3 million), a build up of stock (£2.5 million) and work in progress (£1 million). £2.6 million was put down to normal fluctuations in the cash position. Mr. Wagner said he expected an improvement in April.

Mr. Wagner had obtained the explanations from Mr. Ellis, as one might have expected. Mr. Vos criticised him for failing to check them by reference to the underlying documents, but in the case of some of the extraordinary items he was already aware of the reasons for the expenditure and he was also aware from his own work of the high level of purchases and the increase in stocks. In those circumstances I do not think that he had any reason at that stage to do more than go through the explanations in discussion with Mr. Ellis, as he did. I think it more surprising that Dr. Raab did not react more strongly to being told that the company had spent £9.3 million in three weeks in connection with its general operations, but he said that he thought the management could be trusted and that the explanations provided in the memorandum were plausible.

Against that background a meeting of the board of ERF Holdings was held in Munich on 2nd May 2000. Dr. Schubert, Dr. Hülbert, Mr. Bryant, Mr. David Smith and Mr. Wagner, all of whom were directors, attended the meeting together with Mr. Ellis as company secretary and Dr. Raab as a guest. The latest management accounts available to the board were those as at 31st March 2000. The cash position was one item on the agenda, supported by a note based closely on Mr. Wagner's fax to Dr. Raab of 4th April. By the end of April ERF's indebtedness had increased by a further £10.5 million, though it seems unlikely that that fact was drawn to the attention of the board. Mr. Wagner had been on holiday for two weeks immediately prior to the meeting, returning to his office in Munich only the day before. He spoke to Mr. Ellis by telephone to obtain the latest position and was told that the figures for April were not available but that there had been no developments of any note in relation to the use of cash. The minutes of the meeting show that Mr. Wagner dealt with the topic of cash usage and the consequent effect on interest payments and I am satisfied that he must have done so simply by reference to the paper before the board. I am not surprised that the board did not direct that there be any investigation into ERF's use of cash.(E)The MN executive board meeting on 27th June 2000

A meeting of the MN executive board was held on 27th June 2000. For the purpose of that meeting Mr. Söllner, a member of Department Z, had produced liquidity figures for the whole of the MN group which included a table showing the performance of MN itself and each subsidiary within the group. The position of the group as a whole had deteriorated by DM2,451 million. ERF's indebtedness at 31st May had risen to DM221.8 million (about £70.5 million) although it had previously been forecast to be only DM179.7 million (about £57.4 million) by 30th June. That represented an increase over budget of DM42 million (about £13.36 million) and an increase of about £14.3 million over the figure for 31st March. Dr. Schubert accepted that ERF was using considerably more cash than had been expected, but he confirmed that the board had not thought the position very dangerous because there was a reasonable explanation for it in terms of the matters mentioned in Mr. Wagner's fax, the reduction in the amount of support received from Newcourt, a continued rise in stocks and a degree of disruption to the company's operations. He emphasised, as did other MN witnesses, that, as far as the board could see, the funds had not simply been paid away, but were reflected in an increase in ERF's assets. ERF's failure to produce reliable forecasts of its cash requirements was not necessarily a reflection of anything more sinister than difficulty on the part of Mr. Ellis and his staff in acquiring the necessary techniques. He said that MN's reporting requirements were demanding and priority was therefore given to reporting results rather than to the production of forecasts. It was recognised that the latter exercise posed particular difficulties and therefore the significance to be attached at this stage to poor forecasting was less than it would otherwise have been.

In his expert report Mr. Johnson expressed the view that the behaviour of the MN board in continuing to fund and invest in ERF in such significant amounts and over such a prolonged period in circumstances where there were inadequate financial controls and spiralling cash outflow was extraordinary, commercially irresponsible and irrational. He identified the board meeting on 27th June as one of the occasions on which firm action should have been taken to control cash outflow. This serious criticism of MN's senior management came towards the end of a section of his report in which he had reviewed the development of ERF's indebtedness and the various explanations given for it over the whole of the period from March 2000 to July 2001 and it is difficult to avoid the conclusion that in this respect his views were coloured by hindsight. The board of MN did not have the benefit of hindsight, of course, and its conduct can only be judged by reference to the information available to it at the time. In retrospect it may appear surprising that it was not more concerned about the development of ERF's cash position in June 2000, but it had received what appeared to be reasonable explanations for the use of the additional funds and the accounts appeared to confirm its understanding that the company was still operating at around the break-even mark.

I do not suggest that the board's response to the information before it was entirely beyond criticism, but I do not think it can be classed as irrational or commercially irresponsible in the sense described earlier. There must be room for differences of opinion about how to respond to a situation of this kind and those will inevitably reflect to some extent the corporate culture within which the directors are operating. In the case of MN there was a culture that favoured investment in support of long-term profits and the resources were available to match. Any suggestion that MN should treat ERF in the way that a commercial bank would treat a customer would have been quite alien to the board of MN which expected to support its subsidiaries if it could expect to generate a reasonable profit by doing so.(F)The MN executive board meeting on 19th September 2000

The next opportunity for the board of MN to review the performance of ERF came at a meting on 19th September 2000. By that time a number of further developments had occurred. By early July Dr. Hülbert had become concerned at the discrepancy between the budget for 1999–2000 which had been discussed during the negotiations for the takeover and ERF's actual performance for the year. He had a number of points which he wanted to put to Mr. Bryant and asked

Mr. Wagner to formulate them as questions which he could use to put to Mr. Bryant on the spot. The upshot was a memorandum dated 3rd July 2000 from Mr. Wagner to Dr. Hülbert containing a number of questions, but nothing more was heard of it and it does not appear that Dr. Hülbert ever made use of it to challenge Mr. Bryant over ERF's performance. One question Mr. Wagner suggested that Dr. Hülbert should ask was why the funds committed to stocks and receivables were not under control. I think Mr. Vos was right in saying that it shows that Mr. Wagner was himself aware that there was a problem to be tackled, but it does not follow that he did not understand or accept the explanations that he was getting from Mr. Ellis. It was plain that forecasting was unreliable, but, as the question itself shows, Mr. Wagner thought that cash was being used to finance additional assets. Why that was necessary was essentially a production issue.

On 11th August 2000 Mr. Ellis sent MN's Controlling department ERF's financial status report for July which showed that its indebtedness on the ICA had increased by a little over £9 million to something over £65 million with a forecast of a slight reduction over the next three months. When Dr. Neuss, the controller in Department Z responsible for ERF, asked Mr. Ellis for an explanation he was told that additional cash had been required because production at Sandbach had stopped in advance of the move to Middlewich, that the workforce had been given holiday pay and that there had been an increase in stocks of 70 trucks. However, the stock and receivables report showed a reduction of £7.8 million which prompted Dr. Neuss to ask for another explanation. Eventually he received the explanation that ERF had received a payment of £6.8 million from a customer at the end of June which should have gone to Newcourt and that the repayment in early July had affected the figures for that month. Dr. Neuss accepted that explanation at the time, although he agreed in cross-examination that in the light of the other information then available it was not a plausible explanation for the increase in debt or the reported reduction in stock and receivables. He said that his confidence in Mr. Ellis had been reinforced by receiving the auditors' approval of ERF's accounts for the period ending 30th June and that he accepted the figures provided to him. Mr. Wagner also said that he drew confidence from the fact that the auditors had passed the financial statements, including the balance sheet that confirmed that the cash borrowing had been turned into assets.

In my view, although Dr. Neuss can be criticised for the way in which he responded to the information and explanations he received from ERF, it is necessary to bear in mind that he was working in an environment in which everyone at MN still had considerable confidence in Mr. Ellis and could take legitimate comfort from the fact that the auditors had confirmed that the accounts for the year ending 30th June 2000 gave a true and fair picture of ERF's financial position. However, the reports for August, which showed that indebtedness at the end of the month was about £15.5 million higher than had been forecast in July, prompted Mr. Söllner to ask Mr. Wagner for an explanation. In a telephone conversation the same morning Mr. Wagner explained that the money had been required to fund additional investments, to pay a claim in relation to a guarantee in respect of a bill of exchange relating to trucks exported to South Africa and to cover the costs of the shutdown for the purposes of the move to Middlewich. Later he sent Mr. Söllner a fax in which he apologised for the forecast which he said had not been properly checked and provided an explanation for the increase in indebtedness (£17 million) over the figure shown in the audited balance sheet as at 30th June. Of that £17 million £2 million remained unaccounted for. Mr. Söllner said that he would only have checked these figures against the other information in his department's possession if he had had reason to doubt what he had been told. In this case he did not doubt the explanation given by Mr. Wagner and did not attempt to reconcile it with other information available to him.

With the benefit of hindsight it is easy to be critical of Mr. Söllner's failure to investigate the position more thoroughly, but, although it was his responsibility to obtain an explanation for the increase in ERF's indebtedness, I do not think that he could be expected to challenge the information provided to him unless he had grounds for doing so. Perhaps Department Z was less alert and active in its monitoring of ERF than it should have been, but that does not provide a satisfactory basis for a finding that the board of MN acted in an irrational or commercially irresponsible manner.

In the papers prepared for the board meeting on 19th September attention was drawn to the fact that ERF's indebtedness (about £98 million at 31st August) was at its highest ever level and that there had been a significant increase since the previous month of about

£14.5 million despite the fact that a modest reduction had been forecast. By way of explanation the board was provided with the information given in Mr. Wagner's fax of 15th September. In the light of that information I find it difficult to accept that the board, including the new chairman, Mr. Samuelsson, did not focus on the position of ERF, but equally it cannot have been unaware that ERF was going through a substantial reorganisation of its production and administrative arrangements with the move to new premises and the introduction of new models. At all events, the board did not consider it necessary to call for a complete investigation of ERF's position in order to determine the precise causes of its increasing demand for working capital. Basing himself on Mr. Johnson's report Mr. Vos submitted that the board ought to have taken action at that meeting to bring ERF under control by appointing a finance director and perhaps also by setting up an enquiry into ERF's finances, but no criticism of that kind was directed to Mr. Samuelsson in cross-examination and I should have been reluctant to reach a conclusion of that kind without having heard his response. In fact, as Mr. Kendrick pointed out, the meeting was held at a time when the disruption being caused to ERF's operations was at its height. The board would inevitably have been aware of the potential for borrowing to rise at such a time since MN itself had experience of soaring cash usage at the time of introducing a new model not long before. It may well be that other businessmen would have taken a different approach to the situation as it confronted the board of MN, but that does not justify a finding that this board was commercially irresponsible in its response to the position with which it was confronted.(G)The MN executive board meeting on 28th November 2000

There was a meeting of the MN executive board on 28th November at which ERF's position was again considered. The papers prepared for the meeting referred to the fact that at the end of October indebtedness had risen, contrary to forecast, to almost £117 million. Dr. Raab said that his department knew that ERF was undergoing a period of restructuring and that the increase in borrowing was put down to operational factors. There had by that time also been a reported increase of £10 million in stocks and receivables. The minutes of the meeting do not suggest that the increase was seen as cause for undue concern. Once again, one comes back to a fundamental difference of approach between Mr. Johnson and senior managers of MN such as Dr. Schubert and Dr. Raab. Mr. Johnson considered it extraordinary that MN should have allowed ERF to borrow approximately ten years' earnings, looking at the question in terms of return on capital employed. Dr. Schubert, by contrast, rejected that approach altogether, seeing high levels of borrowing as acceptable, provided they were reflected in increased assets, as a temporary measure to enable the company to weather a period of restructuring. The information provided to the board suggested that there was an increase in ERF's assets in the form of stocks and receivables.(H)Conclusions

Although it is possible to criticise in some respects the way in which the board of MN responded to ERF's continuing demand for funds and although there was undoubtedly some force in Mr. Johnson's view that it was necessary for someone to get control of the business, I do not think that he made sufficient allowance for the fact that MN was misled from first to last by the false information provided by Mr. Ellis. The fact that he was considered trustworthy, if somewhat inept at forecasting, meant that MN's view of ERF's borrowing was always coloured by its understanding that cash was being turned into assets instead of seeping away in the form of operating losses. It is interesting to note that Mr. Bryant had the same understanding. It may be that there comes a point at which the level of debt is such as to cast doubt on other elements within the balance sheet, but unless that was the case here — and I am unable to accept that it was — it is impossible to conclude that MN behaved in a commercially irresponsible or irrational manner without calling into question its entire commercial philosophy. In my view it is not possible to characterise the behaviour of MN's senior management in that way. There are grounds for concluding that Department Z was not as vigorous as it ought to have been in analysing the information it received from ERF and with the benefit of hindsight one can see that there were indications that within ERF things were not as they should have been. If the issue were one of negligence, therefore, there might be more to be said in favour of Freightliner's position, but it is not. The only issue is whether the directors of MN can be said to have behaved in a way that can properly be characterised as commercially irresponsible and irrational. Given the information before them on the occasions when they had to consider ERF's performance, I do not think they can.(iv)Mitigation

It is convenient at this point to consider the steps that MN took to rescue the position after it became aware of Mr. Ellis's fraud in July 2001. Mr. Vos criticised MN for failing to take the right decisions at the right time, thereby increasing its losses rather than containing or reducing them. Given the nature of the argument, it may be appropriate to reiterate what has been said on many previous occasions, namely, that the injured party is not obliged to do more than act reasonably in response to the situation in which he finds himself. Moreover, the burden of showing that he failed to do so is heavy. In a well-known passage in his speech in Banco de Portugal v Waterlow [1932] A.C. 452 Lord Macmillan said at page 506

"It is often easy after an emergency has passed to criticise the steps which have been taken to meet it, but such criticism does not come well from those who have themselves created the emergency. The law is satisfied if the party placed in a difficult situation by reason of the breach of a duty owed to him has acted reasonably in the adoption of remedial measures and he will not be held disentitled to recover the cost of such measures merely because the party in breach can suggest that other measures less burdensome to him might have been taken."

A wrongdoer seeking to show that the injured person failed to take proper steps to avoid or minimise the effcts of the wrongful act must show not only that he failed to take proper steps to protect his own interests but that if he had acted differently the loss he actually suffered would have been reduced or avoided altogether. Mr. Vos submitted that MN failed to mitigate its loss by failing to respond in a sensible manner to the position that confronted it when the fraud was discovered. His criticisms fell under three main limbs: failing to make a single announcement to the market of its intentions with the regard to the future of ERF; continuing production of the existing models at a loss for a period of almost a year pending the introduction of a new model based on the TGA technology; and failing to take immediate steps to integrate ERF into MAN Truck & Bus. Each of these must be considered separately.(A)Announcements to the market

By 9th August 2001 it had become clear that ERF's balance sheet was over-stated by approximately £100 million. Following an extraordinary meeting of the board on 14th August 2001 to consider the implications of the fraud MAN issued a press release on 16th August reporting that following the discovery of irregularities in the balance sheet of ERF Mr. Bryant and Mr. Wagner had been suspended and that Dr. Raab had been appointed chief financial officer of ERF. At that stage nothing was said about the future of ERF except that the situation was still being investigated. Within MN, however, various options were being considered. They included the immediate closure and orderly liquidation of ERF and the production of an ERF truck based on MN's current TGA technology, each of which was the subject of a paper produced for consideration by the board.

The executive board of MN met on 27th August 2001 to consider the way forward. By that time it had become apparent that ERF was producing trucks at a significant loss and that its current operations were therefore not economically viable. There were therefore only two possible courses of action: to close down its operations altogether or to continue with the production of modified TGA trucks at Middlewich under the ERF badge and integrate ERF into MAN Truck & Bus. The board decided that it would be preferable to continue production at Middlewich using TGA technology, provided that could be done profitably, and the necessary enquiries were put in hand under the direction of Mr. van Putten, the director responsible for sales and marketing.

By the end of August the announcement that irregularities had been discovered in ERF's accounts was beginning to cause existing customers concern about the servicing of their vehicles and their future trade-in value and at least one wrote to MN to enquire about the position. On 29th August MN issued press releases in German and English confirming that it intended to "strengthen and focus ERF's activities in the UK". The English version continued as follows:

"The company has announced the creation of a task force to implement faster integration of the manufacturing and administration processes — to speed up new model introductions at Middlewich and to boost 'back office' efficiencies, including the sales and marketing operations of both ERF and MAN UK." The German version referred to the possibility of introducing new products and emphasised the continued existence of ERF in the UK market.

On 5th September 2001 the board met again to review the position. Soundings taken among customers in the UK indicated that the existing market would accept a German-made truck provided the option of the Cummins engine remained available and the distinctive ERF brand was retained. However, in order to retain the option for the Cummins engine a number of modifications would have to be made to the existing TGA cab and those had to be identified and evaluated along with other engineering modifications necessary to retain a distinctive ERF identity. Preliminary studies suggested that significant savings in costs could be achieved through assembling TGA units at Middlewich, but even so it was not clear that production there would be commercially viable and there remained a risk that ERF might have to be shut down. On 18th September the board met again and decided to pursue detailed investigations into the possibility of producing a new range of ERF trucks at Middlewich and to continue with production of the current range until the new models became available in the summer or autumn of the following year. On 8th October MN held a press briefing in London attended by Mr. Samuelsson, Mr. van Putten, Dr. Raab, Mr. David Smith and Mr. Löttgen at which MN's intention to stand behind ERF was emphasised and plans for the production of a new model were outlined.

By December 2001, however, it was becoming clear that it would not be commercially sensible to embark on the assembly of the new model at Middlewich where production costs were significantly higher than those in Munich. The decision was therefore taken to continue production at Middlewich only until the new model became available, after which only some finishing operations would be carried on there. That decision, together with the integration of ERF's sales and support service into the MAN Truck & Bus operations, was announced to the press on 28th February 2002.

Mr. Vos submitted that it was a major error on MN's part to announce its intentions to the world in a piecemeal way. Once the decision had been taken to produce a new ERF truck it was inevitable that production would have to cease at Middlewich for economic reasons and a decision to that effect should have been taken and announced at once. Alternatively, if some time was needed to consider the position, an announcement should have been deferred until a conclusion had been reached. Either way, what MN should have done was to make one statement setting out all the changes it proposed to make, thereby getting all the bad news out of the way at once while attributing it to the need to deal with the fraud. Although any announcement of that kind would have undermined the confidence of customers to some extent, a single statement would have minimised the effect. By making two announcements, one in August and a contradictory one in February, the effect was magnified and resulted in a greater loss of support than necessary. He criticised the decision to continue production of the existing ECS and ECX models which he argued was primarily motivated by a desire on the part of MN not to alienate the British government at a time when it was hoping to obtain a large order for military support vehicles from the Ministry of Defence ("MOD").

It is convenient to deal with the MOD contract first. Towards the latter part of 2001 MN was tendering for a substantial contract to supply support vehicles to the MOD. Mr. Samuelsson accepted that it was an important piece of business for MN and that its chances of obtaining the contract would have been jeopardised by a decision to close down ERF with the consequent loss of many jobs. In those circumstances I should have been surprised if it had not played some part in MN's thinking and Mr. Samuelsson confirmed that it was one factor that had to be taken into account. However, I do not accept that it was the primary motive for the decision to continue production at Middlewich if at all possible. As the minutes of the board meetings show, MN was concerned to ensure that ERF survived as a brand with a strong market presence. One way of reassuring, and thus retaining, customers was to maintain production at Middlewich, if that could be justified commercially. On the face of it, therefore, there were sound reasons for investigating the possibility of doing so, quite apart from any desire not to jeopardise MN's prospects of obtaining the MOD contract. If it had been the case that MN had decided to keep production going at Middlewich for the sole purpose of enhancing its prospects of obtaining the MOD contract, there might be something to be said in favour of Mr. Vos's argument. As is it, however, I do not accept that it was the primary reason for MN's actions.

Freightliner's criticism of the way in which MN made announcements to the market depended in a large measure on the contention that MN first said one thing and then another, thereby engendering a climate of uncertainty and distrust. Mr. Samuelsson accepted that when it made its first public announcements in August and September 2001 MN did not know what form the reorganisation of ERF would ultimately take, but he did not accept that they were contradicted by the later announcement in February 2002 or that making two announcements was likely to be damaging to MN's position. He thought that the most important thing following the discovery of the hole in ERF's balance sheet was to settle the market by making it clear to customers as quickly as possible that the company would continue in existence and would provide the support they were looking for. He did not accept that the first announcement amounted to saying that production would continue at Middlewich. Indeed, he said that it had been carefully worded to give an assurance of continuity without committing MN to that course.

In his report Mr. Johnson criticised MN's approach on other grounds. In his view it had failed to understand the difficulties of maintaining separate brands which did not undermine each other's market position. It had also failed to understand the problems of poor productivity at Middlewich or the likelihood of significant erosion of ERF's market share. He regarded the original decision to try to keep production going at Middlewich as highly questionable and one that led to further damage when it had to be abandoned. It was his view that there was no prospect of ERF's becoming a profitable brand in the long term and that MN should have taken the opportunity offered by the discovery of the fraud to cut its losses, make an orderly transfer of the business to MN and close ERF down.

The discovery of the fraud and the enormous deficiency in the assets of ERF which it had been concealing undoubtedly placed MN in a very difficult position. Although an assessment was made of the costs of closing ERF down, there appears to have been considerable reluctance on the part of all concerned to take that course, partly out of concern that it might harm MN's commercial reputation, but mainly because it considered that there was real value to be obtained from the exploitation of ERF's market position. Although Mr. Johnson disagreed with that assessment, I do not think that it was so clearly wrong that MN can be criticised for having adopted it. The desire to retain production at Middlewich must be seen as part and parcel of the same decision. Having decided to keep ERF in business, I do not think that MN can be criticised for wishing to investigate fully the prospects for continuing production at Middlewich.

The proposition that it is better to announce all the bad news at the same time is one with which it is not easy to quarrel, but, as Mr. Samuelsson pointed out, you cannot announce what you do not know. Although it was clear that things could not go on as before, MN's response to the situation was likely to have far-reaching consequences for employees, dealers and customers as well for as MN itself. Quite a lot of work had to be done before a decision could be taken on the commercial feasibility of producing an ERF truck with a Cummins engine based on MN's TGA technology. Mr. van Putten suggested that a minimum of three to four months' work was needed before a decision could be made. MN thought, quite reasonably in my view, that it was essential to reassure the market at once in order to maintain the confidence of ERF's customers and dealers. It is all very well for Mr. Johnson to say, as he did in cross-examination, that if he had been in that situation he would have made a decision before making the first announcement, however late into the night he and his people had had to work. Whether an announcement of support for ERF could be delayed for even a few weeks was a matter of commercial judgment on which the views of Mr. Samuelsson and his board are entitled to considerable respect. In my view their strategy was perfectly reasonable. That is not to say that it may not have had some disadvantages, but I do not think it can be regarded as an unreasonable response to the situation in which they found themselves.(B)Continuing production of existing models

The decision to continue production of the existing models at Middlewich pending the availability of the new model was closely bound up with the decision to keep ERF alive as a brand with an active presence in the market. However, it raises different issues because it was taken at a time when it had already become clear that ERF was operating at a loss. To that extent it can be characterised as pouring good money after bad. It is, however, a decision that must be judged in a wider context. To stop all further production immediately would have had a number of consequences. Losses arising from buy-back obligations would have increased as ERF trucks lost value in the market; there would have been a certain amount of finished stock that would have to be sold off very cheaply or scrapped; there would have been a large stock of parts which would have lost most or all of their value; there would be liabilities to suppliers; there would almost certainly have been a loss of confidence among customers; and most importantly there would have been a risk of losing most of the dealer network on which ERF would have to rely to sell the new model.

The risk to the dealer network was a powerful factor in persuading MN of the need to keep production going at Middlewich. The effect on dealers of shutting down production for nine months was clearly described by Mr. David Smith who was closely involved in attempts to reassure dealers and customers during the months following the original announcement. Most of ERF's network of dealers were privately-owned companies whose businesses depended on regular sales and servicing of trucks and the loyalty of their customers. Closing down production at Middlewich pending the availability of a new model would not only have deprived them of the opportunity of selling new trucks for the best part of a year but would have raised serious doubts about the reliability of the new business. It is likely that many would have been attracted to other manufacturers and that the network as a whole would have been seriously weakened as a result.

Mr. Vos understandably placed a good deal of emphasis on the fact that production at Middlewich was loss-making, but as Mr. Samuelsson pointed out, ERF was already committed to most of the costs associated with the continued production of the existing models during the run-down period. The fixed costs of the production plant would be incurred in any event and in his view it made better commercial sense to scale down production and make use of the parts already in stock to make new trucks rather than to write them off as scrap. The labour force had already been reduced to the minimum required for that purpose so that the variable costs represented by their wages were relatively small in the context of the overall costs. Mr. Samuelsson recognised that each truck produced under those conditions would be sold for less than the cost of production, but in his view it was the sensible course to take in preference to incurring the greater losses that would have arisen from stopping production altogether. In my view that was a perfectly rational view to take.

The debate over the comparative costs of continuing production at a reduced level and closing it down altogether brings me naturally to another important aspect of this whole debate, namely, whether the course advocated by Mr. Vos would have resulted in any reduction of MN's loss. Although issues relating to the quantification of loss have been deferred to another occasion, the point is one that must be addressed at this stage because unless a defendant can satisfy the court that by taking a different course of action the claimant would in fact have avoided at least part of his loss, the argument that there was a failure to mitigate is bound to fail. One of the difficulties facing Freightliner in this case is that there is no reliable evidence that the course which it says MN should have taken would have resulted in any overall saving. Mr. Johnson very fairly acknowledged that there were risks and uncertainties in taking either course, but he was not able to provide any assessment of the savings that could have been made by closing down production at Middlewich immediately and could not be sure that it would have resulted in any. All he could say was that "intuitively" he would expect that to have resulted in a saving of costs and reduction of risks in the long run.

Intuition is no bad thing in business, of course, but it is not sufficient in a case of this kind to support an allegation of failure to mitigate. Sometimes the facts speak for themselves and it is possible to see that a significant saving could have been made if a particular course of action had been adopted without the need to quantify it in any detail. If that were the case here, I would have no hesitation in making a finding to that effect, leaving the precise amount of that saving to be determined at a later date. That is not the position, however. The uncertainties surrounding the outcome of the course advocated by Mr. Johnson are such that it is impossible to be satisfied that there would have been any overall saving. MN's careful analysis of the various options open to it cannot be rejected in favour of an intuitive reaction, however well informed.(C)Conclusion

For these reasons I am satisfied that there is no substance in the argument that MN failed to take reasonable steps to mitigate its loss.(v)Losses flowing from the transaction

At this point it is convenient to return to consider a number of matters relating to the issue of just and fair compensation and the identification of the losses flowing from the transaction. In the course of their submissions Mr. Vos on behalf of Freightliner and Mr. Justin Fenwick Q.C. on behalf of the Ernst & Young defendants put forward a number of arguments based in one way or another on the proposition that MN was keen to buy ERF in order to acquire its share of the UK market, was willing to invest large sums of money in order to retain its market share and realise the benefits of the synergies that it had identified and did not want to give up ERF while there was any prospect of achieving its goals. Those arguments were all said to lead to broadly the same conclusion, namely, that much of the losses suffered by MN resulted from its desire to retain ERF for its own purposes, notwithstanding the fact that it had been found to be heavily insolvent, but they raised three rather different issues which call for separate consideration.

The first strand of the argument concerned the principles governing the measure of damages recoverable for fraud as expounded by the House of Lords in Smith New Court v Citibank. Both Mr. Vos and Mr. Fenwick approached that case as laying down a rule that in a case of the present kind damages are to be assessed at the date of the transaction unless the injured party can show that the fraud continued to operate on his mind or that he was in some way "locked in" to a transaction from which he wished to extricate himself. Since, it was said, neither of those situations applied in this case, damages should be assessed as at the date of closing and thus limited to difference between the true net asset value of ERF and that shown in the accounts.

In my view this argument fails to give proper weight to the passages in the speeches of Lord Browne-Wilkinson at page 267 and Lord Steyn at page 282 to which I referred earlier in which their Lordships emphasised that the injured party is entitled to obtain compensation for all the damage directly caused by the fraud, which in a case of this kind means all the damage directly flowing from the transaction. Neither considered that damages were to be assessed at the date of the transaction, although both recognised that where benefits derived under the transaction have to be brought into account it will normally (though not invariably) be appropriate to value those benefits at the date of the transaction. Both recognised that consequential losses caused by the transaction are recoverable. In the present case I am satisfied, for the reasons given earlier, that the loss directly flowing from the transaction is not limited in the way suggested. The fact that the victim of a fraud does not wish to escape from the transaction does not provide grounds for depriving him of compensation for part of the loss that he has sustained as a direct result of the fraud.

The second strand in the argument was that MN poured money into ERF in a way that was so extravagant as to break the chain of causation. On that view it was said that at least part of its loss cannot be regarded as flowing directly from the transaction. I have already dealt with this point. In my view MN's approach to the funding of ERF was not irrational in the light of the information available to it and was not sufficient to break the chain of causation.

The third strand also involved a question of causation, but was rather different in nature. It involved the proposition that even if there had been no fraud MN would have incurred losses in order to keep ERF afloat and to protect its position in the market. Accordingly, it was said, such losses were not caused by the fraud.

The main difficulty with this argument is that it fails to acknowledge the fact that MN would not have bought ERF, and would not therefore have incurred any losses, if it had not been induced by fraud to enter into the transaction in the first place. For the reasons given earlier I am quite satisfied that MN would not have been willing to acquire ERF if the accounts had reflected the true state of its finances and that Mr. Ellis's fraudulent misrepresentations induced MN to enter into and complete the Share Purchase Agreement. In those circumstances MN is entitled to recover all the losses directly flowing from the transaction, including losses sustained in running the business acquired under it. Only losses incurred as a result of extraordinary decisions of a kind that break the chain of causation are irrecoverable. The fact that credit must be given for the benefits obtained under the transaction will ensure that MN is fully compensated, but not over compensated, for its loss.

Mr. Fenwick submitted that this was the first case to come before the courts in which a victim of fraud had sought to recover losses flowing from a transaction from which he did not wish to escape if it were possible to do so. Whether that is so or not, the fact that MN chose to keep ERF alive and eventually to integrate it into its own operations does make it necessary to determine with some care the point at which the transaction induced by the fraud ceased to be the cause of any further loss to MN. Although Mr. Vos identified a number of matters which he submitted broke the chain of causation (to which I have already referred), this particular question was not given a great deal of prominence in the parties' submissions. However, it is necessary to deal with it briefly at this stage if the parties are to prepare effectively for the determination of any remaining disputes relating to the quantification of damages.

In Annex 1 to its particulars of claim MN set out the losses it claims to have suffered as a result of the fraud. These reflect the expenses incurred in keeping ERF in operation throughout the period up to 31st March 2003 when ERF and Man Truck & Bus were merged into MAN ERF UK Ltd. Without pre-judging any of the issues that may arise at a later hearing in relation to particular items of expenditure, that is in my view a fair date to take for these purposes. Until September 2002 production of the ECS and ECX models continued at Middlewich, albeit on a reduced scale. Thereafter steps had to be taken to complete the corporate restructuring of ERF which stemmed from its inability to continue as a producer of trucks. I would also accept that in principle expenses flowing from steps taken prior to 31st March 2003 are likely to be recoverable. However, any disputes as to whether particular items of expenditure, whether incurred before or after 31st March 2003, can properly be recovered will have to be resolved on another occasion. Nothing I say in this judgment is intended to pre-empt that question.4.Quantum

As I indicated earlier, both parties recognised that it would be undesirable for me to deal with disputed issues relating to quantum at this stage, partly because there remained a good prospect that the expert accountants would be able to reach agreement on most, if not all, of the figures and partly because it was thought preferable for detailed submissions on this part of the case to await my conclusions on liability. As far as they are concerned, it is unnecessary to add to what I have said already, but there remains one point which I think it is convenient to deal with at this stage, namely, whether MN must give credit for any benefit received by MAN through disposing of MAN Australia.

Mr. Kendrick submitted that, since this part of the defence was not the subject of a detailed pleading and since no evidence had been served in relation to it, the argument should be rejected out of hand. I would not go that far, especially since it was recognised from quite an early stage in the trial that issues of quantum would have to be deferred. There is still time, therefore, for the case to be properly pleaded and for evidence to be adduced, if necessary, at the appropriate time. However, Mr. Kendrick submitted that the argument must in any event fail for four separate reasons and it is to these that I now turn.

The first reason he put forward was that MN received no identifiable monetary consideration for the transfer of MAN Australia and therefore there was no payment for which credit could be given. In my view that is not a good point. Benefits may take a variety of forms. In this case MAN agreed to include MN Australia in the transaction because it was a drain on its own resources but of value to Western Star. It is likely, therefore, that a figure of some kind could be put on the benefit to MN of getting rid of that subsidiary, although it would be necessary to take account of the costs of preparing it for the take-over.

The second point was that MN would not have continued to retain MAN Australia as a loss-making subsidiary in perpetuity. That seems to me to be a fair point, but one which depends entirely on the facts. Not surprisingly, little attention was directed at the trial to this question and it is not a matter on which it would be appropriate for me to make findings at this stage.

The third point was that there has in fact been no net benefit to MN because it had to incur substantial costs in preparing the company for take-over. As I have said, I accept that any costs of that kind would have to be brought into account in calculating the net benefit to MN, but again, that is a question of fact which cannot be determined on this occasion.

Finally, Mr. Kendrick submitted that the Share Purchase Agreement was carefully constructed to ensure that the transfer of ERF to MN and the transfer of MAN Australia to Western Star were not legally interdependent. It is quite true that the Share Purchase Agreement makes separate provision for the two sales (although some Articles, notably Articles 11 and 12, contain provisions applicable to both), but I do not think that detracts from the fact that they formed related parts of a single transaction. If one is seeking to identify the loss suffered by MN as a result of entering into the Share Purchase Agreement, it is necessary to consider the benefits derived under the agreement as a whole. Once it is accepted that benefits obtained by MN are to be taken into account, therefore, it is right in principle that that should include any benefit obtained from the disposal of MAN Australia.5.Interest

MN seeks an award of compound interest on that part of its damages that represents the original purchase price and the value of the inter-company loan which it repaid under the Share Purchase Agreement. In the light of the decisions in President of India v La Pintada Compania Navigacion S.A. [1985] A.C. 104 and Westdeutsche Landesbank Girozentrale v Islington LBC [1996] A.C. 669 and the recent decision of the Court of Appeal in Black v Davies [2005] EWCA Civ 531 (unreported, 6th May 2005) it was common ground that the court has power in the exercise of its equitable jurisdiction to award compound interest on damages for deceit only in cases where money has been obtained and retained by fraud.

On the face of it Western Star did obtain and retain as a result of the fraud both the purchase price and the value of the inter-company loan to ERF which MN discharged which together amounted to about £86 million. Mr. Vos submitted, however, that Freightliner did not obtain or keep the proceeds of the fraud, and that, if it is to be taken as having done so, I should not exercise my discretion in a way that would punish it for something for which it was not truly culpable.

The basis for Mr. Vos's first submission was that because of the terms under which it acquired Western Star Freightliner did not in fact obtain the benefit of the payments in question. That is no answer to the claim, however, because Freightliner now stands in the shoes of Western Star and its position has to be considered by reference to the liability of Western Star. In my view this clearly is a case in which the person liable for the fraud has obtained and retained money as a result of that fraud. I am satisfied, therefore, that I have jurisdiction to award compound interest on that part of the damages which reflects those two elements of MN's loss.

Mr. Vos's second submission depended on the twin propositions that Western Star itself did not behave in a disreputable manner, being liable vicariously for the fraud of Mr. Ellis, and that an award of compound interest is punitive in nature. I do not think either of these is sustainable. A person liable for a wrongful act, albeit only vicariously, is fully responsible in the eye of the law for that act and its consequences. He cannot require the injured party to accept a reduced measure of compensation to reflect the fact that he was not personally at fault. In this context it is important to bear in mind that an award of interest is not made with a view to punishing the wrongdoer. In some cases it may be intended to ensure that the wrongdoer does not profit from his wrongful act, but more commonly it is intended to ensure that the injured party is fully compensated for his loss. There has been an increasing willingness to recognise that an award of simple interest does not fully compensate the injured party for the loss caused by being kept out of his money, nor does it adequately reflect the benefit to the wrongdoer of having had the use of it. As a result it has become routine for arbitrators to award compound interest in the exercise of their powers under section 49(3) of the Arbitration Act 1996 . In circumstances such as those of the present case I do not regard an award of compound interest as punitive, merely as an effective means of ensuring that a successful claimant obtains proper compensation for his loss. In the present case I am satisfied that it is entirely appropriate to exercise my discretion in favour of awarding compound interest to the extent that I have power to do so. 6.Summary of conclusions

I can summarise my conclusions on this limb of the case as follows. MN was induced to purchase ERF from Western Star by fraudulent statements made by Mr. Ellis at a time when he was acting on behalf of Western Star to further the negotiations between them. As a result Western Star became vicariously liable to MN for all the losses directly caused to it by entering into the transaction represented by the Share Purchase Agreement. All the losses incurred by MN between the date of closing and the discovery of the fraud flowed directly from the transaction; neither the continuing fraud of Mr. Ellis nor the manner in which MN managed ERF can properly be regarded as a separate and independent cause of loss. MN did not fail to act reasonably in mitigation of its loss after the fraud was discovered. The restructuring of the business of ERF was completed by 31st March 2003, at which time the transaction ceased to be the cause of any further loss, other than losses arising out of events which had already occurred prior to that date. In order to ensure that MN is not over-compensated for its loss, it will be necessary when assessing damages to give full credit for the value of ERF at that date. MN should be awarded compound interest on that part of the damages that represents the original purchase price of ERF and the amount of the inter-company loan from Western Star. All issues of quantum, other than those determined in the course of this judgment will be adjourned to another occasion.C.Freightliner's claim against E&Y (UK)

Freightliner contended that if, as I have held, it was liable to MN in respect of Mr. Ellis's fraud, it was entitled to recover over against E&Y (UK) on the grounds that its liability had resulted from the breach of one or more duties owed by E&Y (UK) to Western Star in relation to the audit of ERF and the due diligence exercise. It therefore becomes necessary to consider the nature and scope of any duties owed by E&Y (UK) to Western Star, whether E&Y (UK) were in breach of any of them and, if so, what were the consequences of those breaches.1.Was E&Y (UK) in breach of a duty of care owed to Western Star in relation to the audit of ERF?(a)Did E&Y (UK) owe Western Star a duty of care to ensure that the accounts of ERF gave a true and fair view of its financial position?

Auditors are appointed by a company to investigate and form an opinion on the adequacy of its accounting records and returns and to report to the shareholders whether in their opinion the accounts give a true and fair view of its financial position: see per Bingham L.J. in Caparo Industries Plc v Dickman [1989] Q.B. 653, 680–681 cited with approval by Lord Bridge at[1990] 2 A.C. 605 ,625. In the words of Lord Oliver in the same case

“It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.”

The auditors' primary duty, therefore, is owed to the company pursuant to the contract under which they are engaged, but it is now accepted that they also owe a duty of care under the general law to the shareholders as a body who can be expected to exercise their rights and powers in a general meeting on the basis of the audited accounts: see Caparo v Dickman per Lord Bridge at page 626C–E, Lord Oliver at page 654C and Lord Jauncey at page 662A–B. Mr. Vos described this as the “general audit duty” and it is convenient to adopt his terminology. Since ERF was a wholly-owned subsidiary of Western Star during the whole of the period leading up to its sale to MN, it was not in dispute that E&Y (UK) owed Western Star a general audit duty of the kind envisaged by Lord Bridge and others in Caparo v Dickman . Mr. Vos submitted that in the circumstances of the present case this general duty included specific duties, namely, a duty to inform Western Star that Mrs. Sinderson had become concerned about Mr. Ellis's competence and integrity and a duty to investigate the tip-off received from Mr. Pointon and to modify its audit work in the light of it.

Mr. Vos submitted that Western Star was entitled to rely on a breach by E&Y (UK) of this general audit duty to recover in its own name losses in the form of any liability it may have incurred to MN as a result of the dishonesty of Mr. Ellis, but in my view this argument must be rejected for a number of reasons. The duty of care owed by the auditors to the shareholders is unusual in a number of respects. It is not owed to shareholders as individuals, but to the shareholders as a body, and is a duty which has as its object the protection of their interest in the proper management of the company. The damage from which the auditors must take care to protect the shareholders is a diminution in the value of their interest in the company, that is, in the value of their shares, but as Lord Bridge pointed out at page 626D–E, the interest of the shareholders in the proper management of the company is indistinguishable from the interest of the company itself and therefore any loss falling within the scope of this duty that is suffered by the shareholders will be recouped by a claim against the auditors in the name of the company. It follows that neither individual shareholders, nor for that matter the shareholders as a body, can bring an action in their own names to recover that loss. This was one of the points made by the House of Lords in Johnson v Gore Wood & Co. [2002] 2 A.C. 1 and may explain why there appears to be no reported case in which shareholders individually or as a body have succeeded in recovering damages for a breach of this duty.

Moreover, it is difficult to see how the loss which Freightliner seeks to recover in this case can be brought within the scope of a general audit duty of this kind. The loss is not one which arises out of the mismanagement of ERF but one which was caused by dishonest statements made by Mr. Ellis on behalf of Western Star in the course of negotiations for the sale of the company. It may be that if E&Y (UK) had carried out its audits of ERF's 1998 and 1999 statutory accounts with proper skill and care his actions would have come to the attention of Western Star, but it does not follow that the loss suffered by Western Star in this case was within the scope of the general audit duty. In my view it was not.

In support of this part of his argument Mr. Vos placed some reliance on the decision of the Court of Appeal in Sasea Finance Ltd v KPMG [2001] 1 All E.R. 676 . The defendants, KPMG, had acted as auditors of Sasea. It was discovered at a later date that two of Sasea's managers had been defrauding the company on a substantial scale. Sasea brought a claim against KPMG alleging that it had been negligent in failing to identify certain fraudulent transactions with the result that the fraudsters had been allowed to remain in a position where they could continue their activities at the company's expense. The court accepted that if in the course of their work the auditors find that an employee has been defrauding the company and is in a position to go on doing so, they have a duty to bring that to the attention of the company at once.

Mr. Vos submitted on the basis of this decision that E&Y (UK) had a duty to carry out the audit carefully and, if they found that frauds were being committed, to draw that to Western Star's attention immediately in order to enable proper steps to be taken. However, in my view this decision takes the matter no further. It is not difficult to see why auditors should be under a duty to inform the directors immediately if they find evidence of fraud having been committed by someone who is in a position to continue his activities if allowed to do so. In Sasea v KPMG this was considered to be one aspect of the auditors' duty to the company as their client, but I am prepared to assume for the purposes of argument that the auditors owe a corresponding duty of care to the shareholders as a body to ensure that information of that kind is brought to the attention of the directors promptly. Even so, that is just another way of putting the same argument. The auditors' duty is to take care to prevent the company suffering loss through frauds committed against it. The fact that the exercise of proper care would also have prevented harm of another kind being caused to an individual shareholder (or even all the shareholders in their individual capacities) does not mean that such loss falls within the scope of the auditors' duty of care or that they can be held liable in respect of it.

Freightliner also alleged that E&Y (UK) were in breach of their general audit duty in failing to respond properly to the tip-off from Mr. Pointon. This is a matter to which I shall return in more detail a little later, but I think it is clear that insofar as E&Y (UK) had a duty as auditors to investigate the tip-off and to modify their audit procedures in the light of it, that was a duty they owed to ERF and to the body of shareholders as a whole. It was not a duty which they owed to individual shareholders.

For all these reasons I am satisfied that Freightliner cannot rely on a breach of the general audit duty to recover its loss. If it is to succeed it can only do so on the basis that E&Y (UK) owed Western Star what Mr. Vos described as a "special audit duty", that is, a duty at common law to take reasonable care when carrying out their audit to protect it from the kind of harm that it suffered in this case.

Since the decision in Hedley Byrne & Co Ltd v Heller & Partners Ltd [1964] A.C. 465 and the approval by the House of Lords of the dissenting judgment of Denning L.J. in Candler v Crane, Christmas & Co [1951] 2 K.B. 164 the courts have recognised that a duty of care to prevent economic loss may arise when one person provides information or advice to another in circumstances where the relationship between them is sufficiently close, the purpose for which the information or advice is given is sufficiently clear and the risk of harm to the recipient if the information turns out to be wrong is sufficiently obvious for it to be fair and just to impose such a duty on the person giving the information or advice. However, although the general principle is now well established, its application in any given case is by no means free from difficulty, partly because the courts have remained very conscious of the dangers of imposing on professional advisers duties of care to persons other than their own clients.

In Candler v Crane, Christmas & Co [1951] 2 K.B. 164 Denning L.J. considered that the existence of a duty of care should be confined to those cases in which the statement has been communicated and relied on in connection with the very transaction in respect of which the claim is made. In that case the plaintiff was considering making an investment in a mining company, but before doing so he wanted to see its accounts. The managing director therefore asked the defendants to complete the accounts which were then in the course of preparation because they were needed to enable them to be shown to the plaintiff who was a potential investor. The accounts were prepared and shown to the plaintiff who relied on them in making an investment. However, they contained numerous errors and failed to give a true picture of the company's position. The claimant made an investment, but the company was wound up within a year and he lost his money.

The facts of the case provided strong grounds for holding the accountants liable to the plaintiff. They were informed that the accounts were required for the purpose of being shown to him as a potential investor who would rely on them in making his decision so that it could fairly be said that the accountants had prepared the report “for the guidance of the very person in the very transaction in question” (per Denning L.J. at page 163). There had been in a very real sense an assumption of responsibility of a kind which has since generally been regarded as the basis of liability in tort for this kind of negligent misstatement. In Candler v Crane, Christmas the accountants were told in terms that the claimant was a potential investor and that he wished to see the accounts for the purpose of deciding what course to take. It has since been accepted, however, that knowledge of the fact that the statement may be relied on and of the purposes for which it may be relied on may be acquired inferentially and that it is necessary, therefore, to pay close attention to the circumstances in which it came to be communicated to the claimant. In Caparo v man Lord Oliver (with whom Lord Roskill and Lord Ackner agreed) said at page 637H—

“The point that is, as it seems to me, significant in the present context, is the unanimous approval in this House of the judgment of Denning L.J. in Candler's case [1951] 2 K.B. 164 , 181 in which he expressed the test of proximity in these words: “did the accountants know that the accounts were required for submission to the plaintiff and use by him?” In so far as this might be said to imply that the plaintiff must be specifically identified as the ultimate recipient and that the precise purpose for which the accounts were required must be known to the defendant before the necessary relationship can be created, Denning L.J.'s formulation was expanded in the Hedley Byrne case, where it is clear that, but for an effective disclaimer, liability would have attached. The respondents there were not aware of the actual identity of the advertising firm for which the credit reference was required nor of its precise purpose, save that it was required in anticipation of the placing of advertising contracts. Furthermore, it is clear that “knowledge” on the part of the respondents embraced not only actual knowledge but such knowledge as would be attributed to a reasonable person placed as the respondents were placed. What can be deduced from the Hedley Byrne case, therefore, is that the necessary relationship between the maker of a statement or giver of advice (“the adviser”) and the recipient who acts in reliance upon it (“the advisee”) may typically be held to exist where (1) the advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time when the advice is given; (2) the adviser knows, either actually or inferentially, that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose; (3) it is known either actually or inferentially, that the advice so communicated is likely to be acted upon by the advisee for that purpose without independent inquiry, and (4) it is so acted upon by the advisee to his detriment. That is not, of course, to suggest that these conditions are either conclusive or exclusive, but merely that the actual decision in the case does not warrant any broader propositions.”

The nature of the relationship between the auditor and a third party who seeks to rely on the accounts was considered again in Galoo Ltd v Bright Graham Murray [1994] 1 W.L.R. 1360. The plaintiff in that case agreed to buy a majority of the shares in a company at a price expressed as a multiple of its earnings as calculated by the defendants. After it had acquired the company the claimant made loans to the company and later purchased the bulk of the remainder of its shares. The claimant alleged that the accounts prepared for the purpose of the original acquisition and for each subsequent year contained serious inaccuracies and that the defendants as auditors had been negligent in failing to discover and report them. It sought to recover its losses on the grounds that if the defendants had acted with reasonable skill and care the company's insolvency would have become apparent and it would have ceased to trade. The claimant would not then have purchased the company in the first place, nor would it have made the subsequent loans to it and would have avoided making continuing trading losses.

For present purposes it is necessary to consider only the first of those claims. Having considered Caparo v man and Morgan Crucible Co. Plc v Hill Samuel & Co. Ltd [1991] Ch. 295 Glidewell L.J. noted at page 1381E that an auditor may owe a duty of care to a takeover bidder if he approves a statement which confirms the accuracy of accounts which he has previously audited, or which contains a forecast of future profits, when he has expressly been informed that the bidder will rely on the accounts and forecast for the purpose of deciding whether to make an increased bid and intends the bidder should so rely. Later at page 1382 he said

"Mere foreseeability that a potential bidder may rely on the audited accounts does not impose on the auditor a duty of care to the bidder, but if the auditor is expressly made aware that a particular identified bidder will rely on the audited accounts or other statements approved by the auditor, and intends that the bidder should so rely, the auditor will be under a duty of care to the bidder for the breach of which he may be liable."

In Electra Private Equity Partners v KPMG Peat Marwick [2001] 1 BCLC 589 the question arose whether a company's auditors had undertaken responsibility for the accuracy of its auditing or for statements reporting on the company's accounts made to a firm of accountants acting as advisers to a potential investor, and in particular whether a conscious assumption of responsibility is necessary in order to give rise to a duty of care. Having referred to the principal authorities Auld L.J. (with whom the other members of the court agreed) rejected the submission that a conscious assumption of responsibility is required. He held that although evidence of actual intention may well be a strong indicator of a duty of care, it is not a necessary ingredient for proof of it. He adopted the statement of Morritt L.J. in Peach Publishing Ltd Slater & Co [1998] PNLR 364 at page 373 that the essential enquiry is

"… whether having regard to all the circumstances of the case and looking at the matter objectively it can be said that [the accountant] undertook responsibility to [the potential investor] for the substantial accuracy of the … accounts."

Mr. Vos also drew my attention to the decision of the Court of Session in Royal Bank of Scotland v. Bannerman, Johnstone, Maclay [2003] SLT 181 in which the court rejected the submission that a duty of care could not arise unless the maker held an intention that the recipient should rely on it. That decision has since been affirmed on appeal: see [2005] CSIH 39.

In the light of these and other decided cases it was, not surprisingly, common ground that whether an auditor has assumed responsibility to someone other than his client is a matter to be determined objectively by reference to all the circumstances of the case. From time to time attempts have been made to identify the factors most likely to be of significance when making this enquiry, most notably on two occasions by Neill L.J. in James McNaughton Paper Group Ltd v Hicks Anderson & Co [1991] 2 Q.B. 113 and later as Sir Brian Neill in Bank of Credit and Commerce International (Overseas) Ltd v Price Waterhouse [1998] BCC 617. These cases are both of considerable assistance inasmuch as they help to direct the mind to matters that are likely to prove important in analysing facts of the case before the court, but the terms in which they are couched are inevitably influenced by the particular circumstances of the case. In my view Mr. Fenwick was right in saying that when a claim is made by a third party against a company's auditors based on an alleged duty of care in relation to the statutory accounts, close attention must be paid to the particular statement on which the claimant seeks to rely, the circumstances in which and purpose for which that statement was made and the type of loss which the claimant is seeking to recover. The auditors will only be held to have incurred such a duty if it can be shown that they knew and intended that their statement as to the company's accounts would be communicated to and relied on by a particular person or class of persons for a particular purpose in connection with a particular transaction.

The concept of assumption of responsibility featured large in the parties' submissions in this case. Its origin is to be found in the speeches of their Lordships in Hedley Byrne v ler , most clearly in that of Lord Devlin to which Lord Goff referred in Henderson v Merrett [1995] 2 A.C. 145 at page 179. In Smith v Eric S. Bush [1990] 1 A.C. 831 some doubt was cast on the utility of this concept which it was thought did not adequately reflect the fact that the law imposes a duty of care on the maker of a statement if the circumstances warrant it. In Bank of Credit and Commerce International (Overseas) Ltd v Price house Sir Brian Neill expressed the view at page 634D that the test of assumption of responsibility, if properly applied, ought to lead to the same conclusion as the threefold test of foreseeability, proximity and reasonableness and although it may not be an ideal test under all circumstances, it was adopted with obvious approval by Lord Goff in Henderson v Merrett . It has since been applied by Morritt L.J. in Peach Publishing Ltd Slater & Co and by Auld L.J. in Electra Private Equity Partners v KPMG [2001] 1 BCLC 589 . I am glad of that because in a case such as the present it has the merit in my view of directing one's mind to the essential nature of the relationship between the auditor and the third party which is necessary to give rise to a duty of care.

Mr. Fenwick submitted that E&Y (UK) provided information about ERF's accounts to Western Star for statutory audit purposes alone and to enable ERF's accounts to be consolidated with those of Western Star. It did not, he said, provide that information with a view to its being used as a basis for determining the terms of a sale of ERF to MN.

The transaction which gave rise to the loss in the present case was the sale of ERF by Western Star to MN. It is that transaction, therefore, to which attention must be directed when considering whether E&Y (UK) assumed a responsibility to Western Star or anyone else for the correctness of its audit statements. The loss suffered by Freightliner in this case takes the form of liability in damages for deceit arising from the statements made by Mr. Ellis in the course of the negotiations with MN. In order to succeed in its claim Freightliner must show, therefore, that E&Y (UK) owed Western Star a duty to take reasonable care to protect it from liabilities of that kind. (The same principle would apply, of course, if Freightliner's loss had taken the form of a liability for damages for misrepresentation under the Share Purchase Agreement).

Given the nature of relationships between Western Star and ERF and between E&Y (UK) and E&Y Canada, E&Y (UK) must have realised that both the 1998 and 1999 audit reports would be passed to Western Star who could be expected to rely on them both for the purpose of producing consolidated accounts for the Western Star group as a whole and for the purposes of making decisions about the future conduct of ERF's business. I am not persuaded, however, that at the time it produced its 1998 audit report E&Y (UK) can be taken to have known that Western Star would rely on it for any other purposes. At the time the audit certificate was given in May 1999 the negotiations with Daimler-Chrysler had fallen through two months earlier and there was no indication that Western Star was actively seeking another purchaser for the ERF group. As controlling shareholder of ERF Western Star can no doubt be regarded as representing the body of shareholders entitled to determine the future direction of ERF and thus as the person to whom a general audit duty of the kind discussed earlier was owed. However, it is clear from Caparo v Dickman that in the ordinary way the auditor does not owe a duty of care to any individual shareholder who may decide on the strength of the company's statutory accounts to sell his existing shares or to buy more shares in the company and the fact that Western Star owned or controlled all the shares in ERF does not in my view affect that position. The fact that E&Y (UK) may have recognised that Western Star might decide to dispose of ERF at some uncertain date in the future did not give rise to a relationship between them that would normally be regarded as sufficiently close to support a duty of care.

In the middle of November 1999, however, E&Y (UK) did undoubtedly become aware that Western Star intended to provide MN with a copy of the 1998 accounts when they were asked to make copies of their working papers for that year's audit available for review by Deloitte & Touche. They agreed to do so on terms similar to those contained in the "hold harmless" letter under which they had provided copies of their working papers relating to the 1999 audit. However, that was not sufficient in my view to establish a duty of care in favour of Western Star. E&Y (UK) were not asked to, and did not, give any confirmation to Western Star at that time that the accounts were accurate and could safely be relied on for any particular purpose in connection with the sale of ERF to MN and in those circumstances it is difficult to see how they can be treated as having assumed any responsibility to Western Star for their accuracy.

The position in relation to the 1999 accounts is rather different. Not only was E&Y (UK) aware by September 1999 of the existence of the current negotiations with MN, it was made clear before the audit certificate was signed that Western Star was anxious to obtain the audited accounts as soon as possible in order that they could be made available to MN for its consideration in connection with the purchase of ERF. The audit certificate was signed on 4th November 1999 shortly before Mr. Bryant and Mr. Ellis collected the audited accounts from E&Y (UK)'s offices in Manchester. They returned immediately to the Cottons hotel where Mr. Bryant gave a copy to Mr. Wagner for use in connection with the negotiations generally.

Mr. Fenwick submitted that E&Y (UK) did not provide a copy of the June 1999 accounts to Western Star for any purpose relating to the sale of ERF and did not undertake any responsibility to Western Star for their accuracy in relation to any aspect of that transaction. In examining that submission it is necessary to begin with what took place on, and immediately prior to, 4th November. Mrs. Sinderson had been pressed by Mr. Bryant on a number of occasions to complete the audit as quickly as possible so that he would have the accounts in time for the beginning of the due diligence exercise, but he did so as managing director of ERF and as one of the people responsible for their production. Mrs. Sinderson said that she did not regard herself as having given a copy of ERF's accounts to Western Star, merely to ERF and in my view that is correct, at least as far as that occasion is concerned. (In February 2000 E&Y (UK) invoiced Western Star for the provision of certain information including copies of the statutory accounts of ERF, but it is not clear when and in what circumstances they had been provided.) Mr. Bryant and Mr. Ellis were the managing director and financial controller respectively of ERF and collected the audited accounts from E&Y (UK) in that capacity. Mr. Bryant was also a director of Western Star, of course, but he signed the accounts in his capacity as a director of ERF and there is nothing to indicate that he was acting in any other capacity in relation to the accounts or that he gave Mrs. Sinderson any reason to think that he was.

It must have been obvious to Mrs. Sinderson, however, both from her knowledge of the fact that it was the parent company of ERF and from her knowledge of the negotiations, that copies of the accounts would be sent by ERF to Western Star as soon as possible, as indeed they were. She could certainly foresee, therefore, and in my view must be taken to have known, that Western Star would itself rely on the accounts in the negotiations with MN as presenting a true and fair view of ERF's financial position. Mere foreseeability is not enough to give rise to a duty of care, however. It is also necessary for there to have been a relationship between the parties of such proximity as to support the conclusion that there was an assumption of responsibility. In this case, therefore, Western Star must show that E&Y (UK) assumed responsibility to it for the accuracy of its audit statement so as to be under a duty to take care to protect it from the kind of loss which Freightliner seeks to recover.

In Candler v Crane, Christmas Denning L.J. laid some emphasis on the fact that the accounts in that case had been provided to the claimant for the specific purpose of enabling him to decide whether to invest in the mine. The purpose for which the statement was made and communicated to the claimant is always likely to be highly relevant to the existence of a relationship giving rise to a duty of care. In James McNaughton Paper Group Ltd v Hicks Anderson & Co Neill L.J. in the course of discussing factors likely to be relevant to the existence of a duty of care referred to the need to identify the purpose for which the statement was made and communicated to the claimant. He pointed out that although in some cases the statement will have been prepared or made for the express purpose of being communicated to the claimant for the purpose for which he made use of it, in many cases it will have been made primarily for a different purpose and for the benefit of someone else. In such cases it becomes necessary to look carefully at the precise purpose for which the statement was communicated to the claimant. These are likely to be important considerations because unless it can be shown that the statement was communicated to the claimant for a particular purpose relating to the harm he has suffered, he is unlikely to be able to show that the defendant assumed a responsibility to take care when making it to protect him from that harm. As Mr. Vos accepted, although the purpose for which the statement is required may be specifically identified or described in general terms (see per Lord Oliver in Caparo v Dickman at page 638), the maker must know that it is required for a particular purpose in order for him to be in a position to appreciate the risks involved and for it to be fair to treat him as having assumed a responsibility to the claimant or to impose on him a duty of care.

In the present case one of the primary purposes for which the audit statement was made was to provide information to Western Star about ERF's financial position so that it could exercise its rights as shareholder to influence the way in which the company was run. Mr. Fenwick, while accepting that the question is to be judged objectively by reference to what the parties should reasonably have concluded from the facts available to them, submitted that in the case of a statutory auditor something more is required in order to impose on the auditor a duty of care either to an individual shareholder or to a third party. In my view that it correct. The position of the individual shareholder and the third party are indistinguishable for this purpose, save for the fact that it is likely in practice to be easier for a third party to whom the accounts are provided by or with the consent of the auditor to establish a duty of care simply because of the absence of any existing statutory relationship. In order for Freightliner to succeed in this case, therefore, it must be able to show that the audit statement attached to ERF's accounts was communicated to Western Star not only for the recognised statutory purposes but also for the purposes of enabling it to rely on the accounts in the negotiations with MN.

One of the difficulties facing Mr. Vos in this case is that of identifying any purpose for which the audited accounts were communicated to Western Star beyond that contemplated by the statutory provisions. Mrs. Sinderson was aware in November 1999 of the negotiations for the sale of ERF and was aware that the accounts were required urgently so that copies could be given to MN and from her previous involvement in mergers and acquisitions she must have foreseen that both MN and Western Star would be likely to rely on the audited accounts as giving a true and fair picture of ERF's financial position. However, it is clear from what was said in Caparo v Dickman that by itself that is not enough. There is no evidence of anything passing between Western Star and E&Y (UK) to indicate that Western Star was intending to rely on the accounts for any particular purpose in its negotiations with MN or that it was seeking an assurance from her that it could safely do so, and although Mrs. Sinderson signed the audit certificate, she did nothing to indicate that E&Y (UK) were assuming responsibility for the accuracy of the accounts for any purposes of that kind. E&Y (UK) knew, of course, that MN was carrying out a due diligence exercise, but apart from making their audit working papers available to Deloitte & Touche they were not consulted about it and played no part in it.

The difficulties do not end there, however. The loss which Freightliner seeks to recover in the present case is a consequence of Western Star's liability for the fraudulent statements made by Mr. Ellis during the negotiations with MN, a liability which was the direct result of the dishonesty of Mr. Ellis rather than the inaccuracy of the accounts themselves. Similarly, if Western Star had been liable for fraudulent misrepresentation under the Share Purchase Agreement, it would have been the result of attributing to Western Star Mr. Ellis's knowledge of his own fraud rather than the existence of any inaccuracies in the accounts. In neither case could it be said that the loss was of a kind that might be expected to flow from the existence of inaccuracies in the accounts and it is difficult, therefore, to accept that E&Y (UK) assumed a responsibility to protect Western Star from it. Only in the case of the misrepresentation relating to ERF's tax position could it be said that liability was the direct result of a failure to carry out the audit carefully.

One can see here a reflection of the principles governing the measure of damages recoverable in cases of this kind. As Lord Hoffmann pointed out in South Australia Asset Management Corporation v York Montague Ltd at page 214, the law normally limits liability for wrongful acts to those consequences which are attributable to that which made the act wrongful, which in the case of liability in negligence for providing inaccurate information means liability for the consequences of the information being inaccurate. An auditor can reasonably expect, therefore, that if he negligently certifies that a company's accounts give a true and fair view of its financial position, the scope of his liability to anyone to whom he owes a duty of care in making that statement will be limited to the loss flowing from the inaccuracy of his audit certificate. If E&Y (UK) had undertaken a special audit duty to Western Star, the consequences of their negligence would no doubt extend to such loss as it might have incurred in respect of the difference between the true net asset value of the company and that shown in the accounts, for example, by reason of a breach of warranty. They would not extend, however, to losses caused by fraud on the part of a person for whom the Western Star was vicariously liable.

An additional factor on which Mr. Fenwick placed a certain amount of reliance was the existence of the “hold harmless” letters which E&Y (UK) insisted on receiving from both Western Star and MN before it agreed to release its audit working papers to Deloitte & Touche. He submitted that those letters made it quite clear that E&Y (UK) was unwilling to accept liability of any kind over and above that which they were obliged to accept as statutory auditors.

On 19th October Mrs. Sinderson wrote to Mr. Stewart Smith confirming the terms on which E&Y (UK) would make their working papers available in connection with the due diligence exercise. Her letter included the following paragraph:

“As you will appreciate, our working papers were created for the particular purpose of our audit of the Company's statutory financial statements and not for the purpose of the proposed sale of the Company, or indeed for any other purpose. Consequently, the working papers and the information in them may not be suitable for the purposes of the proposed transaction. However, you and the Company will accept the risk and not hold Ernst & Young responsible, if the Purchaser's and/or the Accountants' review of our working papers or our explanations or representations made orally to them results(a)

in the termination of, or alteration to, the proposed transaction; or(b)

in any action at any time against you or [ERF] respectively, if the Purchaser, the Accountants or any of the other parties involved with this proposed transaction misuse any confidential information obtained from a review of our working papers or by way of explanation from us.

For the avoidance of doubt, nothing in this letter is intended to affect any rights the Company may have against Ernst & Young as auditor of the Company.”

The “hold harmless” letter addressed by E&Y (UK) to Deloitte & Touche and MAN contained the following passage: “6.

… we are prepared to grant the accountants access to the Working Papers and at our discretion give explanations in relation thereto or other information or representations relating to or arising from our work (all information derived from any of these sources being referred to in this letter as “Information”) only on condition that the Purchaser and the Accountants acknowledge the foregoing and agree to the following conditions:

…(2)

The Purchaser and the Accountants accept that Ernst & Young neither owe nor accept any duty to the Purchaser or the Accountants whether in contract or in tort or howsoever arising, in relation to the Information or any part of it. In these circumstances, if the Purchaser and the Accountants wish to rely upon any part of the Information, they each accept that they do so entirely at their own risk.”

Mr. Fenwick submitted that by those letters E&Y (UK) made it clear that they were not willing to accept liability to anyone for any claims arising out of the sale of ERF. Accordingly, he said, a reasonable person in the position of Western Star would not have believed that E&Y (UK) intended to take responsibility for losses of any kind which might arise from the transaction. Mr. Vos submitted, however, that the letters were directed by E&Y (UK) solely to the use of their working papers, an argument described by Mr. Fenwick as “highly technical and misconceived”.

For my own part I do not find Mr. Fenwick's submission very persuasive. It is important to understand the context in which the “hold harmless” letters came to be written. By the end of October 1999 E&Y (UK) were very close to completing their work on the 1999 statutory accounts. Those accounts were in fact signed on 4th November. The request to release their working papers was made solely for the purposes of the due diligence exercise and although E&Y (UK) were prepared to allow Deloitte & Touche access to their papers and to provide information and explanations in relation to the work they had done for the purposes of the audit, they were not willing to accept liability for the consequences of giving MN access to information which would not otherwise have come into its hands. However, the working papers are quite different from the audit report itself. Although “Information” was defined in the letters as meaning any information derived from the working papers, that obviously meant information derived by the recipients from the papers themselves, not the audit report produced by E&Y (UK) itself on the basis of the work reflected in the papers. The “hold harmless” letters cannot therefore be understood as relating to wider questions of responsibility or to any liability that might arise out of the use to which the statutory audit might be put.

Finally, I need to say something about the extent to which Western Star relied on what is said to have been an assumption by E&Y (UK) of responsibility for the accuracy of ERF's accounts. Mr. Fenwick submitted that Mr. Peabody was the only person who made decisions of any importance on behalf of Western Star and that, since he had not been called to give evidence, there was no basis for concluding that Western Star had relied on any statement by E&Y (UK) that the accounts gave a true and fair view of ERF's financial position.

In my view this submission fails to give adequate recognition to the fact that those who were conducting the negotiations on behalf of Western Star, principally Mr. Bryant and Mr. Stewart Smith, were in constant communication with Mr. Peabody, either directly or through Mr. Burke, or to the fact that Mr. Burke and Mr. Bryant were themselves directors of Western Star. In view of the fact that Western Star (which for this purpose means Mr. Peabody) was prepared to warrant that the June 1999 accounts gave a true and fair view of ERF's position, it is impossible as a matter of commonsense to conclude that he did not rely on the audit certificate in doing so.

In view of all these matters I am unable to accept that E&Y (UK) owed a duty of care to Western Star to protect it from a loss of the kind which it seeks to recover in this case.(b)Were E&Y (UK) in breach of duty?

In these circumstances it is both unnecessary and inappropriate to consider whether E&Y (UK) was in breach of any duty of care to Western Star, but since the question was fully debated in argument, I shall express my views on it as briefly as I can. For these purposes I shall assume that in carrying out their audits of ERF's 1998 and 1999 annual accounts E&Y (UK) owed a duty of care to Western Star to protect it from such loss as it might suffer in connection with the sale of ERF to MN as a result of any material inaccuracy in the accounts.(i)Reconciliation of the purchase ledger and the purchase ledger control account

E&Y (UK) admitted from the outset that they had been negligent in their auditing of the purchase ledger control account in both 1998 and 1999. In order to understand how that came about it is necessary to described briefly how ERF's books of account were kept.

In common with many other companies, details of transactions with individual suppliers, including the amount due in respect of each transaction and amounts paid, were entered in the suppliers' accounts in the company's purchase ledger. At any given time, therefore, that ledger should have shown the net balance owed by the company to each supplier and the transactions that had given rise to it. Individual suppliers' balances on the purchase ledger were carried to the purchase ledger control account in the company's general ledger which showed the aggregate outstanding balance due from the company to its suppliers. The general ledger, which provided the basis for the preparation of the statutory accounts, should therefore have contained a complete record of the company's assets and liabilities at any moment in time. This ledger provided the basis for the figure for trade creditors shown in the statutory accounts.

In order to ensure that the ledgers were consistent with each other summary postings should in principle have been made to the purchase ledger control account at the same time as individual entries in respect of purchase invoices, credit notes and payments were posted to the purchase ledger. In practice, however, that frequently did not happen for a variety of reasons, including errors on the part of accounting staff and failures to post corresponding entries to different ledgers at the same time. That is a very common failing and it is usual, therefore, for there to be a discrepancy between the aggregate balance on the purchase ledger and the balance on the purchase ledger control account. In order to ensure that a discrepancy of that kind can be properly accounted for it is necessary to prepare a reconciliation by which the difference is satisfactorily explained. This exercise forms a standard part of any audit of a company's accounts.

In the present case the false journals posted by Mr. Ellis to the purchase ledger control account produced a discrepancy of about £18 million as at 30th June 1998, as described earlier. For the purposes of the audit he produced a reconciliation showing that the difference between the balances on the two ledgers was attributable to payments which had been made before the end of the financial year but which had not been posted to the purchase ledger at that date. The accounting experts agreed that the size of the discrepancy was such as to require verification by reference to supporting evidence, but E&Y (UK) took no steps to do so and the false reconciliation was not identified as such. It was accepted that in that respect they were negligent.

A similar situation arose in the course of the 1999 audit. This time the discrepancy between the purchase ledger and the purchase ledger control account was a little over £21 million. Again Mr. Ellis provided a false reconciliation, as described earlier, and again E&Y (UK) failed to verify it. Again, it was admitted that they were negligent in failing to do so.(ii)Understatement of VAT liability

The financial statements showed that as at 30th June 1998 ERF was owed VAT in the sum of £191,106 representing claims for repayment made in May and June of that year. Mr. Ellis admitted that since the middle of 1997 he had caused ERF to make false claims for repayment of VAT each month. He considered, perhaps correctly, that the fraud was more likely to be discovered if there were a change in the pattern of ERF's VAT returns and had persisted in it partly for that reason. It is safe to conclude, therefore, that the VAT returns for May and June 1999 were produced as part of a continuous course of conduct designed to defraud Customs & Excise.

In August 1998 two of E&Y (UK)'s VAT specialists undertook a review of ERF's VAT records as part of the audit process. Although they did not carry out a full VAT audit, they did examine the VAT returns working files and saw that ERF was generally recovering between £50,000 and £100,000 of tax each month. (In fact ERF received repayments of about £3 million in 1998 and a similar sum in 1999). The intention of undertaking a review of that kind was to take advantage of the audit process to introduce E&Y (UK)'s specialist services to the client, but it is clear that the audit team relied on the review to carry out the work that it would otherwise have had to do itself.

Mr. David Spence, the accountant called by Freightliner to give expert evidence on auditing standards and procedures, said that the VAT specialists, or those within the audit team who relied on their findings, ought to have made an effort to understand why ERF was always in a repayment position and why there was a consistent pattern of repayments, since that was unusual for a company carrying on that kind of business. He considered that E&Y (UK) had been negligent in failing to make those enquiries. E&Y (UK)'s auditing expert, Mr. Edward Middleton, agreed that he would have expected the tax specialists to have identified the VAT position over the financial year as a whole and accepted that if they had realised that ERF had recovered as much as £3 million a simple proof in total test, even if limited to the output tax, would have led to the conclusion that something was wrong. That in turn should have led to a more searching enquiry.

In the event, the accounts showed a VAT asset of £191,000 instead of a liability which Mr. Spence put at about £5 million and Mr. Whitaker, an expert forensic accountant called by E&Y (UK), put at about £4 million. On either view the discrepancy was large enough to be material.

In my view E&Y (UK)'s work in relation to ERF's VAT accounts for the 1998 financial year fell below the standard to be expected of reasonably competent auditors. That came about because the VAT specialists failed to inform the audit team that ERF had been reclaiming VAT each month and because the audit team failed to ask the VAT specialists all the right questions. The result was that the accounts substantially over-stated ERF's position in relation to VAT.

In 1999 the position was similar. The accounts showed a VAT debtor of £591,502 representing the amounts reclaimed in May and June of that year. E&Y's Global Release Audit Manual called for the company's tax position to be one of the matters taken into account at the planning stage of every audit, but in this case, for some reason not explained in the audit papers, it was considered unnecessary to do so. Mrs. Sinderson said that she thought the VAT specialists had continued to have dealings with ERF after the 1998 audit, but the audit team does not appear to have made any specific enquiries into the VAT position and continued to rely on the work done the previous year. They must have satisfied themselves that the figure in the accounts could be reconciled to the VAT returns and must therefore have become aware of the size of the outstanding claim for repayment, but it obviously did not strike anyone as surprising that it was so large, despite what they knew about the company's business and its trading position.

Mr. Spence said that for ERF to be in a substantial repayment position for two consecutive return periods while apparently operating at a profit should have led E&Y (UK) to make further enquiries. Mr. Middleton also accepted that although a reasonably competent auditor might not immediately assume that similar amounts had been reclaimed each month leading to a recovery of about £3 million over the over the year as a whole, the amount reclaimed in respect of those two periods was large enough to have caused him to check the position. I am satisfied that in failing to carry out that step E&Y (UK)'s work fell below the standard to be expected of reasonably competent auditors and that they were negligent. Mr. Spence considered that instead of showing a debtor of £591,502 the June 1999 accounts should have shown a VAT creditor of £7,559,389. Mr. Whitaker thought that the correct figure was a creditor of £6,669,000, but he accepted that whichever was correct the amount was material.(iii)Discrepancy between cash balances and trade creditors

ERF Ltd maintained a manual cash book to record payments made by the company and payments received from third parties. Individual payments to suppliers were posted to the purchase ledger and batch totals were posted to the cash book periodically. Batch totals of payments made by cheque were posted to the cash book at the time the cheques were prepared and sent out. Receipts were posted to the sales ledger and batch totals were posted to the cash book periodically. The bank control account in the general ledger was updated from the cash book monthly.

At the end of the financial year in June 1999 the bank control account showed a credit of £3,910,612, but the cash book showed an overdrawn balance of £5,765,716. The discrepancy of £9,676,328 represented four batches of cheques posted to the cash book on 30th June. The payments had also been posted to the purchase ledger, thereby reducing the total trade creditors. During the preparation of the accounts one of Mr. Ellis's assistants, Mr. Giltrap, adjusted the bank balance by re-crediting the value of the cheques on the grounds that, although they had been written, they had not been sent out before the end of the year. However, he inadvertently failed to make a corresponding adjustment to the purchase ledger which meant that either the cash position was over-stated (Mr. Spence's view) or that the trade creditors were understated (Mr. Middleton's view). It is unnecessary to decide between these competing views since either way the net assets of ERF were over-stated by £9,676,328 unless there was some other compensating error in the accounts. Despite the close scrutiny given to ERF's accounts, no such error has come to light and I am satisfied that none existed. Mr. Spence and Mr. Middleton agreed that a competent auditor exercising reasonable skill and care would have identified this discrepancy and I am satisfied that E&Y (UK) were negligent in failing to do so.(iv)Provision for warranties

ERF gave three different kinds of warranty in respect of its trucks: a two-year basic warranty against defective workmanship and materials; an optional ‘Suredrive’ warranty against defective workmanship and materials for up to a further three years following the expiry of the basic warranty; and, from 1st September 1998, a ‘Driveline’ warranty covering the engine, gearbox and transmission only for a third year following the expiry of the basic warranty. In addition, it sometimes paid on a discretionary basis for repairs to vehicles under five years old. Provision had to be made in the company's accounts for the future cost of carrying out warranty repairs on trucks already sold. The relevant auditing standard (paragraph 420.3 of the Statements of Auditing Standards ("SAS") issued by the Auditing Practices Board) provides that auditors should satisfy themselves that adequate provisions have been made in one or more of the following ways: by reviewing and testing the procedures used by management to develop the estimate used; by comparing the estimate prepared by management with an independent estimate; or by reviewing previous estimates in the light of subsequent events.

The 1998 accounts contained a provision for warranty repairs in the sum of £2,150,305. This had four elements: (i) a detailed estimate of the first year's warranty costs relating to vehicles sold during the year based on the historical average of warranty costs per vehicle per month increased for inflation and multiplied by the total number of months outstanding in respect of all warranties, plus a small additional amount; (ii) a round figure of £150,000 in respect of the second year; and (iii) an additional sum of £28,525 in respect of export sales; (iv) allowances in respect of inter-company warranties. The allowances were included in the accounts within the figure for inter-company creditors and warranty claims against suppliers.

Mr. Spence was of the view that this calculation failed adequately to take into account the fact that the basic warranty was for two years and that the 'Suredrive' and 'Driveline' warranties each extended to the third year (and in the case of 'Suredrive beyond). He also considered that some provision should have been made for the cost of discretionary repairs. The two principal criticisms made of E&Y (UK) in this context were that they had accepted without further investigation an unsatisfactory explanation for the provision made for the second year of the basic warranty, namely, that claims made in the second year were largely in respect of matters which gave ERF a right to recover from its suppliers, and that they had failed to identify the fact that ERF had not made sufficient allowance for the cost of discretionary repairs.

Although a warranty claim arising from a defective component might well have given ERF the right to make a claim against its supplier, the value of such a claim is only as great as the will and ability to enforce it. A document prepared by a member of the E&Y (UK) audit team indicates that there were strong grounds in his view for thinking that in practice ERF was often unable to recover against its suppliers. Mrs. Sinderson considered the provisions for the two years of the basic warranty together, which appears to have influenced her towards accepting the management's figure for the second year without subjecting it to critical scrutiny. Mr. Middleton considered that it was acceptable to evaluate the provision as a single figure, although given the nature of the explanation provided by the management he accepted that further steps should have been taken to see if the allowance for the second year was adequate.

If an auditor decides to verify a provision of this kind by reviewing and testing the procedures used by management to develop the estimate, it is necessary to follow through the whole of the procedure in question. E&Y (UK) did not do that in this case because they failed to test the allowance made for the second year. Moreover, I think they can properly be criticised for failing to identify the fact that management made no allowance for the costs of claims arising during the third year under the 'Suredrive' warranty. I am satisfied that in these respects E&Y (UK) failed to meet the standards to be expected of reasonably competent and careful auditors and were negligent.

Whether provision should have been made for the cost of discretionary repairs depends on whether they are to be regarded as costs incurred in relation to past sales or costs incurred to generate future goodwill. Mr. Spence preferred the former view, Mr. Middleton the latter. In my view there is a distinction of principle between costs incurred pursuant to existing contractual commitments and costs incurred voluntarily. Whatever expectations ERF's previous practices may have nurtured among its customers, its willingness on occasions to bear the costs of repairs not covered by a warranty can in my view only have been intended to retain the goodwill of the customer in question (and perhaps of others who might get to hear of it) in the hope that he would buy another ERF truck in the future. On this question I prefer the view of Mr. Middleton and conclude that it was not necessary to make provision for those costs. It was accepted that in those circumstances the difference between the figure in the accounts and that calculated by the experts was not material.

The provision for warranty costs in the 1999 accounts was £1,938,080. Again, it included an amount of £150,000 for the second year of the basic warranty and no provision was made for the additional costs of the 'Suredrive' or 'Driveline' warranties. In formulating their work plan for the 1999 audit E&Y (UK) recognised the need for a detailed evaluation of the provision put forward by management, but failed to carry it through. I am satisfied that in this respect their work did not meet the standards to be expected of reasonably competent and careful auditors, but since for the reasons explained earlier I do not think that it was necessary to make provision for the costs of discretionary repairs, the difference between the correct provision and that contained in the accounts was not material.(v)Failure to report concerns about ERF

Freightliner also alleged that E&Y (UK) were in breach of their duty as auditors in the way in which they responded to certain information they acquired in the course of the audit procedure. The first of these complaints concerned Mrs. Sinderson's 'ERF Concerns' memorandum in which she set out a number of her concerns about ERF in general and about the competence and integrity of Mr. Ellis in particular. They had arisen as a result of her experiences during the audit, in particular from Mr. Ellis's failure to inform her at the outset that he could not obtain a trial balance from the BaaN system, from his assurance before the fieldwork had begun that all normal monthly accounting controls had been performed and from her discussions with Mr. Giltrap from whom she learnt that regular monthly reconciliations had not been performed. She first voiced her concerns that Mr. Ellis was substantially understating the difficulties with the BaaN system in August 1998 while the fieldwork was still in progress and about two weeks later had mentioned her concern about his capabilities and about deficiencies in the financial systems. In October 1998 she had seen a memorandum written by Mr. Ellis in which he had stated that there had been detailed reconciliations to support the balance sheet control accounts and that ERF could now operate the BaaN system with the normal monthly control processes. Neither of those statements accorded with her understanding of the position. A conversation with Mr. Bryant during a visit she made to Canada left her with the impression that he was not very interested in the accounting function and that Mr. Ellis had not told him about the difficulties that had been experienced with the BaaN system.

Mrs. Sinderson was prompted to record her concerns by a request from Mr. Kendrick for her comments on the draft Audit Observations report prepared by E&Y (Canada) as part of its audit of Western Star. In her memorandum she set out a number of observations on ERF's management which, although not directed exclusively towards Mr. Ellis, raised a number of serious questions about his competence and integrity. In particular, she cast doubt on his willingness to bring unwelcome information to the attention of senior management, referred to a tendency on his part to withhold information and to be evasive in his dealings with the audit team, and questioned his competence in handling the technical aspects of the accounting and control procedures. In her view he was determined to give the impression that he had things under control when that was far from the case. She was also concerned that an unwillingness on the part of senior management within Western Star to tolerate under-performance was creating a risk that the accounts might be manipulated in order to give an impression that the group was doing better than was really the case. In cross-examination Mrs. Sinderson amplified these comments, saying that she regarded Mr. Ellis as a person who would say whatever was most convenient at the time.

Mr. Vos submitted that Mrs. Sinderson was at fault in failing to bring these concerns to the attention of Mr. Bryant as managing director of ERF, a criticism that was supported by Mr. Spence. He was of the view that she could and should have spoken to Mr. Bryant privately about these matters and, if she did not find him receptive, that she should have taken steps to relay her concerns to more senior management within Western Star itself. Mr. Middleton thought otherwise, but his opinion was based on his understanding that the views expressed by Mrs. Sinderson were provisional and still developing.

Mrs. Sinderson said in evidence that the memorandum was written primarily for her own benefit. Although at the time she composed it she thought it would be desirable to discuss Mr. Ellis's performance with Mr. Bryant, her views about Mr. Ellis were still provisional and had not reached the point at which she thought she had a robust case for telling the directors of ERF that his lack of competence was causing severe problems for the group. She described the memorandum as setting out points that she was considering at the time.

I can well understand that an auditor's assessment of the client's financial controller will develop over a period of time as the audit progresses and that it may be desirable to note one's reactions as one goes along, However, the document does not read in that way. It is far more definite and suggests that Mrs. Sinderson had formed some quite firm views by the time it came to be written. It also indicates that her concerns about the situation at ERF and about the ability of Mr. Ellis to perform his role in the group adequately had reached the point at which she thought it desirable to raise the matter with senior management, not necessarily to say that she thought Mr. Ellis was incompetent, but to share her concerns and perhaps to obtain a greater insight into the situation. Mr. Fenwick understandably warned against the dangers of reading this memorandum in the light of what was later discovered about Mr. Ellis and of crediting Mrs. Sinderson with a degree of insight that she did not possess at the time. I think he was right to do that, but even so, the memorandum itself shows that she had sufficient grounds for taking the matter up with senior management. Although her views of Mr. Ellis may still have been developing, it is clear that she had reached the point at which she herself thought that she ought to take action of some kind, if only to enable her to reach a clear conclusion one way or the other about him. In those circumstances I do not think that Mr. Middleton's assessment of her position was entirely correct.

In my view Mrs. Sinderson should have taken steps to raise her various concerns about the operation of the accounting and control function within ERF with Mr. Bryant, but I do not think that her failure to do so materially affected the course of events. In June 1998 Mr. Burke had become aware for the first time that ERF was unable to obtain a trial balance from the BaaN system, but shortly after that he was told that a trial balance had been obtained and had been accepted by E&Y (UK). It apparently did not strike him at the time that Mr. Ellis had not mentioned his difficulties until the financial year was almost at an end; nor did he regard it as a matter of great concern that for the whole of that year the information provided to management had been based partly on estimates. His department was already aware that Mr. Ellis was prone to giving over-optimistic assessments of ERF's position and was also aware in a general way of the other matters raised in Mrs. Sinderson's memorandum. If Mrs. Sinderson had raised her concerns with Mr. Bryant I think it likely that he would have told her to speak to Mr. Burke. Mr. Bryant understood the need for competent financial management, but I do not think that he would have wanted to take responsibility for reviewing Mr. Ellis's position in relation to a matter of this kind which he would have seen as falling within Mr. Burke's area of responsibility. Mr. Burke would have understood and accepted the criticisms levelled against Mr. Ellis, but they would have added little to what he already knew. They might have led him to be more cautious in his approach to Mr. Ellis and his reporting, but I do not think they would have led him at that stage to remove Mr. Ellis from his position or appoint someone else to supervise him.(vi)Failure to respond adequately to the tip-off

The second complaint concerned E&Y (UK)'s response to the tip-off. The conversation between Mr. Pointon and Mrs. Sinderson gave rise to a number of issues between the parties, but they are ultimately of little or no importance because the most that can be said of the tip-off is that it ought to have led E&Y (UK) to review and verify all the uncorroborated information it had received from the management of ERF in the course of the audit. If that had been done, it was said, the audit team would have realised that the reconciliation of the purchase ledger control account provided by Mr. Ellis could not be verified and his manipulations would have been discovered, but since it was accepted that E&Y (UK) was negligent in failing to carry out a proper verification of the reconciliation in the first place, it adds nothing of any substance to this part of Freightliner's case. However, in view of the fact that Freightliner also made claim against E&Y (Canada) arising out of the way in which Mr. Kendrick dealt with the information about the tip-off he received from Mr. Sinderson, it is necessary to make further findings about tip-off itself and her response to it.

The first issue concerns exactly what Mr. Pointon said to Mrs. Sinderson during their conversation on 20th September 1999. Mr. Pointon's recollection was that the information his daughter had given to him was that improper or inaccurate information was being created within the Accounts department of ERF at the request of management. Although he was asked to elaborate on the nature of the information and the purposes for which it was being created, he was quite clear that he had not been given any details of that kind. Mr. Pointon's daughter, Mrs. Cartwright, had received her information from a colleague at ERF, Miss Wilson. Although Miss Wilson said in her statement that she had told Mrs. Cartwright of a practice of "double invoicing", Mrs. Cartwright could not recall anything of that kind. She said that the information she had been given was very general in nature. Her recollection was therefore consistent with Mr. Pointon's.

Mrs. Sinderson made a note of her conversation with Mr. Pointon as it took place and this later formed the basis for a file note which she produced in the middle of November, some two months after the conversation had taken place. Unfortunately the original note has since been lost. The file note records that Mr. Pointon had said that the incorrect information related to sales and margin figures on second-hand vehicles acquired under buy-back arrangements and Mrs. Sinderson was confident that the word "sales" had been mentioned, although she could not remember in precisely what context. She recalled that her conversation with Mr. Pointon had lasted between five and ten minutes and that during it she had asked him a number of questions to obtain more details of the nature of the information that was causing concern. One can see from the file note that by the time she came to draft it Mrs. Sinderson had it firmly in her mind that Mr. Pointon had mentioned vehicles purchased under the buy-back arrangements, but I am satisfied she was mistaken about that. Miss Wilson's reference to double invoicing and the evidence from other sources about the practice of early invoicing, to which I shall come later, strongly support the conclusion that it was that which had given rise to the concerns which eventually found their way to Mr. Pointon. At the time of her conversation with Mr. Pointon the audit team was still working on the treatment in the accounts of buy-backs and I think it likely that Mrs. Sinderson herself raised the question of sales and margins on buy-back vehicles with Mr. Pointon in the course of attempting to probe for more detailed information. Having done so, and having obtained a neutral answer from him, I think she read more into it than was justified and came away with the impression that that was the area of concern. I am not persuaded that Mr. Pointon himself said anything to indicate that the misleading information related to sales of any description.

Mrs. Sinderson discussed the tip-off with her audit team on 23rd September and together they considered the areas in which critical information had been provided by the management of ERF. They did not consider the purchase ledger control account reconciliation because it was not linked to buy-backs and was not recognised as involving a management representation.

Mr. Middleton accepted that the tip-off in this case represented information which indicated that fraud or error might exist within the meaning of the relevant accounting standard (SAS 110. 29) and that it was therefore necessary for Mrs. Sinderson to consider the respects in which the auditors were relying on representations from management. However, he did not consider the purchase ledger control account reconciliation to be a representation for these purposes because it was apparently supported by the records to which it referred. Mr. Spence, however, said that E&Y (UK) should have reviewed all representations made to them by management that were not supported by independent evidence.

Mr. Fenwick submitted that it would be impossible for auditors who had received a somewhat vague tip-off of this kind to revisit every representation made to them by management throughout the whole period of the audit. He suggested that what starts life as a representation may properly be treated as a fact once it has been verified to the auditors' satisfaction. I think there is a lot of force in that argument, but if that approach is to be properly applied it is important for the auditors to retain a clear sight of what constitutes verification and what does not. As Mr. Middleton accepted, although the purchase ledger control account reconciliation provided by Mr. Ellis was apparently capable of being verified by reference to the accounting records, it had not in fact been verified and until it had been it was nothing more than a representation that the items to which it referred were indeed reconciling items. In fact they were not, as any attempt to verify them would have demonstrated. All this points to the conclusion that E&Y (UK) should have recognised that the reconciliation was nothing more than a management representation which had not been verified and ought therefore to be reviewed. In this case, however, it appears that the member of the audit team responsible for verifying the reconciliation had wrongly marked the record in such a way as to indicate that it had been verified to the underlying documents. In those circumstances, even if Mrs. Sinderson and her team had extended the scope of their review to encompass all unverified representations made by management, I do not think they could have been criticised for treating this one as an item of established data rather than a mere representation.(c)What were the consequences of E&Y (UK)'s negligence?

Although I have concluded that E&Y (UK) were negligent in a number of respects, only their failures when conducting the audit of each of the 1998 and 1999 financial years to verify the purchase ledger control account reconciliation and properly to investigate the VAT position are of any real significance. I now turn to consider what the consequences were in each case.(i)The 1998 audit

If an attempt had been made in the course of the 1998 audit to verify the purchase ledger control account reconciliation put forward by Mr. Ellis by reference to the underlying documents and accounting records it would quickly have become apparent that it was entirely false. Mr. Ellis's attempt to reconcile an apparent discrepancy of £18 million by reference to a series of payments made after the end of the financial year is likely to have raised serious questions about his competence or his integrity or both. I think it likely that his initial reaction to being confronted with the inadequacy of the reconciliation would have been to try to pass it off as a mistake, but it does not require very much thought to realise that an explanation of that kind would have been barely plausible. At that point matters would have developed in one of two ways: either the auditors would have realised that Mr. Ellis was not to be trusted and would have carried out a detailed investigation into the source of the discrepancy, or they would have sent him away to produce a valid reconciliation. If the auditors had carried out an investigation, I think it more likely than not, as Mr. Spence suggested, that the fraud would have been detected in view of the amounts involved and the nature of the manipulations.

The evidence leaves me in no doubt that it was not possible to produce a valid reconciliation, except for the sum of about £5 million that had not been carried over from the J.D. Edwards system into the BaaN system at the end of 1997, so that if Mr. Ellis had been sent away to try again, he would have been unable to produce a reconciliation that would have satisfied the auditors without manufacturing false records and underlying documents to support it. I do not think he would have attempted to do that and at that stage he would have been cornered. Mr. Ellis might have admitted his fraud straight away, but if he did not there would undoubtedly have been an enquiry into the source of the discrepancy. It is very likely, therefore, that the fraud would have been discovered by that route also. It is also likely that while these matters were under investigation enquiries would have been made into ERF's VAT position. Since they would have disclosed that the company was regularly claiming repayment of VAT, it is likely that there would have been an investigation into the reason for that which in turn would have led to the discovery that fraudulent claims were being made. The investigators would have been starting from much the same position as Mrs. Frobisher and would probably have uncovered the unusual entries on the purchase ledger control account within about three months. Mr. Fenwick submitted that these entries might have been put down to errors rather than deliberate manipulations, but Mr. Spence, whose evidence on this point I found persuasive, considered that the number and nature of the journals involved would have led the investigators to the view that they were the result of dishonesty rather than mere incompetence. It is likely, therefore, that the investigation would have led to the discovery of Mr. Ellis's frauds before the end of the year.

It is difficult to know what would have happened after that, but I am quite sure that before taking any further steps Mr. Peabody would have wanted to know the precise state of ERF's finances and what had caused them to deteriorate so significantly. He was experienced in turning round ailing companies and the evidence suggests that he would have attempted to turn ERF around unless he judged its position to be hopeless. BDO and Grant Thornton, the accountants instructed by MN and Freightliner respectively in this case, were able to agree a reconstruction of ERF's balance sheet as at 8th March 2000 which showed that the group had an excess of liabilities over assets of about £70 million instead of the net assets of about £27 million reported in the December accounts. The manner in which a loss of that kind could have occurred has not been clearly identified, however. A comparison between the margins reported by Mr. Ellis to management between July 1998 and March 2000 and the margins during the same period derived from the information held on the MacPac system, which automatically recorded the movement and cost of the components used in the assembly of all trucks, suggests that ERF was not making operating losses of sufficient magnitude to account for it. The accountants instructed by E&Y, PKF, did not agree the reconstruction of the balance sheet and Mr. Whitaker suggested that compensating assets might have been hidden somewhere in the accounts, but as I have already said, despite all the work that has been done on ERF's accounts, no one has been able to identify any compensating assets of any kind. In the absence of any cogent criticism of the reconstruction, therefore, I accept it as correctly reflecting the position at that time.

Technical obstacles have made it impossible to examine the accounts maintained on the J.D. Edwards system prior to 1st July 1997. The fraudulent recovery of VAT which became systematic from around the middle of 1997 obviously improved the company's apparent profitability, but there is nothing to suggest that the monthly reports provided to management prior to the introduction of the BaaN system were out of line with the information contained in the group's ledgers. That makes it unlikely that ERF was trading at a significant loss before 1st July 1997 and likely that the deficiency identified as at 8th March 2000 was almost entirely the result of operational losses incurred since that date. It is impossible on the evidence before me, however, to make any finding about precisely how those losses were incurred.

ERF's accounts for the year ending 30th June 1998 showed net assets of about £9.6 million. In these circumstances I am satisfied that an enquiry into the financial condition of ERF in early January 1999 would have led to the conclusion that after adjusting for the under-statement of trade creditors it actually had net liabilities of about £8.4 million and was trading at a significant loss. However, since the accounts were generally "in a mess" (to quote Mr. Spence), a full investigation would have taken some time to complete. I am unable to accept that MN would have been willing to buy ERF under those circumstances and in the light of the evidence about the way in which companies of this kind are valued within the industry for the purposes of acquisition I am unable to accept that a buyer could have been found for ERF in the middle of 1999. Western Star would therefore have been faced with a choice between providing a substantial amount of additional capital in order to keep ERF going in the hope of operating it at a profit in the long run and putting it into liquidation. On balance I think the latter would have been the more likely outcome. The overwhelming likelihood in view of the VAT frauds is that Mr. Ellis would have been dismissed. Western Star would have suffered a loss in the liquidation, the amount of which will have to be determined, if necessary, on another occasion.(ii)The 1999 audit

My conclusions in relation to the 1999 audit are substantially the same. I am satisfied that when challenged Mr. Ellis would probably have tried to pass off the reconciliation as an error, but again it would by its very nature have cast doubts upon his competence or integrity which would be likely to have had greater force in view of the fact that Mrs. Sinderson had already formed an unflattering view of his character and abilities. Once again, it would not have been possible to produce a valid reconciliation without manufacturing false records and again I do not think that Mr. Ellis would have tried to escape from the difficulty in that way. Mr. Fenwick submitted that Western Star had no interest in conducting an enquiry into ERF's accounts at a time when it was negotiating a sale of the group to MN at a substantial profit, but I do not think it would have had any alternative. The June 1999 accounts played an important role in the negotiations and MN knew that they were being audited. It would have been impossible for E&Y (UK) to sign an audit certificate until the problem was resolved and it could not be resolved without an investigation into the cause of the discrepancy. Although it was suggested that the difficulty might have been dealt with by way of a warranty, I do not think that MN would have been prepared to accept that. It would have been obvious that there was a serious problem holding up the completion of the audit and I do not think that MN would have been willing to proceed at a price acceptable to Mr Peabody, if at all, until it had been cleared up. The VAT position would also have provoked further enquiries. I think that an investigation was inevitable, therefore, with the consequent discovery of the frauds by about the end of November 1999 and the dismissal of Mr. Ellis soon after.

In those circumstances I think that the sale to MN would have fallen through. ERF's share of the market depended on its remaining in operation as a producer of trucks. It could not do that unless it received a sizeable injection of capital and its methods of production were overhauled to make it more efficient. MN was interested in ERF as a going concern; there is little to suggest that it was interested in acquiring an insolvent company trading at a loss. The most likely outcome, therefore, is that Western Star would have put ERF into liquidation by around the end of June 2000.(d)The scope of E&Y (UK)'s liability

Mr. Fenwick submitted that even if E&Y (UK) did owe a duty of care to Western Star in making its audit statement, the loss which Freightliner is seeking to recover did not fall within the scope of that duty. In my view, however, that is just another way of approaching the question whether E&Y (UK) owed a duty of care to Western Star at all. Once it is accepted that the existence of a duty of care cannot be determined without considering the nature of the harm against which it is said the defendant had a duty to protect the claimant, the scope of the alleged duty inevitably forms part of the enquiry. The kind of loss which falls within the duty of care will depend to a large extent on what is foreseeable as being the likely result of a failure to take care at the time when the duty arises. In the present case it was foreseeable that Western Star would rely on the accuracy of the accounts in its dealings with MN and that, if a contract were concluded between them for the sale of ERF, it might contain warranties which would be broken if the accounts were inaccurate. Loss in the form of liability to MN for breach of warranty would, therefore, fall within the scope of the duty of care.

Mr. Fenwick then submitted that any liability Western Star might have incurred to MN under the Share Purchase Agreement was far more extensive than would ordinarily have been the case because it failed to insist on setting some limit on its liability for misrepresentation or breach of warranty. That led to a certain amount of debate about whether it is usual for the vendor of a company to warrant that its accounts give a true and fair view of its financial position without placing some limit on its liability if the warranty is broken. Mr. Fenwick drew my attention to comments in a number of textbooks which suggest that warranties of this kind are usually limited in some way, but Mr. Spence said that in his experience it was not unusual for there to be no express limit on the seller's liability, though he thought that in practice it would be limited by the amount of the consideration (perhaps on the basis that the company could not be worth less than nothing).

In my view the evidence in this case does not support the conclusion that warranties of this nature unlimited in amount are so unusual that their presence in the Share Purchase Agreement could not reasonably have been foreseen. However, the question is of no practical significance in the present case in which any liability that Western Star might have incurred to MN under the Sale and Purchase Agreement (other than a liability in relation to ERF's tax position, to which it was accepted different considerations apply) would not have arisen from a simple misrepresentation or breach of warranty but from fraud involving Mr. Ellis. The one thing that was not foreseeable at the time when the audit statement was signed and the accounts of ERF delivered to Western Star was that the nature of his participation in the negotiations coupled, perhaps, with the inclusion in the Share Purchase Agreement of section 1.6, would cause Western Star to incur a liability to MN for fraudulent misrepresentation. I am unable to accept that a loss of that kind fell within the scope of any duty of care that E&Y (UK) could have owed to Western Star.(e)Limitation

The engagement letter under which E&Y (UK) agreed to act as auditors of ERF included the following paragraph: “Limitation of Liability

I would draw your attention to section 11 of Part III of the terms of business headed “Limitation of Liability”. We fully realise that it is not possible to limit the firm's liability to shareholders arising from its role as auditor under the Companies Act 1985, and we do not seek to do so … However, to the extent that we may provide other services to you which are not covered by a separate letter of engagement, our liability to each company listed on the attached schedule in respect of those services will be limited to £2 million in accordance with that section.”

Section 11 of Part III of the terms of business provided as follows; “Limitation of Liability

For all causes of action accruing in any 12 month period, commencing on the date of our engagement letter, the liability of our firm (including its partners, staff and associated entities) to each company listed in the schedule to our engagement letter in respect of breach of contract or breach of duty or fault or negligence or otherwise whatsoever arising out of or in connection with this engagement shall be limited in total to £2 million to cover claims of any sort whatsoever (including interest and costs) arising out of or in connection with this engagement …"

Mr. Stewart Smith confirmed that Western Star had become aware of the terms of the engagement letter in the summer of 1998 and had approved the appointment of E&Y (UK) as ERF's auditors on those terms. Mr. Fenwick submitted that if E&Y (UK) did owe a duty of care to Western Star to take reasonable care to ensure that the accounts gave a true and fair view of ERF's financial position, its liability for any breach of that duty was limited to £2 million in accordance with the terms of business because Western Star was aware that E&Y (UK) was only prepared to carry out work on that basis.

In support of his argument Mr. Fenwick drew my attention to a number of cases in which it has been said in different contexts that a person who has been engaged under a contract to provide certain services is entitled to rely on the terms of his contract to limit his liability to a third party arising in tort as a result of the negligent performance of those services. In particular he relied on a passage in the judgment of Robert Goff L.J. in Leigh and Sillivan Ltd v Aliakmon Shipping Co. Ltd [1985] Q.B. 350 at page 396F in which he said

"Indeed the case can be simplified into one in which A breaks his duty to B, and the question is whether a third party, C, can proceed directly against A in respect of damage thereby suffered by him. In such circumstances (and in this I find myself differing from Lloyd J. in The Irene's Success [1982] Q.B. 461) it seems to me unthinkable that, if C is to have a direct cause of action against A, that right of action should be uncontrolled by those provisions which regulate A's liability to B."

Lord Brandon cast doubt on that proposition when that matter came before the House of Lords ([1986] A.C. 785 at page 817) but in Pacific Associates v Baxter [1990] 1 Q.B. 993 Purchas L.J. considered that the existence of an exclusion clause in the contract between A and B could not be excluded from the circumstances which had to be taken into account when considering the relationship between A and C. Later still, in White v Jones [1995] 2 A.C. 207 , Lord Goff at page 268 appears to have regarded it as axiomatic that a solicitor who had negligently failed to give effect to his client's instructions when drafting his will would be entitled in an action by the beneficiary to take advantage of any term in his contract with the testator restricting or excluding his liability.

This is an important and potentially far-reaching issue and since it is unnecessary to decide it in the present case I prefer to do no more than express a provisional view. The present case differs in certain important respects from the kind of situation that their Lordships were dealing with in White v Jones in which the object of the testator's instructions was to confer a benefit on the claimant who was himself not in communication with the solicitor. The position in this case is much more closely analogous to that which arose in Hedley Byrne v ler itself, there being (on this hypothesis) sufficient direct or indirect communication between the parties to give rise to an assumption of responsibility on the part of E&Y (UK) to Western Star. That is an important factor, because the existence of a channel of communication provides an opportunity for the maker of the statement to exclude or restrict liability for errors. In such cases I am inclined to think that it is more appropriate to treat the existence and terms of the contract between A and B as part of the circumstances in which the relationship between A and C falls to be assessed. In this case it is important to ask not only whether Western Star knew of the terms of the engagement letter, but whether that letter and the terms of business when read together and in the context of the surrounding circumstances indicated clearly that E&Y (UK) intended to assume responsibility for the correctness of the audit statement only on limited terms. The fact that the engagement letter draws a distinction between audit work and "other services" tends to militate against that conclusion in a case where the assumption of responsibility is for the correctness of an audit statement, as does the fact that the terms of business themselves contemplate the existence of a formal engagement. Having regard to the absence of any significant degree of communication between the parties in relation to the use of the audited accounts by Western Star in this case, I am not persuaded that E&Y (UK) effectively restricted their liability in that way, but, as I have said, it is unnecessary to express a final view on this question. 2.Were E&Y (UK) in breach of a duty of care owed to Western Star in relation to the conduct of the due diligence exercise?(a)What duty did E&Y (UK) owe to Western Star in relation to the conduct of the due diligence exercise?

Mr. Vos submitted that E&Y (UK), together with E&Y (Canada), were instructed to act for Western Star in relation to the due diligence exercise carried out by MN and that they each owed Western Star a duty to carry out their functions in that regard with reasonable skill and care. Certainly E&Y (UK) did agree to provide Western Star with some assistance in connection with due diligence. Thus, they agreed to make their working papers available to Deloitte & Touche and to answer questions arising out of them. They also gave advice in relation to buy-backs, second-hand vehicles, and related matters and took part in telephone conference calls when various aspects of the negotiations were being discussed. No doubt, insofar as they did provide advice and assistance, they were under a duty to act with reasonable skill and care, but it has to be said that the part they played in the due diligence exercise was extremely limited.(b)Were E&Y (UK) in breach of duty?

In its statement of case in the Part 20 proceedings Freightliner alleged that E&Y (UK) were in breach of duty in the following four respects: (i) in failing to take reasonable care to ensure that the accounts provided to MN gave a true and fair picture of ERF's affairs; (ii) in failing to inform Western Star about Mrs. Sinderson's concerns as to Mr. Ellis's competence and integrity; (iii) in failing properly to respond to or investigate the tip-off and a related rumour that there was something wrong with ERF's accounts (what became known as the “Misener rumour”, to which I shall come later); and (iv) in failing to inform Western Star that financial information being provided to MN was, or might be, inaccurate. The last of these complaints was not pursued in evidence or argument, however, and I therefore take it to have been abandoned.

Perhaps the first point to make in relation to the remaining three allegations is that in reality they are all complaints about the conduct of the audit and if well-founded could be the subject of a claim by ERF itself. None of them relates to the services that E&Y (UK) were engaged by Western Star to perform in connection with MN's due diligence exercise. E&Y (UK)'s sole function in that regard was to make working papers and explanations available to Deloitte & Touche. They were not engaged to act in a general supervisory capacity to ensure that information provided to MN was correct; nor was it part of their function to review and confirm the work that had previously been carried out for the purposes of the audit. They were not instructed by Western Star to investigate the tip-off or the Misener rumour as part of the due diligence exercise and insofar as either of them might be relevant to ERF's accounts their evaluation was a matter that was directly relevant to the performance of their duties as auditors. It was not the subject of a separate undertaking to Western Star. It is unnecessary to repeat what I said earlier about the ‘ERF Concerns’ memorandum. Although I think that Mrs. Sinderson should have discussed her concerns with Mr. Bryant, her duty to pursue the matter arose out of her conduct of the audit, not out of any role that E&Y (UK) were asked to play in the due diligence exercise. In these circumstances I am unable to accept that E&Y (UK) owed Western Star any of the duties in connection with the due diligence exercise on which it seeks to rely.3.Contributory fault

In their defence to the Part 20 claim E&Y (UK) alleged that if Freightliner had suffered any loss by incurring a liability to MN, that loss was caused wholly or in part by the fault of Western Star and that the damages it can recover from E&Y (UK) should be reduced accordingly. In other words, they said that any liability that Western Star had incurred to MN had resulted from a failure to take reasonable care to protect its own interests. Since I have already held that E&Y (UK) did not owe a duty of care to Western Star and is therefore not liable for the loss Freightliner has suffered, questions of contributory fault do not arise, but I think it appropriate, nonetheless, that I should make findings on matters that bear on this question which was canvassed at some length in Mr. Fenwick's closing submissions.

In their defence E&Y (UK) make a large number of allegations of fault on the part of Western Star, not all of which were pursued with any vigour, or in some cases at all, at trial. It is convenient, therefore, to deal with those that were pursued by reference to the separate heads under which Mr. Fenwick grouped them in his submissions. Before doing so, however, it is necessary to say something about the principles that apply when considering this question.

Section 1(1) of the Law Reform (Contributory Negligence) Act 1945 provides that

"Where any person suffers damage as the result partly of his own fault and partly of the fault of any other person or persons, a claim in respect of that damage shall not be defeated by reason of the fault of the person suffering the damage, but the damages recoverable in respect thereof shall be reduced to such extent as the court thinks just and equitable having regard to the claimant's share in the responsibility for the damage". "Fault" is defined in section 4 as meaning

"negligence, breach of statutory duty or other act or omission which gives rise to liability in tort or would, apart from this Act, give rise to the defence of contributory negligence."

The damage suffered by Freightliner in the present case takes the form of the loss sustained by reason of its liability to MN for deceit. In respect of each allegation of contributory fault, therefore, it is necessary to consider whether there was an act or omission on the part of Western Star of a kind that was blameworthy, in the sense that it involved a failure to take reasonable care for its own interests, and was a contributory cause of that loss. The nature of the damage suffered by Freightliner in the present case makes the issue of causation particularly important. There can be no doubt that the principal cause of Freightliner's liability to MN was Mr. Ellis's willingness to make false and dishonest statements to MN about ERF's accounts coupled with Western Star's decision to put him forward as a spokesman on its behalf in the negotiations. On the face of it, therefore, unless it can be shown that Western Star ought to have known that the accounts had been manipulated or should have realised that there was a risk that Mr. Ellis might deliberately attempt to mislead MN in some way, it is not easy to see how any act or omission on its part can have been a contributory cause of that liability. Equally, unless it can be said that Western Star was at fault in failing to detect that Mr. Ellis was manipulating ERF's accounts, it is difficult to see how it was at fault in a way that contributed to the magnitude of its loss. The fact is that Mr. Ellis's frauds were intended to conceal the true position from Western Star as much as from the management of ERF.

Mr. Vos submitted that if E&Y (UK) as auditors owed Western Star a duty to protect it from loss resulting from inaccuracies in the audit statement, Western Star was entitled to rely on them to discharge that duty so as to absolve it from any requirement to take care for itself. However, although I would accept that there may be cases in which the nature of the duty owed by the defendant to the claimant may be such as effectively to exclude the possibility of contributory fault, I do not think it is helpful or appropriate to attempt to deal with the matter in that way, especially in a case such as this where a large number of different allegations of fault are raised. In my view it is preferable to examine each allegation on its merits bearing in mind, of course, the nature of the auditors' function.

I therefore turn to the various heads of fault on which E&Y (UK) relied.(a)Early invoicing

ERF's factoring arrangements with Newcourt provided for the sale to Newcourt of receivables arising in respect of trucks delivered to distributors or direct to customers. Under the systems established between Newcourt and ERF the issue of an invoice by ERF automatically triggered the sale of the receivable and the transfer of funds from Newcourt to ERF. Delivery, that is the handing over of the finished vehicle, was identified in the MacPac system as 'Workstation 900'. The preceding point in the system, 'Workstation 800', was the point at which assembly was completed, the truck had been road-tested and any minor defects had been rectified. When a truck reached 'Workstation 800' on the MacPac system the accounting systems would automatically prompt staff to issue an invoice. To that extent, therefore, the practice of issuing invoices and obtaining payment before trucks were actually delivered was endemic in the system, but in such cases the truck was complete and represented valuable security as far as Newcourt was concerned. That practice, although technically an example of early invoicing, can therefore be disregarded. However, there is reliable evidence from a variety of sources, most notably from Mr. Bryant, that it became an established practice at ERF for trucks to be invoiced, and for the resulting receivables to be sold to Newcourt, before they had been completed. This practice took different forms which grew up in different ways and at different times and which need to be considered separately.

The first practice was that of early invoicing at the month end. The production staff at ERF normally worked a four-day week and the production line itself stopped on a Thursday, but it was not uncommon for some work to go on over week-ends and public holidays in order to complete vehicles that were in the final stages of assembly and testing. The accounts staff worked a standard five-day week and although accounting periods were nominally monthly, prior to Western Star's take-over they always ended on a Sunday. Every month, therefore, it was possible for trucks to be completed at a time when the accounts staff were not working. (Later, after Western Star acquired ERF, accounting was carried out on a calendar month basis and therefore there was much less opportunity for the same situation to arise.) Mr. Bryant described how in these situations it became an established practice at the end of each month for him to assess how many trucks were likely to be completed before the end of the month and to override the computer in order to show them as having reached Workstation 800, thereby enabling invoices to be issued before the month's end.

Although Mr. Fenwick identified a number of apparent inconsistencies both in Mr. Bryant's own account of these matters and between Mr. Bryant's account and the account given by Mr. Ellis, many were more apparent than real and stemmed from that fact that Mr. Bryant was attempting to explain how things had been done both before and after the take-over by Western Star. I found Mr. Bryant to be a straightforward and forthright witness and not one who was afraid to face the facts or who attempted to mislead. In any event, his description of the practice differed from that given by Mr. Ellis, if at all, only in its details. I am also satisfied that the motive for this type of early invoicing was to ensure that production figures were as healthy as possible and to reduce the number of vehicles awaiting final completion (sometimes referred to as the “float”) rather than to accelerate the receipt of funds from Newcourt. Mr. Bryant and Mr. Ellis both said that they understood Newcourt to have been aware of the practice and to have condoned it. Newcourt's formal position, as evidenced by an e-mail sent by one of its managers, Mr. Burrows, to ERF in January 1999, was that the factoring facility could only be used in relation to trucks that had been delivered and that its agreement should be obtained if ERF wanted to make use of it to fund completed trucks pending delivery. However, Mr. Burrows was in regular contact with Mr. Ellis and he must have been aware that it was ERF's practice to invoice after completion but before delivery because from time to time Newcourt would check the stock held at ERF's premises. Indeed, Mr. Burrows confirmed in cross-examination that what he was really concerned about was completion rather than delivery. Whether he was specifically aware of the practice of invoicing early at the end of the month is less clear. However, Mr. Bonnet, a director of Newcourt, often attended meetings of ERF's executive management team at which there were discussions about matters relating to production and the number of vehicles that had cleared the production line and were awaiting final completion. Whatever the true position, I am satisfied that both Mr. Bryant and Mr. Ellis thought that Mr. Bonnet condoned this particular practice. If the level of production was stable it was not something that would have had any significant impact on ERF's accounts after the first occasion since each month the figures would have lost to the previous month broadly as much as they gained from the next.

The second practice was more serious and consisted of invoicing trucks at a time when they were in the early stages of assembly, well before they had been completed. It occurred at various times during the month and does not appear to have been related in any way to the reporting of figures at the month's end. Analyses of invoicing and deliveries carried out by PKF and Grant Thornton showed that between May 1999 and March 2000 invoices were raised manually for substantial numbers of trucks which had not yet reached Workstation 800. In order to correct the position credit notes were issued to customers to cancel the original invoice and a second invoice was issued at a later date. That had to be done manually because the computer system would not allow a second invoice to be issued in respect of the same truck. In some cases successive invoices and credit notes were issued in relation to the same vehicle.

The effect of this practice was to accelerate the receipt of funds from Newcourt and to improve ERF's apparent productivity. It is difficult to see what other objects it can have had and it is significant that it ceased almost entirely soon after ERF was acquired by MN. Since this practice also involved an element of robbing Peter to pay Paul, its impact on the company's overall trading results was negligible, although it did distort the results at the year end by over-stating the number of vehicles completed and sold and under-stating to a corresponding extent the number and total value of components held in stock. In my view, however, its main purpose was to accelerate the receipt of payment and thereby help to alleviate pressure on the company's cash resources.

The existence of this practice is established by the documents themselves and the analysis carried out by the accountants. The only dispute of any significance was whether it went on with the knowledge and approval of Mr. Bryant, as Mr. Fenwick submitted must have been the case. The person responsible for producing invoices was the sales invoicing clerk, Mrs. Brenda Hewitt. In the ordinary way she was automatically informed by the MacPac system of vehicles that had reached ‘Workstation 800’ and were ready to be invoiced. It was her responsibility to check the details of the order shown on the system and, if satisfied that they were correct, to print four copies of the invoice which she then passed to another clerk for filing and despatch. Mrs. Hewitt described how “towards the month-end or year-end” she was given a list of about 20 vehicles that were to be invoiced early, originally on a piece of paper and later in an e-mail from Mr. Ellis. She identified one such e-mail which he had sent her on 9th February 2000 relating to a total of 26 trucks, some of which had been ordered by distributors and some by national customers direct from ERF. She said that some of the trucks invoiced early would go on to clear production the following week but that others might remain in production for much longer. She understood that Mr. Bryant decided which trucks should be invoiced early because in her view Mr. Ellis was not close enough to the production process to make a decision of that kind and she remembered Mr. Bryant coming round to her office from time to time to check that she was getting on with her work and invoicing all the trucks she had been told to invoice. However, she also said that the instructions themselves always came from Mr. Ellis and that the visits Mr. Bryant made to the office were at the end of the month.

Mrs. Hewitt's description of how early invoicing worked left me with the strong impression that she was describing different aspects of the two different practices to which I referred a little earlier. She recalled that the lists given to her by Mr. Ellis were of vehicles that she could expect to see coming up on her screen, in other words, through the operation of the MacPac system which would be consistent with the month-end early invoicing practice described by Mr. Bryant but not with the invoicing of vehicles which were not shown on the computer as having reached ‘Workstation 800’. Mr. Ellis's e-mail of 9th February 2000, on the other hand, does not fit with a practice of early invoicing at the month's end.

Mrs. Jean Bennion was responsible for keeping the sales ledger. She said that the practice of early invoicing and the frequent need to issue credit notes and substitute invoices caused a lot of additional work and a certain amount of confusion. She said that she had raised the matter with Mr. Ellis on occasions, but neither she nor Mrs. Hewitt recalled ever having spoken to Mr. Bryant about it.

At the time in question Mr. Geoffrey Williams was the Sales Pricing Manager whose responsibilities included the management of the invoicing section. He described how it was possible to enter a vehicle's identification number into the MacPac system before it had reached the stage of completion in order to trigger the issue of an invoice. His description of early invoicing, with which he strongly disagreed, generally agreed with the description of early invoicing at the month's end given by Mr. Bryant. His understanding that it was approved by Mr. Bryant was to that extent correct. Mr. Williams had a thorough understanding of the MacPac system and the modifications that had been made to it over the course of time, one of which allowed an invoice to be raised in respect of a vehicle at any time after it had been entered on the system. He said that he had expressed his disagreement with the practice of early invoicing to Mr. Ellis, but had not taken it up with Mr. Bryant. He thought there was no point in doing so since the instructions had come from him.

Although he was forcefully challenged by Mr. Fenwick, Mr. Bryant was adamant that he had not authorised the practice of early invoicing during the course of the month and did not know that it had been going on. I have no doubt that Mr. Bryant was a tough and sometimes overbearing manager, but, as I have already said, I found him to be an honest and straightforward witness who did not seek to evade the question and was not given to prevarication. This form of early invoicing cannot be passed off as a relatively harmless way of reducing the float and ensuring that completed trucks did not have to wait to be invoiced for purely administrative reasons. It plainly involved a fraud on Newcourt and one is therefore entitled to look for some cogent evidence to support Mr. Fenwick's submission before concluding that Mr. Bryant authorised it.

It is striking, in my view, that none of those who gave first-hand evidence of the practice said that instructions for this form of early invoicing had come from Mr. Bryant himself; on the contrary, they were agreed that they had come from Mr. Ellis. Nor had anyone taken the matter up with him and there is no direct evidence that Mr. Bryant authorised the practice or that he was aware of it. The inference that this form of early invoicing was carried out with the authority and approval of Mr. Bryant ultimately rested on three rather oblique pieces of evidence. The first was that he was an active managing director who made it his business to know what was going on in ERF. The second was that everyone understood that the instructions had come from him. The third was that early invoicing caused serious administrative problems within ERF and some friction between ERF and its distributors and must therefore have come to his knowledge.

In my view the evidence does not support the conclusion for which Mr. Fenwick contended. I accept that Mr. Bryant was an active ‘hands-on’ manager, but his interest and expertise lay in the fields of engineering and production. That may account for his willingness to sanction early invoicing at the month's end, a practice which other witnesses accepted was endemic in the industry as a whole. He was not as interested in the financial side of the business, however, which he largely left in the hands of Mr. Ellis. I am unable to attach a great deal of significance to general accounts of complaints from distributors. Without knowing the nature of their complaints, their frequency and the extent to which they were directed to Mr. Bryant personally it is impossible to draw the conclusion that they were sufficient to bring the practice to his attention. Given Mr. Bryant's reputation and his obvious involvement in the early invoicing at the month's end, I do not find it surprising that Mrs. Hewitt and others should have assumed that the instructions they received from Mr. Ellis had his approval. Looking at the evidence as a whole, however, I think the true explanation is that they did not and that Mr. Ellis, having realised that invoices could be raised at any stage in the production process, began giving instructions to issue invoices while trucks were in the early stage of assembly as a means of assisting ERF's cash flow. That is consistent with his own evidence in cross-examination which on this question is in my view broadly reliable.

Apart from these major instances, early invoicing also occurred from time to time in two quite different situations: when a batch order was largely, though not entirely, completed; and when a customer specifically requested an invoice before delivery. Neither of these has any direct bearing on the issues that arise in this case and it is unnecessary to say any more about them.

Mr. Fenwick submitted that the practice of early invoicing, especially of the second kind, was a potent cause of Freightliner's loss because it fostered the view within ERF that it was permissible to use any means necessary to ensure that reported results were as favourable as possible. In my view that is to overstate the position significantly. I am unable to accept that Mr. Bryant tolerated, or gave the impression that he would tolerate, fraud of the kind that Mr. Ellis had been perpetrating in relation to the VAT returns and it is significant in my view that as time went on one of Mr. Ellis's purposes in manipulating the accounts was to hide the truth from Mr. Bryant and others within ERF itself. Having heard evidence from a number of those who were employed by ERF at that time, I am quite satisfied that it was not an organisation in which a general climate of dishonesty prevailed or one in which dishonesty in dealings with the outside world was encouraged by Mr. Bryant or anyone else. I think it is possible to draw a distinction between month-end invoicing of the kind to which Mr. Bryant undoubtedly was a party and the invoicing of vehicles at an early stage in their production simply for the purposes of assisting cash flow. I do not think that Mr. Bryant's practice of early invoicing at the month's or year's end contributed in any way to the damage suffered by Freightliner.(b)Spanish invoicing

In the course of the investigations into ERF's financial affairs it was discovered that ERF Spain was in possession of a large number of trucks which it had been unable to sell on the Spanish market. Although ERF treated the trucks as having been sold to ERF Spain and issued invoices accordingly, the terms of sale enabled ERF Spain to avoid paying for them until it had sold them to distributors. It was common ground that ERF Spain had in fact issued invoices to distributors in respect of some of the trucks, despite the fact that they had been delivered on a consignment basis and had not been sold by the distributors to customers. Mr. Bryant said that the managing director of ERF Spain, Mr. Fernando Criado, had falsely reported these as outright sales to the distributors.

Mr. Fenwick submitted that the situation had been brought about by the actions of Mr. Peabody and Mr. Bryant who had put pressure on Mr. Criado to order more trucks than ERF Spain could reasonably hope to sell and had forced him to put corresponding pressure on the distributors in Spain to accept larger numbers of trucks than they could sell. Having done so, Mr. Bryant, it was said, had allowed ERF's accounts department to treat the trucks as having been delivered under firm contracts of sale in order to inflate ERF's figures.

I am satisfied that when Mr. Peabody and Mr. Bryant visited Mr. Criado in early 1999 they did indeed put him under a good deal of pressure to sell more trucks. Mr. Bryant accepted that that was the case and it is consistent with what I was told of his managerial style and that of Mr. Peabody. It does not follow, however, that Mr. Criado was told to issue fictitious invoices to distributors or to report deliveries made on a consignment basis as outright sales. Those who investigated the position in the summer of 2000, in particular, Mr. Wagner, questioned both Mr. Criado and Mr. Bryant about the matter and obtained conflicting responses. Mr. Criado, who sought to lay the blame on Mr. Bryant, promised to provide Mr. Wagner with firm evidence to support his allegations, but he consistently failed to do so and in those circumstances it is hardly surprising that Mr. Wagner felt that he should accept Mr. Bryant's explanation. Mr. Bryant said in evidence that ERF Spain was allowed to operate with very little supervision and it may be that he was at fault in failing to realise that the number of trucks being ordered by ERF Spain was greater than it could expect to sell or that the number of sales being reported might be unreliable. However, the evidence does not in my view support the conclusion that Mr. Bryant or Mr. Peabody was party to a dishonest attempt to inflate ERF's results.(c)Weakening of ERF's management

At the time of its acquisition by Western Star ERF had a full-time managing director, Mr. Bryant, a finance director, Mr. Colin Fuller, and two senior financial managers, Mr. Williamson and Mr. Ellis. At the end of 1997 Mr. Peabody persuaded Mr. Bryant to become managing director of Orion in addition to his duties at ERF, the intention being that he should devote half his time to each company. In the event Orion required more than its share of his attention. Mr. Bryant spent more than half his time in North America dealing with matters unrelated to ERF and part of the time that he spent in this country was also devoted to the affairs of Orion. While he was abroad, however, Mr. Bryant was able to keep in touch with the management team at Sandbach by telephone, fax and e-mail.

When ERF was acquired by Western Star it de-listed from the London Stock Exchange with a consequent reduction in reporting obligations. In addition, Western Star's ability to provide financial support for ERF was expected to reduce the amount of work required in managing its external financing arrangements. Accordingly, when Mr. Fuller left ERF a few months after the take-over the decision was taken not to replace him, since neither Mr. Bryant nor Western Star thought that it was any longer necessary to have someone at board level to oversee the group's finances. As a result the group thereafter operated without a finance director. In early 1998 Mr. Williamson left ERF to become financial controller of Western Star. Again, it was not thought necessary to replace him and Mr. Ellis was left in charge of the Finance department. Although he had no formal accountancy qualifications, he was considered to be hard-working and efficient and was supported by Mr. Giltrap and Mr. Broad, both of whom had, or were in the course of acquiring, professional qualifications. In May 1998 Mr. Ellis was appointed company secretary of ERF. He was supported in that role by Mr. John Pinney who was a qualified chartered secretary with previous experience of acting as a company secretary.

Mr. Fenwick submitted that these changes in the senior management of ERF significantly weakened financial control within the group in a way that had a direct bearing on the damage suffered by Freightliner. I think there is little doubt that the changes I have described did seriously weaken the financial management of ERF. Mr. Bryant was not primarily a financial man and was not particularly well qualified by training or inclination to exercise financial control of the group. He was inclined to accept uncritically what he was told by his senior financial managers and when he became responsible for Orion in addition to ERF the time he could devote to that area of his responsibilities was even more limited. However well Mr. Ellis was thought to have done his job in the past, by the time E&Y (UK) became the group's auditors in the spring of 1998 he was clearly struggling to cope with all the responsibilities that had been placed on him. Moreover, he was not subject to any significant degree of supervision.

However, it does not follow that Western Star was at fault in any relevant respect in reducing ERF's financial management in that way. The obvious risk of doing so was that the records of ERF would not be properly maintained and that the management of ERF and Western Star would not have access to the information needed to enable the business to be conducted efficiently, but at the time no one had any grounds for doubting Mr. Ellis's honesty and there was no reason to think that there was a risk that he might falsify the accounts. Mr. Fenwick did not attempt to explain in any detail how this reduction in the financial staff of ERF helped to cause Freightliner's loss, but in my view the most that can be said is that the presence of a finance director might have deterred Mr. Ellis from attempting to produce false information or, if he had done so, that such a person might have detected the fact. All that is a long way removed from the fraudulent statements which gave rise to Freightliner's liability. In my view the link between the weakening of ERF's management (in which I include the decision to put Mr. Ellis in charge of the Finance department) and the loss suffered by Freightliner is too tenuous to enable it to be regarded as a cause of that loss.(d)Unreasonable pressure on ERF to produce results

It was accepted that Western Star set what were described as “challenging” targets for all its subsidiaries, including ERF. That was Mr. Peabody's way of doing business. There is nothing wrong with that, of course, if all it means is setting targets that are reasonably capable of achievement, albeit with effort. Mr. Fenwick submitted, however, that in reality Western Star put undue pressure on its subsidiaries to perform at levels which they could not realistically expect to achieve with the result that managers were induced to resort to improper practices to keep the parent company happy.

Mr. Burke described how each year the subsidiaries produced forecasts and business plans for the coming year which they presented to Mr. Peabody when he visited them. ERF's forecast for 2000 showed a projected increase of 11.2% in the number of trucks sold, despite the fact that its actual performance in 1999 had fallen short of the projection for that year by 18%. The five-year plan showed ERF increasing its market share from 10.5% in 1999 to 12% by the end of 2004 with a margin rising from 5.3% to 8.9% before declining to 8.4% by the end of the period. He accepted that these plans could fairly be described as “aggressive”. These forecasts were developed by senior management in consultation with Mr. Peabody and one can only conclude that there was considerable pressure on managers from the very top to produce the most optimistic forecasts and to make the company perform in accordance with them. This approach may produce good results, even if targets are not met, but it may also lead managers to manipulate the figures if the company is not performing as well as expected and for that reason it was one of the matters that caused Mrs. Sinderson some concern. In the hands of Mr. Peabody and Mr. Bryant, neither of whom was very tolerant of failure, it was a dangerous tool for improving performance. In my view the forecasts produced by ERF in 1999 and 2000 were unrealistic and were themselves one source of pressure.

In the course of his evidence Mr. Ellis said that he was regularly put under pressure to improve ERF's results at the quarter- and year-end. He said that he would receive a request from Mr. Burke or Mr. Stewart Smith, sometimes through Mr. Bryant, to review various items in the accounts to ensure that they were not over-prudent and that ERF's reported profits were as high as they reasonably could be within the confines of the relevant accounting standards. He said that he was sometimes told that the results needed to be improved by £250,000 or even £500,000 and was expected to review the accounts to see whether that could be achieved. Mr. Vos invited me to reject that part of Mr. Ellis's evidence, but in some respects what he said is consistent with other evidence of Western Star's approach to business and with what Mr. Burke and Mr. Smith said about its approach to accounting. The drawing of accounts involves many matters of judgment and it is possible to apply the same accounting principles (in this case UK GAAP) more or less conservatively. Mr. Smith and Mr. Burke both accepted that it was Western Star's policy to account aggressively, that is less conservatively, within the bounds of what was permissible. I do not accept that either of them simply asked Mr. Ellis to produce a certain figure by more aggressive accounting, but Mr. Burke spoke frequently to Mr. Ellis and I accept that on many occasions they discussed areas of the accounts in which ERF had failed to meet its forecasts or in which there might be legitimate room for improvement. However, I do not accept that Mr. Burke or anyone else encouraged Mr. Ellis to manipulate the accounts in violation of the applicable accounting standards or to improve ERF's results in an artificial manner.

Nonetheless, I accept that there was constant pressure on ERF to report good results; whether it played any part in exposing Western Star, and hence Freightliner, to liability to MN is another matter. Mr. Ellis explained at some length what had led him to falsify the accounts and also what had led him to commit his VAT frauds. In neither case was he motivated by a desire to produce the kind of results that he thought Western Star expected to see. He embarked on the VAT fraud as a means of obtaining additional working capital when funds were tight and persisted in it largely in the hope of avoiding detection. The manipulation of the ledgers which led to the falsification of the year-end accounts was originally dictated by the need to reconcile the company's books with the information previously given in the monthly management reports. Once begun, it too was continued in the hope of avoiding detection. In neither case does it appear that he was involved in falsifying the accounts in order to be able to report figures in line with previous forecasts. The pressure to produce results was not a substantial cause of Mr. Ellis's actions and in any event is too far removed from his misstatements to MN to be regarded as one of the causes of Freightliner's loss.(e)The introduction of Baan Financial

ERF experienced problems with the BaaN system from the outset. In December 1997 Mr. Ellis sent the first of a number of reports to Western Star identifying the problems that were being experienced and the matter was taken up by E&Y (UK) and E&Y(Canada) in the course of their audits in 1998 and 1999. I think Mr. Fenwick was right in saying that the underlying problem was that the system had been introduced at ERF without being properly adapted to ERF's particular needs and without there having been adequate staff training. It was compounded by the decision not to continue to operate the J.D. Edwards system in parallel as a back-up. The critical decisions were all taken by Western Star.

Mr. Vos submitted that there was insufficient evidence of the true nature or causes of the problems with the BaaN system to enable any blame to be laid at Western Star's door, but in my view that overstates the position somewhat. Common sense, supported in this case by the expert evidence of Mr. Alan Ward, suggests that the introduction of a new electronic system for storing and processing financial information is unlikely to be successful unless the staff who are to use it are given adequate training. Moreover, difficulties may be encountered in the introduction of even a well-established system as a result of human error and technical problems. As Mr. Ward confirmed, a limited period of parallel running is highly advisable until it is clear that the new system is operating satisfactorily.

BaaN was a reputable and widely used system and no criticism can be attached to Western Star for deciding to implement it across the group in order to provide a unified accounting and reporting system. The fact is, however, that its introduction at ERF was fraught with difficulties which persisted for many months, despite efforts on the part of ERF, Western Star and BaaN themselves to overcome them. In order to decide who, if anyone, was at fault in relation to the various problems encountered by ERF it would be necessary to consider in some detail the nature of the difficulties encountered at each step, their precise cause, the steps taken to resolve them and, in particular, the part played by Western Star. Mr. Ward was called to give evidence of good practice in the implementation of the BaaN system at a company such as ERF and to express an opinion on whether that practice had been followed in the present case. He was not asked to consider the particular problems that had arisen in this case, what caused them or who was responsible for them and was understandably reluctant to be drawn into that area of debate. He did comment, however, on the absence of technical records of the kind that would be required to undertake an enquiry of that nature.

In my view Western Star as the company with primary responsibility for the implementation of the BaaN system throughout the group was at fault in one respect, namely, in failing to ensure that ERF kept the J.D. Edwards system running in parallel with the BaaN system until the latter was operating satisfactorily. Apart from that, however, although there are grounds for questioning aspects of the way in which it oversaw the implementation of the system, the evidence does not point clearly to failings on the part of

Western Star as having been a significant cause of the problems encountered by ERF.

In any event, I do not think that any shortcomings on the part of Western Star in the introduction of the BaaN system can be regarded as a relevant fault for this purpose or that the accounting problems which arose as a result were sufficiently closely connected with Mr. Ellis's frauds to be regarded as a cause of the damage suffered by Freightliner. At most they gave rise to the circumstances in which Mr. Ellis was faced with problems in reporting which he chose to resolve in a dishonest way. His first step was to produce management reports based on estimates. That would not have been unacceptable in itself if he had explained what he was doing and why, but he did not. Then, when faced at the end of the year with a substantial discrepancy between the monthly reports and the records held on the BaaN system, he chose to manipulate the records rather than bring the problem to the attention of management. In my view whatever shortcomings there may have been in the introduction of the system and whatever the problems to which they might have been expected to give rise, it was not foreseeable that they might have consequences of that kind. The difficulties arising from the introduction of the BaaN system cannot in my view be regarded as a cause of Mr. Ellis's manipulation of the accounts, much less as a cause of his dishonest statements to MN.(f)Accepting management reports based on estimates

It was common ground that by about the end of 1998 Western Star knew that the monthly management reports it was receiving from ERF were based to some extent on estimates and might therefore be inaccurate. Mr. Fenwick submitted that Western Star was at fault in accepting information of that kind and ought to have insisted on receiving reports containing figures derived from ERF's books.

Mr. Burke said that shortly after he learnt that Mr. Ellis's management reports had been based on estimates he received the draft audit report from E&Y (UK) confirming that the statutory accounts for the 1998 year were satisfactory. That led him to understand that there was no material discrepancy between those accounts and the reports he had been receiving during the year. Moreover, the draft management responses to E&Y (Canada)'s Audit Observations Report, which were produced in January 1999 based in part on information provided by Mr. Ellis, indicated that the BaaN system was now providing accurate information and that the earlier problem had therefore been resolved. According to Mr. Burke, the issue did not surface again until late October or early November 1999 when he received the management recommendation letter from E&Y (UK) following the 1999 audit. That letter raised a number of matters that called for action on the part of Western Star, but the company was then heavily involved in the sale of ERF to MN and neither Mr. Burke nor Mr. Peabody appears to have been keen to grapple with them at that stage. It is reasonably clear from Mr. Burke's evidence that they both regarded them as weaknesses that would have to be addressed in due course if the sale to MN did not go through. If it did, of course, they would no longer be Western Star's concern.

Once again, although there are grounds for criticism of Western Star, I am unable to accept that it was at fault in a way that contributed in any material way to the damage that Freightliner has suffered. Once again, the difficulty lies in the fact that Western Star had no reason to think that Mr. Ellis was fundamentally dishonest. In those circumstances I do not think that it was at fault in accepting management reports that were based partly on estimates, especially when the audits of both the 1998 and 1999 year-end accounts appeared to confirm that those reports had been broadly reliable. It is true that, if Mr. Ellis had not made use of estimates in preparing his monthly reports, there could have been no discrepancy at the end of the year between those reports and the year-end figures derived from the ledgers, but that is to say no more than his use of estimates played a part in creating a problem which he chose to resolve dishonestly by manipulating the ledgers, which in turn merely provided the circumstances in which he chose to make dishonest statements to MN. Western Star's acceptance of management accounts based partly on estimates cannot, therefore, properly be regarded as a cause of the damage suffered by Freightliner.(g)Failure to monitor and control ERF

Mr. Fenwick submitted that although Western Star was deeply involved in the management of ERF, it failed to exercise proper control over its subsidiary or to monitor its business adequately. That failure, he submitted, manifested itself in a number of different ways: in a failure to ensure that the management of ERF dealt adequately with the concerns raised by

E&Y (UK) in their Recommendations to Management report issued following the 1998 audit; in a failure to monitor the effects of the introduction of the BaaN system; in a failure to consider the possible implications of the accounting difficulties that arose as a result, in particular the inability to produce monthly reconciliations and the use of estimates in preparing management accounts with the resulting risk of irregularities or errors; in a failure to ensure that ERF maintained adequate accounting records; and in a failure to maintain an adequate internal audit function.

All these complaints, apart from the last one, proceed on the basis that Mr. Peabody, Mr. Stewart Smith and Mr. Bryant were directors of Western Star as well as ERF. However, I do not think that one can simply ignore the corporate structure so as to treat failings on the part of the directors of ERF as failings on the part of Western Star, even when the relationship between the parent and subsidiary is as close as it was in this case. The Recommendations to Management report was provided to ERF and it was the primary responsibility of the board of ERF to take such action as it thought necessary in the light of it. ERF was required to report to Western Star on the steps taken in response to that report and its explanations were placed before Western Star's Audit Committee. The criticisms of Western Star's conduct in monitoring the steps taken by ERF were not explored in cross-examination and I am not satisfied that there was any fault on its part in this respect.

The directors of ERF undoubtedly had a responsibility to ensure that the group maintained proper accounts, but in my view Mr. Vos was right in saying that any complaint that they failed to discharge that responsibility must be made with sufficient clarity and precision to enable them, as well as the court, to know in what respects their conduct is said to have fallen short of what was required. In the event the matter was neither pleaded nor investigated in the degree of detail that would be necessary to enable me to make a finding about it.

The complaint that Western Star did not maintain an adequate internal audit function was likewise not explored with the witnesses and no expert evidence was called in relation to it. By November 1997 Mr. Burke had come to realise that Western Star needed to establish an internal audit function and proposals were produced for consideration by the Audit Committee at its meeting in April 1998. In its Audit Observations Report following the 1998 audit E&Y (Canada) was able to report that the company had begun to develop an internal audit function and in May 1999 a member of the finance department was appointed to carry out and develop further the internal audit process. In the circumstances I am unable to find that Western Star was at fault in failing to operate an adequate internal audit function at an earlier date.(h)Failure to respond properly to the tip-off

I have already described how E&Y (UK) responded to the tip-off received from Mr. Pointon and have explained why in my view they were negligent in failing to reconsider the purchase ledger control account reconciliation produced by Mr. Ellis. However, E&Y (UK) said that if they were at fault, so too was Western Star in failing to respond to the information in such a way as to protect its own interests. In particular they said that Western Star failed to make its own investigation into the subject matter of the tip-off, that it discussed it with Mr. Bryant, despite the fact that he might be one of those to whom it related, that it tried to persuade them that there was nothing in it and that it made enquiries into the source of the information in a way that was likely to discourage any other informant from coming forward.

When Mr. Burke was told about the tip-off he asked Mr. Kendrick to look into it. In view of the fact that E&Y (UK) had not completed their work on ERF's accounts and that no precise information had been given about the nature of the information said to have been false, that was not an unreasonable response. Mr. Pointon's intention had been to alert the auditors to the possibility that some of the information being provided to them might be false and E&Y (UK) were better placed than anyone else to look into the matter. It is difficult to know what more Western Star could usefully have done at that stage. Given the nature of the tip-off, it was undoubtedly unwise, as Mr. Burke himself accepted, to discuss it with Mr. Bryant, but there is nothing to suggest that that actually had any adverse consequences. It had no bearing on Mrs. Sinderson's response to the tip-off, nor did it affect E&Y (UK)'s ability to discover that the purchase ledger control account reconciliation was false. It is said that Western Star failed to follow the matter up adequately, but it has to be borne in mind that the information was very vague and in my view Mr. Burke was entitled to assume that E&Y (UK) had carried out whatever investigations and checks were appropriate to enable them to be satisfied that the accounts gave a true and fair view of ERF's financial position.

In this context it is necessary to mention briefly an e-mail that Mr. Kendrick sent to Mr. Burke on 15th October 1999 in which he said that

"… in the context of the "deep throat" red flag it is particularly incumbent upon both E&Y and management to be diligent, full and frank as we go forward through to the completion of both the statutory audit and the due diligence process. Based on our conversations and John Bryant's conversation with Alison [Sinderson], I don't believe this will or should be an issue."

Mr. Vos submitted that this amounted to an assurance by Mr. Kendrick that there was no need for Western Star to be concerned by the tip-off, but Mr. Burke did not read the message in that way and it seems to me clear that Mr. Kendrick was commenting on the need for complete openness between ERF and its auditors rather than the tip-off itself. In the end, however, I am satisfied that nothing turns on the point.(i)Failure to understand ERF's business

Next E&Y (UK) contended that, if ERF's accounts were materially incorrect, as Freightliner alleged, the group must have been making substantial trading losses and that Western Star itself was at fault in failing to understand or monitor properly ERF's business. The business of assembling trucks was not inherently complex, it was said, and was one which allowed margins to be calculated without any real difficulty. Day to day decisions about the running of the business were based on current information of the kind provided by the monthly management reports. If, therefore, the profitability of the business had begun to decline seriously without anyone being aware of the fact, there must have been a serious failure in the production of information or its assessment by management.

Mr. Bryant confirmed that during 1999 ERF had found it harder to sell trucks and that as a consequence the order book declined. In order to maintain production he put pressure on distributors to take trucks for stock, but in order to persuade them to do so it was necessary for ERF to bear the costs of financing them pending sale. As a result its indebtedness to Newcourt rose from £23 million in January 1999 to about £30 million in October and about £41 million by March 2000. However, Mr. Bryant said that he had not been aware at the time of the way in which that indebtedness was developing. Mr. Fenwick also criticised Mr. Bryant for failing to understand that the cost of components recorded within the MacPac system was revised whenever any significant changes occurred and therefore reflected any savings. Mr. Bryant seems to have thought that the standard cost of producing a vehicle by reference to which margins were calculated was revised only once a year. He may therefore have thought that cost reductions during the course of the year enabled him to give additional discounts, whereas in truth they had already been taken into account.

I think it is fair to say that as managing director Mr. Bryant should have taken more trouble to inform himself about the financial position of ERF and that all those responsible for the group's operations should have analysed with greater care the management information that was being provided to them month by month. However, that information was being manipulated by Mr. Ellis from the autumn of 1997 onwards and I am by no means persuaded that a more diligent approach to financial management would have led them to discover the true position. The audit of the 1998 year-end accounts appeared to confirm that the information that had been provided during the course of the year had been broadly reliable and they had no reason to think that the information provided in the following year was likely to be any less reliable. I am unable to accept, therefore, that Western Star was at fault in this respect.(j)The representations and warranties in the Share Purchase Agreement

Finally it was said that Western Star failed to take proper care of its own interests by agreeing to include in the Share Purchase Agreement the representations and warranties relating to June and December 1999 Accounts and the comprehensive warranty of ERF's tax position despite being aware of several matters that suggested that it was unwise to do so.

The starting point for this argument is the fact that ever since he had received the first draft of E&Y (UK)'s Management Recommendations report in late October or early November 1999 Mr. Burke had been aware that Mr. Ellis had been lying to him for over a year about the use of estimates in compiling the monthly management accounts. Mr. Burke had discussed the matter with Mr. Peabody who in turn had raised it with Mr. Bryant. I am satisfied that all three of them, therefore, knew about it and in those circumstances it is unlikely that Mr. Stewart Smith did not know about it as well. Mr. Fenwick submitted that all the directors of Western Star were therefore aware that Mr. Ellis, who had been responsible for producing most of the financial information given to MN, was prepared to resort to dishonesty to cover up shortcomings within his department. They should therefore have realised that the June and December Accounts might be unreliable.

The difficulty I have with this argument is that it ignores the fact that the June 1999 Accounts had been audited and also the fact that by the autumn of 1999 Western Star had been told that the operation of the BaaN system had improved considerably. Although Mr. Burke and the others knew that Mr. Ellis had lied about the use of estimates and therefore that he was willing to resort to a measure of dishonesty to cover up difficulties within his department, they had no reason to think that he was willing to take the far more serious steps of manipulating the company's books and defrauding Customs & Excise. The audit of the 1999 year-end accounts had shown that there were no significant discrepancies between the monthly management accounts and the annual accounts, which suggested that the estimates used in the production of management accounts during the course of the year had been made in good faith and had been broadly accurate. Although there were good reasons for thinking that Mr. Ellis required assistance and supervision, Western Star did not have reason to think that he was fundamentally dishonest. In the circumstances there was no reason to think that the December 1999 Accounts did not give a true and fair view of ERF's financial position and even less reason for thinking that the June 1999 Accounts did not do so.

In those circumstances, whether it was or was not commercially wise to give the warranties in question, I do not think that the decision to do so can be regarded as negligent or as a fault which contributed to Freightliner's loss.4.The contribution claim

Freightliner contended that, if it was liable to MN in respect of the loss caused by Mr. Ellis's fraud, it was entitled to recover a contribution from E&Y (UK) under section 1 of the Civil Liability (Contribution) Act 1978 on the grounds that they were also liable to MN in respect of the same damage, having negligently provided inaccurate information to MN about ERF's financial position.

Section 1(1) of the Civil Liability (Contribution) Act 1978 provides as follows:

"Subject to the following provisions of this section, any person liable in respect of any damage suffered by another person may recover contribution from any other person liable in respect of the same damage (whether jointly with him or otherwise)."

Section 6(1) provides:

"A person is liable in respect of any damage for the purposes of this Act if the person who suffered it (or anyone representing his estate or dependants) is entitled to recover compensation from him in respect of that damage (whatever the legal basis of his liability, whether tort, breach of contract, breach of trust or otherwise)."

In the present case the damage suffered by MN is the loss it has sustained as a result of the purchase of ERF. Freightliner is liable in respect of that damage because it is vicariously liable for the fraud of Mr. Ellis which caused MN to enter into and complete the Share Purchase Agreement. If Freightliner is to obtain a contribution from E&Y (UK) it must show not only that E&Y (UK) are liable to MN but also that they are liable in respect of the same damage within the meaning of the Act.(a)Did E&Y (UK) owe a duty of care to MN?

I have already referred to the main authorities dealing with liability for negligent misstatement on the part of auditors. At the time E&Y (UK) gave their audit statement in relation to the 1998 accounts no one had the sale of ERF to MN in contemplation. The most that could be said is that the abortive negotiations with Daimler-Chrysler had shown that Western Star was not averse to selling ERF if acceptable terms could be agreed, but in the world of business that is not saying very much. It was certainly not a situation in which E&Y (UK) could reasonably contemplate that any particular person would rely on the audited accounts in connection with any particular transaction.

By the time the 1999 audit statement was issued the position had changed. E&Y (UK) were aware that Western Star was actively pursuing negotiations with MN for the sale of ERF and were also aware not only that MN wanted to see the audited accounts but that it had insisted on being provided with a copy of them before embarking on its due diligence. Mrs. Sinderson may not have known exactly what aspects of the accounts MN was mainly interested in, but I am satisfied that she must have known that MN would rely on them as providing a reliable statement of ERF's financial affairs as at 30th June 1999.

In Electra Private Equity Partners v KPMG Peat Marwick the court had no difficulty accepting the concept that an auditor could incur liability to a potential investor in the company and in my view no distinction can be drawn between a potential investor and a potential purchaser. Indeed, in ADT Ltd v Binder Hamlyn [1996] BCC 808 the purchaser of a company succeeded in its claim against the auditors on those grounds after they had given it a direct confirmation that they stood by the audited accounts. The court considered that by doing so the auditors had made an independent statement to the purchaser that the accounts were reliable.

The present case differs in certain important respects, however. In the first place, there was no direct communication of any kind between E&Y (UK) and MN. That is not necessarily fatal to the claim since it was recognised in Hedley Byrne v Heller itself (see per Lord Morris of Borth-y-Gest at pages 502–503 and Lord Hodson at page 5140) that liability for negligent misstatement may arise in cases where the maker of the statement intends that the person to whom it was originally made will communicate it to another for him to rely on for a particular purpose in connection with a particular transaction. In order to hold the maker of the statement liable, therefore, the same requirements must be satisfied, albeit at one remove.

In this case Mrs. Sinderson was clearly aware that both Western Star and MN were likely to rely on the accuracy of the audited accounts in their negotiations for the sale and purchase of ERF. However, that by itself is not enough to give rise to liability in circumstances where the primary purpose of producing audited accounts is to enable the shareholders to exercise their collective powers of management. That much is clear from what was said in Caparo v Dickman . As in the case of Western Star, the critical question in my view is whether E&Y (UK) provided the audited accounts to MN through Western Star in such circumstances as make it fair to hold that they assumed a responsibility to MN for their material accuracy. For the reasons given earlier I do not think that much assistance is to be gained from the existence of the “hold harmless” letter. In particular, I do not think that the expression “Information” can be construed as extending to the audit report itself, notwithstanding the way in which that expression was defined. The fact that MN was, and was known to be, receiving advice from Deloitte & Touche is a factor which tends to count against the existence of a duty of care since the very purpose of instructing them was to enable MN to obtain independent verification of the audit procedures implemented by E&Y (UK). The most important factor in my view, however, is the absence of any direct relationship between E&Y (UK) and MN. When considering the position of statutory auditors I think it is important to maintain a clear distinction between those cases in which all that can be said is that the auditors can foresee that a third party (perhaps even an identifiable third party) may make use of the company's accounts when deciding on a course of action and those cases in which the auditors have entered into a closer relationship with a third party of the kind necessary to give rise to an assumption of responsibility. A failure to observe such a distinction creates the risk of imposing a duty of care on auditors in favour of third parties in cases where they cannot fairly be said to have stepped outside their statutory function.

In the present case all that can be said is that Mrs. Sinderson knew that Western Star would provide copies of the audited accounts to MN and that MN might rely on them. She was not asked to agree to copies being provided to MN for any particular purpose, or indeed at all, because Western Star was entitled to make them available to anyone it chose without her agreement. In the circumstances it is difficult to see how the position of MN in this respect could be any stronger than that of Western Star. In neither case can it be said that E&Y (UK) provided the accounts for the purpose of the transaction or otherwise acted in such a way as to assume a responsibility for their accuracy. In these circumstances I am satisfied that E&Y (UK) did not owe a duty of care to MN and that Freightliner's claim to recover a contribution must therefore fail. That makes it unnecessary for me to consider the other issues that arise in relation to this head of claim, but since they were fully argued I propose to express my view on them as briefly as I can.(b)Was there a breach of duty?

If I had concluded that E&Y (UK) owed a duty of care to MN, the next question would have been whether there had been a breach of that duty. The nature of any duty owed by E&Y (UK) to MN would have been the same as that which was said to have been owed to Western Star, namely a duty to exercise reasonable care to ensure that the audit statement was correct. Since it was common ground that in conducting its audits of ERF E&Y (UK) had failed to meet the standards to be expected of a reasonably competent auditor in the respects described earlier, it follows that there would have been a breach of that duty of care. Nothing more need therefore be said about it.(c)For what damage might E&Y (UK) be held liable to MN?

It is necessary, however, to consider in a little more detail for what damage E&Y (UK) would be liable and whether it would be the same damage as that in respect of which Freightliner is liable to MN within the meaning of the 1978 Act.

Mr. Fenwick submitted that E&Y (UK) could only be held liable to MN for the loss caused by the inaccuracy of its audit report, that is, for a proportion of the damages recoverable by MN equal to the difference between the value of ERF as it appeared from the accounts and its true value at 30th June 1999. In my view that is correct and follows from the application of the principles set out in South Australia Asset Management Corporation v York Montague Ltd . Mr. Vos accepted that Freightliner could not recover a contribution in respect of that element of its liability to MN which represented the original purchase price and it follows from that alone that E&Y (UK) could not be held liable for the whole of the loss that MN is entitled to recover from Freightliner.

The meaning of the expression “the same damage” in section 1(1) of the Act was considered by the House of Lords in Royal Brompton NHS Trust v Hammond [2002] 1 W.L.R. 1397 . In that case the claimant, the employer under a major construction project, brought proceedings against the architects to recover damages for breach of contract and negligence in certifying extensions of time in favour of the contractor and for delay, loss and expense arising out of negligent advice to lay a damp-proof membrane. The architects made a Part 20 claim against the contractor claiming a contribution under the 1978 Act on the grounds that it was liable to the plaintiff for delay in completing the work. An application by the contractor to strike out the architects' claim turned on whether they were both liable for the same damage within the meaning of the Act.

The leading speech was given by Lord Steyn, but a convenient and succinct analysis of the principles most relevant to the problem before me can be found in the speech of Lord Bingham at page 1401 where he said: “5.

It is plain beyond argument that one important object of the 1978 Act was to widen the classes of person between whom claims for contribution would lie and to enlarge the hitherto restricted category of causes of action capable of giving rise to such a claim. It is, however, as I understand, a constant theme of the law of contribution from the beginning that B's claim to share with others his liability to A rests upon the fact that they (whether equally with B or not) are subject to a common liability to A. I find nothing in section 6(1)(c) of the 1935 Act or in section 1(1) of the 1978 Act, or in the reports which preceded those Acts, which in any way weakens that requirement. Indeed both sections, by using the words “in respect of the same damage”, emphasise the need for one loss to be apportioned among those liable.6.

When any claim for contribution falls to be decided the following questions in my opinion arise. (1) What damage has A suffered? (2) Is B liable to A in respect of that damage? (3) Is C also liable to A in respect of that damage or some of it? … I do not think it matters greatly whether, in phrasing these questions, one speaks (as the 1978 Act does) of “damage” or of “loss” or “harm”, provided it is borne in mind that “damage” does not mean “damages” (as pointed out by Roch LJ in Birse Construction Ltd v Haiste Ltd [1996] 1 WLR 675 , 682) and that B's right to contribution by C depends on the damage, loss or harm for which B is liable to A corresponding (even if in part only) with the damage, loss or harm for which C is liable to A. This seems to me to accord with the underlying equity of the situation: it is obviously fair that

C contributes to B a fair share of what both B and C owe in law to A, but obviously unfair that C should contribute to B any share of what B may owe in law to A but C does not."

Lord Steyn accepted that Act should be given a broad interpretation, but he too emphasised that there must be liability in respect of the same damage and that "damage" does not mean the same as "damages". Agreeing with Lord Bingham, he rejected any suggestion that the expression "the same damage" could be read expansively as meaning substantially or materially similar damage. He held that the architects and the contractor in that case were not liable to the plaintiff in respect of the same damage since the architects' liability (if established) was for the consequences of their advice whereas the contractor's liability was for failing to complete the works on time.

The fact that liability arises in different ways does not prevent it from relating to the same damage: that much is clear from section 6(1) of the Act. The situation in the present case, however, is that Freightliner is liable in deceit to indemnify MN in respect of all the losses flowing from the transaction whereas E&Y (UK), if they had been liable to MN, would have been liable to indemnify it only in respect of the loss flowing from the inaccuracy of their audit statement. Mr. Vos submitted that the damage suffered by MN in this case was the loss it sustained as a result of purchasing ERF and that both MN and E&Y (UK) are therefore liable in respect of the same damage, albeit to a different extent. In my view that is right. MN based its decision to acquire ERF in part at least on the audited accounts which it believed to be materially accurate and as a result it suffered damage. The extent to which it is entitled to recover that loss from different persons depends on the nature of their wrongdoing, but the damage is the same. Support for that conclusion can be found in the passage from the speech of Lord Bingham in the Royal Brompton al case, to which I referred earlier, in which he expressly envisaged that a contribution could be recovered from a person who was liable for only part of the loss in respect of which the person claiming a contribution was liable. It is also consistent in my view with the reasoning of Lord Hoffmann in South Australia Asset Management Corporation v York Montague Ltd at page 216D where he said that when assessing damages for breach of a duty of care in providing information it is necessary to compare the loss the claimant has actually suffered with what his position would have been if he had not entered into the transaction and then ask what element of that loss is attributable to the inaccuracy of the information. That seems to me to involve not only a recognition that the claimant may have suffered greater loss as a result of entering into the transaction than he can recover from the defendant, but also that in reality the claimant suffers one loss, for only part of which he can hold the defendant liable. In my view, therefore, if E&Y (UK) had been liable to MN for negligent misstatement they would have been liable in respect of the same damage as Freightliner, but to a limited extent. (d)Apportionment of loss

Finally there would come the question of apportioning the loss. Neither party felt able to make detailed submissions on this question in advance of learning my conclusions on the main issues in the action and in the event, since I have concluded that E&Y (UK) did not owe a duty of care to MN, it does not arise. In those circumstances I do not think it appropriate to express any view on the matter.5.Conclusion

For the reasons given in this section of the judgment I have reached the conclusion that Freightliner's claim against E&Y (UK) fails.D.Freightliner's claim against E&Y (Canada)1.Breach of duty as auditors

E&Y (Canada) were auditors of the Western Star group for the years ending 30th June 1998 and 30th June 1999 and in carrying out that function were bound to act in accordance with the standards of skill and care to be expected of a reasonably competent Canadian auditor. Freightliner contended that they failed to do so in two respects: in failing to make appropriate reports to management and in failing to respond adequately to information received from sources outside the group.(a)Failing to make appropriate reports to management

There are two limbs to this complaint: the first is that E&Y (Canada) failed to report the concerns expressed by Mrs. Sinderson about Mr. Ellis's competence and integrity; the second is that they approved the issue of an Audit Observations report that incorporated comments made by Mr. Ellis following the audit of ERF's accounts for the year ending 30th June 1998 which had previously been approved by Mrs. Sinderson without obtaining confirmation from her that she still regarded them as satisfactory.(i)Failing to report the contents of the 'ERF Concerns' memorandum

I have described earlier how Mrs. Sinderson came to draft her 'ERF Concerns' memorandum, how she sent a copy to Mr. Kendrick and later discussed its contents with him. Freightliner submitted that Mr. Kendrick as the group's auditor was negligent in failing to bring her concerns about Mr. Ellis to the attention of Mr. Burke or any of the other senior managers of Western Star.

Mr. Frank Kelly, an accountant with extensive experience of Canadian auditing standards and procedures who was called as an expert witness by Freightliner, was of the firm opinion that Mr. Kendrick as the group's primary auditor ought to have informed Mr. Burke or someone else at Western Star of the fact that Mrs. Sinderson had reservations about Mr. Ellis's competence and integrity and should also have brought it independently to the attention of the Audit Committee. He considered that, although Mr. Kendrick could be expected to have discussed Mrs. Sinderson's views with her, he ought to have exercised his own professional judgment in deciding whether to relay her concerns to Western Star and thought that they were of sufficient importance to require such a report to be made. In what manner and in what terms it should be made would depend in part on the outcome of his discussions with Mrs. Sinderson.

Mr. Robert Nobes, the expert auditor called by E&Y (Canada) whose experience as an auditor in Canada was no less impressive than that of Mr. Kelly, recognised that in her memorandum Mrs. Sinderson was voicing criticisms of Mr. Ellis's character and abilities and he too thought that it was a matter of professional judgment on the part of Mr. Kendrick how they should be handled. Taking what was said in the memorandum at face value he did not think that the criticisms were so serious that they needed to be taken straight to senior management to enable them to consider whether Mr. Ellis should be dismissed. He thought that Mrs. Sinderson had become rather frustrated with Mr. Ellis and was letting off steam rather than raising matters that she thought needed to be drawn to the attention of senior managers to enable them to consider what action to take. He pointed out that she could have raised the matter in her own Recommendations to Management report, but had not thought it necessary to do so and could, if necessary, have asked Mr. Kendrick to include a reference to them in his Audit Observations report. He accepted, however, that following their conversation it was left to Mr. Kendrick to decide what to do about the problem and that he had to deal with it somehow. He was inclined to accept that Mr. Kendrick as the group auditor had an obligation to keep an eye on the problem, but he was of the view that it was primarily Mrs. Sinderson's responsibility to take the matter forward if she thought it necessary to do so. He accepted that it was a matter about which Mr. Kendrick had to form his own judgment, but he did not think that matters had reached the point at which the only course open to a reasonably competent auditor was to draw the matter to the attention of the Audit Committee.

When assessing for this purpose the nature of the criticisms made of Mr. Ellis in the 'ERF Concerns' memorandum it is necessary to bear in mind that Mr. Kendrick had the benefit of discussing them with Mrs. Sinderson which no doubt gave him a better understanding of what was really bothering her. Mrs. Sinderson herself said in evidence that when she wrote the memorandum her doubts about Mr. Ellis were developing but had not reached the point at which she considered she had sufficient grounds for telling the directors that there was a problem with the financial controller. On the other hand, she clearly did regard her concerns about him as something that Mr. Kendrick ought to have in mind as part of the information at his disposal as auditor of Western Star, even though she left it to him to decide what to do with that information. I infer from this that the purpose of the proposed meeting with Mr. Bryant was partly to share her concerns with him and to obtain his response and partly to obtain a better insight into how well it was thought Mr. Ellis was doing his job and how he was regarded generally. It is very likely that when she discussed the memorandum with Mr. Kendrick she made all that clear to him.

Paragraph 5220.07 of the handbook published by the Canadian Institute of Chartered Accountants ("the CICA Handbook") which provides guidance to accountants practising in Canada states that an auditor should communicate to the audit committee any significant weaknesses in internal control which he identifies in the course of his audit. The question in this case is whether Mrs. Sinderson's concerns about Mr. Ellis amounted to evidence of a significant weakness in internal control, and whether, even if they did not, any reasonably competent auditor in the position of Mr. Kendrick would have drawn them to the attention of Western Star's Audit Committee or its senior management.

Although her memorandum could be understood without further explanation as casting serious doubts on Mr. Ellis's ability and integrity, Mrs. Sinderson described her comments as “concerns” and I am satisfied that that is what they were. In other words, they were matters that she thought should be investigated with Mr. Bryant before deciding whether there were grounds for action. It is not so much a matter of watering down the memorandum, as Mr. Vos suggested, as of understanding what information reached Mr. Kendrick as a result of his reading of the memorandum and his subsequent discussion with Mrs. Sinderson. At that stage in the audit process she had not identified what could properly be described as serious weaknesses in internal controls and accordingly, I do not think that the situation fell within the ambit of paragraph 5220.07 of the CICA Handbook.

Once Mrs. Sinderson had told Mr. Kendrick about her concerns he had a duty as primary auditor to decide what to do with that information. Although I do not think that it was negligent of him not to put it before the Audit Committee, there is still the question whether he ought to have followed it up, at least by ensuring that Mrs. Sinderson had resolved the matter to her own satisfaction. Although I think that many auditors faced with that information would probably have taken that step, I am not persuaded that Mr. Kendrick was negligent in failing to do so. What Mrs. Sinderson had reported to him were concerns of a kind that she ought to have raised with Mr. Bryant but which she could be expected to resolve for herself in the course of carrying out her audit procedures. In my view he was entitled to leave the matter in her hands and to take no further action unless and until he heard further from her.(ii)The Audit Observations

E&Y (Canada) began preparing their Audit Observations following their audit of the 1998 accounts in October of that year. A draft produced on 29th October contained comments on a number of accounting and financial control problems at ERF, including the absence of monthly closing procedures resulting from difficulties with the BaaN system. It was noted that ERF had not been able to derive a trial balance from the system during the year or for year end purposes until significantly after the balance sheet date.

An amended version of the document was sent to Mrs. Sinderson for her comments on 22nd November and another version was sent on 23rd November. Both made less of the problems with the BaaN system than the first draft, although they both referred to ERF's inability to obtain a trial balance of the general ledger. Shortly after, on 24th November, Mrs. Sinderson sent a copy of the ‘ERF Concerns’ memorandum by fax to Mr. Kendrick.

On 10th December Mr. Ellis sent Mr. Kendrick some draft management comments responding to the Audit Observations. They included the following comment:

“Although we would agree that there was no trial balance available at each month end, the figures provided on a monthly basis were generated from reports produced by the other systems in place within ERF, i.e. MACPAC, Motis and the warranty contract maintenance systems. These are proven systems from which accurate information has been obtained in the past which was reconciled to the previous financial systems J.D. Edwards.

To ensure that a full and accurate trial balance was available at the year end every line item was reconciled to give both ERF and E&Y total comfort in the year end result produced.”

On 11th December the draft ERF management observations were sent to Mrs. Sinderson for her comments. She replied on 15th December saying that they were “by and large all right” and although her response suggested that she might have some reservations, she did not take issue with the passage quoted above.

By mid-January the Audit Observations report had been amended to incorporate the comments received from Mr. Ellis. In particular, it included the following passage under the heading ‘Accounting Estimates’:

“ERF accepts that during the year a number of estimates were put forward in the production of the monthly accounts. However, at the year end, a complete and accurate trial balance was made available where every line item was reconciled, therefore, giving both ERF and Ernst & Young complete comfort in the year end result produced.” The draft Audit Observations report presented to Western Star's Audit Committee on 25th January differed in some respects from the earlier versions, but this passage remained unchanged.

On 15th February Mrs. Sinderson sent an e-mail to Mr. Kendrick telling him that she was due to meet Mr. Bryant in two days' time. She commented on the fact that the accounts were not ready due to Mr. Ellis's delays and failure to submit information and said that she would like to discuss with him how best to raise with Mr. Bryant the subject of Mr. Ellis's poor performance. She asked Mr. Kendrick to call her when he got in. He failed to do so.

On 19th April there was a further meeting of the Audit Committee at which a revised version of the Audit Observations report was considered. The purpose of that report appears to have been to inform the committee of the progress made in dealing with the auditors' recommendations and it is unclear whether E&Y (Canada) were directly involved in producing it.

Mr. Kelly agreed that when compiling the Audit Observations that were submitted to Western Star's Audit Committee on 25th January Mr. Kendrick was entitled to rely on Mrs. Sinderson's assurance that the management comments received from ERF were acceptable. However, he considered that the continued delay in completing the accounts and the note of concern sounded by Mrs. Sinderson in her e-mail of 15th February should have led him to question whether she was still satisfied with that management response. He thought that if he failed to do so, there was a risk that members of the Audit Committee might be misled into thinking that the problems at ERF had been resolved. Mr. Kendrick did not ask Mrs. Sinderson whether she stood by her earlier comments and Mr. Vos submitted that in failing to do so he failed to exercise the degree of skill and care to be expected of a reasonably competent auditor.

Mr. Nobes agreed that as primary auditor Mr. Kendrick should have responded to Mrs. Sinderson's request for him to contact her to talk about Mr. Ellis's performance and he also accepted, somewhat reluctantly, that an auditor ought to draw the client's attention to any management response which was clearly incorrect, although he regarded management responses as essentially the responsibility of managers and did not think that an auditor had a duty to review in detail everything they said.

The evidence of both experts supports the conclusion that until the final version of the Audit Observations report has been submitted to the Audit Committee an auditor has a continuing duty to review its contents, including any management responses, and to draw the client's attention to anything that he knows to be incorrect or misleading. That does not mean, however, that the auditor has a continuous duty to review all management responses in order to satisfy himself that they are correct. How active the auditor needs to be in this respect must to some extent be a matter of professional judgment. Mrs. Sinderson had expressed a view about the management response in question which Mr. Kelly agreed Mr. Kendrick was entitled to accept at face value and nothing had happened in the intervening period to suggest that she might have changed her mind on that particular question. Nor, despite her continuing frustration at Mr. Ellis's inability to provide information when required, was there anything in her e-mail of 15th February to suggest that she might by then have formed a different view. Although there may be other reasons why Mr. Kendrick should have contacted Mrs. Sinderson in response to her message, I do not think that he was negligent in failing to ask her prior to the meeting of the Audit Committee in April whether the comments she had originally made still held good.(b)Failing to respond adequately to the tip-off and the Misener rumour

One of the issues surrounding the tip-off was whether Mr. Kendrick or Mr. Misener, one of Newcourt's senior employees, was the first to tell Mr. Burke that there might be a problem with ERF's accounts. In my view little, if anything, turns on this question. Mr. Burke recalled that on 21st or 22nd September 1998 he had received a telephone call from Mr. Misener in the course of which Mr. Misener told him that an anonymous call had apparently been made to E&Y (UK) saying that misrepresentations had been made to ERF's auditors with the knowledge of a senior member of its management. This was the so-called “Misener rumour” to which I referred earlier. Mr. Misener said that he had been asked by Mr. Nullmeyer, the most senior manager at Newcourt directly responsible for Western Star's business, to make the call. Mr. Burke said he remembered mentioning the matter to Mr. Stewart Smith and Mr. Smith said he had a recollection of Mr. Burke coming into his office and saying something about a rumour. He could not remember any further details, however.

Mr. Nullmeyer said that he had first become aware of this matter when he received a telephone call from the chief executive officer of Newcourt, Mr. Hudson. Someone, perhaps Mr. Peabody or Mr. Bryant, had apparently spoken to Mr. Hudson suggesting that Newcourt might be the source of a rumour about ERF's finances. Mr. Hudson had asked Mr. Nullmeyer whether he or Mr. Misener knew anything about it and had asked him to find out more. Mr. Nullmeyer said he delegated that task to Mr. Misener. Mr. Misener said he called Mr. Burke straight away to assure him that the rumour had not come from Newcourt and to see what more he could find out.

Mr. Misener admitted that his own recollection of his conversations with Mr. Nullmeyer and Mr. Burke was rather vague, but he was fairly confident that Mr. Burke was already aware of the rumour by the time he spoke to him and he was adamant that he had not said anything about a telephone call to E&Y (UK) or about misrepresentations being made to the auditors.

All these conversations took place a long time ago and I do not think that any of the witnesses had a very clear recollection of exactly what was said. In Mr. Burke's case there is the added difficulty that he had conversations with a number of people within a short space of time. Mr. Kendrick spoke to others apart from Mr. Burke, in particular Mr. Arthur, a senior partner of E&Y (Canada). It is possible that he, rather than Mr. Peabody or Mr. Bryant, might have been the person who originally spoke to Mr. Hudson and that the first intimation of the tip-off reached Mr. Burke by that route, but I think it more likely that by the time Mr. Burke spoke to Mr. Misener the information had already reached him from Mr. Kendrick.

Mr. Burke said that he asked Mr. Kendrick to look into the tip-off and he accepted that Mr. Kendrick may have told him that E&Y (UK) were already looking into it as part of their audit work. That makes perfectly good sense on both sides. Mr. Kendrick was the primary point of contact between Mr. Burke and Ernst &Young generally, as well as being the partner of E&Y (Canada) responsible for the Western Star account. Given that E&Y (UK) were currently engaged in their audit of ERF, it would have been surprising if Mr. Burke had not asked Mr. Kendrick to look into the tip-off since he would expect the auditors to assess it and take it into account in the course of their work in any event. The natural response from Mr. Kendrick would be to say that Mrs. Sinderson and her team were looking into it. I find it difficult to believe that Mr. Burke expected E&Y (Canada) to mount an independent investigation and I am unable to accept that he did so. I am unable to accept, therefore, that E&Y (Canada) entered into a contract of any kind with Western Star to investigate the tip-off.

E&Y (Canada)'s audit report on the Western Star group's consolidated accounts for the year ending 30th June 1999 was dated 24th August 1999 which was the date on which the audit was substantially completed. Nonetheless, paragraphs 5405.02 and 5405.13 of the CICA Handbook recognise a continuing requirement for auditors to respond to new information coming to their attention which might affect the accounts or their opinion on them. Paragraph 5405.13 in particular provides that if the auditor becomes aware of a possible misstatement that might have affected his report he should discuss the matter with management and, if necessary, with the board.

Mr. Kelly considered that Mr. Kendrick ought to have to satisfied himself that ERF's accounts were reliable by discussing the implications of the tip-off fully with Mrs. Sinderson and by taking active steps to ensure that her team had taken adequate steps in response to it. He also considered that in order to comply with paragraph 5405.13 Mr. Kendrick should have discussed the tip-off with Western Star's management and Audit Committee. Mr. Nobes took a rather different view. He acknowledged the duties set out in the CICA Handbook, of course, but he regarded the tip-off as little more than a rumour which at that stage was not supported by firm evidence of any kind. He considered that, having discussed the matter with Mrs. Sinderson in some detail, Mr. Kendrick was entitled to rely on her and her team to respond as they thought appropriate to the tip-off in completing their audit of ERF's accounts. Accordingly, unless she expressed further concerns, he was entitled to assume that the accounts as certified by E&Y (UK) were satisfactory.

Paragraph 5135.14 of the CICA Handbook says that if an auditor encounters circumstances which make him suspect that the financial statements are materially misstated he should perform procedures to confirm or dispel that suspicion. Mr. Nobes referred to the tip-off many times in the course of his evidence as an "unsubstantiated rumour" which led Mr. Vos to accuse him of seeking to play down its significance. However, not all matters which might alert an auditor to the possibility of error or fraud are of the same cogency and I think a distinction can properly be drawn between the discovery by an auditor of something within the company's books or records that gives rise to a suspicion of material error or fraud and the receipt of an indirect and largely unsubstantiated suggestion that false information of an unspecified kind may have been given to the auditors.

Mr. Kendrick knew that the tip-off in the present case came from an apparently reliable source and, although not specific, was regarded by Mrs. Sinderson as something that needed to be taken seriously. Nonetheless, I find it difficult to accept that it was a matter that he ought necessarily have referred to the Audit Committee. Paragraph 5405 of the CICA Handbook seems to me to be directed to the situation in which the auditor has reason to think that the accounts are misstated in some particular respect, which in many cases may itself involve the exercise of professional judgment. I do not think that a tip-off of the kind that was received in the present case was of that kind, or at least that it was so clearly of that kind that any reasonably competent auditor would have thought it necessary to discuss it with the Audit Committee.

In my view the real question is whether Mr. Kendrick was entitled to trust Mrs. Sinderson and her team to take whatever steps were appropriate in response to the tip-off, or whether he owed a duty to Western Star to monitor her response in sufficient detail to satisfy himself that she had taken what he would regard as appropriate steps. Mr. Kelly said that although Mr. Kendrick had no reason to doubt Mrs. Sinderson's competence, the tip-off was of such potential significance to Western Star that any reasonably competent primary auditor would have taken an active role in overseeing or directing its investigation which would involve gaining an understanding of, and approving, the procedures to be followed by E&Y (UK), the results of those procedures and the conclusions reached as a result of them. In other words, Mr. Kelly thought that Mr. Kendrick should effectively have taken over responsibility for deciding not only how E&Y (UK) should respond to the tip-off but for ensuring that their response was properly implemented.

Although I accept that Mr. Kendrick did owe his client a duty to satisfy himself that E&Y (UK) had properly taken account of the tip-off when deciding whether ERF's accounts were materially accurate, I am not persuaded that he owed it a duty to take as active a role as Mr. Kelly suggested. Nor am I persuaded that it would have made any difference to the final outcome if he had done so. Mr. Kelly did not suggest that Mr. Kendrick ought to have reviewed all the details of the audit procedure, so at some point he was entitled to trust Mrs. Sinderson's professional judgment. How active the primary auditor needs to be in a situation of this kind must depend to some extent on the nature of the information that has come to light, but where the auditor dealing with the subsidiary's accounts is a partner in an associated firm of high standing I do not think that the primary auditor can be criticised for placing a good deal of reliance on his or her work. Again, to a large extent it must be a matter for professional judgment. In the present case, for example, Mr. Kendrick might have asked Mrs. Sinderson whether she intended to review representations received from management generally and should have warned her against limiting the review to too narrow an area. However, it is likely that when Mrs. Sinderson related her conversation with Mr. Pointon to Mr. Kendrick she gave him the impression (which she herself had formed) that the tip-off related to information currently being provided to the auditors in relation to sales and margins on second-hand vehicles traded in under the buy-back arrangements, rather than information that had been provided some time earlier. In the circumstances Mr. Kendrick could not have been expected to identify specific representations in unrelated areas, such as the purchase ledger control account reconciliation, for further review. If he had asked for details of what steps had been taken in response to the tip-off he would probably have been told that the team had reviewed all management representations they considered relevant. I think he would have been entitled to accept an assurance of that kind in this case and I do not think he could have been expected to take the matter any further.

In the circumstances Freightliner has failed to persuade me that Mr. Kendrick was negligent in the way he responded to the tip-off or that any breach of duty on his part was a contributory cause of E&Y (UK)'s failure to review the purchase ledger control account reconciliation.2.Failing to act with reasonable skill and care in connection with the due diligence exercise

E&Y (Canada) as Western Star's auditors were asked to provide general accountancy advice and assistance in connection with the sale of ERF to MN. For that purpose Mr. Kendrick visited England during the due diligence exercise to provide support to the negotiating team and to answer questions raised by Deloitte & Touche in the event that Mrs. Sinderson was unavailable for any reason. Clearly they had an obligation to exercise reasonable skill and care in providing such advice and assistance.

Mr. Vos submitted that Mr. Kendrick was negligent in performing his duties in connection with the due diligence exercise in three respects: in failing to exercise reasonable skill and care to ensure that ERF's accounts gave a true and fair view of its financial position; in failing to inform Western Star of Mrs. Sinderson's concerns about Mr. Ellis's competence and integrity; and in failing to investigate the tip-off properly. In my view, however, the function that E&Y (Canada) was asked to perform in relation to the due diligence exercise did not involve that kind of monitoring of ERF's affairs. Insofar as E&Y (Canada) owed a duty of care to Western Star in relation to matters of that kind their duty arose from their appointment as auditors of the Western Star group and have already been considered in that context.3.Contributory fault

In common with E&Y (UK) E&Y (Canada) maintained that if any breach of duty on their part had caused loss to Western Star, Western Star itself was partly to blame for that loss by failing to take reasonable care to protect its own interests. E&Y (Canada) relied on the same matters as E&Y (UK).

In view of the conclusions I have reached on the issue of liability this question does not arise. However, for the reasons explained earlier I do not think that Western Star was at fault in this case in failing to take proper care of its own interests.4.Conclusion

For all these reasons Freightliner's claim against E&Y (Canada) also fails.
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