

Limiting and disclaiming liability

One clause can make all the difference.

Over the past 20 years, the accounting profession has been increasingly subject to professional negligence actions. Apart from direct claims brought by their clients, accounting firms are continually faced with law suits by third parties in respect of their professional services. At times, the claims can be so catastrophic as to bring down entire practices.

It is, therefore, essential that certified public accountants (CPAs) employ proper risk management techniques to minimise their liability exposure. One option which CPAs should seriously consider is to exclude or limit potential liabilities:

- (in the case of non-statutory audit work carried out for their clients) by a term in the engagement letter; and
- (in the case of third parties) by a disclaimer.

Limiting or excluding liability to clients

Given the contractual relationship between a CPA and its client, any term seeking to restrict or exclude liability must be expressly agreed by the client and included in the engagement letter.

At present, however, CPAs are prohibited by section 165 of the Companies Ordinance from contractually disclaiming and limiting liability towards their audit clients in respect of statutory audit appointments under the Companies Ordinance, Cap 32. This prohibition, though, does not extend to non-statutory audit work and non-audit engagements. On this basis, subject to any relevant foreign law, limitation or exclusion clauses can be introduced into engagement letters in respect of audit appointments of foreign companies that are not governed by the Companies Ordinance.

As CPAs are paid by a client to provide professional services, it is generally more appropriate for them to seek to limit (as opposed to exclude) their liability towards their clients. The usual way in which CPAs limit their liability is to negotiate a cap on their maximum liability for breach of contractual obligations or negligence. The cap may be either a specified amount of money or calculated as a multiple of the fees paid. As discussed further below, in order to be enforceable, limitation (as well as exclusion) clauses require careful drafting and are subject to a test of reasonableness.

Excluding liability towards clients is appropriate in limited circumstances. It is common practice for CPAs to include in their engagement letters a total exclusion of liability for claims by their clients involving fraud, misrepresentation or wilful default on the part of the clients or their employees.

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Disclaiming liability against third parties

The law concerning accountants' liability to third parties remains a developing area. Despite a growing body of case law, it is often difficult (if not impossible) to predict with certainty the extent of a CPA's potential liability to a third party in a particular situation.

In the light of this, the need to adopt proper disclaimers is particularly critical when it comes to protecting CPAs against the risk of inadvertently assuming a duty of care towards third parties. Such a risk may easily arise since the work product of a CPA is often subject to general circulation, unlike the case in many other professions. Audit reports, for example, will necessarily be scrutinised by a wide range of third parties – who have no contractual relationship with the CPA – for a variety of different reasons.

There are a number of cases where the courts have pointed out the crucial role of disclaimers in determining whether or not a CPA has assumed responsibility towards a third party. As early as the decision in *Caparo Industries v Dickman* (1990), the House of Lords in England specifically admitted the possibility of a disclaimer in the audit report itself. In both the cases discussed below, we can see:

- the importance attached by the courts to the fact that the auditors in question could have disclaimed liability (to identifiable third parties) but failed to do so;
- that the absence of a disclaimer may be a factor which the courts will consider as pointing to an assumption of responsibility by a CPA towards a third party.

ADT v BDO Binder Hamlyn (1995)

The action arose out of ADT's acquisition of Britannia Securities Group (BSG). BDO Binder Hamlyn (BDO) was one of BSG's joint auditors and had been involved in an audit of BSG's 1989 accounts. Prior to the acquisition, ADT made it clear to BDO that the final hurdle before making the offer was to obtain certain assurances from BDO.

During a meeting with ADT, BDO's audit partner confirmed to ADT at its request that he would "stand by their accounts" and that he was aware of nothing else which ADT should be told. The audit turned out to have been negligently performed and ADT suffered loss in making the acquisition. ADT claimed that but for the representations made by BDO, it would not have proceeded with the acquisition or, at least, it would have proceeded on different terms.



The English High Court decided that BDO, through the representations made by its audit partner, had assumed responsibility towards ADT for the accuracy of the audited accounts. In particular, the judge said, if the audit partner had insisted on a disclaimer, this would have been regarded as a red flag by ADT, which would then have made further inquiries.

The court awarded damages against BDO of £65m, which after adding interest and costs, amounted to a total of £105m. The award exceeded the indemnity cover by around £34m.

The case demonstrates how the auditors of a target company can incur colossal liabilities towards a prospective purchaser as a result of unguarded assurances. This case highlights the need for auditors to protect themselves either via a disclaimer or to abstain from giving such assurances in these circumstances.

The Bannerman Johnstone Maclay (2002) case

Similarly, in the controversial *Royal Bank of Scotland plc v Bannerman Johnstone Maclay* decision, the Outer House in Scotland (equivalent to the High Court in Hong Kong) also regarded the absence of a disclaimer by the auditors as central to the finding of liability.

BJM were auditors of APC Ltd whose principal lender was the Royal Bank of Scotland (RBS). RBS also had an equity interest in APC. It was a requirement of RBS's facility letters that APC provide its audited financial statements to RBS within six months of its financial year end. Copies of APC's audited accounts were passed by APC to RBS for the purpose of assisting RBS in its lending decisions. RBS subsequently sued BJM for its losses suffered as a result of its reliance on APC's audited accounts, which contained material inaccuracies. BJM applied to strike out the claim on the basis that it did not owe RBS a duty of care.

The court decided, as a preliminary issue, that the facts pleaded by RBS were sufficient in law to give rise to a duty of care. Significantly, it held that, although there was no direct contact between BJM and RBS, BJM could have disclaimed liability to RBS when they learnt that RBS would be entitled to see the audited accounts for the purpose of assisting it with its lending decisions. The absence of such a disclaimer was a significant factor supporting the finding of a duty of care. This aspect of the decision was upheld on appeal.

The salient message emerging from the two cases mentioned above is that, once it is known that a third party may rely on the auditors' report or representations, disclaiming liability is a good way of trying to avoid liability.

Ways of disclaiming liability towards third parties

Where CPAs seek to disclaim their liability to third parties, this must be done expressly in writing.

Disclaimers may be placed in the engagement letters to clients and also in the actual work product of a CPA (for example, in audit reports or written advice). Specifically, ways in which CPAs may exclude their liability towards third parties include clearly restricting:

- the intended recipients of their work product;
- the use to which their work product may be put; and
- (where practicable) circulation of their work product without prior written consent.

In addition, where the third parties are identifiable and specific circumstances warrant it, a CPA may send a separate disclaimer letter directly to the third parties involved.

CPAs providing audit services should also have regard to the disclaimer wording recommended by the Hong Kong Institute of Certified Public Accountants in its Technical Bulletin issued on 27 May 1993, following the first instance decision in *Bannerman*. The following disclaimer wording was recommended to be placed in audit reports, so as to disclaim liability to parties other than the shareholders as a body:

“It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with [section 141/section 141D] of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any

other persons for the contents of this report.”

The HKICPA suggests that auditors consider taking a similar approach in respect of other public reporting engagements such as interim reviews, regulatory reports and reports issued under other legislation.

It must be emphasised that the use of disclaimers does not necessarily guarantee that CPAs will not owe any duty of care to third parties. As the Technical Bulletin rightly highlights, CPAs should remain vigilant to avoid the words being overridden by actions (either contemporaneous or subsequent) which are inconsistent with the disclaimer.

Effectiveness of disclaimers and limitation clauses

Getting limitation and exclusion clauses wrong can be costly. Whether such clauses are suitably drafted to achieve the desired effect – and whether they are enforceable – are, of course, issues on which legal advice should be sought. The appropriate wording to be adopted and its efficacy will depend on the circumstances of each individual case.

The importance of clarity in the drafting of limitation and exclusion clauses cannot be overemphasised – a point vividly illustrated by the decision in *University of Keele v Price Waterhouse* (2004).

Price Waterhouse advised the university on setting up a profit-related pay scheme, which ultimately failed. The university sought damages, including the loss of the tax savings that would have been achieved had the scheme been successfully implemented. While admitting negligence, Price Waterhouse sought to rely on a

limitation clause in its engagement letter:

- The first limb of the clause stated that, subject to a limit on liability which was equal to twice the anticipated savings from the scheme, Price Waterhouse accepted “liability to pay damages in respect of loss or damage suffered by you as a direct result of our providing the services”.
- The second limb stated that “all other liability is expressly excluded, in particular consequential loss, failure to realise anticipated savings or benefits ...”

The loss of anticipated savings was held to be covered by the first limb and was not excluded. The problem with the clause, according to the English Court of Appeal, was that (on the face of the clause) the loss fell under both limbs. The key to the interpretation of the whole clause was the word “other” at the start of the second limb. It suggested that the first limb took precedence over the second, which only excluded loss not covered by the first limb. The difficulty with the clause was that it failed to set out clearly the relationship between its two constituent limbs, one accepting liability and the other excluding it.

Generally, a CPA should be aware of the following matters when using exclusion and limitation clauses:

- The clauses must be clearly and unambiguously drafted. They must state explicitly what liability is intended to be excluded or limited. In respect of disclaimers to third parties, CPAs must make clear the party for whom – and the sole purpose for which – their work is carried out. They must ensure that third parties are under no illusion that they rely on the CPA’s work at their own risk.
- It is important to make each individual exclusion

or limitation clause self-standing and to ensure there is no inconsistency between the clauses.

- The clauses must satisfy the reasonableness test imposed by the Control of Exemption Clauses Ordinance, Cap 71. In this regard, the balances of financial resources and bargaining position, the availability of insurance cover, the value of fees, and the scale of loss foreseeable are all relevant. It is for the CPA to show that the clauses are reasonable, otherwise they will be void.
- A total exclusion of liability is less likely to be considered reasonable except in exceptional circumstances.
- It is important to ensure that any disclaimer is not overridden by any statements or representations, whether made contemporaneously or at a later date, which are inconsistent with it.

Conclusion

As the accounting profession continues to face claims of professional negligence, it is important that steps are taken to adopt sensible precautions through the appropriate use (and regular review) of exclusion and limitation clauses. Given all the adverse effects which a legal claim can have on a CPA’s practice, management time and resources are obviously better spent on trying to reduce – or, better still, to eliminate – the risk of exposure than dealing with the consequences of it.

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Limiting the risk

The new UK Companies Act 2006 will allow auditors to conclude liability limitation agreements with their clients.

The new Companies Act 2006 reforms and restates company law in the UK. It will be fully operational by 1 October 2008. Until then, there will be a phased introduction of the provisions of the new legislation. Parts of the Act are already in force. Chapter 6, which will take effect from 6 April 2008, contains important new provisions about auditors' liability that will enable auditors to enter into liability limitation agreements (LLAs) with their clients.

An LLA is an agreement that purports to limit an auditor's liability to a company in respect of any negligence, default, breach of duty or breach of trust by the auditor vis-a-vis the company, and which occurs during the audit of the accounts. Broadly speaking, arrangements protecting auditors from liability are regarded as void under section 532 of the Act. However, the legislation expressly exempts LLAs providing they comply with section 535 and are authorised by members of the company (see section 532(2)).

Scope of LLAs

So what are the requirements of section 535? First, the LLA can only cover acts or omissions relating to the audit that occur during a single financial year. It must also specify the financial year to which it applies. Second, and in order to prevent adverse effects on competition, the

Secretary of State can issue regulations about what should (or should not) be contained in the LLA.

Subject to these parameters, an LLA can be in any form and the limit on the amount of the auditor's liability does not have to be a specific sum of money or calculable only according to a formula contained in the agreement. It will therefore be possible to limit auditors' liability in line with their relative responsibility for the damage actually suffered by the company.

Section 536 sets out the authorisation procedures. Basically, an LLA is regarded as authorised by members of the company providing

it has in fact been formally authorised under section 536 and that authorisation has not been subsequently withdrawn. Separate authorisation procedures exist for private and public companies. The common factor is that a resolution must be passed (either before or after the LLA has been concluded) approving the terms of the agreement.

Disclosure

Finally, an LLA must be disclosed by the company in a form specified by the Secretary of State. It seems likely the disclosure will either have to be via a note attached to the company's annual accounts or it will have to be expressly set out in the directors' report.



Sting in the tail

So far, so good, but there is a potential sting in the tail. Section 537 provides that an LLA cannot limit the auditor's liability to less than the amount that is fair and reasonable in all the circumstances of the case. In this context, particular attention will be paid to the auditor's statutory responsibilities, the nature and purpose of the auditor's contractual obligations to the company and the professional standards expected of him or her. In determining what is fair and reasonable, no account is to be taken of anything that has happened after the loss and damage in question has happened, or which could affect the possibility of recovering compensation from others who may be liable for the same loss or damage.

Future

It will be interesting to see how the UK courts interpret LLAs in the future. Depending on how this new instrument develops, it may ultimately be appropriate to introduce LLAs into Hong Kong's company law.

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New Watchdog

Sophia Kao and Shum Man-to, leaders of the Financial Reporting Council, say they aim to investigate audit irregularities and strengthen compliance. By Tavis Lam.

For decades, the Hong Kong Institute of CPAs has played an important regulatory role overseeing the profession. In July 2007, culmination of the Institute's 2002 reform proposals was achieved when the Hong Kong FRC commenced operations.

The FRC has taken over the Institute's responsibility for investigating alleged auditing and financial reporting irregularities of Hong Kong's listed companies. Sophia Kao, the FRC's chair, says preparation work for the watchdog

took six months and the biggest challenge was to find high-calibre accountants who are willing to join its investigative team.

Kao tells A Plus the FRC aims to boost the investing public's confidence in the market through higher transparency and accountability. "To build public trust, we have to demonstrate we are able to carry out our statutory duties in an efficient, effective, impartial and independent manner," she says.

Examining audits

The FRC has two separate arms overseeing auditing and financial reporting of listed companies. The Audit Investigation Board, chaired by Shum Man-to, chief executive of the FRC, has four full-time accountants who conduct investigations upon receiving complaints on suspected auditing irregularities. Shum declines to say whether the council has received any complaints so far.

"Anybody can make a complaint to us provided that they have the information which meets the statutory requirements to start an investigation," Shum says.

Under the Financial Reporting Council Ordinance, the board can collect information from anyone related to the investigation, be it the auditor, the management or other employees of the listed company that it believes have relevant information, he says.

The board will then compile an investigation report and give recommendations to the FRC including whether a case should be referred to the Institute for disciplinary hearing, or to the police and the Independent Commission Against Corruption if criminal offences are involved.

The media has reported that some people think the investigation reports should be made public. But Shum says the decision will be made on a case-by-case basis because the FRC needs to strike a balance between maintaining confidentiality of any person named in the reports and protecting public interest.

Kao says while the FRC may not release the names of auditors and companies that run afoul of the rules, "we will be publishing our statistics from time to time to tell the public about our work and progress, and to give them an overview of the types of cases we handled."

Reporting standards

Another function of the FRC is to ensure companies' compliance with financial reporting standards. This responsibility lies with the Financial Reporting Review Panel, made up of 35 government appointed members including business leaders, scholars and accountants.

When the FRC decides to initiate investigation on a company, at least five panel members will be picked to form an independent enquiry committee. The probe then follows similar procedures as the



Audit Investigation Board and would eventually advise the FRC on possible actions.

The FRC has been working with the Institute to develop a memorandum of understanding that will define the working relationship between the two bodies. It is working on similar arrangements with the Securities and Futures Commission, The Stock Exchange of Hong Kong Ltd. and the Companies Registry.

Shum says the understanding is that if the Institute comes across anything that is suspicious, it will refer the case to the FRC for either investigation or enquiry. After the FRC has done its part, if an Institute member is involved, it will refer the case back to the Institute for follow-up action. The Institute retains disciplinary powers over members.

Can the watchdog bite hard?

The FRC is jointly funded by the Institute, the Companies Registry Trading Fund, the SFC, and the Hong Kong Exchanges and Clearing Ltd. with an annual budget of HK\$10 million for the first three years. The four organizations have also contributed another HK\$20 million to set up a reserve fund for the body.

Lawmakers have expressed concern whether the budget is enough for the FRC to perform its investigations effectively because 60 percent of the funds would be spent on staff wages and expenses, according to news reports. But Kao says it is hard to comment at this stage whether the budget is too tight because the volume of complaints is unclear.

Critics have also questioned whether the FRC can maintain its impartiality given its ties with the Institute, but Shum says, “We won’t favour the

accountants and we won’t treat them unfairly. No matter what the public opinions are, we are objective and fair.” He says most accountants perform their duties professionally.

To improve its credibility, the FRC has Kao, a non-accountant, as its head and five other lay members, two of which were nominated by the Securities and Futures Commission and the Hong Kong Exchange and Clearing Ltd.

Kao says the government chose her precisely because she is not an accountant and has no close ties with the commercial sector. But will her lack of an accounting background be a hindrance to her role as chair? According to Kao, the answer is no: “I was a council member for the Institute for two years where I gained a good knowledge of how the Institute operates and also the issues they experienced in terms of investigation work.”

Likewise, Shum, who retired from the government as director of accounting services in 2003, says his background as a civil servant enables him to remain impartial.

As the FRC’s head, Kao says their priority is to improve Hong Kong’s business environment for the accounting profession and the public. “The members and the staff of the FRC are brought together by a vision to upkeep and maintain a high level of financial reporting. So, together we will oversee the integrity of financial reporting in Hong Kong,” she says.

FRC members’ profiles

Sophia Kao Kao was the human resources director of the Airport Authority Hong Kong from 1991 to 1999. She was a lay council member of the Hong Kong Institute of CPAs from 2004 to 2006. She is

now the chairperson of the Women’s Commission.

Shum Man-to (ex-officio) Shum is a CPA and was the director of the government’s accounting services from 1999 to 2003. He served as an ex-officio council member of the Hong Kong Society of Accountants for over four years.

Moses Cheng Cheng is an independent non-executive director of the Hong Kong Exchanges and Clearing Ltd. and a senior partner of the law firm PC Woo & Co. He was a former member of the HKEx’s listing committee.

Mark Dickens Dickens was an executive director of the Securities and Futures Commission from 1997 to 2005. Before he joined the SFC in 1991, he worked for the Australian National Companies and Securities Commission in various positions including general counsel and senior director.

Kam Pok-man Kam, a CPA, is the group financial controller of Jardine Matheson Ltd. and a member of the standards advisory council of the International Accounting Standards Board. He was the president of the Hong Kong Society of Accountants in 1999 and 2000.

Martin Hadaway Hadaway is formerly the chief executive of Gammon Construction Ltd. and is the principal of Sunridge Management Ltd. He is a fellow of the Hong Kong Institution of Engineers and a member of the Vocational Training Council.

Sophie Leung Leung is a member of the Legislative Council representing the textile and garment constituency. She is also a Hong Kong deputy to the 10th National People’s Congress.

Vernon Moore Moore is a CPA and has been the executive director of CITIC Pacific Ltd. since

1990. He is also a director of Cathay Pacific Airways Ltd., CLP Holdings Ltd. and Hong Kong Air Cargo Terminals Ltd., and the chairman of New Hong Kong Tunnel Company Ltd. He was a council member of the Institute.

Judy Tsui Tsui, a CPA, is the dean of the business faculty at the Hong Kong Polytechnic University and is an expert in corporate governance. She was a council member of the Hong Kong Society of Accountants from 2001 to 2004.

Gordon W. E. Jones (ex-officio) Jones has been the Registrar of Companies since 1993. He joined the Hong Kong government as an administrative officer in 1973 and has served in various departments of the government’s secretariat. He is an ex-officio member of the Institute.

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Audit confirmations and the Limitation Ordinance

The case of Cycle Links Co Ltd v Chevalier Construction (Hong Kong) Ltd was decided on 8 March 2007. One of the issues that arose for determination was whether audit confirmations issued by the defendant to the plaintiff could be relied upon by the plaintiff in support of its claim that certain retention monies due under two construction sub-contracts were still due and payable by the defendant. The plaintiff sued to recover these sums; the defendant raised a limitation plea, arguing that the plaintiff's claims were statute barred. In response the plaintiff argued that, as a result of the audit confirmations, the defendant had acknowledged the debts and had thereby caused time to run afresh under section 23(3) of the Limitation Ordinance (Cap 347) ("the Ordinance").

The relevant part of this particular provision reads as follows:

"Where any right of action has accrued to recover any debt ... and the person liable or accountable therefor acknowledges the claim or makes any payment in respect thereof, the right shall be deemed to have accrued on and not before the date of the acknowledgment or the last payment ..."

Pursuant to section 24(1) of the Ordinance every such acknowledgment must be in writing and signed by the person making the acknowledgment.

Two questions therefore arose: (1) Did the audit confirmations amount to an acknowledgment; and (2) if so, did they comply with the requirements of section 24(1)? Given that the case in question concerned an application by the defendant to strike out the plaintiff's case, all the plaintiff had to do was to establish that it had an arguable case that should be allowed to proceed to trial. Deputy High Court Judge To found for the plaintiff on both issues.

The audit confirmations in question bore the defendant's company stamp and a signature. That was enough to satisfy the requirements of section 24(1) of the Ordinance. As for the acknowledgment issue, the audit confirmations constituted a written note, issued by the defendant, seeking the plaintiff's confirmation that the debts stated therein were due from the defendant to the plaintiff. Arguably, therefore, that constituted an acknowledgment for the purposes of section 23(3) of the Ordinance.

In this case the Deputy Judge commented that, if the defendant does not want time to start to run, it must take steps to avoid doing anything which might constitute an acknowledgment. He went on to say that the defendant could have excluded the debt from its accounts (and in fact should have done if it no longer considered the debt to be repayable). Alternatively, it could have informed its auditors of the position and

instructed them to seek confirmation rather than seeking confirmation itself (as it had in this case). The Deputy Judge then continued:

"In fact, it has become a practice for companies to write to their trading partners ... and invite them to respond to confirmations sought by their auditors and leave it to its auditors to seek confirmation thereby avoiding any possible argument on acknowledgment under the Limitation Ordinance or for any other purpose".

Whilst we would not wish to suggest that this case imposes any additional duties on auditors with regard to the audit confirmation process, we thought it was worth flagging for your attention. In our view it is a matter for the management of the audit client to determine which debts are included within the company's financial statements and, if there are any debts which are disputed or where the issue of acknowledgment may be a factor, it is up to management to draw this to the auditors' attention so that confirmation requests can be sent out in an appropriate form.

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Auditors' liability regimes (2)

The results of the European Commission's public consultation are summarised below.

In the Spring 2007 issue of CPA Protect ("Auditors liability regimes" on p 9), we reported on the steps being taken by the European Commission to analyse the economic impact of the current EU rules on auditors' liability regimes. The Commission's consultation paper on the subject – launched in January 2007 with responses due in by 15 March – suggested the following four possible options for liability reform in the EU:

- **Option 1:** the introduction of a single European-wide cap.
- **Option 2:** a variable cap depending on the size of the client company.
- **Option 3:** a cap based on a multiple of audit fees.
- **Option 4:** the introduction of proportionate liability.

In total, there were 85 responses to the consultation. Twenty of these were from international respondents (including the Big Four accountancy practices) and the remainder came from 15 countries within Europe. Unsurprisingly, auditors formed the largest category of respondents (30) with responses also being submitted by insurers (10), companies (9), investors (8), academics/banks/miscellaneous (6 each), regulators (5), member states (3) and other market participants (2).

The auditing professionals unanimously supported the Commission's initiative, whereas the non-auditor respondents expressed differing views. Overall, 66% of respondents supported some form of reform, 29% were opposed and 5% were undecided.

As for the level of support for each of the four options, it is harder to draw clear conclusions from the responses because a large number of those who support the Commission's initiative expressed

views about each of the options suggested by the Commission. Thus, when considering support for each of the options in percentage terms, the responses exceeded 100%. That said, the clear preference from the audit profession was Option 3 (70%), with 57% favouring Option 4 and 50% in favour of a combination of proportionality and a cap. Proportionality was the preferred option for those outside the audit profession (61%). The other options were less popular: Option 1 - 24%; Option 2 - 24%; and Option 3 - 18%.

The auditor respondents have asked the European Commission to issue a recommendation on this.

Further updates will follow in future editions of CPA Protect.

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