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UNIVERSITY OF WOLLONGONG

DEPARTMENT OF ACCOUNTANCY



**THE EXTENT OF AN ACCOUNTANT'S
LIABILITY TO THIRD PARTIES**

by Brian H Andrew

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THE EXTENT OF AN ACCOUNTANT'S
LIABILITY TO THIRD PARTIES

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The Extent of an Accountant's Liability to Third Parties

Since the House of Lords in Hedley Byrne & Co Ltd. v Heller and Partners Ltd [1] enunciated the possibility of professional persons owing a duty of care to third parties for the consequences of negligent mis-statements, accountants have been concerned with the extent of this duty and their potential liability. Accountants normally owe a duty of care to their client as a term of the contract of engagement and the extent of this duty has become clear from a range of cases concerning the law of contract [2]. But the duty of care owed under a contract may be different in kind to that owed to a third party under the law of tort.

In interpreting this duty the courts have been aware of the now famous concern as to the extent of the liability expressed by Cardozo C. J., that the recognition of a duty might "...expose accountants to liability in an indeterminate amount for an indeterminate time to an indeterminate class".[3] This warning of Cardozo C.J. concerning unlimited liability was apparently taken to heart by U.S. courts, as the Ultramares case has been described as "... the precedent for negligence

[1] [1964] A.C. 465

[2] See for example Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co. Ltd [1958] 1 WLR 45, Re Thomas Gerrard & Son Ltd [1968] C.R. 445, Pacific Acceptance Corporation Ltd v Forsythe Ors (1970) 92 W.N. (N.S.W) 29 and Cambridge Credit Corporation Ltd v Hutcheson and Ors, (1985) 2 ACLC 263.

[3] Ultramares Corporation v Touche et al (1931) 225 N.Y. 170 at 179.

and deceit actions for at least thirty years' [4], despite the earlier decision of the same judge in Glanzer v Shepherd [5], which indicated that a person could be held responsible to a third party for damages suffered as a result of reliance on negligent advice. These developments in U.S. common law were of some significance in the Hedley Byrne case as Lord Reid referred to both Ultramares and Glanzer in his judgment, [6] and the Ultramares case has played a significant part in the development of negligence actions in Britain. [7]

British Commonwealth courts were late in adopting the principle of liability to third parties for negligent statements, but the Hedley Byrne decision has had considerable impact in a range of different situations since handed down in 1964. Accountants were first affected only 10 years ago with the decision, in 1976, of the Supreme Court of Canada in Haig v Bamford et al [8]. This was followed in 1978 by the

[4] Pockson J.R.H.H., Accountants' Professional Negligence, The Macmillan Press Ltd, London & Basingstoke, (1982), p. 101.

[5] (1922) 233 N.Y. 236

[6] Hedley Bryne & Co Ltd v Heller and Partners Ltd [1964].

[7] Cited by Cohen L.J. at p. 207 as support for the denial of recovery and Denning L.J. at p. 183 in his dissenting judgment in Candler v Crane Christmas and Company [1951] 2 K.B. 164.

[8] (1976) 72 D.L.R. (3rd) 68

decision of the New Zealand Court of Appeal in Scott Group Ltd v McFarlane [9], and more recently the decision of the Court of Appeal in JEB Fasteners Ltd v Marks, Bloom & Co. [10] and of Lord Stewart of the Scottish Court of Session in Twomax v Dickson, Mc Farlane & Robinson, [11]. These two recent cases seems to have caused considerable uncertainty in the accounting profession. [12]

Consequently, this paper considers the above four Commonwealth cases on an accountant's duty to third parties in accordance with the apparent rule in Hedley Byrne, and examines the extent of duty revealed by the cases. This survey provides support for a logical limit to the duty, which attempts to balance the unlimited liability problem which concerned Cardozo C.J. above, and which has bothered all Commonwealth Courts since Hedley Byrne, with the need to protect the community from incompetent professional work.

[9] (1978) 1 N.Z.L.R. 553

[10] (1983) 1 All E.R. 583

[11] (1983) Scots Law Times Reports 98

[12] See for example C. Baxter, New professional negligence liability judgement - an auditor's nightmare, Accountancy, August 1981, p. 98 and C.Nobes, Auditor, protect thyself., Accountancy, April 1985.

Negligence Actions

The problem of determining the extent of an accountant's liability for statements made in the course of carrying on the profession, is a common problem in the law of torts. A tort is a civil wrong, and tort law is concerned with providing compensation to a plaintiff who suffers damage as a result of the actions of another party who owes a duty of care to the plaintiff. Compensation, not punishment of a wrong doer, is the essence of tort law, and there must be some limit upon the extent of liability consistent with the need to compensate the victim and the community interest in keeping an (otherwise) viable business in operation. No-one is likely to be well served by bankrupting a tortfeasor and the unlimited liability problem raised by Cardozo C.J. has concerned all common law courts.

The notion of negligence as a separate basis of tort liability can be traced to the early part of the nineteenth century. Its earliest source can be seen in relation to a limited number of callings, such as innkeepers, carriers, surgeons and attorneys, where the practitioners held themselves out to the public, as possessing a level of competence sufficient for the pursuance of their 'professions'. Such persons were required to perform their functions in accordance with a standard of 'reasonable skill and competency', and were held responsible for certain, but not all, harm resulting from their negligence. Inherent in the liability was the idea of a person, such as a

surgeon, owing a duty to take care in the performance of the professional activity, and this duty was owed to clients and to a limited class of other persons affected by the action of the 'professional'.

During the nineteenth and early twentieth century tort law developed as a series of separate duty relationships expressed in the form, 'An occupier owes the following duty to an invitee....', and there was considerable debate about whether there was any general law of negligence. But in 1932 the decision of the House of Lords in the famous Donoghue v Stevenson [13] case provided a unifying point for negligence actions and "This famous decision first treated negligence as a tort in itself" [14]. In his judgment Lord Atkin made the now famous general statement about the duty of care in negligence actions:

"You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who, then, in law is my neighbour? The answer seems to be - persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question" [15].

[13] [1932] A.C. 562

[14] Mr Justice K.S. Jacobs, Law & Fact in the Duty of Care, in T. Simons (ed.) Negligence and Economic Torts, Selected Aspects, Law Book Company Ltd., Sydney, 1980.

[15] Donoghue v Stevenson [1932] A.C. 562, per Lord Atkin at p. 619.

From the early cases the following elements of the cause of action in negligence can be inferred:

1. A legally recognised duty to conform to a certain standard of conduct.
2. Breach of the duty to exercise the required standard of care.
3. Damage or material injury to the interests of the plaintiff.
4. A reasonably proximate connection between the defendant's conduct and the plaintiff's injury.

Lord Atkin's 'neighbour principle' was an attempt to formulate a general rule for determining the situations in which a person who caused harm should be held to owe a duty of care to the person harmed. But the principle was enunciated in a case of personal injury suffered by the buyer of a faulty product and was based upon a test of foreseeability which may be appropriate in physical damage and personal injury cases but which may not be easily transferable to cases involving economic loss resulting from negligent mis-statements. The relationship between the parties appears relatively clearer in the physical damage area than is the relationship between an accountant who negligently issues an incorrect audit opinion and a user of the accounts who suffers loss through reliance on the accounts; and the same tests of foreseeability may not be appropriate in both sets of cases.

A further complicating feature of the test of 'foreseeability' proposed under Lord Atkin's 'neighbour principle' is that it could be applied to two different aspects of the action which gave rise to liability, firstly, whether or not the act complained of could be 'reasonably foreseen' as likely to produce the damage complained of and secondly, whether or not the plaintiff could be 'reasonably foreseen' to be a member of the class of persons likely to be affected by the act complained of. In other words, is the damage a 'foreseeable' consequence of the act complained of and is the complainant a 'foreseeable' victim of the act? This dual dimension to the foreseeability rule is of considerable importance in determining a logical limit to the extent of an accountant's duty to third parties.

The Duty of Care

The duty issue involves a mixed question of law and fact which must be resolved before any liability can arise and, in the negligence cases generally, the courts have tended to expend most effort in addressing legal questions about the existence and quality of a notional duty of care. In this regard it is regrettable that Commonwealth courts have tended to take the view that a unified approach should be applied in economic loss, physical damage and personal injury cases and to adopt a similar approach to determining the duty question in all these areas.

This approach was a feature of the influential judgment of Lord Wilberforce in Ann's v Merton London Borough Council [16] where he brought together personal injury, physical damage and economic loss cases described as 'the trilogy of cases in this House, Donoghue v Stevenson, Hedley Byrne & Co Ltd v Heller and Partners Ltd and Home Office v Dorset Yacht Co Ltd' [17] in a generalisation aimed at determining the duty question:

"...the position has now been reached that in order to establish that a duty of care arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather the question has to be approached in two stages. First, one has to ask whether, as between the alleged wrong doer and the person who has suffered damage there is a sufficient relation of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise...." [18]

[16] [1978] A.C. 728

[17] per Lord Wilberforce at p.751

[18] *ibid*

This suggests the application of a simple 'foreseeability' (reasonable contemplation) test in all negligence actions and it also suggests that the onus of disproving a duty of care could be shifted to the defendant when a 'neighbourhood' relationship is established. As will be seen, this speech of Lord Wilberforce has been cited and relied upon in the two most recent British cases concerning an accountant's liability to third parties, and it has become an important statement of principle which is likely to be followed by courts in determining the duty question.

This unified approach is unsatisfactory as there are a number of substantive differences between economic loss, physical damage and personal injury cases which justify a different approach in each area; not the least of which is the qualitative difference between injury to a person, which can never be compensated by money, and economic loss which may be insured against and can be fully compensated by a money payment. A further important practical difference between the physical damage and personal injury cases and the economic loss cases is the issue of remoteness, the problem identified by Cardozo C.J. above of exposing the defendant to an indeterminate liability; and this is the key to any logical limit to the accountants' liability.

Adoption of the same foreseeability test as enunciated by Lord Atkin in Donoghue v Stevenson [19] would expose accountants to an indeterminate liability, as the manufacturer of the faulty product was held responsible to members of the class of users of the product, and there are so many different potential users of accounting reports. There are several possible alternatives to this approach, involving limiting the duty to a specific known user or a specific foreseeable user or to all members of a foreseeable class of users, but a suitable approach should have regard to the relationship between the supplier and the user of information and the purpose for which the information was supplied.

Any test should be based upon commercial and business practices as well as the foreseeability of loss and should focus upon the circumstances surrounding the loss. A test which aims to determine the supplier of information's liability in a reasonably balanced way should focus on two factors, a known use of the information and use by a foreseeable user. It is argued here that primary emphasis should be placed on the specific permissible use of information and use in the type of transaction for which it was supplied rather than upon the class of users to whom a duty of care is owed.

[19] op cit

The Commonwealth Cases

An often overlooked but most important case concerning an auditor's liability to third parties for negligent mis-statement occurred in the Canadian case of Haig v Bamford et al [20], where the Supreme Court of Canada unanimously held an auditor liable to a third party who had lost money through reliance on a negligently prepared audit opinion. The defendant firm of accountants had prepared a set of accounts and an audit report for the firm of Scholler Furniture and Fixtures Ltd, and the chief shareholder S. Scholler had used the audited accounts in an attempt to obtain more capital for the business. In the Saskatchewan Court of Queens Bench, McPherson J. found that the defendants knew that the accounts "would be used by Sedco (Saskatchewan Economic Development Corporation), by the bank with whom the company was doing business, and by a potential investor in equity capital" [21]. He also found the accountants negligent in that "They had not done an audit and they should have said so" [22] rather than attaching an audit opinion to the unaudited accounts. At the trial the judge held that the defendants owed a duty to Haig because "he must be included in the category of persons who could be foreseen by the defendants as relying on exhibit p. 5 (the accounts) in a matter affecting their economic interests" [23], in other words because he was a

[20] (1976) 72 D.L.R. (3rd) 68

[21] (1972) 32 D.L.R. (3rd) 73

[22] per Mc Pherson J. at p. 75

[23] *ibid*, at p. 77

foreseeable user of the accounts, i.e. 'a potential investor in equity capital'.

In the Saskatchewan Court of Appeal the decision of McPherson J. was overturned in a majority judgment, following the principle that :

"...had the appellants been aware that the respondent existed as a prospective investor and that the statements would specifically be shown to him they would on the basis of Lord Denning's judgment be liable" [24].

But the appellants were not aware of Haig's existence or that the accounts would be shown to him so "they owed the respondent the duty to be honest and are not liable to him for negligence" [25] The test proposed by the Court of Appeal majority would be the most restrictive test possible, as it focused exclusively upon a third party user, requiring actual knowledge of the identity of the specific user before a duty of care arose.

This view was overturned by unanimous decision, of the Supreme Court of Canada, where the leading judgment of Dickson J. was followed without additional comment by five members of the bench; whilst two members agreed with Martland J., who offered a different ratio but agreed with Dickson J. in the disposition of the appeal. This division on the ratio in the case is of some

[24] (1974) 53 D.L.R. (3rd) 85, per Hall J.A. at p. 99

[25] *ibid*, p. 102

importance as Martland J. and his concurring brethren were concerned to determine the matter by reference to the fact that:

"the respondents knew, prior to the completion of the financial statement, that it would be used by Sedco, by the bank with which the company was doing business and by a potential investor in equity capital, the respondents owed a duty of care, in the preparation of that financial statement, to that potential investor (the appellant), even though they were not aware of his actual identity" [26].

This decision over-ruled the Court of Appeal's narrow 'specific known user' test and substituted a duty of care owed to any member of a known class of users. This decision returned to McPherson J's notion of a duty owed to a foreseeable member of a known class of users, a breadth of potential liability argued above to be appropriate but insufficient as the sole test of liability.

The majority judgement, read by Dickson J., seems more in line with the test of liability suggested here, in that there were ten references (including those quoted from other cases) to the use that was to be made of the information. The majority judgement was concerned with the indeterminate liability problem, as Dickson J. observed that:

"It does not necessarily follow that the doors must be thrown open and recovery permitted whenever someone's economic interest suffers as the result of a negligent act on the part of an accountant". [27]

[26] (1976) 72 D.L.R. (3rd) 68, per Martland J. at p.69

[27] (1976) 72 D.L.R. (3rd) 68, per Dickson J. at p.74

The decisive consideration was that 'the accounts were prepared for the guidance of a "specific class of persons", potential investors, in a "specific class of transactions", the investment of \$20,000 of equity capital.' [28] Thus, the accountants knew that the accounts were required for a specific purpose and of the limited class of users and, most importantly, they had a clear idea of their potential liability, i.e. \$20,000.

Thus, it was of considerable importance that the accounts were prepared for a 'special purpose' [29] and 'What was important was the nature of the transaction or transactions for which the statements were intended, for that is what delineated the limits of potential liability' [30], but unfortunately this does not appear to be part of the ratio in the case. The ratio appears to have been limited to a rejection of the Court of Appeal's narrow interpretation of the idea of duty owed only to a specific known user [31]. The judgment can, however, be seen as consistent with the test proposed above in that the intended use of the information and the existence of a limited class of users were both known to the accountants, and both of these factors apparently influenced the Supreme Court majority, who were concerned by the problem of indeterminate liability and aware of the need to find a suitable limit to liability.

[28] *ibid* at p. 76

[29] *ibid* at p. 74

[30] *ibid* at p. 76

[31] see p. 75

There is nothing peculiarly Canadian about this case, as the Court cited the leading English authorities on negligent misstatements and was affected by the unifying tendency of the British law of negligence, as noted in Anns v Merton [32] above. They were also aware of the indeterminate liability problem and cited the leading U.S. cases, and they appeared to be aware of the U.S. tendency to divide the tort of negligence into a number of separate categories dealing with physical damage, personal injury and economic loss as different cases. This was a landmark decision in being the first court of final appeal in any common law jurisdiction to find that an accountant could owe a duty of care to a third party. It was also the first Commonwealth Court Case to result in an award of damages to a third party who had suffered economic loss through reliance on negligent words. At this time it is one of only two Commonwealth cases where an accountant has been found to owe a duty of care to a third party and where there was an award of damages to the injured party, i.e. where all the elements of the tort of negligence were found to have been proven. In the next two cases considered here the Courts found negligence, the existence of a duty of care and breach of the duty, but no sufficiently proximate relationship between the accountant's negligence and the plaintiff's loss as to justify an award of damages.

[32] op.cit, note 16

The second important case concerning accountants is the well known decision of the New Zealand Court of Appeal in Scott Group Ltd v McFarlane [33], and this case appears to have further widened the scope of an auditor's possible liability for negligence. In this case the defendant auditors had given an unqualified audit opinion each year for John Duthie Holdings Ltd; despite being aware of some deficiencies in the group accounts arising from the different balance dates of the holding company and its subsidiaries. The plaintiff company had relied upon these audit reports in acquiring John Duthie, but after the takeover it was found that Duthie's bank overdraft was understated by \$38,000. The defendant auditors did not deny the error, or their responsibility for detecting it. However, Quilliam J. of the New Zealand Supreme Court dismissed the claim, holding that published accounts were for the benefit of shareholders, not third parties, and the auditor's principal responsibility arose from a contractual and statutory responsibility to shareholders.

[33] op.cit note 9, this case is discussed in an article by A.G. Davidson, Auditors' Liability to Third Parties for Negligence, Accounting & Business Research, Autumn 1982.

The New Zealand Court of Appeal reversed the decision of Quilliam J., on the issue of the auditor's liability. Holding that they were liable, for their negligence to the third parties who had relied upon their opinion in preparing the takeover bid for the auditors' client company. The auditors were not aware of the bid at all, but the majority of the Court found them liable for their negligence, as they could be expected to contemplate such a bid because of the state of their client, and thus the offeror was a foreseeable user of the accounts. The position in respect of individual purchasers of shares was left open, but if this approach was followed by the courts then auditors would appear to be the professional group most affected by the Hedley Byrne decision. An audit report is a public document which provides a large number of financial statement users with information on the reliability of the audited accounts. The auditor's opinion may be relied upon by creditors, investors, employees and customers, and all of these users of the information contained in the accounts could reasonably be foreseen as likely to be influenced by the auditor's opinion. Thus, the potential liability arising from the Scott Group case may be vast, though a limit to the liability appears in the case, as a majority of the Appeal Court held the auditors liable, but a different majority ruled the complainant had not proved that they had suffered any compensatable damage, because of the lack of a causal link between the default of the auditors and the damage, suffered by the plaintiff.

A further limit to the extent of duty may arise from a somewhat unsatisfactory feature of the case, the existence of three different judgments, each based upon a different test of liability. The most dangerous of the three judgments was that of Woodhouse J, who asserted in regard to the duty of care:

"The issue has been made increasingly complex by the successive and varying formulas that have been used in an effort to confine the general area of responsibility, in particular for negligent words or in respect of purely economic losses. At this initial stage at least it should be possible to remove some degree of uncertainty - in my opinion it is done by the comprehensible and straightforward test of foreseeability" [34].

He, rather lightly, dismissed the indeterminate liability problem stating that:

"...I do not think that the imposition of responsibility for negligent advice would lead to an intolerable burden upon auditor defendants. There is the initial need to establish a duty of care situation in terms of the critical requirement of reasonable foresight; and then there is the need to provide evidence in terms of causation. I am satisfied that these matters alone would prevent any risk of an open-ended type of duty" [35].

[34] per Woodhouse J. at p. 574

[35] ibid at p. 576

But, fortunately for accountants, Woodhouse J. was in the minority in holding for the appellants on both the duty issue and the award of damages. His reasoning appears to favour liability in a broad range of 'commercial arrangements' and includes a 'duty to those persons whom they can reasonably foresee will need to use and rely upon them when dealing with the company or its members in significant matters affecting the company assets & business' [36], and such a test would appear to include all potential users except the ordinary members of the investing public.

Cooke J. agreed with Woodhouse J. in holding that there had been negligence by the accountants who owed a duty of care to the third party plaintiffs, but agreed with Richmond P. that the plaintiffs had not discharged the onus of proving that the accountants' negligence was causative of their loss and he was in the majority in refusing the plaintiff's claim. Cooke J. was concerned by the problem of indeterminate liability, apparently wishing to limit the accountants' liability by reference to the special position of a share buyer who succeeds in a take-over bid, as he said:

'A company purchasing all or the majority of the shares is more directly and closely affected than, for instance, an ordinary purchaser of shares on the stock market. And in all ordinary circumstances there will in fact be only one offeror who makes a successful take-over offer on the basis of the carelessly certified accounts' [37].

[36] *ibid.* at p. 576

[37] *per* Cooke J. at p. 582

This judgment exhibited some concern to limit liability by reference to a reasonably foreseeable use of the information, as Cooke J. observed "that it was a takeover transaction and moreover a reasonably foreseeable one" [38] and he found that "It was a classic case for a takeover or merger" [39]. Taking this approach he found that "the evidence discloses a plain risk of a takeover and the virtual certainty that in such an event the accounts would be relied upon by the offeror" [40]. These observations suggest a test of duty based upon an actual member of a foreseeable class of users who use the information for a foreseeable purpose, a test which is somewhat more inclusive than that suggested above but at least recognises the importance of the intended use of the information. Cooke J. was of the opinion that "the damages are also necessarily limited" [41] and that "In relation to members of the public proposing to rely on the published accounts, however, a disclaimer would operate, not as an exemption from liability attaching by virtue of any rule of law, but as negating any assumption of a duty of care" [42]. Thus, it may be possible for auditors to limit the extent of their duty by issuing a suitable disclaimer.

[38] per Cooke J. at p. 582

[39] *ibid*

[40] *ibid*

[41] *ibid* at p. 583

[42] *ibid* at p. 581

Richmond P. approached the issue quite differently from the other two members of the bench. He refused to recognise a duty of care and took the view that "the evidence failed to disclose circumstances which either make the auditors aware, or ought to have made them aware, that the 1970 accounts were indeed required as a basis for a take over offer" [43] and "that a mere general possibility of that kind is not sufficient to give rise to a special relationship" [44]. Thus, he focused on the use of the information and required that the loss be suffered in a transaction that involved a use of the information actually known to the respondent at the time of preparing the information. This test appears consistent with that suggested above and it is to be hoped that Richmond P's view of the extent of the duty of care will prevail. He was part of the majority who refused damages, but this followed from his finding on the duty of care issue, which meant that he did not need to consider the causation question considered by Cooke J.

The Scott Group case is of great importance as it affirmed the existence of a legal duty of care owed by auditors to third party users of the audit opinion. The case appears to have widened the class of persons that may take action against an auditor for negligence in the conduct of the audit to include

[43] per Richmond P. at p. 567

[44] *ibid*

persons who can prove that they reasonably relied upon the auditor's opinion. This liability may arise even though the auditor was unaware of the third party's existence or interest at the time of the audit report, but the differing judgments have left the position unclear.

In the English case of JEB Fasteners Ltd v Marks, Bloom and Co [45] the defendant firm of accountants had prepared an audited set of accounts for JEB Fasteners Ltd where the company's stock was reported at its net realisable value. This figure was well above its cost, though the stock was described as being valued at the lower of cost and net realisable value. As a result the company's profit was overstated by over £ 13,000 and a loss was turned into a reported profit of £ 11.25. The company was taken over and the new owners sued the auditors, alleging negligence in preparing and attesting the inaccurate accounts.

In his judgment Woolf J. relied heavily upon the important statement of principle concerning the circumstances in which a duty of care could arise in the speech of Lord Wilberforce in Anns v London Borough of Merton [46] noted above. Though this

45 (1981) 3 All ER 289

46 Op. cit, note 16.

case did not concern accountants or auditors the speech of Lord Wilberforce was quoted with approval in both the Scott Group case and in Ross v Caunters [47], the other two cases relied upon by Woolf J.

Woolf J. found the auditors to have been negligent in a number of aspects of the preparation and attestation of the accounts and stated the principle to be applied in the case as:

"the appropriate test for establishing whether a duty of care exists appears in this case to be whether the defendants knew or reasonably should have foreseen at the time the accounts were audited that a person might rely on those accounts for the purpose of deciding whether or not to take over the company and therefore could suffer loss if the accounts were inaccurate. Such an approach does place a limitation on those entitled to contend that there has been a breach of duty owed to them. First of all, they must have relied on the accounts and, second, they must have done so in circumstances where the auditors either knew that they would or ought to have known that they might.

As in the Scott Group case Woolf J. found that, the auditors should have been aware of the possibility of a takeover because of the company's circumstances and that they owed a duty of care to the potential acquirer even though they were unaware of any actual takeover activity at the time the accounts were prepared. They did know of the company's liquidity problems and that it was seeking outside financial support from the plaintiff, but not of

[47] [1980] Ch 297

[48] per Woolf J. at p. 296

the plaintiff's intention to acquire the company. Here again, as in the Scott Group case, there was no award of damages against the auditors because of what Woolf J. described as the causation issue.

The causation issue concerned the extent of reliance placed upon the accounts in the takeover of JEB Fasteners. Woolf J. took the view that the acquirer knew, or should have known, that the accounts were inaccurate, from enquiries made during the course of negotiations and "the fact that the company was not breaking even must have become clearly apparent although the figures which were being used were very approximate and, to a large extent, estimated figures" [49]. Accordingly he found that "the negligence of the defendants was not causative of any loss" [50] and that the acquirers may have relied on the accounts and been influenced by them but "that you can be influenced by something even though if you had not been influenced you would have acted in the same way" [51]. Consequently, there was no award of damages against the defendants, indicating the difficulties faced by third parties in proving all the elements required for a successful action in negligence.

[49] per Woolf J. at p. 305

[50] *ibid* at p. 305

[51] *ibid* at p. 305

The causation issue and the award of damages, were the subject of an appeal in JEB Fasteners Ltd v Marks, Bloom & Co [52], where the Court of Appeal upheld the decision of Woolf J. on the causation issue, though criticising the method of approach adopted. The narrow ground of the appeal is of primary importance in understanding the limitations of the initial judgment. The Court of Appeal did not uphold Woolf J.'s finding of negligence or his decision concerning the duty of care, as neither of these issues were before the Court. Thus, the initial decision in the JEB Fasteners [53] case remains important in supporting the line of approach adopted in the Scott Group case, but as a decision of a single justice of the High Court of England it may not be followed by higher courts and may have only limited persuasive power in future legal action. Further, the Court of Appeal was critical of the method of approach adopted by Woolf J., and his decision on the extent of duty may not add much to our present understanding.

The other unusual case in which an auditor was found to have breached a duty of care owed to a third party, and which resulted in the award of damages against the auditor, was the Scottish case of Twomax Ltd v Dickson, McFarlane and Robinson [54]. In this case Twomax acquired a controlling interest in another

[52] [1983] 1 All ER 583

[53] [1981] 3 All ER 289

[54] [1983] Scots Law Times Reports 98

company, Kintyre Knitwear Ltd, and two years later, around the end of 1975; Kintyre went into receivership and later liquidation after the audited accounts had shown a trading loss of £ 88,000. The pursuers in the case alleged that the 1973 reported profit was a myth, and that they had relied on the audited accounts in deciding to invest in Kintyre.

In his judgment Lord Stewart stated that:

"The nub of their case is contained in the following arguments: 'Because of the defenders' said failures to observe the duties of competent company auditors, the figures presented in the said accounts of Kintyre Knitwear Ltd were grossly misleading and produced a seriously distorted picture of the company's affairs. Instead of trading profitably the said Kintyre Knitwear Ltd had in fact been trading at a loss both before and after the purchase of the said shares by the first-named pursuers in 1973...'"

In the course of his judgment Lord Stewart considered certain aspects of the 1973 audit in detail and concluded that overseas commissions owed by Kintyre had been understated by £3,200 and the failure of the auditors to detect this was 'because of slack and careless auditing methods' [55] which 'raised a presumption of negligence' [56]. He also noted that the auditor 'Mr McFarlane made no attempt to circularise any debtors for the 1973 audit' [57], that the provision for bad or doubtful debts was understated by £367 and that "the smallness

[55] per Lord Stewart at p. 100

[56] *ibid*

[57] *ibid*

of that sum may be due more to good luck than to good judgment" [58]. This last comment played an important part in the final judgment because of a large write-off of bad debts (of about £64,000) in March 1975 and evidence advanced that some part of this should have been written off in prior years.

These two errors, amounting to £3,567, were the only specific errors found in the 1973 accounts but Lord Stewart accepted argument "that the profits in the year to 31 March 1973 are substantially overstated in the audited accounts" [59] despite the lack of detailed evidence in support of this conclusion. He found that the large trading loss revealed in 1975 was "arrived at by compensation for and correction of errors from previous years" [60]. Despite the lack of specific evidence to support the conclusion, Lord Stewart found that:

Given the shortcomings of the company's records combined with the shortcomings of the defenders' methods, to which I shall refer, the conclusion I reach is that in fact no such enormous loss was incurred during the third year but the high probability is that both the two earlier years had been unprofitable or at the best only marginally profitable" [61].

[58] *ibid*

[59] per Lord Stewart at p. 101

[60] *ibid*

[61] *ibid*

He then went on to declare that he was "satisfied that the accounts of 31 March 1973 were negligently prepared by the defenders and negligently audited by Mr McFarlane" [62], and also that the auditor had failed to exercise reasonable care and skill in the audit and that his methods were 'sadly wanting'.

The conclusion of negligence appears to have been supported by the evidence of what the auditor had done in relation to the activities expected of a normally competent auditor, and this finding of negligence appears an appropriate one in view of the evidence. However, the Court was not presented with specific evidence to support the conclusion on the 1975 accounts, and this part of the judgment, based on deduction from purely circumstantial evidence, could be considered unusual.

In deciding that the auditors owed a legal duty of care to the pursuers, Lord Stewart placed considerable weight upon the comments of Lord Wilberforce in Ann v Merton London Borough Council noted above, again emphasising the importance of this judgment in determining a professional person's duty to third parties. This established a framework for consideration of the Scott Group case; Woolfe J's judgment in the JEB Fasteners case and Ross v Caunters, and these last three cases provided the legal basis for the finding that "Mr McFarlane owed a prima facie duty of care in the auditing of the 1973 accounts" [63].

[62] *ibid*

[63] per Lord Stewart at p. 105

Lord Stewart also observed "that Mr McFarlane should have foreseen before he certified the 1973 accounts that these accounts might be relied on by a potential investor for the purpose of deciding whether or not to invest" [64] and that the pursuers were members of the class of potential investors to whom a duty of care was owed. This appears to have extended the duty of care to include all potential investors. Such a wide class of persons to whom a duty of care is owed may present considerable problems for auditors, but it is likely that future courts may prefer a narrower view of the class of persons who are owed a duty of care. Further, the judgment of a single justice of the Outer House of the Scottish Court of Session is not binding upon any English or other Commonwealth court and may have only limited persuasive power.

Damages of £ 33,000 were awarded against the auditors, to fully compensate the pursuers for the cost of the shares bought plus interest, as Lord Stewart found that "the proper way of looking at it is that each pursuer lost the sum paid for the shares as soon as the payment was made" [65]. This award is surprising in view of the circumstantial nature of the evidence, the lack of serious discrepancies proved in the 1973 accounts and Lord Stewart's comment that "I also bear in mind that even on the basis of the inaccurate 1973 accounts an independent appraisal of

[64] *ibid*

[65] per Lord Stewart p. 106

the accounts concluded that investment in Kintyre was a gamble" [66]. One may well ask why gamblers should be compensated when their wager went astray! This perspective again leads to the view that the case was unusual and that it should not be viewed with alarm by auditors, as the decision itself may not be very influential.

These two cases, JEB Fasteners and Twomax, may not be followed by higher courts, and their significance cannot easily be appraised at this stage. Unfortunately they do indicate the acceptance of a simple 'foreseeability' rule in cases of negligent mis-statement and highlight the importance of Lord Wilberforce's statement in Anns concerning the approach to be adopted in negligence actions. The application of a single 'foreseeability' rule to all negligence actions would be inappropriate because of the different circumstances surrounding the various actions encompassed by the tort of negligence, and the majority in the Canadian Supreme Court and in the New Zealand Court of Appeal seemed to be aware of the problem and prepared to base their judgments on a different rule.

[66] *ibid*

Conclusion

It has been argued above that a duty of care in cases involving negligent mis-statement which results in economic loss should be based upon a test which has regard to the preparers knowledge of the proposed use of the information and of the class of persons who could be expected to use the information. A duty of care should only be found to exist if the preparer of the information has actual knowledge of the intended use of the information and the information is used by a member of a foreseeable class of users for the specific purpose known to the preparer.

There is support for this approach in the judgment of Richmond P. in the Scott Group case, and the other member of the majority, Cooke J., was not prepared to apply a simple test based upon a 'reasonably foreseeable' user. He did not require actual knowledge of the use of the information but the judgment does indicate that the preparer's knowledge of the intended use, or at least a foreseeable use of the information, was important. Cooke J. appeared to require that the information be used by a limited class of foreseeable users in a transaction that was 'reasonably foreseeable' by the preparer of the information at the time of preparation.

The majority judgment in Haig v Bamford, read by Dickson J., is also consistent with the suggested requirement that knowledge of the proposed use of the information is an essential requirement for a duty of care to be owed by the preparer of information to a third party user. The decisive consideration in the case appeared to be that the "accounts were prepared for the guidance of a "specific class of persons"... in a "specific class of transactions".... [67], and that the loss occurred in the very transaction that the accounts were prepared to influence. Thus, the preparer and auditor of the accounts knew of the purpose for which the accounts were required, and the loss was suffered by a member of the foreseeable class of users who relied on the information to provide the equity capital needed by the company.

Such a limit to the duty of care owed by accountants to third parties should not be too onerous, as it would impose liability for negligent mis-statements in a way that was consistent with the need to control professional performance without creating an indeterminate liability to all users at any time and in an open-ended amount, the primary concern of Cardozo C.J. in Ultramares. The liability should be such as to compensate a limited class of foreseeable users for their losses, without creating havoc in the profession. The fears raised by the JEB Fasteners & Twomax cases are real, and it is to be hoped that courts follow the more reasonable line of Richmond P. in the Scott Group case.

[67] (1976) 72 DLR (3rd) 68, per Dickson J. at p. 76

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