THE LIABILITY OF AUDITORS TO THIRD PARTIES IN NEGLIGENCE

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I. INTRODUCTION

An audit of accounts is primarily intended for the use of the audit client, the company whose accounts have been audited. The auditor owes the audit client a duty of care in tort and also (usually) under the terms of the audit contract.[1] However, a variety of parties other than the audit client may also rely on the audited accounts. In particular, potential investors and creditors often rely on the audited accounts of a company in making an assessment of the company's value and/or its creditworthiness. Should the auditor be liable to these third parties if he or she negligently audits the accounts? The auditor's liability, if any, to third parties can arise only in tort, as there is no privity of contract between the auditor and the third party. The central question is one of duty of care: does the auditor owe a duty of care in tort to anyone other than the audit client?

This question has attracted considerable attention of late because of the decision of the House of Lords in *Caparo Industries plc v Dickman*.[2] Because

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1 *Hardie (Qld) Employees' Credit Union Ltd v Hall, Chadwick & Co* [1980] 2 Qd R 362; *BGJ Holdings Pty Ltd v Touche Ross & Co (a firm)* (1988) Aust Torts Reps para 80-152.

2 [1990] 2 AC 605. For a selection of the many case notes, see R Baxt "The Liability of Auditors - The Pendulum Swings Back" (1991) 8 *Companies and Securities Law Journal*

the House of Lords restricted the extent to which auditors are liable to parties other than the audit client, the decision has been greeted with some relief by the auditing profession.[3] In Australia, the questions of the moment are: what will the Australian courts do? Will they follow the restrictive approach taken in *Caparo*? In this article, I shall try to answer those questions, not by focussing on *Caparo* (although it will be considered), but by considering the approach taken in a number of different jurisdictions, in an effort to broaden the perspective of the debate in Australia. I shall also briefly consider the effect of disclaimers of liability in this context.

II. TO WHOM IS THE AUDITOR'S DUTY OWED?

The line delineating the outer limit of an auditor's liability in tort may be drawn in many possible places. The narrowest possible approach is to hold that the auditor owes a duty of care in tort to the audit client *only*. According to this approach, known as the 'privity test', the defendant auditor owes the plaintiff a duty of care in tort only if there is also privity of contract between the parties. As a result, there is no liability to third parties in tort. This was the approach taken by the New York Court of Appeals in *Ultramares Corporation v Touche*,[4] where Cardozo CJ made the famous statement that to hold an auditor liable in tort to anyone other than the audit client would be to expose auditors to "liability in an indeterminate amount for an indeterminate time to an indeterminate class".[5] Although this phrase is repeated like a mantra in the cases and articles in this area, it is worth noting that only five of the American states still use the *Ultramares* 'privity test';[6] the others have gone on to adopt much broader tests, as I shall show shortly.

Beyond the 'privity test', there is liability to third parties in some form or another, and there are many possible tests for the existence of a duty of care.

249; R Baxt, Note (1990) 64 *ALJ* 436; JG Fleming "The Negligent Auditor and Shareholders" (1990) 106 *LQR* 349; GS Morris "The Liability of Professional Advisers: Caparo and After" [1991] *JBL* 36.

3 See, for example, R Stephenson "A Time of Rejoicing for Company Auditors" (1990) 134 *Sol Jo* 818; G Livanes "Fair Enough?" (1990) 61(8) *Charter* 56.

4 174 NE 441 (1931).

5 *Ibid* at 444.

6 New York, Colorado, Florida, Arkansas and Indiana: see JW Bagby and JC Ruhnka, "The Controversy over Third Party Rights: Toward More Predictable Parameters of Auditor Liability" (1987) 22 *Georgia Law Review* 149 at 160-1 and 179. It is a little misleading to say that *Ultramares* represents "the better view in the United States" - see JG Fleming "The Negligent Auditor and Shareholders" note 3 *supra* at 350-1.

Some of those possibilities were described as follows by Dickson J in the Supreme Court of Canada in *Haig v Bamford*:[7]

> From the authorities it appears that several possible tests could be applied to invoke a duty of care on the part of accountants vis-a-vis third parties: (i) foreseeability of the use of the financial statement and the auditor's report thereon by the plaintiff and reliance thereon; (ii) actual knowledge of the limited class that will use and rely on the statement; (iii) actual knowledge of the specific plaintiff who will use and rely on the statement.

Each of these three tests has been adopted in some common law jurisdiction or another, so an Australian court can find persuasive authority for the adoption of any test that it might wish to choose. In this section of the article, I shall first consider the three tests themselves, and the authorities supporting them. Then, I shall consider a fourth test, that of foreseeability of reliance on the auditor's report by the plaintiff *plus* a relationship of proximity between plaintiff and defendant. I suggest that it is this fourth test that is most likely to be adopted in Australian courts. Finally (for this section), I shall compare and contrast the practical effect of the four tests, with particular reference to their likely impact on auditors' liability insurance.

A. REASONABLE FORESEEABILITY ALONE

Perhaps the best known application of a test based on reasonable foreseeability alone is the decision of the majority of the Court of Appeal of New Zealand in *Scott Group Ltd v Macfarlane*.[8] The defendant, Macfarlane, audited the accounts of a company named John Duthie Holdings Ltd, which were consolidated accounts for that company and a number of subsidiaries. The plaintiff, Scott Group Ltd, relied on the audited accounts in making a takeover offer for the shares in John Duthie Holdings Ltd. By an elementary error in the consolidation of the accounts of the group, the assets of the holding company, John Duthie Holdings Ltd, were overstated by $NZ38,000, as some items had been counted twice. The same kind of error had been made in previous years, and the defendant was aware of some discrepancy but did not investigate it at any time.

By a majority of two to one, the Court of Appeal of New Zealand held that the defendant was not liable to the plaintiff in negligence. However, a differently constituted majority held that the defendant did owe the plaintiff a duty of care, even though the plaintiff was not the audit client, and even though there was no evidence that the defendant knew that the plaintiff would rely on the audited accounts. Woodhouse and Cooke JJ held (Cooke J obiter)[9] that the

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7 (1976) 72 DLR (3d) 68 at 75. Laskin CJC, Ritchie, Spence, Pigeon and Beetz JJ agreed with Dickson J.

8 [1978] 1 NZLR 553.

9 Although Cooke J agreed with Woodhouse J that the defendant auditor owed the plaintiff a duty of care, he held that the defendant was not liable in negligence on the facts of the

defendant owed the plaintiff a duty to take care in auditing the accounts, simply because it was reasonably foreseeable that someone other than the audit client might rely on them. Woodhouse J rejected the use of more restrictive tests for the existence of a duty of care, saying:[10]

> I do not think there is any need for or any sound reason in favour of a more restrictive approach. 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.

On the facts of the case, both Woodhouse and Cooke JJ held that it was reasonably foreseeable that someone other than John Duthie Holdings Ltd might rely on the audited accounts, because it was reasonably foreseeable that someone might make a takeover bid for the company. Cooke J said:

> The evidence shows that John Duthie Holdings Ltd was rich in assets but somewhat unimpressive in earnings...It was a classic case for a takeover or merger...And it was no less obvious that, as the company was a public one, any takeover would be preceded by a study of the published accounts.

The reasonable foreseeability test in general, and the *Scott Group* decision in particular, are usually criticised on the grounds that they are too broad, as the class of people who may foreseeably rely on audited accounts may be very large. In the *Scott Group* case itself, the dissenting judge, Richmond P, said:[11]

> It would be going too far to treat accountants as assuming a responsibility towards all persons dealing with the company or its members, in reliance to some greater or lesser degree on the accuracy of the accounts, merely because it was reasonably foreseeable, in a general way, that a transaction of the kind in which the plaintiff happened to become involved might indeed take place.

Notwithstanding these criticisms, the *Scott Group* reasonable foreseeability test was followed by the Lord Ordinary, Lord Stewart, in the Outer House of the Court of Session in Scotland in *Twomax Ltd v Dickson, McFarlane & Robinson*,[12] and by Woolf J in the Queen's Bench Division in England in *JEB Fasteners Ltd v Marks, Bloom & Co (a firm)*.[13] In each of these cases, the court held that the defendant auditor was liable to third party investors who had invested in the audit client in reliance on the audited accounts prepared by the defendant, because it was reasonably foreseeable that investors would so rely.

Although the simple reasonable foreseeability test initially found support in the United Kingdom, it was decisively rejected by the House of Lords in

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particular case, because the plaintiff had failed to prove that the error in the audited accounts had had any effect on the value of the shares purchased by the plaintiff: *ibid* at 585-9.

10 *Ibid* at 574.

11 *Ibid* at 566.

12 1983 Scots Law Times 98.

13 [1981] 3 All ER 289 (affirmed on other grounds [1983] 1 All ER 583).

Caparo Industries plc v Dickman,[14] which impliedly overruled both *Twomax* and *JEB Fasteners*. The House of Lords preferred the dissenting judgment of Richmond P in the *Scott Group* case. Lord Oliver of Aylmerton echoed Cardozo CJ when he said:[15]

> [I]t is almost always foreseeable that someone, somewhere and in some circumstances, may choose to alter his position upon the faith of the accuracy of a statement or report which comes to his attention and it is always foreseeable that a report - even a confidential report - may come to be communicated to persons other than the original or intended recipient. To apply as a test of liability only the foreseeability of possible damage without some further control would be to create a liability wholly indefinite in area, duration and amount and would open up a limitless vista of uninsurable risk for the professional man.

Although the United Kingdom has now turned its back on the reasonable foreseeability test on the basis that it is too broad, the trend is quite the opposite in the United States.[16] There, the old *Ultramares* 'privity test' has been abandoned in favour of the reasonable foreseeability test in New Jersey,[17] Wisconsin,[18] California,[19] and Mississippi.[20]

The decision of the Supreme Court of New Jersey in *Rosenblum Inc v Adler*[21] is generally regarded as the leading American case in this context. In *Rosenblum*, the defendants, Touche Ross & Co, had audited the financial statements of Giant Stores Corporation. The plaintiffs alleged that they had relied on the audited financial statements in selling their businesses to Giant Stores in exchange for shares in Giant Stores. The shares became worthless when large-scale management frauds on Giant Stores were discovered. The plaintiffs alleged that the defendants had been negligent in failing to detect these frauds when auditing Giant Stores' accounts. The defendants sought summary judgment on the basis that they could not be liable to the plaintiffs as third parties, under the *Ultramares* test. The Supreme Court of New Jersey rejected *Ultramares*, and adopted the reasonable foreseeability test for the

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14 [1990] 2 AC 605 at 624-5, per Lord Bridge of Harwich, and at 643-9, per Lord Oliver of Aylmerton.

15 *Ibid* at 643.

16 For a general analysis of the United States law, see JW Bagby and JC Ruhnka, "The Controversy over Third Party Rights: Toward More Predictable Parameters of Auditor Liability" (1987) 22 *Georgia Law Review* 149; RJ Gormley,"The Foreseen, The Foreseeable and Beyond - Accountants' Liability to Nonclients" (1985) 34 *Defense Law Journal* 75; JA Siciliano "Negligent Accounting and the Limits of Instrumental Tort Reform" (1988) 86 *Michigan Law Review* 1929.

17 *Rosenblum Inc v Adler* 461 A 2d 138 (NJ 1983).

18 *Citizens State Bank v Timm, Schmidt & Co* 335 NW 2d 361 (Wisc 1983).

19 *International Mortgage Co v John P Butler Accountancy Corp* 223 Cal Rptr 218 (Cal App 4 Dist 1986).

20 *Touche Ross & Co v Commercial Union Insurance* 514 So 2d 315 (Miss 1987).

21 461 A 2d 138 (NJ 1983).

existence of a duty of care. The opinion of the court was delivered by Schreiber J, who said:[22]

> When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes.

Although *Rosenblum* is not followed in all states, it is "now widely hailed as the heir-apparent to *Ultramares*".[23] At the very least, it shows that New Zealand is not the only jurisdiction to have adopted the reasonable foreseeability test, and it confirms that that test is not universally regarded as being too broad.

B. ACTUAL KNOWLEDGE OF THE LIMITED CLASS THAT WILL USE THE AUDITED ACCOUNTS

The second of the three tests described by Dickson J in *Haig v Bamford*[24] was applied by the Supreme Court of Canada in *Haig*'s case itself. The defendants audited the accounts of a company named Scholler Furniture & Fixtures Ltd, knowing that the audited statement would be used by the Saskatchewan Economic Development Corporation as the basis for a decision about whether to make a loan to Scholler Furniture. As the defendant auditors knew that a particular third party would be relying on the audited accounts, they would have owed that third party a duty of care even under the third test. However, the Supreme Court of Canada rejected the third test as being too narrow. After describing the three possible tests in the passage quoted above, Dickson J continued:[25]

> The choice in the present case, it seems to me, is between test (ii) and test (iii), actual knowledge of the limited class or actual knowledge of the specific plaintiff. I have concluded on the authorities that test (iii) is too narrow and that test (ii), actual knowledge of the limited class, is the proper test to apply in this case.

The court did not positively rule out the adoption of the first test, saying that it was not necessary on the facts of the case to decide whether or not the reasonable foreseeability test should be adopted.[26] However, subsequent cases have not gone beyond the position adopted in *Haig*, and it can now be said with some degree of certainty that there is no liability in Canada for statements passed on to a reasonably foreseeable, but unknown, third party.[27]

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22 *Ibid* at 153.

23 JA Siciliano note 16 *supra* at 1938.

24 Note 7 *supra.*

25 (1976) 72 DLR (3d) 68 at 75.

26 *Id.*

27 See, for example, *Dixon v Deacon Morgan McEwan Easson* (1989) 64 DLR (4th) 441, where an auditor was granted summary judgment in an action brought by an unknown third party who had purchased shares on the stock exchange in reliance on the auditor's report. See also

A version of the second test was also adopted by the House of Lords in *Caparo Industries plc v Dickman*,[28] although there it was done by endorsing the dissenting judgment of Denning LJ in *Candler v Crane Christmas & Co*,[29] rather than by following the decision of the Supreme Court of Canada in *Haig*. In considering to whom auditors owe a duty of care, Denning LJ said, in *Candler*'s case:[30]

> They owe the duty, of course, to their employer or client; and also I think to any third person to whom they themselves show the accounts or to whom they know the employer is going to show the accounts, so as to induce him to invest money or take some other action on them.

Although Denning LJ referred to "any third *person*" in the singular, it is clear that the House of Lords in *Caparo* accepted that an auditor may owe a duty of care to a *class* of third parties, if he or she knows that the audit client will show them the audited accounts, and that they will rely on them. Thus, for example, Lord Bridge of Harwich said:[31]

> [A]n essential ingredient of the 'proximity' between the plaintiff and the defendant [is] that the defendant knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind...and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter upon that transaction or upon a transaction of that kind.

The House of Lords justified its adherence to a criterion of *knowledge* of the use of the audited accounts by reference to the purpose for which audited accounts are prepared and published. For example, Lord Roskill said:[32]

> I think that before the existence and scope of any liability can be determined, it is necessary first to determine for what purposes and in what circumstances the information in question is to be given.

The Law Lords turned to the provisions of the *Companies Act* 1985 (UK) for assistance in determining the purpose for which audited accounts are prepared and published.[33] For example, after considering the legislative history of the

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Beebe v Robb (1977) 81 DLR (3d) 349, where it was held that a marine surveyor was not liable to an unknown third party who had purchased a boat in reliance on the surveyor's survey certificate.

28 [1990] 2 AC 605.

29 [1951] 2 KB 164.

30 *Ibid* at 180. This dictum was quoted and/or endorsed by each of the Lords in *Caparo*: see [1990] 2 AC 605 at 623, per Lord Bridge of Harwich, describing it as "a masterly analysis"; at 628, per Lord Roskill; at 629, per Lord Ackner; at 637, per Lord Oliver of Aylmerton; at 656-7, per Lord Jauncey of Tullichettle.

31 [1990] 2 AC 605 at 623.

32 *Ibid* at 629. See also at 652, per Lord Oliver.

33 *Ibid* at 625-6, per Lord Bridge; at 630-1, per Lord Oliver; at 658-60, per Lord Jauncey.

statutory requirement that company financial statements be audited, Lord Oliver said:[34]

> I do not, for my part, discern in the legislation any departure from what appears to me to be the original, central and primary purpose of these provisions, that is to say, the informed exercise by those interested in the property of the company, whether as proprietors of shares in the company or as the holders of rights secured by a debenture trust deed, of such powers as are vested in them by virtue of their respective proprietary interests.

This view of the purpose of an audit of accounts was used both to justify the decision that no duty was owed to potential investors, and also to hold that the defendant auditors did not owe a duty to individual existing shareholders. Prima facie, the auditor's duty was to the company and to the body of shareholders as a whole.[35] The plaintiff, Caparo Industries plc, had alleged that it had suffered loss both in its capacity as an investor that had purchased shares in reliance on the audited accounts, and in its capacity as an individual shareholder, after having bought the shares. Its action failed in both capacities.

Australian commentators have questioned whether the views expressed in *Caparo* accurately reflect the purpose of the Australian statutory provisions requiring financial statements to be audited.[36] Whether or not one agrees with Lord Oliver's view of the purpose of audited accounts, it at least explains why the House of Lords adopted the second test rather than a test based on foreseeability alone. According to this view, an unknown third party is outside the range of the auditor's duty of care because he or she is outside the class of people for whom the information is prepared (that is, the company itself and the body of people with "proprietary interests" in the company). The auditor will only be liable to third parties if he or she *knows* (rather than merely foresees) that the information will be given to, and used by, someone other than those for whom it is prepared.

A similar test is stated in the American *Restatement (Second) of Torts* (1977), s 552, which limits the liability of a professional for negligent misstatements to losses suffered:[37]

> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or *knows* that the recipient intends to supply it; and
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> (b) through reliance upon it in a transaction that he intends the information to influence or *knows* that the recipient so intends or in a substantially similiar transaction.

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34 *Ibid* at 631.

35 *Ibid* at 626-7, per Lord Bridge; at 654, per Lord Oliver; at 662, per Lord Jauncey.

36 G Gay and P Schelluch "The Auditor's Liability to the Company, Shareholders and Third Parties" (1991) 8 *Companies and Securities Law Journal* 59; R Baxt "The Liability of Auditors - the Pendulum Swings Back" note 2 *supra*.

37 *Restatement (Second) of Torts* (1977), s 522(2). Emphases added.

Several states have adopted the *Restatement* view to confine liability to third parties whom the auditor *knew* would receive and rely on the information: this has been done in Iowa,[38] Texas,[39] Utah,[40] Kentucky,[41] New Hampshire,[42] and Georgia.[43] In Rhode Island,[44] Minnesota,[45] and Ohio,[46] the *Restatement* view has been relied on to support the proposition that a duty is owed to any person or limited class of persons whose reliance on the audited accounts was 'specifically foreseen' or 'actually foreseen' by the auditor. Other, later, decisions in both Iowa[47] and Texas,[48] have relied on the *Restatement* to support the proposition that a duty is owed to those whom the auditor knew *or ought to have known* would receive and rely on the information,[49] which is, as I shall show below, a rather different proposition. Thus, although the *Restatement* appears on its face to state a version of the second test, some interpretations of it have gone considerably beyond the position stated in *Haig* and *Caparo.*

C. ACTUAL KNOWLEDGE OF THE SPECIFIC PLAINTIFF WHO WILL USE AND RELY ON THE STATEMENT

We have seen that the Supreme Court of Canada in *Haig* rejected the third of Mr Justice Dickson's three suggested tests as being too narrow.[50] No jurisdiction has expressly adopted a test that is, in its terms, as narrow as the third test. Nevertheless, some applications of the second test have been so narrow that they come very close to the third test in effect.

For example, in *Mariola Marine Corporation v Lloyd's Register of Shipping (The Morning Watch)*,[51] the owner of the yacht "Morning Watch", a man appropriately named Mariner, requested the defendants, Lloyd's Register of Shipping, to carry out a Special Survey of the vessel for the purposes of sale. The defendants' surveyor classed the vessel 100 A1, subject to the need for a few specified minor repairs. The plaintiffs were interested in purchasing the

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38 *Ryan v Kanne* 170 NW 2d 395 (Iowa 1969).

39 *Shatterproof Glass Corp v James* 466 SW 2d 873 (Tex Civ App 1971).

40 *Milliner v Elmer Fox & Co* 529 P 2d 806 (Utah 1974).

41 *Ingram Industries v Nowicki* 527 F Supp 683 (ED Ky 1981).

42 *Spherex Inc v Alexander Grant & Co* 451 A 2d 1308 (NH 1982).

43 *Badische Corp v Caylor* 630 F Supp 1196 (ND Ga 1986).

44 *Rusch Factors Inc v Levin* 284 F Supp 85 (DRI 1968); *Rhode Island Hospital Trust National Bank v Swartz, Bresenoff, Yavner & Jacobs* 455 F 2d 847 (US Ct Apps, 4th Cir, 1972).

45 *Bonhiver v Graff* 248 NW 2d 291 (1976).

46 *Haddon View Investment Co v Coopers & Lybrand* 436 NE 2d 212 (1982).

47 *Larsen v United Federal Savings and Loan Association* 300 NW 2d 281 (Iowa 1981).

48 *Blue Bell Inc v Peat, Marwick, Mitchell & Co* 715 SW 2d 408 (Tex Ct App 1986).

49 The same position has been adopted in Illinois, without reference to the *Restatement* - see *Merit Insurance Co v Colao* 603 F 2d 654 at 659 (1979).

50 Note 25 *supra*.

51 [1990] 1 Lloyd's Rep 547.

yacht. Although Mariner did not actually show the Lloyd's survey certificate to the plaintiff, he specifically assured the plaintiff that the yacht had just passed a Lloyd's Special Survey. In reliance on that fact, the plaintiff purchased the yacht, which proved to have major structural defects that had not been detected in the course of the Special Survey. Phillips J held that the defendants did not owe the plaintiff a duty to take reasonable care in conducting the Special Survey.

Most of Mr Justice Phillips' judgment is taken up with a consideration of the decision of the Court of Appeal in *Caparo*,[52] but in a postscript added after publication of the decision of the House of Lords in *Caparo*, he said that he was confirmed in his view by that decision. After quoting from the House of Lords in *Caparo*, Phillips J said:[53]

> The facts of this case do not satisfy those requirements. The Special Survey was not carried out for this purpose of a particular transaction - although Mr Mariner no doubt wished the Special Survey to be carried out before the vessel was put on the market as this was likely to enhance the sale prospects. No particular purchaser was in contemplation at the time of the survey. While it was possible that a purchaser would rely upon the Special Survey without independent inquiry this was not probable or highly probable. For these reasons neither the result nor the reasoning of the House of Lords in *Caparo v Dickman* causes me to alter my conclusions on the issue of proximity.

Clearly, this is a very narrow interpretation of the decision of the House of Lords in *Caparo*. The Lloyd's surveyor must have known that the Special Survey would be relied upon by *some* potential purchasers of the vessel, as the survey was done specifically for the purposes of sale. It was quite different from the normal biennial surveys conducted by Lloyd's for the purposes of entry in the Lloyd's Register. It was the equivalent of an audit of accounts that was done specifically and expressly for the purpose of attracting investment. One might have thought that the facts of *The Morning Watch* would have satisfied the version of the *Caparo* test suggested by Lord Bridge in the passage quoted above,[54] which was also quoted by Phillips J in *The Morning Watch*.[55] The defendants actually knew that the outcome of the survey would be communicated to someone such as the plaintiff, a member of an identifiable class of potential purchasers. Although the defendants had no knowledge of the particular purchaser or the particular transaction, they knew that the information in the survey was sought by Mariner specifically in connection with a transaction of a particular kind, namely, sale of the vessel. Nevertheless, Phillips J held that no duty was owed. One of the factors that he cited in support of that decision - "No particular purchaser was in contemplation at the time of the survey" - shows how close this decision comes to being the

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52 [1989] QB 653.

53 Note 51 *supra* at 562-3.

54 Note 31 *supra*.

55 Note 51 *supra* at 562.

embodiment of Mr Justice Dickson's third test, that of actual knowledge of the particular plaintiff who will use and rely on the statement.

In *Al Saudi Banque v Clark Pixley (a firm)*,[56] Millett J took an even more restrictive approach, holding that an auditor owed no duty of care to a limited class of identified third parties. The plaintiffs were ten banks, which had given credit to a company named Gallic Credit International Ltd after relying on its audited accounts, which had been audited by the defendants. Three of the banks were not existing creditors at the time the audited accounts were published; seven of them were. Following the decision of the Court of Appeal in *Caparo*,[57] Millett J held that the defendant auditors owed no duty to any of the banks. The three banks that were not existing creditors were in the same position as the potential investors in *Caparo*: it was reasonably foreseeable that someone in their position might rely on the audited accounts, but that was all. This was not sufficient to give rise to a duty of care. However, Millett J also held that no duty was owed to the seven banks that were existing creditors. He said:[58]

> What of the remaining seven plaintiffs who were existing creditors of the company at the time of the relevant balance sheet date? They were a limited class and their identity and the amount of their exposure was known to the defendants when they signed the report. But their position is not at all comparable with that of shareholders. They played no part in appointing the defendants as auditors. The defendants were under no statutory obligation to report to them and they did not do so. They did not supply copies of their reports to them, nor did they send them to the company with the intention or in the knowledge that they would be supplied to them. Clearly, to hold that a duty of care was owed to them would be going further than can be supported by any existing English authority.

Implicit in this passage is the notion that the purpose of the audited accounts was to provide information to the shareholders. Because the information in the audited accounts was intended for the shareholders, anyone other than the shareholders would be owed a duty only if the defendant auditors intended or knew that the audited accounts would be supplied to them. These views correspond closely to those of the House of Lords in *Caparo*, and the *Al Saudi Banque* case was expressly approved there.[59] The emphasis on the supposed purpose of the audited accounts in both *Caparo* and *Al Saudi Banque* shows how the version of the second test adopted in *Caparo* can be even narrower in effect than Mr Justice Dickson's third test. Even though the defendant auditors knew the identity of the seven banks that were existing creditors, and knew the extent of the debts that Gallic International owed to them, they did not owe the banks a duty of care, because their position was "not at all comparable with that of shareholders".

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56 [1990] Ch 313.

57 Note 52 *supra*.

58 Note 56 *supra* at 336.

59 Note 2 *supra* at 623, per Lord Bridge; at 641-2, per Lord Oliver; at 662, per Lord Jauncey.

D. THE FOURTH TEST - REASONABLE FORESEEABILITY-PLUS-PROXIMITY

One can predict with some confidence the *form* of the duty test that will be adopted in Australia. It is now well settled that the test for the existence of a duty of care in Australia is that of reasonable foreseeability of loss or injury, tempered by an overriding requirement of proximity of relationship between plaintiff and defendant. The most recent endorsement of the proximity-based test is to be found in the decision of the High Court of Australia in *Gala v Preston*,[60] where Mason CJ, Deane, Gaudron and McHugh JJ said:[61]

> Commencing with *Jaensch v Coffey* (1984) 155 CLR 549, this court, in a series of decisions, has accepted that a relevant duty of care will arise under the common law of negligence only in a case where the requirement of a relationship of proximity between the plaintiff and the defendant has been satisfied: see *Sutherland Shire Council v Heyman* (1985) 157 CLR 424 at 461-2, 506-7 60 ALR 1 *Stevens v Brodribb Sawmilling Co Pty Ltd* (1986) 160 CLR 340 at 354-5; 63 ALR 513; *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act 1979* (1986) 162 CLR 340 at 354-5; 68 ALR 161; *Cook v Cook* (1986) 162 CLR 376 at 381-2; 68 ALR 353. The requirement of proximity constitutes the general determinant of the categories of case in which the common law of negligence recognises the existence of a duty to take reasonable care to avoid a reasonably foreseeable risk of injury. In determining whether the requirement is satisfied in a particular category of case in a developing area of the law of negligence, the relevant factors will include policy considerations.

Although *Gala* was a case of physical injury caused by negligent driving, the general principles stated by the majority apply as much to cases of negligent misstatement as they do to cases of negligent driving. In *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act 1979*,[62] Gibbs CJ, Mason, Wilson and Dawson JJ said:[63]

> [T]he correct view is that, just as liability for negligent misstatement is but an instance of liability for negligent acts and omissions generally, so the treatment of the duty of care in the context of misstatements is but an instance of the application of the principles governing the duty of care in negligence generally.

Thus, it is clear that Australian courts will adopt a test which, in form at least, is unlike any of the three tests described by Mr Justice Dickson in *Haig*. In its *form*, the fourth test, that of foreseeability-plus-proximity, appears to fall somewhere between the first and second of Mr Justice Dickson's three suggested tests. However, the *effect* of the fourth test will depend upon the meaning given to the concept of proximity in the circumstances. Until the courts have determined what factors must be present in the relationship between the plaintiff and the defendant for the requirement of proximity to be satisfied in the present type of case, the effect of the fourth, Australian, test will remain

60 (1991) 172 CLR 243.

61 *Ibid* at 252.

62 (1986) 162 CLR 340.

63 *Ibid* at 354.

unclear. For example, the fourth test could be made identical in effect to the *Caparo* version of the second test if the High Court of Australia were to hold that, in these circumstances, the requirement of proximity is only satisfied if the defendant auditor knew that the audited accounts would be shown to the plaintiff or to a limited class of which the plaintiff was a member. Alternatively, the fourth test could be made identical in effect to the first test if the High Court of Australia were to hold that reasonable foreseeability of reliance on the audited accounts by third parties *is* sufficient proximity of relationship in these circumstances, as it is in most cases of personal injuries caused by negligence.[64]

At present, the most authoritative indication of the likely content of the requirement of proximity in the present type of case is to be found in obiter dicta in the judgment of the majority in the *San Sebastian* case. In their joint judgment, Gibbs CJ, Mason, Wilson and Dawson JJ referred with apparent approval to two Rhode Island cases, *Rusch Factors Inc v Levin* and *Rhode Island Hospital Trust National Bank v Swartz, Bresenoff, Yavner & Jacobs.*[65] Their Honours explained the effect of those cases as follows:[66]

> The two decisions provide support for the proposition that, where a statement is made for the purpose of inducing the plaintiff, or the members of a limited class including the plaintiff, to commit themselves financially upon the basis that the statement is true, and the plaintiff acts in reliance on the statement, the law will impose a duty of care on the maker of the statement...[I]t is necessary not only that A intends that B or members of a class of persons should act or refrain from acting in a particular way, but also that A makes the statement with the intention of inducing B or members of that class, in reliance on the statement, to act or refrain from acting in the particular way, in circumstances where A should realize that economic loss may be suffered if the statement is not true.

The fact that Gibbs CJ, Mason, Wilson and Dawson JJ apparently approved of the stated effect of the Rhode Island cases can be gleaned from the following passage of their joint judgment:[67]

> It follows then that if the [plaintiffs'] case is to succeed they must establish at least, amongst other things...that the [defendants] made the representation with the intention of inducing members of the class of developers to act in reliance on the representation.

If this is to be one of the requirements of proximity in this context, and if there can be no liability unless the defendant intended to induce the plaintiff to rely on the statements in question, then it would seem that the fourth test in Australia will be even more restrictive in effect than the version of the second test adopted by the House of Lords in *Caparo*. In *Caparo*, the House of Lords at least contemplated the possibility that an auditor might be liable to a third

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64 See, for example, *Sutherland Shire Council v Heyman* (1985) 157 CLR 424 at 495, per Deane J.

65 Note 43 *supra*.

66 Note 62 *supra* at 357-8.

67 *Ibid* at 358.

party if the auditor *knew* that that third party would be likely to rely on the audited accounts.[68] According to the view apparently supported by the majority in *San Sebastian*, Australian auditors may not be liable to third parties at all. In auditing the accounts of the audit client, the auditor may foresee that parties other than the audit client may rely on the audited statements, and he or she may even positively know that third parties will rely on those statements, but it will seldom, if ever, be the case that the auditor will audit the accounts *intending* to *induce* third parties to rely on them. The auditor will not usually have any interest in inducing third parties to rely on the audited accounts, or any reason for wanting third parties so to rely.

In short, by focussing on the *intention* of the defendant auditor, rather than on his or her knowledge or foresight, the majority seems to have stated its support for a test that is so restrictive that it will hardly ever be satisfied. Also, with due respect, it is difficult to see how support for such a test can be drawn from the Rhode Island authorities cited by the majority. The test adopted in *Rusch Factors Inc v Levin*[69] was stated simply by Pettine DJ as follows:[70]

> This Court holds that an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons.

Whatever 'actually foreseen' may mean, it clearly does not mean 'intended'. It seems that 'actually foreseen' is merely another way of saying 'identified',[71] so that an auditor would be liable under the *Rusch Factors* test if he or she knew that an identified third party, or an identified and limited class of third parties, would rely on the statements, whether or not he or she *intended* to *induce* the third party to rely on them. In other words, the *Rusch Factors* case seems to support the *Caparo* position rather than the position apparently stated by the majority in *San Sebastian*.

The views expressed by Gibbs CJ, Mason, Wilson and Dawson JJ in the *San Sebastian* case cannot be regarded as conclusive. Those views were expressed obiter, and it does not seem that the majority was attempting to give a definitive account of the factors that will be taken into account in determining whether the requirement of proximity is satisfied. Furthermore, there is Australian authority that provides at least some support for the proposition that a duty is owed to a known third party, even if the defendant did not intend to induce that third party to use the information. For example, in *BT Australia Ltd v Raine & Horne Pty*

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68 See, for example, *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] 1 All ER 148, a post-*Caparo* case where the defendant was held to be liable to a *known* third party. Compare *McNaughton (James) Paper Group Ltd v Hicks Anderson & Co (a firm)* [1991] 2 QB 113. These two cases are considered in M Percival "After Caparo - Liability in Business Transactions Revisited" (1991) 54 *MLR* 739.

69 Note 43 *supra*.

70 *Ibid* at 93.

71 See Gormley, note 16 *supra* at 87-91.

Ltd,[72] the Supreme Court of New South Wales held that a duty of care was owed to "passive third parties",[73] who suffered loss as a result of the provision of information by the defendant, even though they did not rely on the information themselves. At the request of a unit trustee, the defendant, a property valuer, had valued property that was the main asset of the unit trust, knowing that the unit trustee intended to use the valuation in the exercise of its duties as trustee and investment manager. As the defendant knew that the holders of the trust units would suffer loss if the unit trustee relied on misleading information, it was held that the defendant owed a duty to the identifiable class of unit holders. It is but a short step from holding that a duty is owed to a known 'passive third party' to holding that a duty is owed to a known 'active third party'. That step was taken by the Supreme Court of Victoria in *AGC (Advances) Ltd v Lowe Lippman Figdor & Franck*,[74] where it was held that an auditor owed a duty of care to a known third party, even though there was no indication that the auditor intended to induce that third party to rely on the audited accounts. The defendant auditors knew that the plaintiff, a finance company, would rely on the audited accounts in deciding whether to extend credit to the company in question, and the defendants actually supplied the plaintiff with a copy of the audited accounts themselves. In these circumstances, the defendants did not attempt seriously to pursue the argument that they owed the plaintiff no duty of care,[75] and Vincent J had little difficulty in holding that a duty was owed, by applying the statement of the Australian law relating to negligent misstatement contained in the judgment of Marks J in *Norris v Sibberas*.[76] Vincent J said:[77]

> When a company, which is widely known to be engaged in the business of finance, and has to the knowledge of an auditor engaged in dealings with one of the auditor's clients, requests the auditor to provide information about that client, it would not appear to involve the exercise of a substantial measure of imaginative creativity to encompass the reasonable possibility that the party requesting the information may rely upon it in the course of its business relationship with that client.

Notwithstanding what was said by the majority in the *San Sebastian* case, the *BT Australia* and *AGC (Advances)* cases show that the Australian position is at least as broad as the English, in that an auditor may owe a duty to a known third party if it is also known that the third party will rely on the information. After

72 [1983] 3 NSWLR 221. Compare *Fassifern Investments Pty Ltd v Gordon* (unreported Supreme Court, NSW, Abadee J, 12 September 1991), where it was held that no duty was owed by a design engineer to an unknown third party.

73 *Ibid* at 233, per Wootten J.

74 (1991) Aust Torts Reps para 81-072.

75 *Ibid* at 68,569 per Vincent J.

76 [1990] VR 161 at 171-2. Murphy and Beach JJ agreed with Marks J. *Norris* is considered in M Davies "Special Skill in Negligent Misstatement" (1990) 17 *MULR* 484 at 489-91.

77 Note 74 *supra* at 68,572.

all, this is nothing more than the position originally adopted by the House of Lords in *Hedley Byrne & Co Ltd v Heller & Partners Ltd*,[78] which was itself a case of a known third party. The question still remains, though: how much further than that will the Australian courts go, if at all?

Other Australian cases do give some indication of a more expansive approach to the requirement of proximity in cases of negligent misstatement. In particular, there seems to be considerable support for the proposition that there is sufficient proximity of relationship between plaintiff and defendant if the defendant knew *or ought to have known* that the plaintiff (or an identifiable class of which the plaintiff is a member) would be likely to rely on the statements in question. For example, when speaking of the concept of proximity in general terms in *Sutherland Shire Council v Heyman*,[79] Deane J said:[80]

> The requirement of proximity...may reflect an assumption by one party of a responsibility to take care to avoid or prevent injury, loss or damage to the person or property of another or reliance by one party upon such care being taken by the other in circumstances where the other party knew *or ought to have known* of that reliance.

Similarly, when considering the appropriate test for the existence of a duty to take care in making statements, Barwick CJ said, in *Mutual Life and Citizens' Assurance Co Ltd v Evatt*:[81]

> The information or advice will be sought or accepted by a person on his own behalf or on behalf of an identified or identifiable class of persons. The person giving the information or advice must do so willingly and knowingly in the sense that he is aware of the circumstances which create the relevant relationship. He must give the information or advice to some identified or identifiable person in the given circumstances of the implications of which he is, *or ought to be*, aware.

The composite phrase 'knew or ought to have known' is often used, but it is not often used with much precision. Sometimes, the words 'or ought to have known' are tagged on after 'knew' as if they were an obvious afterthought; sometimes, the phrase 'knew or ought to have known' is used as if it were roughly synonymous with the phrase 'reasonably foreseeable'. Used with precision, though, the words signify a kind of half-way house between knowledge and reasonable foreseeability: broader than the former, but narrower than the latter. I *ought* to know many things that I do not, in fact, know. For example, if the Lloyd's surveyor in *The Morning Watch*[82] did not know that the Special Survey would be used for the purposes of the sale of the vessel, it can

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78 [1964] AC 465.

79 (1985) 157 CLR 424.

80 *Ibid* at 497-8. Emphasis added.

81 (1968) 122 CLR 556 at 570. Emphasis added.

82 Note 51 *supra*.

certainly be said that he *ought* to have known.[83] However, to say that I *ought* to have *known* that something might happen is to say much more than that I ought reasonably to have foreseen it. After all, an event is reasonably foreseeable if it is merely not "far-fetched or fanciful".[84] As Lord Oliver pointed out in *Caparo*,[85] it is always reasonably foreseeable that audited accounts - even confidential accounts - may be communicated to, and relied on by, persons other than the original or intended recipient. Nevertheless, it does not follow from this fact alone that an auditor *ought* to *know* that the audited accounts will be passed on to, and relied on by, third parties.

The judgment of Barwick CJ in *Evatt* appears to have been generally endorsed by a majority of the High Court of Australia in *Shaddock & Associates Pty Ltd v Parramatta City Council (No 1)*.[86] If it is used as the starting-point for a consideration of what factors are relevant to the requirement of proximity, the fourth test will be broader in its scope than the *Caparo* test, and broader in scope than the position apparently suggested by the majority in the *San Sebastian* case, but narrower in scope than the *Scott Group* test. An example of how the Barwickian approach might work in practice is to be found in the decision of the Court of Appeals of Texas in *Blue Bell Inc v Peat, Marwick, Mitchell & Co*.[87] The plaintiff, Blue Bell Inc, was a clothing manufacturer that extended credit to a group of department store companies, collectively known as Myers Department Stores Inc. The defendants, Peat Marwick Mitchell, had audited the accounts of various members of the Myers group, and, at Myers' request, had provided Myers with seventy copies of the audited financial statements, instead of the twenty-five copies originally requested. Soon after, Myers filed for bankruptcy, and the plaintiff recovered only a small part of what it was owed by Myers. The plaintiff sued the defendants, alleging that the defendant had negligently audited the financial statements of Myers, and that it (the plaintiff) had suffered loss by extending credit to Myers in reliance on those audited statements. The defendants applied for summary judgment, which was granted at first instance. On appeal, the Court of Appeals in Texas reversed the order for summary judgment and held that the defendants could be liable to the plaintiff in the circumstances. The court rejected the *Caparo*-like

83 For example, see *Gordon v Moen* [1971] NZLR 526, where a marine surveyor was held to owe a duty of care to the purchaser of a boat because the surveyor ought to have known that the survey would be used for the purpose of raising finance or selling the boat.

84 *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at 47-8, per Mason J.

85 Note 15 *supra*.

86 (1981) 150 CLR 225. It is not clear that there is a majority in favour of Barwick CJ's view because of ambiguities in the judgment of Murphy J - see M Davies note 76 *supra*. The majority in the *San Sebastian* case appeared to take the view that *Shaddock* endorsed the judgment of Barwick CJ in *Evatt*: see (1986) 162 CLR 340 at 356.

87 Note 48 *supra*.

view expressed in s 552 of the *Restatement (Second) of Torts* (1977)[88] in the following terms:[89]

> To allow liability to turn on the fortuitous occurrence that the accountant's client specifically mentions a person or class of persons who are to receive the reports, when the accountant may have that same knowledge as a matter of business practice, is too tenuous a distinction for us to adopt as a rule of law. Instead, we hold that if, under the current business practices and the circumstances of the case, an accountant preparing audited financial statements knows *or should know* that such statements will be relied upon by a limited class of persons, the accountant may be liable for injuries to members of that class relying on his certification of the audited reports...Among the factors relevant to this issue is the fact that Blue Bell was a trade creditor of Myers at the time PMM prepared the financial statements in question and that PMM was, therefore, aware of Blue Bell as one of a limited number of existing trade creditors who would, in all probability, be receiving copies of the financial statements. Furthermore, PMM supplied Myers with seventy copies of the financial statements, indicating knowledge by PMM that third parties would be given the reports...Consequently, in deciding whether PMM had a duty to Blue Bell, a fact finder must determine whether PMM knew or should have known that members of such a limited class would receive copies of the audited financial statements it prepared.

If the *Haig/Caparo* second test had been applied in *Blue Bell*, the court would have held that the defendants, Peat Marwick Mitchell, did not owe the plaintiff, Blue Bell, a duty of care. Peat Marwick Mitchell did not *know* that Myers intended to give the audited financial statements to Blue Bell, and they did not *know* that Blue Bell might rely on the statements to make decisions about extending credit to Myers. Nevertheless, it seems clear that the defendants *ought* to have known that Myers intended to show the audited accounts to third parties, and *ought* to have known that the Blue Bell would have been one of those parties. Further, Blue Bell was a member of what Barwick CJ would have described as 'an identifiable class' of existing creditors. In these circumstances, it seems that the Barwickian approach would lead to the result that Peat Marwick Mitchell owed Blue Bell a duty of care.[90]

Although the Barwickian approach is different from the three tests previously considered, it is like them in one respect, in that it focusses on the defendant's end of the relationship between the auditor and the third party. Under each of the tests and factors considered so far, including the Barwickian approach to the fourth test, the court looks at the situation from the defendant's point of view, by asking whether the defendant auditor knew, or ought to have known, or ought to have foreseen, or intended that the plaintiff third party would rely on the audited

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88 Note 37 *supra*.

89 715 SW 2d 408 at 412-3, per Akin J. Emphasis in the original.

90 Of course, there is no decision about these matters in *Blue Bell* itself, where the Court of Appeals of Texas was merely considering a motion for a rehearing after the trial judge had ordered summary judgment for the defendants.

accounts. As has recently been pointed out,[91] the defendant's point of view is only one of the factors that should be taken into account in considering whether there is sufficient proximity of relationship between the defendant auditor and the plaintiff third party. Many other factors may be relevant, including, in particular, the question of whether the plaintiff acted reasonably in relying on the audited accounts.[92] For example, if it would be reasonable in the circumstances to expect the plaintiff to commission his or her own, 'second opinion' audit of the accounts of the company before investing or lending, then it would not be reasonable for that plaintiff to rely solely on the audited accounts prepared by the defendant, and no duty should be owed. Thus, a duty might be owed to small, private investors or lenders, but not to institutional investors, large takeover bidders or banks, who might be expected to make their own inquiries about the financial viability of the company.[93]

The fact that many factors may be relevant to the requirement of proximity does not mean that it is a question of fact, to be resolved merely by reference to the particular circumstances of the case.[94] In the series of cases that developed the proximity-based test, much emphasis was placed on the need to develop a reasoned approach to the proximity requirement that depends on the *type* of case, rather than on the facts of each particular case.[95] In the United States, several jurisdictions have produced reasoned analyses of the various factors that should be taken into account in determining whether the maker of a statement owes a duty of care to third parties. These American decisions can be used to provide a ready-made analysis of the type of factors that may be taken into account in Australia under the rubric of 'proximity'. The leading case is *Biakanja v Irving*,[96] where the Supreme Court of California first departed from the *Ultramares* 'privity test'.[97] Gibson CJ said:[98]

> The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty

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91 G Gay and P Schelluch note 36 *supra* at 61; R Baxt "The Liability of Auditors - The Pendulum Swings Back" note 2 *supra* at 254-5.

92 See the *San Sebastian* case note 62 *supra* at 355: "When the economic loss results from negligent misstatement, the element of reliance plays a prominent part in the ascertainment of a relationship of proximity between the plaintiff and the defendant, and therefore in the ascertainment of a duty of care."

93 R Baxt, note 2 *supra* at 254-5.

94 *Sutherland Shire Council v Heyman* (1985) 157 CLR 424 at 498, per Deane J.

95 *Id.*

96 320 P 2d 16 (1958).

97 The Supreme Court of California has since departed even further from *Ultramares* by adopting a reasonable foreseeability test in the *International Mortgage* case note 19 *supra*.

98 Note 96 *supra* at 19. Shenk, Carter, Traynor, Schauer, Spence and McComb JJ agreed with Gibson CJ.

> that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct and the policy of preventing future harm.

The six-pronged *Biakanja* test is very reminiscent of the Australian proximity-based approach including, in particular, the explicit reference to the role of policy, which was also mentioned by the High Court of Australia in *Gala*.[99] *Biakanja* has been applied to cases involving auditors[100] in Missouri[101] and North Carolina.[102] For example, in *Raritan River Steel Co v Cherry, Bekaert & Holland*,[103] the second plaintiff, Sidbec-Dosco Inc, sold raw steel on credit to Intercontinental Metals Corporation (IMC), on the basis of a favourable audit report prepared by the defendants, Cherry Bekaert and Holland. The audit showed IMC to have a net worth of $7 million, when in fact its net worth was at least 'a negative $10 million'. IMC then filed for bankruptcy. As Sidbec-Dosco was not able to recover any of the debts owed to it by IMC, it sued the auditors, Cherry Bekaert and Holland. The defendant auditors applied for summary judgment, which was granted at first instance. The Court of Appeals of North Carolina allowed Sidbec-Dosco's appeal, holding that the defendant auditors could owe Sidbec-Dosco a duty of care in the circumstances, even though they did not know that IMC would show the audit statement to Sidbec-Dosco, and even though they did not know that Sidbec-Dosco would use the audit statement in extending credit to IMC.[104] Whichard J (with whom Johnson and Phillips JJ agreed) considered and rejected each of the *Ultramares* privity test, the test stated in s 552 of the *Restatement (Second) of Torts* (1977), and the *Rosenblum* reasonable foreseeability test, before adopting the *Biakanja* test as the most appropriate in the circumstances.[105] Whichard J said:[106]

> The *Biakanja* test...avoids the necessity of an arbitrary, purpose-based determination of liability by allowing a court to weigh the purpose of the audit as one of several determinative factors.

It will be recalled that the House of Lords in *Caparo* specifically emphasised the purpose of an audit as the major factor behind its adoption of the second

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99 Note 61 *supra*.

100 *Biakanja* itself concerned a notary public, not an auditor.

101 *Aluma Kraft Manufacturing Co v Elmer Fox & Co* 493 SW 2d 378 (Mo App 1973), following *Westerhold v Carroll* 419 SW 2d 73 (1967), a decision of the Supreme Court of Missouri in a non-auditor case.

102 *Raritan River Steel Co v Cherry, Bekaert & Holland* 339 SE 2d 62 (NC App 1986).

103 *Id.*

104 The court also held that the defendants, Cherry, Bekaert and Holland, owed the first plaintiff, Raritan River Steel Co, a duty of care because they themselves had sent Raritan River Steel a copy of a Dun & Bradstreet report containing a reference to their audit.

105 Note 102 *supra* at 66-9.

106 *Ibid* at 69.

test.[107] In contrast, under the *Biakanja/Raritan River Steel* approach, the purpose of the audit is not "exclusively determinative",[108] but is merely one of several factors to be taken into account. To this extent, then, it would seem that the *Biakanja/Raritan River Steel* approach is far more consistent with the Australian proximity-based fourth test than is the *Caparo* test.

Whether the purpose of the audit is taken into account as the key factor, or merely as one of several factors, it seems that it may have a different effect in Australia than it had in England in *Caparo* itself. In *Caparo*, the House of Lords took the view that the purpose of a statutory audit of a company's accounts is simply to enable those with 'proprietary interests' in the company to make an 'informed exercise' of their rights and powers.[109] Australian commentators have argued that the purpose of audits of company accounts under Australian company law is much broader, including the provision of information to both present and potential providers of equity or loan capital and to creditors.[110] Similarly broad views of the purpose of audited accounts have been expressed in the United States. For example, in *United States v Arthur Young & Co*,[111] Burger CJ, writing for the unanimous Supreme Court of the United States, described the role of the independent auditor as follows:[112]

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.

In summary, it can be said that the combination of the Barwickian 'knew or ought to have known' approach to duty of care and the broader Australian view of the purpose of an audit of accounts may well produce the result that the fourth test will be broader in effect than *Caparo*, as well as being different in form.

E. COMPARATIVE ANALYSIS OF THE PRACTICAL EFFECT OF THE FOUR TESTS

The debate about what is fair and reasonable with respect to auditors' liability is polarised. Those who would restrict the duty of care owed by auditors to third parties tend to look at the situation from the point of view of the defendant auditor. The fear of indeterminate liability is a defendant's fear, and, at bottom, it is a fear of uninsurable liability or, as Lord Oliver put it in *Caparo*, "a

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107 See pp 177-8 *supra*.

108 Note 102 *supra* at 69.

109 See the text to note 34 *supra*.

110 G Gay and P Schelluch note 36 *supra* at 61-2; R Baxt "The Liability of Auditors the Pendulum Swings Back" note 2 *supra* at 254.

111 104 S Ct 1495 (1984).

112 *Ibid* at 1503.

limitless vista of uninsurable risk for the professional man".[113] In addition, there is the fear that even if insurance against the risk of liability to third parties can be bought, premiums will be unmanageably high. Thus, those in favour of a restrictive approach to auditors' liability tend to emphasise the burden of insurance that would fall on auditors if liability were not restricted. For example, one Australian commentator wrote recently:[114]

> The proponents of the less restrictive approach appear to have lost sight of two important points: who pays [for insurance] and how much. This type of insurance is already expensive. Imagine the cost if more people could sue! The auditor will pay for it initially and will then pass it on to the client. The shareholders pay for it in foregone dividends. The third party pays no part of the premium...Why do predators in a takeover situation need to be protected? Can we really class them and the banks as unfortunate and innocent victims?

At the other end of the spectrum, those who oppose restrictions on the duty of care look at the situation from the point of view of the plaintiff, the third party who has relied on the misleading audited statements to his or her detriment. For example, in *Rusch Factors Inc v Levin*,[115] Pettine DJ said:[116]

> Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk on to its customers, who can in turn pass the cost on to the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?

From the defendant's point of view, it is said that the restrictive approach to auditors' liability promotes the flow of commercial information, by encouraging auditors to certify the commercial status of companies without fear of reprisal if they innocently err.[117] From the plaintiff's point of view, it is said that the restrictive approach *dis*courages commercial activity, as creditors and investors will be less inclined to lend or invest if they cannot rely on the accuracy of audited company accounts because the auditor is not liable for negligently preparing or certifying them.[118] From the defendant's point of view, it is said that a broad approach to liability would increase the cost of audit services for all users, and would discourage auditors from auditing the accounts of any company with many third party contacts.[119] From the plaintiff's point of view, it is said that a broad approach would decrease the cost of credit for all

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113 Note 15 *supra*.

114 G Livanes *Fair Enough?* (1990) 61(8) *Charter* 56 at 60.

115 Note 44 *supra*.

116 *Ibid* at 91.

117 G Livanes, note 114 *supra*.

118 K Mullan "Putting Two and Two Together" (1990) 140 *NLJ* 491 at 492: "the meaning of caveat emptor might be extended and to it might be added caveat creditor and caveat investor".

119 G Livanes, note 114 *supra*; JA Siciliano note 16 *supra* at 1960.

borrowers, as it would reduce the number of loan defaults and the need for investors to buy second opinions from independent auditors.[120]

These opposing views show that there can be no 'right' answer to the question of whether auditors should be liable to third parties, as any answer will have its supporters and its detractors.[121] The best that one can hope for is a position that does not attract too much opprobrium from either side. It seems to me that the fairest and most reasonable position is one somewhere between the version of the first test adopted in *Scott Group* and the version of the second test adopted in *Caparo*.

Although the adoption of the reasonable foreseeability test does not appear to have brought ruin to the auditors of New Zealand, New Jersey, Wisconsin, California, and Mississippi, there do seem to be grounds for believing that it is too broad. The criterion of reasonable foreseeability is now so undemanding that its adoption would expose auditors to liability to virtually all potential investors and creditors as well as existing shareholders and creditors. As noted above,[122] it will hardly ever be 'far-fetched and fanciful' that an audited statement of accounts may be passed on to, and used by, potential creditors and investors, particularly as such statements are, to some extent, public documents in Australia.[123] In any event, the High Court of Australia has made it quite clear that a test based on reasonable foreseeability alone is inappropriate in cases where the plaintiff has suffered purely economic losses.[124] Thus, it seems both undesirable and unlikely that Australian courts will effectively adopt the first test by holding that reasonable foreseeability of reliance is sufficient proximity to satisfy the fourth test.

Conversely, there also seem to be grounds for believing that the second and third tests are too narrow. There is much cogency in the view expressed by the Court of Appeals of Texas in the *Blue Bell* case,[125] that it is undesirable to allow liability to turn on the fortuitous occurrence that the audit client specifically mentions to the auditor that a particular third party or class of third parties is to receive the audited accounts. Since the decision in *Vaughan v Menlove* in 1837,[126] the law of negligence has, in general, steered clear of liability tests based on the subjective knowledge of the defendant. There seems to be little reason to deny liability because the evidence does not show that the auditor *knew* that third parties would rely on the audited accounts, when the evidence clearly establishes that the auditor *ought* to have known, in the light of

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120 JW Bagby and JC Ruhnka, "The Controversy over Third Party Rights: Toward More Predictable Parameters of Auditor Liability" (1987) 22 *Georgia Law Review* 149 at 187.

121 By the same token, it is comforting to note that one cannot give a 'wrong' answer, either.

122 Note 15 *supra*.

123 Note 110 *supra*.

124 See, for example, the *San Sebastian* case, note 62 *supra* at 353-4.

125 Note 89 *supra*.

126 (1837) 3 Bing (NC) 468; 132 ER 490.

"current business practices and the circumstances of the case".[127] By introducing a degree of objectivity to the court's assessment, the 'knew or ought to have known' approach has the advantage that it gives the court the opportunity to consider current business practice and commercial conditions in determining whether the defendant auditor ought to have known that the audited accounts would be passed on to, and relied on by, third parties. Thus, I would suggest that it would be undesirable for Australian courts effectively to adopt the second or third tests by holding that the requirement of proximity in the fourth test is satisfied only if the auditor knew that third parties would see and rely on the audited accounts.

I suggest that a version of the fourth test that is based on a 'knew or ought to have known' requirement, as in the *Blue Bell* case, and which also takes into account a number of factors, as in the *Biakanja/Raritan River Steel* approach, would produce the most desirable result in practice. As well, it would be quite consistent with the approach that the High Court of Australia has taken to duty of care questions in recent years. Although such a test would probably not be the best of both worlds, it may succeed in avoiding the excesses of the polar extremes described above. Liability under such a test would not be 'indeterminate', as it would be much more restrictive in effect than the first test. If necessary, policy factors could be taken into account in fixing the outer limits of liability: policy questions were listed as one of the six relevant factors in *Biakanja*,[128] and *Gala*'s case makes it quite clear that policy may be considered in Australia in determining whether a relationship of proximity exists.[129] Such a test should not be too narrow, either. If it were to be adopted, liability of auditors to third parties would be by no means unusual, which would reflect the essentially public nature of audited accounts.

III. AUDIT DISCLAIMERS

In the *Scott Group* case, Cooke J commented on the fact that the defendant auditor in that case had not included a general disclaimer of liability with the audited accounts. He said:[130]

> Perhaps some auditors, naturally jealous of their professional reputation, would hesitate to announce such a disclaimer, nor do we know what the attitude of the stock exchange might be.

In a brave new world of expanded liability to third parties, auditors may be more concerned with the potential cost of liability and/or liability insurance than with their professional reputations or the attitude of the stock exchange. As a

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127 Note 89 *supra*.

128 Note 98 *supra*.

129 Note 61 *supra*.

130 Note 8 *supra* at 581.

result, the use of general disclaimers of liability by auditors may become more widespread.

There can be no doubt that disclaimers of liability are, in general, effective. This has been clear ever since *Hedley Byrne & Co Ltd v Heller & Partners Ltd*,[131] where the House of Lords held that the defendants were not liable to the plaintiffs because their advice was given 'without responsibility'. It has been suggested that a disclaimer in the following terms might be effective to protect auditors from liability to third parties:[132]

> Nothing in this Report may be relied upon by any other person, other than [the company]. [The auditor] disclaims any assumption of responsibility for any reliance on the report or accounts to which the Report relates by any person other than [the company].

According to one view, disclaimers such as this are effective because liability for negligent misstatements is based on an assumption of responsibility by the defendant, so that the presence of a disclaimer indicates that no duty of care arises, because the defendant has not assumed responsibility for his or her statements.[133] Another view of the effect of disclaimers can be found in the judgment of Barwick CJ in *Mutual Life and Citizens' Assurance Co Ltd v Evatt*:[134]

> The duty of care, in my opinion, is imposed by law in the circumstances. Because it is so imposed, I doubt whether the speaker may always except himself from the performance of the duty by some express reservation at the time of his utterance. But the fact of such a reservation, particularly if acknowledged by the recipient, will in many instances be one of the circumstances to be taken into consideration in deciding whether or no a duty of care has arisen and it may be sufficiently potent in some cases to prevent the creation of the necessary relationship. Whether it is so or not must, in my opinion, depend upon all the circumstances of and surrounding the giving of the information or advice.

According to this view, an auditor's disclaimer of liability might not be effective if the relationship between the plaintiff and the defendant were such that the defendant knew or ought to have known that the plaintiff would rely on the audited accounts, notwithstanding the disclaimer of liability therein. Considerations of this kind were taken into account in the House of Lords in *Smith v Eric S Bush*,[135] although in a slightly different context. In *Smith*'s case, the plaintiff applied to a building society for a mortgage to assist her in buying a

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131 Note 78 *supra*.

132 D Partlett "Liability of Auditors to Third Parties in Negligence" (1979) 17 *Law Society Journal (NSW)* 93 at 107. Partlett disclaimed responsibility for the effectiveness of the clause. See also the disclaimer of liability in the *BT Australia* case, note 72 *supra*: "This report is for the use of the party to whom it is addressed and for no other purpose, and no responsibility is accepted to any third party for the whole or part of the contents of this report."

133 See, for example, *Hedley Byrne*, note 78 *supra* at 486, per Lord Reid.

134 Note 81 *supra* at 570.

135 [1990] 1 AC 831.

house. The building society commissioned the defendants, who were property valuers, to survey the house and estimate its value. The defendants reported that no repairs to the house were necessary when, in fact, two chimneys were inadequately supported. The valuation report contained a disclaimer of liability. The building society told the plaintiff that the valuation report was not a structural survey, and advised her to seek independent professional advice. Nevertheless, the plaintiff relied solely on the defendants' report, and bought the house. She sued the defendants when one of the chimneys collapsed, and the defendants sought to rely on the disclaimer of liability in the report. The House of Lords held that the disclaimer of liability was not effective in the circumstances, because it was not 'reasonable', as it was required to be by the provisions of the *Unfair Contract Terms Act* 1977 (UK). In considering the 'reasonableness' of the disclaimer for the purposes of the Act, Lord Griffiths identified four relevant factors, the second of which was as follows:[136]

> [W]ould it have been reasonably practicable to obtain the advice from an alternative source taking into account considerations of cost and time? In the present case it is urged on behalf of the surveyor that it would have been easy for the purchaser to have obtained his own report on the condition of the house, to which the purchaser replies, that he would then be required to pay twice for the same advice and that people buying at the bottom end of the market, many of whom will be young first-time buyers, are likely to be under considerable financial pressure without the money to go paying twice for the same service.

After stating his view that the disclaimer was not effective in the circumstances of the case, Lord Griffiths continued:[137]

> It must, however, be remembered that this is a decision in respect of a dwelling house in which it is widely recognised by surveyors that purchasers are in fact relying on their care and skill...I expressly reserve my position in respect of valuations of quite different types of property for mortgage purposes, such as industrial property, large blocks of flats or very expensive houses. In such cases it may well be that the general expectation of the behaviour of the purchaser is quite different. With very large sums of money at stake prudence would seem to demand that the purchaser obtain his own structural survey to guide him in his purchase and, in such circumstances, with very much larger sums of money at stake, it may be reasonable for the surveyors valuing on behalf of those who are providing the finance either to exclude or limit their liability to the purchaser.

Although these comments are made in the context of a consideration of the provisions of the *Unfair Contract Terms Act* 1977 (UK), and although they relate to valuer's reports done for the purposes of mortgage security, they contain much that is of assistance in considering the likely effect of disclaimers of liability in audited accounts. It has already been suggested that the nature of the plaintiff's interest in the audited accounts may affect the reasonableness of his or her reliance on them, and, thus, the existence of a duty of care, even in the absence of a disclaimer of liability.[138] Those arguments apply with even more

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136 *Ibid* at 858.

137 *Ibid* at 859-60.

138 Page 189 *supra*.

force where the auditor has attempted to disclaim liability for the contents of the audited accounts. It may never be reasonable for an institutional investor, a takeover bidder or a bank to rely solely on the audited accounts of the company, even when they do not contain a disclaimer of liability. When the accounts *do* contain a disclaimer of liability by the auditor, it would seem that it would clearly be unreasonable for third parties of that kind to rely solely on the accuracy of the audited accounts without seeking some kind of a 'second opinion' before investing or lending. In contrast, small, private investors will probably not have the means to conduct an independent investigation into the financial viability of the company, whether or not there is a disclaimer of liability in the audited accounts, neither would it be reasonable to expect them to do so. In these circumstances, it may always be reasonable for such an investor to rely on the accuracy of the audited accounts, even if they contain a disclaimer, because there would be no practicable alternative to doing so, just as there was no practicable alternative for the house purchasers in *Smith*'s case.

IV. CONCLUSION

In this article, I have tried to argue that Australian courts will not, and should not, follow the decision of the House of Lords in *Caparo Industries plc v Dickman*. Whatever position the Australian courts do finally adopt, it will have great practical significance for all professionals. The question of liability to third parties for negligent misstatements will probably be answered first in a case involving auditors, as it is the auditing profession whose statements are most frequently used by third parties. However, the principles stated in that case will presumably be of general application, so that they will govern the liability of all professionals to parties other than their immediate clients. To this extent, then, it is to be hoped that the courts will define the outer limits of liability with precision, if only so that professionals will know precisely how to frame their disclaimers of liability if they choose to put the fear of loss ahead of their professional pride.