CASE COMMENT

SCOTT GROUP v. *McFARLANE*

In *Scott Group Ltd.* v.*McFarlane* [1978] 1 N.Z.L.R. 553 the Court of Appeal faced one of the most thorny aspects of tort liability — namely, the law relating to negligent misstatement. Acting in reliance on a statement of accounts audited by the defendants, the plaintiff company, Scott Group, made a successful takeover bid for a company named John Duthie Holdings Ltd. The consolidated balance sheet of Duthie Holdings for the 1970 financial year contained an accounting error which gave an excessively favourable picture of its asset-backing by $38,000. Duthies had been paid a dividend of that amount by one of its subsidiaries after the close of the financial year of the subsidiary on 30 June but before the close of its own financial year on 30 September. Hence the payment was reflected as a credit in its own accounts of the subsidiary. However the consolidated balance sheet for the 1970 year failed to provide an adjustment for this discrepancy,with the effect that the sum of $38,000 was reflected twice. The auditor's report failed to pick this up. Scott Group made the takeover bid relying on an audit which overvalued the assets of Duthies by $38,000. Scott Group sued the auditors alleging negligent misstatement.

Quilliam J., in the Supreme Court, ([1975] 1 N.Z.L.R. 582) found negligence on behalf of the defendant causing loss to the plaintiff. But he found as a fact that "when the defendants carried out their audit and signed their report they had no knowledge of any intention by the plaintiff (or anyone else) to formulate a takeover offer" (*ibid.,* 586). All that the defendants were required to do by section 166 of the Companies Act 1955 was to prepare an unqualified report on the accounts. Although the auditor's report became a matter of public record in the Companies Office, by virtue of section 133 of the Companies Act, it would be going beyond the extent of liability contemplated in the decided cases to hold that there was a special relationship between the auditors and any person who suffered loss in reliance on what subsequently appeared as an error in the published accounts. There was therefore no legal duty of care owed by the auditors to Scott Group

Ltd. From this judgment the plaintiff appealed.

The Court of Appeal dismissed the appeal. Two judges, Richmond P. and Cooke J., concurred in the result with Woodhouse J. dissenting. Richmond P. found no duty of care subsisting; Cooke and Woodhouse JJ. found that the plaintiff owed the defendant a duty to take care but Cooke J. found that the plaintiff had suffered no loss while Woodhouse J. found that loss had been sustained. The case raises important issues concerning the scope and nature of tort liability and poses an intriguing problem in the doctrine of precedent.

The law of negligence has always been concerned with the net cast by the imposition of a duty of care. Such a duty is jurisprudentially unusual in that it is an obligation the scope of which has not been clearly predetermined. For this reason the common law has feared the spectre of what was described in the famous words of the American judge, Cardozo C.J., as "exposure to liability in an indeterminate amount for an indeterminate time to an indeterminate class" (*Ultramares Corp.* v. *Touche* 255 N.Y. Rep. 170, 174; North Eastern Reporter 441 (1931)). Nowhere has this fear been more forcefully expressed than in the sphere of liability for words. Words are more volatile than acts in the sense that the class of potential litigants affected by negligent misstatements is more expansive than that affected by negligent acts. All the members of the Court of Appeal were mindful of this problem.

In a closely reasoned judgment, Richmond P. traversed most of the authorities. His Honour considered that it was of the essence of a "special relationship" that the maker of a statement should be aware that his advice was required for use in a specific type of contemplated transaction. In the instant case there was the mere possibility of a takeover. The President seems to suggest that the takeover would have to be inevitable and not merely imminent to place the auditors in a special relationship to potential and prospective takeover offerors. Hence there was no duty on the auditors to take care in preparing the statement of accounts. With respect, the President's judgment appears to be too conservative.

Cooke J. considered that a takeover bid was almost certain and that in such an event the accounts would be relied on by an offeror. He counters the kinds of traditional fear of indeterminate liability expressed in the President's judgment by suggesting that in fact there will be only one offeror who makes a successful takeover offer on the basis of the carelessly certified accounts. He found that the plain risk of harm in reliance was reasonably foreseeable. His Honour cited (as did Woodhouse J.) "the contemporary expression" of negligence liability — Lord Wilberforce's speech in *Anns* v. *Merton London Borough Council* [1977] 2 W.L.R. 1024, 1032:

> First one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity of 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 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.

Unlike the President who would not countenance a prima facie duty of care, Cooke J. thought that the mere absence of precedent should not be enough to protect the defendant, and that since there were no considerations to negative the scope of the duty the auditors should be liable to the takeover offerors if damage could be shown to have been suffered. Cooke J., however, decided that no such damage could be found. Damages in tort are awarded as reparation for harm done not,as in contract, for recovery of a promised benefit. His Honour found the true test in the tort of negligent misstatement to be the difference between the price paid and fair value at the time of purchase. But it is clear from the Scott Group's own evidence that it did not suffer any loss — "all that happened was that its profit was not as great as it would have been if the accounts had been correct." Where there is no contract the law is not designed to secure for a person a profit he hoped to make.

Woodhouse J.'s judgment is wide-ranging. His Honour cursorily dismissed the suggestion of indeterminate liability as merely a plea in mitigation to excuse negligent activity because the consequences of liability are too great to justify responsibility. On the contrary, the need for acceptance of responsibility arises because the individual interests of everybody in the community are coextensive and have become increasingly interdependent. The risk can be dealt with by those in the business of giving advice by adequate insurance. The cost of premiums can be passed on as part of the consideration for services. Because the accounts become a matter of public record this responsibility extends to all who can reasonably be foreseen as relying on the reports when dealing with the company. His Honour considered that the requirements of foresight and causation are alone sufficient to prevent any danger of an "open-ended" duty. Considering the problem of damages, Woodhouse J. accepted the test adopted by Cooke J. but stated that the real question is: what lower price (if any) would have been offered and accepted if the error were known? His Honour fixed an account based on the difference between what was actually paid and what probably would have been paid. A formula was determined that set the difference between the price paid and fair value at the time of purchase at $24,500.

The structure of the Court of Appeal's decision raises an intriguing problem — what is the ratio decidendi of the case? We are taught that

every case has a ratio and that the ratio is in some way essential to the decision in the case. It is the proposition without which the case could not have been decided as it was (Wambaugh's test; see Cross, *Precedent in English Law* (1968), p.52). Alternatively, it is the principle derived from the decision on the basis of the material facts (Goodhart's test; see Cross, *op. cit.,* p.67). It is literally the "reason for deciding" or the justification for the decision. But it is difficult to distill a ratio from the result of *Scott Group* v. *McFarlane.* Two judges decided that there was a duty of care. Cooke and Woodhouse JJ., but they were not in the majority as to the result. Richmond P. decided that there was no duty of care. Cooke J. decided that no loss had been suffered. These two judges concurred in the result but their reasons differed. Woodhouse J. found a compensatable loss. So what then is the ratio decidendi of the case? It is submitted that there are three possibilities: (i) The decision and reasoning of the majority. It is submitted however that this cannot be right. First, the two judges found differently on the issue of a duty of care. Secondly, Richmond P. did not even consider the question of loss which was vital to Cooke J.'s finding as he did against the appellants. (ii) The judgment of Cooke J. alone may be the ratio. He concurs with Woodhouse J. as to the issue of a duty of care and concurs with Richmond P. as to the result. But this suggestion too is specious. Why is not the judgment of Richmond P. or that of Woodhouse J. to be seen as providing the ratio of the case? Of course Cooke J.'s judgment was essential to the result but so also was Richmond P.'s. Further, as Lord Halsbury stated, "a case is only authority for what it actually decides" (*Quinn* v. *Leatham* [1901]A.C. 495, 596). The ratio of Cooke J.'s judgment could not be the ratio of the case because the proposition derived from it is at odds with the proposition derived from Richmond P.'s judgment — these propositions could not stand together and the case be decided in the way it was. (iii) The ratio could be the proposition derived from the finding of Woodhouse J. on the question of duty of care coupled with the decision of Cooke J. Does this sound preposterous? In at least one sense it is plausible. It may be that in determining the question of loss the judge had first to determine the question of whether there was a duty of care. If so, then the determination of the issue of a duty of care was essential to the decision about the question of loss. Before Cooke J. could determine the issue of loss (which decided that the appeal should be dismissed) he first had to determine the question of a duty of care and in this he concurred with Woodhouse J. If anything between the judges is essential to the decision in the case, it is this determination. But probably this too is not the ratio of the case. Lord Denning M.R. denied in *Harper* v. *National Coal Board* [1974] 2 W.L.R. 775, that the principle of a case can be

derived from the judgment of a dissenter. Perhaps, and this could be a fourth suggestion, the case has no ratio (it cannot have two ratios since the reasoning of the majority is mutually incompatible). This suggestion is not as absurd as it may sound. There is no logical or doctrinal reason why a case should have a simple clear ratio decidendi. In a recent book, *Legal Reasoning and Legal Theory* (1978) at p.82, Neil McCormick argues that it is "fiction" to believe that *every* case should have a clearly discernible ratio decidendi which is binding law, and that some cases may have no ratio at all. Perhaps the Court of Appeal decision in *Scott Group* v. *McFarlane* is one of them.

PETER CAWTHORN

"SABEMO" — Orthodox Contracts Nightmare?

From the beginning, we are taught that when parties negotiate a contract, either party is free to withdraw at any time before the contract is finally concluded. Clearly, this is because neither party has undertaken obligations or acquired rights against the other party. For this reason, and in view of the fact that the common law has no equivalent of the civil law doctrine of "negotiating in good faith" (*culpa in contrahendo*) it is generally thought that anything one party does in the expectation that a contract will ensue is done at his own risk. Such indeed is the case in the law of contract. (Leaving aside the controversial case of *Reed* v. *Anglia T.V.* [1972] 1QB 60.)

However, contract does not have a monopoly on the law relating to promises and obligations. In particular, there lurks behind the law of contract another body of law, where contract, tort and equity intermingle. This is the law of quasi-contract or restitution, and it is this body of law which often causes the orthodox contract lawyer to throw up his hands in horror.

In the instant case, the subject of this note, one party recovered reliance expenditure incurred by the parties. For those of us who are not familiar with the law of restitution, this may seem a somewhat novel and startling proposition.

In *Sabemo Pty. Ltd.* v. *N. Sydney Municipal Council* [1977] 2 N.S.W.L.R. 880, the Council advertised for tenders for proposals for leasing and redeveloping certain land owned by the Council. Although Sabemo was the successful tenderer, this only brought the parties to the negotiation stage. However, over the next three years, Sabemo, at the Council's request, prepared various schemes, incurring an expenditure of $426,000. At this point in time, no contract looked like being concluded (the Council itself having suggested an alternative

and less costly scheme), so Sabemo sought to recover this reliance expenditure. (The case does not, obviously, come within the doctrine of proprietory estoppel, as per *Willmott* v. *Barber* (1880) 15 Ch.D.96.)

The claim was *quasi ex contractu*, and Sheppard J., relying on four English cases, (*Craven-Ellis* v. *Canons Ltd.* [1936] 2 K.B. 403; *Jennings & Chapman Ltd.* v. *Woodman Mathews & Co.* [1952] 2 T.L.R. 409; *Brewer Street Investments Ltd.* v. *Barclays Woollen Co. Ltd.* [1954] 1 Q.B. 428; *William Lacy (Hounslow) Ltd.* v. *Davis* [1957] 1 W.L.R. 932; [1957] 2 All E.R. 712) found for Sabemo. The Council was under an obligation to reimburse Sabemo, first because the Council was at fault in breaking off the negotiations, and secondly, because the Council had requested the work, and Sabemo was out of pocket. Sheppard J. said (at p.898):

> It seems to me that the English authorities show that the significant change which has come about in the last forty years . . . is that it is now recognised that there are cases where an obligation will be imposed (a promise to pay implied) notwithstanding that the parties . . . did not intend expressly or impliedly, that such an obligation would arise. The obligation is imposed by law in the light of the circumstances of the case. (*Ardent restitutionists would deny that there has been a (recent) change in the law of restitution. They would argue it is simply being seen for what it is, finally emerging from the shadows cast upon it by the orthodox law of contract which has been so predominant in the past.*)

This is not a new pronouncement (see *Craven-Ellis* v. *Canons Ltd.* [1936] 2 K.B. 403, Green L.J; *William Lacy (Hounslow) Ltd.* v. *Davis* (1957) 2 All E.R. 712, Barry J.). However, it is significant in that it is "close to home" and may have a direct bearing on how a contemporary New Zealand case would be decided. (Two New Zealand cases would reach a similar result — *Merren* v. *Loft* [1895] 13 N.Z.L.R. 734; *Perrott* v. *Perrott* (1911) 31 N.Z.L.R. 6; however, see also *Watson* v. *Watson* [1953] N.Z.L.R. 266). Further, from the point of view of those not familiar with the law of restitution, it may be useful in demonstrating that it is sometimes necessary to look outside orthodox contract to find solutions. Certainly, if a promise can be "imposed" by law, irrespective of the intentions of the parties, there exists a more flexible approach than the implied-in-fact obligation or contract, which was at the basis of the cases which Sheppard J. decided not to follow. Finally, such an approach helps to fill the void in the common law which exists by virtue of the absence of a duty to negotiate in good faith.

There is one final point with regard to Sheppard J.'s decision that should be considered. Sheppard J. regarded fault as being the determining factor:

> To my mind the defendant's decision to drop the proposal is the determining factor. If the transaction had gone off because the parties were unable to agree, then I think it would be correct . . . to say that each party had taken a risk . . . that the transaction might go off . . . (p.898)

Within the parameters of the law of contract, this concept of fault

would be a heresy. However, it must again be emphasised that this was an action *quasi ex contractu.* We are not concerned with the principles of intention to contract and consideration, but with the principles of restitution, and obligations imposed by law.

The case is thus one which should cause the contract student to think about the law relating to promises and obligations a little more deeply and possibly, diversely. The law of restitution may not be undergoing radical changes, if the ardent restitutionists are to be believed, but it is certainly undergoing a growing recognition and popularity.

STEVEN DUKESON

H.L. MISENER & SON LTD. v. *MISENER* — THE FIDUCIARY DUTY OF COMPANY DIRECTORS AS VIEWED BY A CANADIAN COURT.

As the Canadian courts led the way in the widening of the concept of the fiduciary duty of company officers with the decision in *Canadian Aero Services Ltd.* v. *O'Malley* (1974) 40 D.L.R. (3d) 371, so it was a Canadian court which recently issued a judgment highlighting several questions as to the extent of this remedy.

H.L. Misener & Son Ltd. v. *Misener* (1977) 77 D.L.R. (3d) 428 is a decision of the Appeal Division of the Nova Scotia Supreme Court. The appellant company was a small one-man building concern run by a Mr. Misener. His wife was a director of the company, its secretary, and also did some bookkeeping and clerical work as an employee of the company. The company entered into negotiations with Maritime Builders Ltd., run by a Mr. Colquhoun, for the sale to it of the assets of H.L. Misener Ltd. The latter company prepared an estimate of the value of the assets which was later amended and the assets were eventually purchased by Maritime Builders Ltd. at the amended figure. Mrs. Misener had known of the figure in the estimate, and ten days after the sale of the company's assets, went to live with Mr. Colquhoun and also became an employee of Maritime Builders Ltd. with a wage increase of $35 per week. Mr. Misener assumed that Mrs. Misener must have disclosed to Mr. Colquhoun the estimated value of the assets and therefore brought the present case for breach of fiduciary duty.

The first point of note is to be found in the judgment of MacKeigan C.J.N.S. He pointed out that in all previous cases involving breach of a fiduciary duty, the officer of the company had taken advantage of

information received either from the company or otherwise by virtue of his position as an officer of the company. The question therefore arose whether the fiduciary duty concept extended to communications of the company information to a third party for the possible benefit of either the officer or that third party. The Chief Justice concluded that it did, justifying this conclusion by confirming that he could see no reason why a servant's duty to his master not to divulge confidential information to others should be greater than the duty of a director to his company (at p.435). However, the Chief Justice was the minority member of the court and the two other judges presiding did not address themselves to this problem.

The next issue which faced the court was as to what constituted the breach of the fiduciary duty. The appellant company had no evidence of actual communication by Mrs. Misener to Mr. Colquhoun, and a clear statement by Mrs. Misener negativing the existence of any such communication had inadvertently been put in evidence by the appellant company. Cooper J.A., one of the majority members of the court, held that there must be actual communication to constitute a breach of the fiduciary relationship, and that such a communication was not established by the evidence (at p.438). MacKeigan C.J.N.S., in his dissenting judgment, saw the possibility of a breach of the fiduciary duty being constituted by a wider range of circumstances than merely communication. He said (at p.436):

> I conceive, however, that a breach occurred when Mrs. Misener established her relationship with Colquhoun, a relationship which *appeared* to be in violation of corporate duty and that that breach would not be negatived even if it were overwhelmingly proved that she had in fact communicated nothing to Colquhoun . . . . Such proof here would be relevant to the quantum of damages.

This view as to what can constitute a breach of the fiduciary relationship is inextricably related to the view expressed by MacKeigan C.J.N.S. (at p.431; see also p.436), with which the writer concurs, that:

> . . . breach of fiduciary duty is not negatived by absence of evidence of loss by the company, nor, indeed, by absence of evidence of any profit by the director. Proven pecuniary loss or profit will inflate the seriousness of a breach and the quantum of damages but not the existence of a breach, albeit nominal and minimal.

A somewhat different view was taken by the majority of the court. Macdonald J.A. put it thus (at p.444):

> I have been unable to find any reported case wherein a director was found to be in actionable breach of his fiduciary duty when there was no evidence:
> (1) that he had made a profit or a benefit, actual or potential as a result of an alleged conflict between his personal interest and with his fiduciary duty and where,
> (2) the company was not shown to have suffered any actual loss as a result of the director's actions.

The majority therefore concluded that there had been no breach of duty by Mrs. Misener as it was not shown that she had gained from the alleged disclosure.

The statements quoted above can be reconciled however. It is submitted that the majority of the court erred in their reasoning that gain to the officer is a necessary element of the breach of duty. The crucial word in the passage quoted from the judgment of Macdonald J.A. is "actionable". As the remedy for breach of fiduciary duty is an account of profits, a breach is not "actionable" in practical terms unless there has been a gain to the officer (this gain usually involving a corresponding loss to the company), so that some recovery may be had. Nevertheless, there may still have been a technical breach of duty without such gain being made. In principle, therefore, it is submitted that MacKeigan C.J.N.S., rather than the majority, was correct in determining the existence of a breach of the fiduciary duty without reference to any gain to Mrs. Misener.

Macdonald J.A. continued by stating (at p.444) that even if the view of MacKeigan C.J.N.S. that no loss was required correctly stated the law, it would have to be established that Mrs. Misener

> entered into an engagement in which she had, or could have had, a personal interest conflicting, or which may have possibly conflicted with the interests of the appellant company.

He concluded (*idem.*) that:

> The type of 'personal interest' arising out of a fiduciary entering into 'engagements' envisaged by the authorities is, in my opinion, one of a commercial or business nature and not as here, purely of an amorous kind which did not give rise to any loss, actual, potential or otherwise to the company nor any profit or benefit, actual or potential to Mrs. Misener.

It is submitted that this reasoning is too limited, for there were possible benefits which could accrue to Mrs. Misener, both in her capacity as an employee of Maritime Builders Ltd. and as housekeeper and companion of Mr. Colquhoun, through the purchase of the assets of the appellant company at the lowest possible price, with the resultant likely increased profitability of Maritime Builders Ltd.

There is also the implication to be found in the judgment of Macdonald J.A. (at pp.444-445) that the size of the company and the officer's interest and position in the company are factors to be taken into account in determining whether the fiduciary duty has been breached in a particular case. Such reasoning is erroneous for these factors merely go to determine the existence of a fiduciary relationship. Once such a relationship is established the rule that the officer may not permit his personal interest to conflict with his duty to the company is strict in its application.

In conclusion, it is submitted that Macdonald and Cooper JJ.A., the majority members of the court, were too restrictive in their application of the fiduciary duty principle in the present case. To remain consistent with the underlying rationale for the imposition of the fiduciary duty, that an officer must act for the benefit of the com-

pany and not himself, the fiduciary duty must extend to cover communications made to third parties by an officer of the company where such a communication may be adverse to the company's interests. Actual communication in such a situation need not ever be necessary where in circumstances such as the present the officer places himself or herself in a position where a court could readily suppose that it is contrary to the interests of the company. Finally, gain to the officer need not be an element of the breach of the fiduciary duty, for there may be circumstances where the strictness of the application of the principle outweighs the consideration of gain to the officer.

D.S. JOHNSTON