LIABILITY OF ACCOUNTANTS AND PROVIDERS OF FINANCIAL SERVICES AND THE EFFECT OF QUALIFICATIONS AND DISCLAIMERS

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Received opinion in the Commonwealth is that in the United States the law of torts has run amok. One reads weekly of enormous sums being claimed and almost as large sums being awarded by juries by way of damages in negligence claims (1). We tend loftily to observe that one can expect little else when such matters are left to lay people. But I suspect that there are many accountants - and others - who consider that the law relating to accountants' liability in our own backyard is just as unsatisfactory. It is amazing how many accountants know of a recent award against a firm of accountants for A$145 million, even if they know no other details about the case (2). On this occasion it is not possible to put down the figure to the folly of a jury. Surely then, many say, there must be something wrong with the law if it permits results of this kind. Who wants to practise as an accountant if one is exposed to liability of such horrendous proportions?

The purpose of my paper is to investigate whether the existing law is imposing too onerous responsibilities on accountants and, if it is, what the most appropriate response is.

1. The basis of liability

(a) Liability in contract

The primary responsibility of an accountant is to his or her client, and such responsibility springs in part from the terms of the contract to provide services. Although the circumstances must be rare where the client and the accountant actually discuss the terms of the accountant's responsibility to be careful in the work which he or she does or in the advice which is given, the law has no difficulty in implying a term as to reasonable care, in accordance with the now well established principles for implication of terms in contracts (3). The standard of care impliedly agreed upon is the standard of the ordinary skilled person exercising or professing to have the special skill or competence of the profession in question (4). A professional person is accordingly not negligent simply because he or she does not achieve the highest level of expertise attained by the cleverest of his or her professional colleagues.

A recent decision in the United Kingdom is of interest on the question of the standard of care required of accountants (5). Trec Rentals Limited was in the business of leasing out trailers. The trailers as a whole were depreciated at the rate of 10% per annum. But the tyres on each trailer cost between one-eighth and one-fifth of the total cost of the trailer, and had a life of approximately 3 to 4 years if the trailers were in regular use. The company's accounting policy was to account for the cost of replacement tyres when the replacements were purchased. As most of the trailers had been acquired 2 to 3 years prior to the date of the accounts whose audit was the subject of the action, very few replacements had been bought and so brought into account as costs to that point; but fairly soon thereafter substantial sums would need to be spent on tyres if the trailers were to remain operational. The principal point at issue was whether the auditors had acted negligently by failing to report any dissatisfaction with the absence from the accounts of any provision for future spending on tyres and of any note regarding the existence of the need for this spending. Woolf J held that the accountants were not liable. For present purposes, the interesting feature of the case is His Lordship's opinion of the legal standing of Statements of Standard Accounting Practise (SSAPs) as issued by the Institute of Chartered Accountants in England and Wales. His Lordship said:

> "While these [SSAPs] are not conclusive, so that a departure from their terms necessarily involves a breach of the duty of care, and they are not (as the explanatory foreword makes clear) rigid rules, they are very strong evidence as to what is the proper standard which should be adopted and unless there is some justifiction, a departure from this will be regarded as constituting a breach of duty. It appears to me important that this should be the position because third parties in reading the accounts are entitled to assume that they have been drawn up in accordance with the approved practice unless there is some indication in the accounts which clearly states that this is not the case."

It is likely that the New Zealand Courts would adopt a similar deferential stance towards SSAPs in New Zealand (6).

If an accountant wishes to limit or even extinguish the obligation to use reasonable care, he or she must reach agreement to that effect with the client. In terms of contractual principle, there could be no impediment to such agreement, but the likelihood is that any such attempt would be regarded as unprofessional conduct. The Council of the Law Society in the United Kingdom has ruled that it is undesirable for a solicitor to contract out of his liability for negligence. They have ruled that the responsibility of the solicitor for the advice he gives is one of the fundamental attributes of the professional person and is part of the special relationship that exists between solicitor and client, as the client is entitled to rely upon the skill and judgment of the solicitor (7). Where a solicitor feels that the matter upon which he or she is asked to advise requires expert advice from counsel, and where the client nonetheless insists that the solicitor should continue to act for him or her and is unwilling to take other advice, the Council suggests that the solicitor should either qualify any advice given to that effect or should determine the retainer on the grounds that he was being prevented from conducting the case properly (8). I suspect that the New Zealand Society of Accountants would probably react in the same way. It should not automatically be assumed, however, that such a stance is necessarily in the public interest. There may be a price to be paid for the restriction on a professional's capacity to contract. The result may not be to encourage greater care, but rather to cause any advice given to be so hedged by qualifications as to be worthless to the client.

Whatever may be the position concerning accountants when giving general financial advice, it is clear that, at least in the situation where an accountant is appointed by a company as its auditor pursuant to s. 163 of the Companies Act 1955, liability cannot by contract be limited or excluded. Any such contract would be void pursuant to s. 204 of the Act.

In this paper, it is not proposed to discuss the precise nature and extent of the auditor's role and the extent to which, for example, the auditor is entitled to rely upon management representations as primary audit evidence and the extent to which auditors may rely upon management representations signifying the limits of existence of available audit evidence. That is more properly the scope of a lecture on auditing for accountants or accountancy students, although the extent of the audit duties will have a bearing on the scope of the duty of care and on the standard of care required (9). Of course, an audit badly done may give the client the right to sue simply for a failure to audit, but the more normal plea would be an allegation of auditing carelessly.

(b) Liability in tort to one's client

It has become common practice when drafting pleadings alleging negligence by a professional person to allege as alternative causes of action breach of contract and tort (10). There are still many who assert that a professional person should not be liable in tort for negligence where there is a contractual relationship between the parties. Such advocates normally cite McLaren Maycroft & Co. v Fletcher Development Co. Ltd (11) in support. Those in this camp also take some heart from a recent Privy Council decision (12), in which Lord Scarman expressed the view:

> "Their Lordships do not believe that there is anything to the advantage of the law's development in searching for a liability in tort where the parties are in a contractual relationship. This is particularly so in a commercial relationship. Though it is possible as a matter of legal semantics to conduct an analysis of the rights and duties inherent in some contractual relationships including that of banker and customer either as a matter of contract law when the question would be what, if any, terms are to be implied or as a matter of tort law when the task will be to identify a duty arising from the proximity and character of the relationship between the parties, their Lordships believe it to be correct in principle and necessary for the avoidance of confusion in the law to adhere to the contractual analysis: on principle because it is a relationship in which the parties have, subject to a few exceptions, the right to determine their obligations to each other, and for the avoidance of confusion because different consequences do follow according to whether liability arises from contract or tort, e.g. in the limitation of action."

In my own view, however, it is likely that when the question of the nature of a professional's liability to his or her client comes squarely before our Court of Appeal (13), the Court of Appeal will hold that concurrent liability in contract and tort is possible.

Such a result would be in line with most recent English authority (14), and Commonwealth authority (15) and is also consistent with principle. Indeed, there are many areas where for decades people have successfully sued in the tort of negligence, notwithstanding their having been in a contractual relationship with the wrong-doer; e.g. claims against doctors, dentists, carriers, other bailees, and those following "common callings".

The law of negligence received a dramatic reformulation in Anns v Merton London Borough Council (16), a decision the principles of which have now been cited countless times in the New Zealand courts. In this case, Lord Wilberforce (17) suggested a two stage approach to the question of whether a duty of care exists. The first stage is to ask whether, as between the alleged wrongdoer and the person who has suffered damage, there is a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises. There can be no doubt that there is such a relationship between the accountant and his or her client. If the accountant acts carelessly, generally speaking it will be within his or her reasonable contemplation that damage to the client may result. The second stage is considered only if that first question is answered affirmatively. The question then is: are there any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damage to which a breach of it may give rise? For myself, I can see no such considerations in the normal relationship between accountant and client. Of course, the duties owed by the accountant to the client may well be affected by or even extinguished by an appropriate exclusion clause in the contract of services, assuming such a clause to be consistent with professional conduct (18). The presence of such a clause would be a consideration which might negative or reduce or limit the scope of the duty or the damages to which a breach of it might give rise.

Lest it be thought that I have over-emphasised the importance of the Anns decision, I also note the decision of the House of Lords in Governors of the Peabody Donation Fund v Sir Lindsay Parkinson & Co. Ltd (19). That, like Anns, was a case concerned with the liability of a local authority when carrying out its duties regarding inspection of construction work. Lord Keith of Kinkel, after referring to Lord Wilberforce's speech in Anns, said (20):

> "There has been a tendency in some recent cases to treat these passages as being themselves of a definitive character. This is a temptation which should be resisted. The true question in each case is whether the particular defendant owed to the particular plaintiff a duty of care having the scope which is contended for, and whether he was in breach of that duty with consequent loss to the plaintiff. A relationship of proximity in Lord Atkin's sense must exist before any duty of care can arise, but the scope of the duty must depend on all the circumstances of the case. In Home Office v Dorset Yacht Co. Ltd [1970] 2 All ER 294 at 307-308, [1970] AC 1004 at 1038-1039 Lord Morris, after observing that at the conclusion of his speech in Donoghue v Stevenson [1932] AC 562 at 599, [1932] All ER Rep 1 at 20, Lord Atkin said that it was advantageous if the law 'is in accordance with commonsense' and expressing the view that a special relation existed between the prison officers and the yacht company which gave rise to a duty on the former to control their charges so as to prevent them doing damage, continued:
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> > 'Apart from this I would conclude that in the situation stipulated in the present case it would not only be fair and reasonable that a duty of care should exist but that it would be contrary to the fitness of things were it not so. I doubt whether it is necessary to say, in cases where the Court is asked whether in a particular situation a duty existed, that the Court is called upon to make a decision as to policy. Policy need not be invoked where reason and good sense will at once point the way. If the test whether in some particular situation a duty of care arises may in some cases have to be whether it is fair and reasonable that it should so arise the Court should not shrink from being the arbiter ...'
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> So in determining whether or not a duty of care of particular scope was encumbent on a defendant it is material to take into consideration whether it is just and reasonable that it should be so."

In my view, while of course justice and reasonableness are always important, the generality of Lord Keith's reformulation of Lord Wilberforce's test is not of great assistance. But accountants ought not to look to the Lord Keith test as giving them the protection they seek, as it is unlikely that a Court would hold that it was unjust or unreasonable to hold an accountant liable in tort to his or her client where the client had been careless in advising the client. The test may potentially be of more assistance on the question of liability to third parties, to which I now turn.

(c) Liability to third parties

Many accountants are prepared to accept that they should be under a duty of care towards their clients, but baulk at any suggestion of their being liable in tort to third parties. But it is now clear that accountants and other professional people may in certain circumstances owe a duty of care to persons other than their clients. Again, the preferred approach, in my opinion, is the two stage test of Lord Wilberforce. Frequently, of course, considerations will negative or at least reduce or limit the scope of the duty. For instance, a duty to be careful of the interests of others could never arise if such led to a conflict with the client's interests. One of the circumstances which led Megarry V-C to hold the solicitors liable to disappointed beneficiaries in Ross v Caunters (21) and our Court of Appeal to hold solicitors potentially liable in similar circumstances in Gartside v Sheffield Young & Ellis (22) was that the independent duty marched with the duty to the client. In the first case, the defendant's solicitors had failed to ensure that the will was validly executed. The spouse of one of the beneficiaries under the will witnessed the will, with the consequence under the Wills Act 1837 that that beneficiary was not entitled to the benefits that the will would have carried to her but for the negligence of the defendants. In the latter case, it was alleged that the defendants had failed to act promptly in drafting a will in terms of the testator's instructions. The testator died before the will was drawn. The plaintiff lost the benefits he would have received under the proposed will.

Another case in which professional people were held liable to a third party was Allied Finance & Investments Ltd v Haddow & Co. (23). In that case, the plaintiff lent one Hill $25,000 on the security of a yacht which the plaintiff understood that he was buying. Before the loan was made, the plaintiff's solicitors forwarded to Hill's solicitors a memorandum of terms of contract and an instrument by way of security over the yacht for Hill to execute, and asked them for a certain undertaking and certificate. Hill's solicitors returned the instrument by way of security signed by Hill and certified that the instrument by way of security was fully binding on Hill and, on behalf of their client, that there were no other charges whatsoever on the yacht. In fact, and to the knowledge of Hill's solicitors, the yacht was being purchased by a company of which Hill was a director and controlling shareholder, and the money was not intended to be used to enable Hill himself to purchase any interest in it. The seller of the yacht was not fully paid and he seized it. Hill became bankrupt. The plaintiff recovered all but about $7000 and brought an action against Hill's solicitors for the balance of its loan. The Court of Appeal held that Hill's solicitors had given a certificate on which reliance by the other party was to be contemplated. They said that while the relationship between two solicitors acting for their respective clients did not normally of itself impose a duty of care on one solicitor to the client of the other, here the proximity of the relationship was so close that a duty of care arose. The defendants were held in breach of that duty and judgment was entered for the plaintiff for the sum claimed, with interest.

The predicament faced by accountants is the large number of people who may reasonably be expected to rely upon certain advice given by accountants. I mention in particular auditors' reports under the Companies Act and auditors' reports under the Securities Regulations 1983. The whole purpose of reports such as these is to allow shareholders, creditors, and prospective shareholders to obtain an independent opinion of the state of the particular company or of its forecasts. Under the Lord Wilberforce formulation, a very wide range of people should be in the reasonable contemplation of accountants as being people who may suffer damage if the accountant is careless. Generally speaking, there will be no special considerations which ought to negative or to reduce or limit the scope of the duty.

Perhaps the best known example in New Zealand is <u>Scott Group Ltd v McFarlane</u> (24). In that case, the appellant company relied among other things on the 1970 accounts of John Duthie Holdings Ltd, being consolidated accounts for that company and a number of subsidiaries, in making a takeover offer for the shares in the holding company. By an elementary error in the consolidation of the accounts of the group, the assets of the holding company were overstated by $38,000, basically because certain items had been included twice. The same kind of error had been made in some previous years and the respondents, the company's auditors, were aware of some discrepancy but did not investigate it at any time, and in 1970, as in previous years, gave an unqualified certificate upon the accounts under s. 166 of the Companies Act. The nature and extent of the error was discovered soon after the takeover was completed. The appellant company brought an action against the auditors.

In the Court of Appeal, the auditors were held not liable. While many accountants may applaud the result, they may be less reassured by their Honours' reasoning. Woodhouse and Cooke JJ both found that the auditors did owe a duty of care to the appellant company, namely the offeror for the shares. But the decision should not be read too widely. Cooke J agreed with Quilliam J in the Court below that the Companies Act did not cast on the auditors any duty in favour of the public (25), a view with which Richmond P certainly agreed, since he held, dissenting on this point, that no duty was owed even to the appellant, the auditors not having been aware that the accounts were required as a basis for a takeover offer (26). Woodhouse J saw the duty in wider terms, and said that a duty was owed to all persons whom they could reasonably foresee would need to use and rely upon the annual accounts when dealing with the company or its members. He placed much reliance on the fact that the audited accounts become a matter of public record by reason of s. 133 of the Companies Act (27). Although Cooke J did not consider a duty was owed to the general public, he certainly thought that a duty should arise in this case because it was reasonably foreseeable that the particular company was ripe for takeover. John Duthie was apparently rich in assets but somewhat unimpressive in earnings. Cooke J described it as "a classic case for a takeover or merger" (28), a fact known to the auditors, and in those circumstances it was obvious that the takeover would be preceded by a study of the published accounts. The use of the accounts by a prospective offeror for the company must reasonably have been seen as virtually inevitable if a takeover proposal did eventuate.

The reason why the appellant did not succeed, notwithstanding Woodhouse and Cooke JJ having found that a duty of care was owed to the appellant and a breach of any duty (if it existed) having previously been admitted by the auditors, was that Cooke J held that the appellant had suffered no loss. He was therefore at one with Richmond P that the appeal must fail. Cooke J found on the evidence that the appellant had suffered no loss; at best its profit was simply not as great as it would have been had the accounts been correct (29). It turned out to be a "fractionally less good bargain than at first sight it appeared" (30). The law of tort is not a vehicle for compensating plaintiffs for the profits they hoped to make. This is still a fundamental distinction between the law of contract and the law of torts.

One other matter in the judgment which may interest accountants is that Cooke J expressed the view that s. 204 of the Companies Act would not prevent an auditor from issuing a disclaimer to members of the public, even though the section clearly prevents an auditor from contracting out of liability to the company and possibly its members. He added a rider, however, that he did not know what the attitude of the Stock Exchange might be if such a disclaimer of responsibility were appended (31).

The case which has caused Australasian accountants most concern, however, is the recent decision of Rogers J in Cambridge Credit Corporation Ltd v Hutcheson (32). The facts of this case are not simple. For present purposes, it will be sufficient if I give the following outline. Hutcheson and others were partners in the firm of Fell & Starkey. Rogers J held that they were negligent in failing to require certain provisions to be made in the annual accounts of the Cambridge Credit Corporation for the financial year ended 30 June 1971. His Honour held that had the defendants not been negligent in noting in the accounts certain amounts that should not have been included in these accounts, the trustee for the debenture holders of Cambridge would have appointed a receiver over the company in 1971 instead of three years later. Had the company gone into receivership in 1971, his Honour found that there would have been a deficiency of $10 million (33). He then compared that hypothetical position with what in fact occurred, namely a minimum deficiency of $155 million. The difference was $145 million (34).

The case is interesting on many points. In this paper, I deal with only several of them. First, it was submitted that Cambridge itself had suffered no loss. Cambridge, instead of being able to pay its creditors 100 cents in the dollar, could pay only 10 cents. But that, it was said, was of no moment to Cambridge; such a loss would have been that of the creditors. That argument was quickly dismissed. His Honour held that Cambridge incurred liabilities to its debenture holders and the fact that Cambridge lacked the capacity to discharge those liabilities did not destroy the liabilities. So long as the liability to the debenture holders existed, Cambridge was entitled to look to the defendants for compensation in respect of its reduced ability to satisfy them (35).

Secondly, the judgment deals with the extent of an auditor's duty to enquire as to possible breaches of section 67 of the Uniform Companies Act 1961 (36). The accounts of Cambridge disclosed as an asset a debt of $1.7 million owed by another company, Wellington Court Holdings Pty Ltd. The plaintiffs asserted that provision should have been made against that debt in the amount of $1.2 million, because the debt to that extent was a bad debt by operation of s.67. The moneys in question were lent by Cambridge to Wellington and then on-lent to Cowdroy Investments Pty Ltd. Cowdroy used the money in part to purchase shares in Cambridge and in part lent it to another company, which indirectly used it to purchase shares in Cowdroy. The particular defendant sought to justify his failure to apprehend that there had been or might have been a breach of the section on the basis that at a seminar, which had taken place shortly after the introduction of the relevant provision in the legislation, he had learnt that there were two exceptions to the operation of s.67, and he considered that the particular transaction came within one of these two exceptions. But Rogers J held on the evidence that the auditor had failed "to turn his attention to the section". At the very least he should have entertained sufficient doubt about the section to have sought legal advice. Had that legal advice been taken, it was likely that the advice would have been that the loans were unenforceable and that the accounts should be noted to that effect (37).

Robert Baxt (38) notes that the judgment leaves open exactly how wide this duty on auditors is. Baxt asks how far an auditor has to go to explore the potential breach of specific provisions of the Companies

Act. Does an auditor have to explore the potential common law breaches on the part of the directors? Do the auditors have to delve into the actions of the company's officers to ascertain whether they have been acting in good faith and in the best interests of the company? Baxt also refers to three cases in which directors obtained an advantage which it was alleged should have gone to their company, but in which a different result was reached in each case as to whether the director had to disgorge the advantage obtained by him (39). What is the auditor to do in such a circumstance? The thrust of the decision of Rogers J is that the auditor must either qualify the accounts or, more appropriately, seek professional advice.

For the sake of completeness, it should be added that auditors may also be held liable in the tort of breach of statutory duty. For instance, there is a clear statutory duty on the auditor to form his or her own opinion and to set it forth in the auditor's report, and it follows that an auditor would be in breach of that duty if he or she simply relied on information supplied by company officers on matters as to which the auditor was required to form an independent conclusion (40). But since to adopt such practices in breach of clear statutory duties would also amount to negligence, separate analysis of what breaches of statutory duty may be actionable at the suit of a person suffering loss as a consequence of the breach is not here attempted (41).

2. Perceived problems with the current law

The complaint of many accountants as to their current liability in negligence is in essence twofold. First, they complain that they owe a duty of care to too many people. Secondly, they consider that the extent of their potential liability for any error is too great.

(a) Duty of care owed to too many?

It is difficult to accept that the first complaint has any validity other than in the auditing sphere. Generally, those who rely on accountants are their clients and others closely associated with them, of whose existence the accountants will usually be fully aware. Indeed, leaving aside auditing, accountants face a narrower band of potential claimants than some other professional groups, e.g. architects and engineers.

So far as auditing is concerned, I believe most accountants would have no objection in principle to their being liable to the company and its members in the event of the audit's being carried out negligently: the principle behind s. 204 of the Companies Act seems not merely reasonable but absolutely vital for the protection of shareholders. Shareholders must be able to rely upon a company's accounts having been carefully audited. Given the more onerous duties now cast on directors, one assumes that they too, especially non-executive directors, also regard the auditor's certificate as of vital importance to them.

So far as liability to others is concerned, the position is more complicated. It is true that a large number of people quite unconnected to the company may use the accounts for many diverse purposes, many of which may not have been in the auditor's mind when carrying out the audit. None of these people has paid the auditors a cent for their work, and yet they may be able to claim millions of dollars by way of damages should they rely upon accounts which turn out to have been negligently prepared and if they should suffer a loss as a result of their reliance.

Can or should anything be done about this? I do not believe that this aspect of the law requires any change. The fact that accountants may be liable to people other than the company under audit and its members does not in fact increase the burden on the auditor. All that is required of the auditor is that he or she be careful in carrying out the audit and giving the statutory certificate. No more care is required as a result of acknowledging non-shareholders as potential plaintiffs. There is no doubt that to exclude an auditor's liability to third parties would require legislative intervention, and it is difficult to see why accountants should be treated differently from other professional people so far as the <u>scope</u> of their liability is concerned, just because the economic loss which might flow from their errors is potentially so great.

(b) Damages too high?

The second complaint is much more difficult. The award of large sums of damages against auditors is becoming more common. This is not really the result of any recent change in the law: that professional people might be liable in tort for negligent advice to clients and others has been well established at least since 1964 (42). Although it may be said that the Courts have in the past few years liberalised the law as to recovery of pure economic loss (43), that has never been seen as a particular problem with respect to negligent advice: since Hedley Byrne, the fact that the loss was purely economic was not seen as a bar to recovery, provided that the other criteria for liability were established. In my opinion, all that has happened is that people throughout the Commonwealth have become more litigation-conscious, almost certainly resulting from the vast increase in real wealth in Western countries in the last two decades.

The award of damages in Cambridge Credit was A$145 million. In the Securitibank Limited litigation, it is now known that the auditors paid $4.29 million, although denying liability (44). Recent articles suggest however that much larger claims are around the corner, with damages of up to US$1 billion being claimed (45). It must not be thought, of course, that accountants alone face these large claims: in a recent New Zealand case, a horticultural adviser, who was asked by the vendor's agent to produce a report on a kiwifruit orchard, was later sued by the purchasers for almost $1 million. The adviser received for his report $170 (46). Nor should it be thought that every claim against accountants will result in horrendous damages awards (47).

3. An Analysis of some of the suggested reforms

(a) The lobbyists

Over the past five years, various groups have addressed the perceived problem. Approaches have been made to the Government in the United Kingdom by the Institute of Chartered Accountants and the Law Society, a submission which was rejected in September 1986 by the Department of Trade & Industry on the grounds that the public interest far outweighed the sectional interests of the various professions (48). This approach followed an earlier review in 1980 by a special sub-committee set up by the UK Inter-Professional Group, comprising representatives of the Bar, the Law Society, the Royal College of Surgeons, the Royal Institute of Architects, and the consultative committee of accountancy bodies, under the chairmanship of David Hirst Q.C., now Mr Justice Hirst. That committee in its report unanimously recommended a limitation of liability for breach of contract or other civil liability of any description incurred in connection with professional practice, except in two cases:

(i) liability for death or personal injury; and

(ii) liability for conduct involving fraud or dishonesty (49).

In Australia, the Companies and Securities Law Review Committee has recently (September 1986) reported to the Ministerial Council for Companies and Securities on the civil liability of company auditors (50). According to a recent newspaper report (51), the Australian Council of Ministers (which is made up of politicians from each state) has agreed in principle that there should be a "cap" on the amount of money that can be awarded by way of damages.

Here in New Zealand, an inter-professional committee on liability has been established by the Institute of Architects, the Institution of Professional Engineers, the Institute of Surveyors, and the Institute of Valuers (52). As well, both the Society of Accountants and the Law Society have had discussions with the Minister of Justice concerning the problem.

(b) Capping liability

The lobbyists' most favoured solution appears to be a statutory limit of liability, coupled with mandatory insurance up to that statutory level. In my respectful opinion, neither proposition is sound. First, it is difficult to see why negligent professional people should be treated differently from other negligent people. The negligent trench digger who cuts an underground electric cable may be liable for hundreds of thousands of dollars by way of damages for economic loss caused to neighbouring factories which suffer power failure (53). Indeed, the professional person is probably in a much better position to judge the risk from his or her actions than is the trench digger; and it would certainly be easier for the professional person to effect a reasonable level of insurance cover than it would be for the contractor.

Secondly, if one assumes that different treatment for professional people can be justified, it is nonetheless difficult to see how membership of the cosy club of capped liability is to be determined. Are horticultural advisers, land agents, merchant bankers, stockbrokers, and insurance representatives to be included? If not, why not?

Thirdly, is the limit of liability to be the same for each profession?

Fourthly, who will really benefit from capped liability? Presumably, whatever limit was fixed, it would need to be reasonably high. Otherwise, the unfairness to potential plaintiffs would be too marked. Indeed, an artificially low figure might lead to some of those who utilise professional services needing to take out their own insurance against potential losses over and above the maximum cap. If the figure is high, then probably it is only the major firms who will principally benefit, because in the nature of things the smaller firms do not generally attract the sort of work which can lead to a massive exposure of risk. It could be argued that the major firms are those best placed to insure themselves.

The principal area of concern for accountants has been the risk flowing from negligently conducted audits. In Australia, the Companies and Securities Law Review Committee (CSLRC) has investigated a number of possible methods by which a statutory limit could be established on liability flowing from negligent auditing. To single out auditing for special treatment in itself involves a number of doubtful assumptions, as discussed above. The CSLRC should not be criticised for considering the perceived problem only in the audit context: that was the brief the Committee received from the Ministerial Council (54). The CSLRC rejected a number of options which had been raised and discussed in its earlier discussion paper

(54), including an option which has been enacted in the Federal Republic of Germany, where auditors' liability has been restricted to 500,000 German marks per audit (55). It is not proposed to discuss here the options discarded by the CSLRC as generally the arguments against them, which arguments the CSLRC accepted, seem unassailable.

The option which the CSLRC ultimately supported was that which fixed the auditors' maximum liability as a multiple of the fee charged for the audit (56). The Committee envisaged that the audit fee would be published in the accounts of the client company, which would then enable interested parties easily to determine the maximum potential liability in each case. The Committee did not feel itself sufficiently informed to make a specific recommendation concerning a suitable multiple, or whether this should be supported by a minimum floor figure. The Committee recommended that this consideration be left to a Working Party.

With the greatest respect to the distinguished members of the CSLRC, it is suggested that this solution could create numerous difficulties and anomalies, even though it is undoubtedly the best solution of those considered. First, it is void of any logical basis. There is in principle no connection between the fee which a firm of accountants may charge to its company client and the quantum of loss suffered by someone relying on the audited accounts.

Further, there will be a great temptation for accountants to peg their audit fees artificially low. That could be achieved in either of two ways. First, there could be "corner cutting": minimum work, minimum fee, with a consequential low maximum cap, making it unattractive for anyone suffering loss in reliance on a negligently prepared audit to bother suing the auditors (57). Alternatively, there could be a temptation to adjust fees, so that the audit fee is artificially reduced, while the fee for other services rendered the company is artificially increased. The CSLRC's response to that is that the existing disclosure requirements in relation to auditors' remuneration could be tightened and that the Courts could be provided with the discretion to review the fee structure where it appeared that the stated figure had been artificially deflated.

The Committee felt itself unable to resolve some further major difficulties in the application of the liability formula. The Committee rejected the possibility that the maximum liability formula should apply to each litigant or to each separate civil action, as potentially giving rise to "capricious results" (58). The Committee favoured a maximum liability formula "to apply to each event the subject of litigation", although it recognised that there may be a real question as to the categorisation of an "event" for the purpose of determining liability. One can immediately perceive the difficulties which might arise from the cap applying to each "event". Suppose A invested in X Limited on the basis of negligently audited 1984 accounts, while B & C invested on the basis of the 1985 accounts, containing the same error (59). Have A, B, and C all suffered loss as a result of the same "event"? Suppose B sued and was successful, which prompted C to sue. Would B's judgment be enforced prior to the determination of C's proceeding? If so, would C force B to disgorge an appropriate share of the damages awarded to B? What if B has, subsequent to obtaining his judgment, gone bankrupt or into liquidation? Consolidation of proceedings may not be the total answer, because C might choose for a number of good reasons to wait and see whether B could establish liability before deciding to commence a proceeding. Obviously C cannot be forced to commence a proceeding at a given time just because B has: any plaintiff in contract or tort has a right to delay up to 6 years before the claim may be time-barred (60).

There will also be further difficulties with regard to groups of companies, where the audit report covers both the holding company's financial statements and the group's consolidated statements. Should the liability limit of the holding company auditor apply only in respect of the fees received by that auditor or the fees payable to all auditors of the group? The CSLRC formed no opinion on that question (61), but noted that on one view, the holding company auditor must take primary responsibility for the consolidated financial statements covered in the report, and therefore the liability limit of that auditor should be a multiple of the group audit fees.

The CSLRC considered that any move to confine to a more reasonable level the potential liability of auditors must be balanced by the introduction of compulsory indemnity insurance to a prescribed level (62). The Committee acknowledged that there were many practical difficulties with a mandatory insurance scheme, and considered that these problems would need to be fully investigated by the Working Party the Committee recommended be established. But, in my view, the objection to mandatory indemnity insurance is a more philosophical one. Whatever logic there may be in favour of capped liability is surely removed by inclusion of the quid pro quo, namely compulsory insurance up to the limit of liability. One can understand the superficial appeal of a minimum level of professional indemnity insurance: the victims of audit failure would be provided with a guarantee of compensation up to the statutory limit, even if they were being prevented from recovering their foreseeable loss above that figure. But this suggestion is surely to turn the law of tort on its head. The primary purpose of an award of damages is to compensate the victim for his or her loss, with a view to restoring the victim as near as possible to the position the victim would have been in but for the tort of the wrongdoer. But damages have another purpose: by making the wrongdoer responsible for meeting the award of damages, Courts are trying to deter others from committing similar wrongs. Insurance vitiates that secondary purpose of damages, but it is tolerated because it at the same time incidentally ensures that the primary purpose is more often achieved (63). What is in effect being proposed is that the victims of accountants' negligence should be barred by statute from recovering proper compensation - thereby negating the first purpose of an award of damages in tort. Then it is proposed that the wrongdoer should be compulsorily insured - thereby negating the second purpose of an award of damages.

And what of the practitioner who cannot afford insurance - say, because he or she wishes to practice in just a limited or part-time way? What of the practitioner who cannot find someone willing to insure him or her? That is by no means an idle consideration in light of the huge underwriting losses currently being experienced by the international insurance industry (64).

(c) Incorporation

The other solution, which I favour, is much less radical. That would be to permit accountants and other professionals to incorporate. The CSLRC purposely did not consider the question of auditors' being able to incorporate, but indicated a willingness "to separately consider whether the Companies Code be amended to allow for the incorporation of auditors, should an expression of interest from Ministers or the profession be forthcoming" (65). If accountants were permitted to incorporate, they could then at least in part assume the cloak of limited liability. In some parts of the Western world, e.g. Federal Republic of Germany, this is already permitted. There is in fact nothing in the New Zealand Society of Accountants Act 1958 to prohibit incorporation (although it must be conceded that the Act has clearly been drafted upon an assumption of sole practice or practice in partnership). Section 34A in fact expressly recognises that accountants might carry on the practice of accountancy as a company. But rule 60 of the Society Rules in unambiguous terms precludes practice other than in one's own name or in a partnership.

Incorporation would carry many benefits. While it would not reduce one's liability for one's own negligence (66) - and that is no bad thing - it would remove one's personal prospective liability for the actions of one's colleagues and employees. It can be assumed that all responsible accountancy practices would continue to carry large professional indemnity insurance, and that each practice would be keen to preserve the firm's reputation. Deloittes Company Limited is not likely to allow itself to be wound up because of a $10,000 award of damages against it. But it would enable the partners of an accountancy practice to make a policy decision. They might decide that they would take insurance cover up to, say, $20 million. But, in the unlikely event of a successful damages claim for more than that amount, they would simply let the company go into liquidation.

Another advantage of incorporation is that it would place accountants on the same basis in the market place as their competitors, many of whom enjoy the benefits of incorporation. The Government, the Commerce Commission, and consumer groups have rightly made it clear that the professions should no longer see themselves as immune from business and market forces: scale fees have gone, and indeed the whole question of licensing members of professions is under review. Unlimited liability as a professional ethic stems from days when accountants and lawyers were never sued: today it has been estimated, at least in the United States, that the new lawyer is likely to be the subject of 3 or more claims in his or her career (67). There is no reason to suspect that the track record of accountants will be any better. In those circumstances, it seems unfair that accountants should not enjoy one of the principal benefits available in the market place, namely that of limited liability.

Whether some minimum level of professional indemnity cover should be required for members of the New Zealand Society of Accountants could be a matter for that Society. One could perceive of the Society's insisting on it as a sales marketing technique, with clients being attracted to seek advice from accountants as opposed to seeking advice from competing professionals or service industries, on the basis that accountants carried a minimum level of professional indemnity cover.

The concept of incorporation, with the possibility of limited liability inherent in it, may well seem heretical to many who prize the professions' traditional stance of standing behind their work, and compensating those who suffer loss as a result of the specialist's negligence. But it is no more "unprofessional" than the suggested alternative of capping liability; indeed, I believe it to be the more "professional" solution. It would also better ensure that appropriate standards are maintained within the accountancy profession, because individuals would remain fully responsible for errors they personally made.

Finally, if the writer may don again his mortar board of the past, this approach appeals because it does not seek to undo the rationalisation of the law of negligence, begun by Lord Atkin in 1932 and continued since then, not least by the New Zealand Courts in the last two decades.

Footnotes

1. For example, in the Auckland Star of 7 May 1987, it was reported that the widow of Challenger astronaut Michael Smith had filed a law suit against the U.S. Government and rocket builder Morton Thiokol Inc. claiming $2.6 billion by way of damages (including punitive damages).

2. Cambridge Credit Corporation Ltd v Hutcheson (1985) 9 ACLR 545 (currently under appeal).

3. BP Refinery (Westernport) Pty Ltd v Shire of Hastings (1977) 52 ALJR 20, 26; Devonport Borough Council v Robbins [1979] 1 NZLR 1, 23; Ware v Johnson [1984] 2 NZLR 518, 534-536; Watkin v Wilson [1985] 1 NZLR 666, 669. For a term to be implied, it must:

   (a) be reasonable and equitable;
   (b) be necessary to the business efficacy of the contract, so that the contract would not be effective without it;
   (c) be so obvious that it goes without saying;
   (d) be capable of clear expression;
   (e) not contradict any express term of the contract.

4. Bolam v Friern Hospital Management Committee [1957] 1 WLR 582, 586; Chin Keow v Government of Malaysia [1967] 1 WLR 813; Whitehouse v Jordan [1981] 1 WLR 246; Wilson v Swanson [1956] S.C.R. 804.

5. Lloyd Cheyham & Co. Ltd v Littlejohn & Co. (as yet unreported, but discussed at some length in Bird, [1986] JBL 393).

6. The reason why the plaintiffs lost was that they knew that the accounts had been prepared on the basis of accounting for expenditure on repairs and renewals at the time it was spent. They maintained that they were nonetheless misled because they assumed that the profit under this basis was not materially different from that under the full accruals basis. But Woolf J considered that this simply revealed a failure on their part to obtain "the usual warranties or make the usual enquiries before investing in Trec".

7. Decision of the Professional Purposes Committee, given 3 November 1967 (9779); see further, A guide to the professional conduct of solicitors, issued by the Council of the Law Society (1974), para. 14:12. I suspect from discussions with Council members of the Auckland District Law Society, that it would adopt a similar stance.

8. Underwood Son & Piper v Lewis [1894] 2 QB 306.

9. For a useful recent article on these questions, see Stokes and Sullivan, "Auditor Reliance upon Management - A Legal Perspective" (1985) 3 C & SLJ 246.

10. Enterprising counsel may also be able to plead in certain circumstances breach of fiduciary duty: see Day v Mead [1987] NZ Recent Law 1 (appeal since heard by Court of Appeal and judgment reserved).

11. [1973] 2 NZLR 100.

12. Tai Hing Cotton Mill Ltd v Lin Chong Hing Bank Ltd [1985] 2 All ER 947 at 957. The decision has been criticised for failing "to consider any of the many decisions over the past decade which have allowed ... claims" in contract and tort: Holyoak, "Accountancy and Negligence", [1986] J.B.L. 120, 130.

13. It did not come "squarely" in Rowe v Turner Hopkins & Partners [1982] 1 NZLR 178, because neither side wished to contend that a solicitor's liability could arise both in contract and in tort. The reason why the client did not wish to assert that was because that would have opened the way to a reduction in his damages pursuant to the provisions of the Contributory Negligence Act 1947. It is almost certainly the case that that Act cannot be pleaded as a defence to a claim in contract (although those who advocate to the contrary may receive some comfort from what Cooke and Roper JJ. said in Rowe at 181). Whether that Act is available as a defence to a claim for breach of fiduciary duty by a professional person will be determined by the Court of Appeal (one assumes) in Day v Mead (see note 10).

14. Sutcliffe v Thackrah [1974] AC 727; Arenson v Arenson [1977] AC 405; Midland Bank Trust Co. Ltd v Hett, Stubbs & Kemp [1979] Ch 384; Ross v Caunters [1980] Ch. 297. Tai Hing (note 12) is not in conflict with those decisions, it is submitted, because there the Privy Council was dealing with the banker-customer relationship, not the professional-client relationship, and further with the duties of the customer, not the duties of the banker. The Privy Council found that, on a proper interpretation of the contracts in question, the customer's obligation when drawing a cheque was limited to exercising reasonable care to prevent forgery ([1985] 2 All ER 947, 954). No wider duty could be implied whether in contract or tort.

15. Aluminium Products v Hill [1981] Qd.R.33; Finlay v Murtagh [1979] I.R. 249; Dominion Chain Co. Ltd v Eastern Construction Co. Ltd (1976) 68 DLR (3d) 385.

16. [1978] AC 728.

17. In a passage justly described as "now famous" by Lord Scarman in Tai-Hing [1985] 2 All ER 947, 953.

18. Voli v Inglewood Shire (1963) 110 CLR 74.

19. [1984] 3 All ER 529.

20. Ibid., 534. All the other Law Lords agreed with Lord Keith's speech.

21. [1980] Ch. 297.

22. [1983] NZLR 37. (The case is still awaiting trial; there has accordingly been no finding yet that the solicitors were in fact negligent.)

23. [1983] NZLR 22.

24. [1978] 1 NZLR 553.

25. Ibid., 581.

26. Ibid., 567.

27. Ibid., 575-576.

28. Ibid., 582. The accountants in JEB Fasteners Ltd v Marks Bloom & Co. [1983] 1 All ER 583 similarly knew that it was highly likely that a takeover or other similar move would take place. And see Turomax Ltd v Dickson, McFarlane & Robinson [1983] SLT 98, on appeal [1984] SLT 424.

29. Ibid., 587.

30. Ibid., 589.

31. Ibid., 581. My enquiries reveal that the situation has apparently never been considered by the Stock Exchange.

32. (1983) 8 ACLR 123; (1983) 8 ACLR 513; (1983) 8 ACLR 526 (NSWCA); (1985) 9 ACLR 545.

33. 9 ACLR 545, 590.

34. Ibid., 592.

35. Ibid., 588.

36. See in NZ Companies Act 1955, s.62.

37. 9 ACLR 545, 564.

38. "The Naked Auditor - 'Liability for an Indeterminate Class of People for an Indeterminate Period of Time?'" (1985) 13 ABLR 154.

39. Ibid., 158, citing Paul A Davies (Aust.) Pty Ltd v Davies and Anor (1983) 8 ACLR 1, Queensland Mines Ltd v Hudson (1978) 18 ALR 1, and Furs Ltd v Tomkies (1936) 54 CLR 583.

40. See, for example, Pacific Acceptance Corporation Ltd v Forsyth (1970) 92 WN (NSW) 29, 67 and Dominion Freeholders Ltd v Aird (1966) 84 WN (NSW) 190, 192, 195.

41. Not every breach of statutory duty gives rise to a civil claim at the hands of a person suffering loss thereby. A series of conflicting dicta is not readily explicable on any logical basis: see Salmond and Heuston on the Law of Torts (18th ed.), pp. 227-230.

42. Hedley Bryne & Co. Ltd v Heller & Partners Ltd [1964] AC 465.

Interestingly, in this case the respondents, who were merchant bankers who gave advice as to the creditworthiness of a particular company, were held not liable because the advice - which was on the whole favourable to the question of advances to the company - was given "without responsibility on the part of the bank or its officials".

43. Caltex Oil (Australia) Pty Ltd v The Dredge "Willemstad" (1976) 136 CLR 529; Junior Books Ltd v Veitchi Co. Ltd [1983] 1 AC 520; New Zealand Forest Products Ltd v Attorney General [1986] 1 NZLR 14; Port v New Zealand Dairy Board [1982] 2 NZLR 282; Takaro Properties Ltd v Rowling [1986] 1 NZLR 22.

44. In re Securitibank Ltd, Goodman v Rutherfurd (unreported, M1604-6/76 (Auckland Registry), Judgment No. 37, 30 October 1985, Barker J., at p.5). Although the settlement was confidential, the amount had to be revealed in relation to another question which called for judicial determination in this complex series of cases.

45. See the article in The Observer, 28 July 1985, which highlighted the following five claims by way of example:

Case	Firm	Country of suit	Amount claimed
Alexander Howden	Arthur Young	UK	£167m.
Continental Illinois	Ernst & Whinney	USA	At least $220m.
De Lorean	Arthur Andersen	USA/UK	$260m/£100m.
ESM Govt.*	Alexander Grant	USA	$1b.
Penn Square	Peat Marwick	USA	$395m.

[* The E.S.M. case ultimately resulted in a jury award of US$70.9 million. But judgments in favour of other plaintiffs against the auditors pushed the total awards to well over US$100m.]

Apparently, in the Drysdale Government Securities Inc. case, referred to on p24 of International Business Week, 29 October 1984, the bulk of the US$49 million loss was met by the auditors, Arthur Andersen & Co. According to International Accounting Bulletin for July/August 1986, Price Waterhouse has been sued in Hong Kong in respect of two Hong Kong companies now in liquidation, Advance Finance and Carrian Investments. According to the same bulletin for February/March 1987, p.3, Calgroup Graphics and a number of its shareholders have sued Price Waterhouse in negligence for C$100m. and Peat Marwick have been sued for US$158m. in the U.S. courts for alleged negligence in the wake of the Ballingarry Mines scandal in Ireland. Not all the claims have arisen from careless auditing. Arthur Andersen was recently held to have given wrong advice to a client in a takeover battle, and has been held liable for damages in the Irish High Court to the extent of IR£200,000: International Accounting Bulletin, April 1987, p3.

It must be stressed that many of the above claims may be entirely without merit, and further that the sums claimed may be manifestly exaggerated. But the significance of them is the size of the claims and the impact which this must have on the extent of insurance cover carried.

46. Clemance v Hollis (unreported, A98/85 (Hamilton Registry), 20 February 1987, Gallen J.) The adviser was in fact dismissed from the trial on its 24th day. The purchasers of the orchard received damages in excess of $840,000 from the vendors' agent.

47. See, for instance, JEB Fasteners Ltd v Marks Bloom & Co. [1983] 1 All ER 583 (where the plaintiffs failed because they could not establish the causal link between the accountants' negligence and their loss - they would have taken over the company in any event) and Pacific Acceptance Corp. Ltd v Forsyth (1970) 92 WN (NSW) 29.

48. Law Talk, 29 April 1987, p.7.

49. Ian Hunter Q.C., "Professional Malpractice Claims and Indemnity Insurance", (1986) 1 Counsel 38, 41.

50. The Companies and Securities Law Review Committee, Report to the Ministerial Council on the Civil Liability of Company Auditors (September 1986).

51. NZ Herald, 21 March 1987, Section 3, page 4.

52. See note 48.

53. New Zealand Forest Products Ltd v Attorney-General [1986] 1 NZLR 14, where Barker J. preferred the dissenting judgment of Edmund Davies L J in Spartan Steel & Alloys Ltd v Martin & Co. (Contractors) Ltd [1973] Q.B. 27. In 1977, the whole of New York City and surrounding areas were negligently deprived of electricity for a period of 25 hours, a situation posing considerable difficulties for recent formulations concerning the recoverability of economic loss: see Clark, "Economic Loss: Further Important Devewlopments?" (1983) 133 NLJ 1055. But Barker J was able to avoid such problems because of the way the case proceeded before him, namely as a question of law before trial.

54. Companies and Securities Law Review Committee, Discussion Paper No. 3 - Civil Liability of Company Auditors (November 1985), paras. [1]-[2].

55. German Stock Corporation Act, art. 168(2). This was discussed in the Discussion Paper (note 54) at paras. [49] and [65]-[66], but was not ultimately supported by the CSLRC: see Report, para. [225]. For a discussion of the various options raised by the CSLRC in its Discussion Paper, see Langfield-Smith, "Limiting the Liability of Auditors - A Review", (1986) 4 C & SLJ 252.

56. Report, paras. [228]-[236].

57. Ibid., para. [229]. If a minimum figure were fixed, this may

reduce the risk of "corner cutting".

58. Ibid., para. [235].

59. For instance, in Scott Group Ltd v McFarlane (note 24), the same error was repeated over several years' accounts.

60. Limitation Act 1950, s. 4.

61. Report, para [236].

62. Ibid., paras. [117], [257]-[262].

63. Salmond and Heuston on the Law of Torts (18th ed.), p.22.

64. Langford-Smith, 4 C & SLJ 252, 254: note the fascinating statistics cited from a number of sources.

65. Report, para. [119].

66. C Evans and Sons Ltd v Spritebrand Ltd [1985] 1 WLR 317.

67. "An American Perspective of Legal Malpractice: Two Decades of Litigation", 1985 ABA London conference.