

LIMITATIONS ON THE TORT LIABILITY  
OF ACCOUNTANTS TO THIRD PARTIES

prepared for the  
Canadian Institute for the Administration of Justice

National Seminar on the Liability of Accountants  
October, 1986

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## LIMITATIONS ON THE LIABILITY OF ACCOUNTANTS TO THIRD PARTIES

### Introduction

Prior to the 1963 it was well established that an accountant was only responsible for negligence to parties with whom he had privity of contract. That situation was reversed when in Hedley Byrne & Co., Ltd. v. Heller and Partners Ltd., the House of Lords decided that a professional advisor could be liable for negligent misstatements even to third parties with whom he had no contract. The impact of this decision on accountants will probably be greater than its impact on any other profession. In fact, the financial statements and reports prepared by accountants are so broadly distributed that if accountants are held responsible to anyone who might rely on the financial statements, the resulting liability may be so great as to radically change the profession. A number of Courts have recognized the potential hardship for the profession and have tried to construct reasonable limitations on the liability of accountants. Unfortunately, no consistent approach has yet emerged, nor has an approach been developed which strikes a reasonable balance between the interests of the accountant, and the interests of the parties who rely on information produced by him.

There are two questions which must be addressed. The first is whether a limitation of liability should be given. This involves a consideration of whether a limitation is necessary to protect accountants and whether a limitation is desirable for society as a whole. Second, assuming that a limitation should be imposed, is there a rational method for doing so? Before addressing these questions, it is useful to consider the history of accountants' liability and the

limitations that have been suggested in Canada and the other common law jurisdictions.

The Liability of Accountants Prior to *Hedley Byrne v. Heller and Partners*

Accounting was historically one of the safer professions. The accountant owed a duty of care only to those with whom he had privity of contract. This meant that the accountant generally had no responsibility to anyone other than his client. Even then, the nature of the accountant's undertaking was such that a breach would seldom lead to a claim for damages. A negligent audit generally produces nothing more than a misdescription of the financial status of the company, and while the accountant may be responsible for any loss to the company arising from such misdescription, the company generally has difficulty showing that it took a specific action in reliance on the error or that it suffered loss as a direct result. Furthermore, if a loss was proven, the rules of contributory negligence applied and the accountant could reduce or escape liability if the error in the statement was known or ought to have been known to management.

In *Donoghue v. Stevenson*, (1932) A.C. 562, the House of Lords abandoned the strict application of the privity rule in favour of the concept that relationships could give rise to a duty of care and that the existence of liability for negligence should be determined by the proximity of the victim to the perpetrator of the act. In his now famous judgment, Lord Atkin said:

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

This statement of the neighbour principle allowed later courts to circumvent many of the no-duty rules that had previously existed, but the rule was not intended to be absolute. According to Lord Reid, the neighbour principle "ought to apply unless there is some justification or valid explanation for its exclusion". Put another way, a duty should arise whenever harm is reasonably foreseeable unless there is some valid public policy reason to limit such a duty.

Donoghue v. Stevenson concerned physical damage, but taken literally, could also have embraced conduct causing purely economic loss. If so, an accountant could be liable to parties with whom there was no privity of contract. This question came before the English Court of Appeal in Chandler v. Crane Christmas & Co., [1951] 1 All E.R. 426. The majority of the Court concluded that the case against the accountant should be dismissed because in the absence of privity of contract there could be no recovery for purely economic loss. In a dissenting judgment Denning L.J. expressed the view that there was no rational distinction between physical damage and economic loss. As to the scope of the accountant's duty, he said:

"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 their employer is going to show the accounts so as to induce him to invest money or take some other action on them. I do not think, however, the duty can be extended still further so as to include strangers of whom they have heard nothing to whom their employer without their knowledge may choose to show their accounts.";

and:

"The test of proximity in these cases is: Did the accountants know that the accounts were required for submission to the plaintiff and use by him?"

The prospect of an accountant having liability to third parties arose when Chandler v. Crane Christmas & Co. was overruled by the House of Lords in Hedley Byrne v. Heller and Partners, [1964] A.C. 465. While the case did not involve an accountant, it established that in certain circumstances a professional advisor might owe a duty of care to parties who might rely on his advice, even in the absence of privity of contract. The majority of the House of Lords were, however, of the view that, for the purposes of determining the scope of liability in any given case, a distinction ought to be made between negligent acts causing physical damage and negligent words causing financial loss. In coming to that conclusion several of them referred to policy reasons expressed by Cardozo C.J. in Ultramares Corporation v. Touche, 174 N.E. 441:

"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

The Court adopted a cautious approach to the scope of the new duty--indicating that it required a closer relationship between the parties than the "reasonable foreseeability" or "proximity" test. They spoke in general terms of circumstances involving a "special relationship" between the parties but did not attempt to define the precise circumstances under which such a special relationship could be said to arise.

The question of an accountant's liability to third parties came before the Supreme Court of Canada in Haig v. Bamford, (1976) 72 D.L.R. (3d) 68. The case concerned financial statements prepared for an ailing company. In carrying out their work, the auditors were aware that the financial statements might be used to raise money either from the bank that the company was dealing with or from an outside investor. The statements were given to and relied

on by an outside investor when he purchased a substantial interest in the company. The company failed and the investor sued the accountants. The majority judgment was delivered by Dickson J. who prefaced his findings by a discussion of the role of accountants in society:

"The increasing growth and changing role of corporations in modern society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the owner-manager of a company and was answerable to him alone has passed. The complexities of modern industry combined with the effects of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to marked reliance which the public must place upon his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.

"With the added prestige and value of his services has come, as the leaders of the profession have recognized, a concomitant and commensurately increased responsibility to the public. It seems unrealistic to be oblivious to these developments. It does not necessarily follow that the doors must be thrown open and recovery permitted whenever someone's economic interest suffers as the result of a negligent act on the part of an accountant. Compensation to the injured party is a relevant consideration but it may not be the only relevant consideration. Fear of unlimited liability for the accountant, 'liability in an indeterminate amount for an indeterminate time to an indeterminate class', was considered a relevant factor in Mr. Justice Cardozo in Ultramares Corp. v. Touche et al."

Dickson J. then set out three possible tests for the founding of a duty of care:

- "(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."

Dickson said that he did not have to consider whether the first test, "foreseeability", was appropriate since he believed that the facts of this case would clearly come within either his second or third tests. He rejected the third test as being too narrow and adopted the second test-- "actual knowledge of the limited class that will use and rely on the statement."

Haig v. Bamford was considered by the New Zealand Court of Appeal in Scott Group Ltd. v. McFarlane, [1978] 1 N.Z.L.R. 553. The Defendants in that case were the auditors of a public company named John Duthie Holdings Ltd. The auditors had expressed an opinion on the firm's financial statements, which, in accordance with the relevant companies legislation, had been filed and were open for public inspection. The Plaintiff, Scott, had been interested in acquiring Duthie although this was not known to the auditors at the time of their audit. Shortly after the takeover Scott discovered an elementary error in the accounting and sued the auditors for negligence. The trial judge dismissed the case on the basis that the auditors owed no duty to Scott. Scott appealed and the Court of Appeal split on the issue of whether there was a duty of care.

The senior Judge, Richmond P., concluded that the auditors owed no duty of care. He specifically rejected the "foreseeability" test as being too broad and concluded that no duty should exist unless the accountant was aware that the financial statements were to be used in a specific type of contemplated transaction. Woodhouse J. found that a duty of care did exist. In doing so, he adopted a statement made by Lord Wilberforce in Anns and Others v. Merton London Borough Council, [1978] A.C. 728:

"The position has now been reached that in order to establish that a duty of care arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather

the question has to be approached in two stages. First one has to ask whether, as between the alleged 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. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negate, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise."

The third Judge, Cooke J., also relied on the speech of Lord Wilberforce in Anns v. London Borough of Merton and agreed that a duty of care was owed. He believed that the evidence disclosed "a plain risk of a takeover and virtual certainty that in such event the accounts would be relied upon by an offeror". He therefore decided that there was a sufficient relationship of proximity or neighbourhood between Scott and the auditors such that it should have been in the reasonable contemplation of the auditors that carelessness on their part would be likely to cause damage to Scott.

The reasonable foresight test has also been applied in JEB Fasteners v. Marks, Bloom & Co., [1981] 3 All E.R. 289. The plaintiff had taken over a company audited by the defendants. While the auditors were aware that the company might require outside financial support, they were not aware of the plaintiff nor of the manner in which such financial assistance would be provided. When the plaintiff subsequently discovered that the audit had been negligently performed, it sought to recover from the auditors. The Court found the auditors responsible, relying on Anns v. London Borough of Merton and Scott Group Ltd. v. McFarlane. Wolfe J. said:

"Without laying down any principle which is intended to be of general application, on the basis of the



authorities which I have cited, the appropriate test for establishing whether a duty of care exists appears in this case to be whether the defendants knew or reasonably should have foreseen at the time the accounts were audited that a person might rely on those accounts for the purpose of deciding whether or not to take over the company and therefore could suffer loss if the accounts were inaccurate."

and:

"I am satisfied that Mr. Marks (the accountant) . . . ought to have realized the accounts could be relied on up till the time that a further audit was carried out by the commercial concerns to whom BG Fasteners Ltd. were bound to look for financial assistance. When he audited the accounts, Mr. Marks would not know precisely who would provide the financial support, or what form the financial support would take, and he certainly had no reason to know that it would be by way of takeover by the plaintiffs. However, this was certainly one foreseeable method and it does not seem to me that it would be right to exclude the duty of care merely because it was not possible to say with precision what machinery would be used to achieve the necessary financial support. Clearly any form of loan would have been foreseeable including the raising of money by way of debenture, and while some methods of raising money were more obvious than others and a takeover was not the most obvious method, it was certainly one method which was within the contemplation of Mr. Marks."

Based on the foregoing, the extent of accountants' liability in Canada is still in some doubt. While in Haig v. Bamford, Dickson J. concluded that an accountant can have liability where he has actual knowledge of the limited class that will use and rely on the statement, he did not specifically reject the test of "reasonable foreseeability". Given the movement in England and Australia to the "reasonable foreseeability" test, it is still possible that this may be adopted as the Canadian standard.

## The Liability of Accountants to Third Parties in the United States

The first significant American case dealing with the potential liability of accountants to third parties was Ultramares Corporation v. Touche, 174 N.E. 441. In Ultramares the New York Court of Appeal overturned a lower court decision in which an accountant had been found liable to a creditor who had extended credit in reliance on the financial statements. While there appeared to be general agreement that the auditors would be liable for fraud, the Court found that there could be no liability where the auditor had been merely negligent in the preparation of the financial statements. Cardozo, C.J. expressed concern that:

"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."

He also expressed concern that if these principles were taken to their logical conclusion, they might fundamentally alter the nature and range of contractual undertakings:

"Everyone making a promise having the quality of a contract will be under a duty to the promisee by virtue of the promise, but under another duty, apart from contract, to an indefinite number of potential beneficiaries when performance has begun. The assumption of one relation will mean the involuntary assumption of a series of new relations, inescapably hooked together."

He concluded:

"Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that, if less than this is proved, if there has been neither reckless misstatement nor insincere

profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract and is to be enforced between the parties by whom the contract has been made. We doubt whether the average businessman receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more."

While a majority of American jurisdictions have held that the lack of privity bars an action for negligence against an accountant, the Ultramares decision has not won universal acceptance in the United States. In recent years, the judicial trend has been toward an abrogation of the privity requirement in favour of a more flexible and equitable standard. In doing so they have applied all three of the possible tests set out by Dickson J. in Haig v. Bamford as well as a fourth test known as the Biakanja test.

(1) Knowledge of The Particular Plaintiff Who Will Use and Rely on The Statement

This was a possible test considered by Dickson J. in Haig v. Bamford but rejected by him as being too restrictive. The test has, however, found some acceptance in the United States, particularly in jurisdictions which had previously favoured the strict privity requirement of Ultramares. In Credit Alliance v. Arthur Andersen & Co. 483 N.E.2d 110 (N.Y. 1985) the Court of Appeals of New York indicated that it was prepared to allow recovery against an auditor where the case met certain criteria--"to wit, a particular purpose for the accountants' report, a known relying party, and some conduct on the part of the accountants linking them to that party". In such circumstances they felt that the relationship between the accountants and the nonprivity parties was "so close as to approach that of privity, if not completely one with it".

(2) Actual Knowledge of the Limited Class That Will Rely on The Statements

A number of U.S. Courts have accepted the test proposed by Dickson J. in Haig v. Bamford, and are prepared to allow recovery where the accountant has actual knowledge of a limited class that will rely on his financial statements or reports. In some cases adopting this test the Court has specifically rejected the "reasonable foreseeability" test as being too broad. In Briggs v. Sterner (1981, SD Iowa) 529 F. Supp. 1155 the Court justified this position by reference to the harm that might result:

"Imposition of a broad duty of care upon accountants to all third parties who might foreseeably rely upon negligently prepared or certified financial statements would have an extremely disruptive effect on current accounting practices. To protect themselves the accountants would greatly increase the costs of the audit to the client. Ultimately such cost would be borne by lenders, investors and the general public. Present methods of raising risk capital would be put in jeopardy. In the Court's opinion, such additional costs of insuring against potential liability would far exceed benefits to be derived from spreading the particular risk of loss involved herein to the public at large. The other causes of action left intact by this ruling provide adequate remedy for plaintiffs' alleged losses."

The "actual knowledge of a limited class" test has now been adopted by the Restatement (2d) of Torts 552 which reads:

"Information Negligently Supplied for the Guidance of Others

- (1) One who, in the course of his business profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
- (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

- (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
  - (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 similar transaction.
- (3) The liability of one who is under a public duty to give information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them."

The Restatement has been adopted in numerous cases from various States and now appears to represent the more generally accepted approach to accountants' liability to third parties.

(3) Foreseeability of the Use of the Financial Statement by the Plaintiff and Reliance Thereon

Two U.S. jurisdictions have adopted the "foreseeability" test used in Scott and JEB Fasteners as the standard for accountants' liability to third parties. In Rosenblum v. Adler, 461 A.2d 138 (N.J. 1983) a corporate plaintiff acquired the stock of the defendant accounting firm's client. When the stock proved worthless, plaintiff sued defendants alleging negligence and detrimental reliance. Applying the reasonably foreseeable test, the Court found defendants liable for negligent misrepresentation. The Court said:

"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.

. . . .

"Certified financial statements have become the benchmark for various reasonably foreseeable business purposes and accountants have been engaged to satisfy those ends. In those circumstances accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice. The public interest will be served by the rule we promulgate this day."

(4) Biakanja Test

Other States such as Missouri and North Carolina have adopted what is known as the Biakanja test. The standard originates with Biakanja v. Irving, 320 P.2d 16 (Cal. 1958). where a will was denied probate because of negligence on the part of the notary public who had prepared it. When a beneficiary under the will sought damages from the notary public, the Court held that third-party liability was a policy matter and applied the following six-factor balancing test:

"[t]he extent to which the transaction was intended to affect the plaintiff; the foreseeability of harm to [plaintiff]; the degree of certainty that the plaintiff suffered injury; the [proximity] 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 Biakanja test would appear to give the court the power to award judgment in any circumstances that would satisfy the foreseeability test, but at the same time the court would retain a broad discretion to absolve the professional from liability.

In Aluma Kraft Manufacturing Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. App. 1973) the Court applied the Biakanja test to accountants. The plaintiff, a buyer of stock of the accounting firm's client, sought damages for negligence in the performance of an audit it relied on in purchasing the stock. Applying the Biakanja test, the Court held that plaintiff had stated a claim sufficient to withstand defendant's motion to dismiss.

In Raritan River Steel Co. v. Cherry, Bekaert, 339 S.E.2d 62 (1986 N.C.) the Court of Appeals of North Carolina rejected the Ultramares test, the foreseeability test, and the Restatement test, in favour of the Biakanja test. The case concerned raw steel that had been supplied to the accountant's client on credit. In granting credit, the plaintiff had relied on information in a Dun & Bradstreet report which incorporated information from the audit. The Court dismissed the auditor's application for a summary dismissal of the claim finding that it was sufficient that the auditors knew that such financial statements would be used for general representations by the client of its financial condition, and that extensions of credit would be based upon such statements.

SHOULD CHARTERED ACCOUNTANTS BE ENTITLED TO SPECIAL PROTECTION?

While the privity rule was a rule of law rather than a rule of policy, it made some sense even from a policy point of view--one could not sue for bad advice or incorrect information unless he had paid for it. When, for policy reasons, it was decided to abandon the privity rule, it was argued that there were equally valid policy reasons for placing reasonable limitations on the liability of accountants. However these policy reasons may be couched, they seem to reflect the concern first expressed in Ultramares: " . . . a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." The best rebuttal to this argument was provided by Woodhouse J. in Scott (at page 571):

"Since then those last few words (of Cardozo C.J. in Ultramares) have been repeated in some judgments almost

as though they reveal a self-evident truth; and not unnaturally they were referred to be counsel for the auditors in the present case. But the attraction and force of the language ought not to lead to uncritical acceptance of that sort of argument--in terrorem as Cooke J. described it recently in Bowen v. Paramount Builders [1977] 1 N.Z.L.R. 394, 422. It is, of course, substantially a plea in mitigation on behalf of a particular class of defendants that they should be altogether excused from liability for their negligent conduct because the consequences are too serious to justify responsibility. It may be regarded as a rather one-sided argument, particularly when it is set up in favour of those who are in business to give advice."

It is easy to agree with the argument that wrongdoers should not be protected at the expense of their victims. This is particularly true when consideration is given to the manner in which the accounting profession has developed during this century. In the case of a public company the audited financial statements not only go to the members but must be kept open for public inspection at the company's offices. This is a significant change from the days when the audit was a private engagement for the benefit of owner-managers and the possibility of the financial statement finding its way into general public circulation was remote. In a sense, the auditor has been elevated to a place independent of the company for which he works and is clearly now working not so much for management but for outsiders. Even in private companies there may be considerable reliance by third parties on the financial statements. Not only is it a standard banking requirement that financial statements be supplied on a regular basis, but financial statements also seem to find their way to various credit agencies who prepare reports for other lenders and suppliers.

On the other hand, concern must be given to the fact that open-ended liability may seriously injure the profession. In Scott, Woodhouse J. thought that this problem could easily be handled by the insurance industry. He said:



"At least in their case (accountants) the insurance industry is well able to accept the risk and spread any losses that otherwise would remain with individuals-- while the members of the profession or business could themselves pass on the cost of premiums like any other overhead as a part of the charge for their services."

While similar arguments have been relied on by various courts to justify an expansion of the scope of recovery in tort, the argument may have had more merit in 1978 than it does in 1986. It now appears that there are limitations to the risks that the liability insurance industry is prepared to underwrite, and some professions are finding that insurance is no longer available at reasonable rates while others cannot insure at all. Furthermore, the costs of liability insurance are no longer a minor item that can be passed painlessly on to the consumer.

So far Canadian accountants have experienced relatively good fortune in the insurance markets. Many are part of large organizations which have been able to insure internationally while the balance have participated in a national programme. By spreading the risk and minimizing the administrative costs, accountants have made themselves more appealing to liability insurers. Nevertheless, the national programme offers a maximum coverage of \$1,000,000 per claim and the administrators of the programme have been unable to find an insurer who is prepared to write coverage for claims beyond the \$1,000,000. This, of course, provides little comfort to accountants facing liability "in an indeterminate amount for an indeterminate time to an indeterminate class".

Since the market for professional liability insurance is largely international, the situation may deteriorate even if Canadian courts provide some relief to accountants. A recent survey of the International Accounting Bulletin reports that the "Big Eight" firms have paid out a total of

nearly \$180,000,000. U.S. in audit-related settlements in the United States alone over the past five years, and that the figure being set aside as potential risk by the insurance underwriters is more than double that amount. A few huge awards, such as the award of \$145,000,000 Australian in Cambridge Credit Corporation Limited v. Hutcheson, 9 Australian Company Law Reports 545 or the jury award of \$80,000,000 U.S. against Arthur Andersen, may cause underwriters to abandon accountants' liability insurance altogether.

Based on the foregoing, two conclusions are obvious. First, the mere fact that accountants may face huge potential liability does not justify a denial of recovery to classes of people who should otherwise be entitled to maintain claims against accountants. Second, it would be desirable to provide accountants with some protection against large claims to diverse groups which may arise from rather trifling errors on the part of the accountant. The desire to protect accountants should not, however, take precedence over the desire to give compensation where otherwise appropriate.

There appear to be five possible ways of restricting the liability of chartered accountants:

- (1) Rules restricting the parties to whom the accountant owes a duty of care;
- (2) Rules setting out the nature of the the reliance required in an action against an accountant;
- (3) Rules relating to damages;
- (4) Disclaimers;
- (5) Legislative protection.

#### (1) Limitations on the Duty of Care

While each of the three rules set out by Dickson J. in Haig v. Bamford has received some degree of judicial acceptance, only one of them offers any reasonable protection to accountants, and it does so only by departing

from otherwise established principles of the law of negligence.

The first rule, which has been adopted by some U.S. jurisdictions, is appealing in three respects. First, it provides recovery to those parties whom the accountant knows to be relying on his work, and in that sense it is fair that the accountant ought to be responsible for their losses. Second, by limiting liability to known parties in known transactions, it allows the accountant to accurately assess his potential liability before undertaking the work. This allows the accountant to either insure appropriately or to decline the work if the potential liability is out of line with the remuneration for the work. Lastly, the rule is easy to apply since in each case the claimant establishes the accountant's knowledge of his potential reliance.

The shortcoming of the actual knowledge test is that it allows recovery by "known claimants" but denies recovery to members of a known class of claimants. As such, it would deny recovery to persons who deposit money, make loans or purchase shares in reliance on the financial statements even though it was obvious to the accountant that such transactions would take place and would, in part, be influenced by the financial statements. In such circumstances it seems difficult to justify a denial of recovery to the members of a class simply because the accountant could not specifically identify the members of the class at the time he did his work.

The second test, "actual knowledge of the limited class", has been adopted in Canada and in a number of U.S. jurisdictions. The first difficulty with the test is that the words "limited class" are ambiguous. Interpreted narrowly the words "limited class" would restrict recovery to cases where:

- (i) the plaintiff belongs to a class that the accountant knew would use and rely on the financial statements, and
- (ii) the class which the plaintiff belongs to is "limited".

Under this interpretation, the test becomes as restrictive as the first test, and shareholders, investors, and creditors could never recover because they are members of unlimited classes. It is doubtful that this is the proper interpretation since the concept of a "class" implies an indeterminate group, and two recent Canadian decisions, Dupuis v. Pan American Mines Ltd. et al. (1979) 7 B.L.R. 288 (Quebec Superior Court) (prospective shareholder) and Ranjoy Sales and Leasing Ltd. et al. v. Deloitte, Haskins and Sells, [1984] 4 W.W.R. 706 (Man. Q.B.) 950 (existing and prospective investors) seem to indicate that recovery is available even where the plaintiff is not a member of limited class.

The more realistic interpretation is that any group which the accountant knows is likely to use and rely on the financial statements falls within the "limited class" to whom a duty is owed. If this is the proper interpretation, and if "classes" is broadly defined, it is difficult to see how the test is materially narrower than the "reasonable foreseeability" test. The audit process itself generally gives the accountant actual knowledge of the broad groups (shareholders, investors, creditors, depositors) who are likely to rely on the financial statements, meaning that only claims arising out of unusual and unanticipated transactions will be excluded by the requirement of "actual knowledge". In most cases, such claims, being unanticipated, would also be excluded under the "reasonable foreseeability" test. If there is little difference between the two tests, there seems to be no justification for departing from the standard of "reasonable foreseeability" which applies to other cases of negligence.

The test of reasonable foreseeability provides ample protection to third parties relying on financial statements and reports. The only difficulty with the test is that it does little or nothing to restrict the scope of the accountant's liability to third parties, and if this test becomes generally accepted, accountants may have to find some other means of limiting their liability.

## (2) Reliance

Even where there has been a clear breach of a duty, an injured party cannot recover unless he can establish a causal connection between the accountant's negligence and the loss that he has suffered. In case of a misrepresentation, the causal connection is described as "reliance", and the injured party cannot recover unless he can show that his loss arises from his reliance on the misrepresentation. Since the liability of accountants to third parties has been developed under the law of negligent misrepresentation, the requirement of reliance has been applied and the third party cannot recover from an accountant unless he can show that his loss has been suffered in reliance on inaccurate financial statements or reports.

There are numerous situations where there is a causal connection between the negligence of an accountant and a loss suffered by a party that does not amount to reliance. The requirement of reliance therefore places a somewhat artificial (and probably unintended) limitation on the potential liability of accountants. Although the issue was not directly addressed, it does arise in Ranjoy Sales and Leasing Ltd. et al. v. Deloitte, Haskins and Sells, [1984] 4 W.W.R. 706 (Man. Q.B.) 950. In that case investors who

loaned money to companies under a variety of trust agreements sought to sue the auditors by way of a class action. Proceedings by way of class action would not have been available unless the principles of fact and law were essentially the same for all members. Counsel for the auditors argued that the class action was inappropriate because the investors had advanced funds under different circumstances and that reliance should therefore be proved separately by each complainant. Counsel for the investors conceded that few investors have ever seen or examined the financial statements, but argued the question of reliance in these terms:

" . . . it is argued that in today's sophisticated commercial world, where investors invest with registered brokers or dealers who are required to file audited statements, the investors are entitled to assume that the auditors have performed their function in a careful way, in accordance with accepted accounting principles. In this sense it is argued that all investors, to the knowledge of the auditors, rely on the audited statements and the auditor's reports. That is particularly so in this case, it was submitted, because the investors were supplied with promotional literature . . . which specifically held out that there had been an audit performed by the defendant."

While this argument was couched in terms of "reliance", it is clear that the claim is really based on the concept that the auditor, as watchdog, is responsible for any loss that is causally connected to his negligence in the performance of the audit. The trial judge concluded that there was sufficient merit in this approach that the plaintiffs ought to be allowed to pursue it to trial. The Manitoba Court of Appeal upheld the decision in Ranjoy but their Reasons for Judgment indicate that the plaintiffs abandoned their argument based on "deemed reliance".

Nevertheless, it is foreseeable that the need for reliance will be challenged in the near future. The classic case would be one against the auditor of a lawyer's trust

account. Such audits are statutorily required by the Law Societies of the various Provinces, and there is little doubt that they are intended in part as a protection for creditors. Furthermore, the accountant should clearly foresee the possibility that the lawyer's clients might suffer loss if the auditor fails to discover defalcations. Nevertheless, it is highly unlikely that any client might actually see or rely on the financial statements, and if actual reliance is required, the auditor might escape liability for very type of loss that his audit was designed to prevent.

A similar issue arose in the Ranjoy case, although it was not directly dealt with because the claims were based on Section 24(7) of the Mortgage Brokers and Dealers Act of Manitoba which not only provided a "deemed privity" between the accountant and investors but also a "deemed reliance" by the investors. The legislation reads:

"An auditor's report referred to in subsection (3) shall be deemed to have been made to the commission as agent for the creditors of the mortgage dealer, and with the intention that the commission shall rely on it to decide whether the mortgage dealer's registration shall be continued in force or not."

If the requirement of reliance remains, one can anticipate that accountants may eventually be faced with a proliferation of such legislation. Nevertheless, in the absence of legislation, the requirement of reliance now stands as the chief protection of accountants against liability to an indeterminate class.

The liability of accountants to third parties can be significantly restricted simply by requiring the claimant to establish direct reliance on financial statements or reports. To do so, the claimant would have to show that he actually reviewed the financial statements, either personally or through an agent hired for that express

purpose. It would not be enough that he relied on advice from an investment broker who had reviewed the financial statements, or relied on a credit report prepared by an agency that in turn had relied on the financial statements. There is some merit in such a rule since it is difficult to say that reliance is substantial when the claimant did not personally review the financial statements.

Even where there has been direct reliance, relief need not always be given since few, if any, investment decisions are based exclusively on the financial statements. Indeed, one would think that financial statements are seldom reviewed until the prospective investor has reached the point where an investment is being seriously contemplated, and certainly all of the information that led the investor to that point must have played some part in the ultimate decision. While it is a difficult task, the court must carefully consider the investment process to determine whether there is a causal relationship between the error in the financial statements and the decision to invest. The first step is to determine whether the error was "material" in the sense that it was capable of inducing an investor to behave as he did. Second, the Court must determine whether the error did in fact induce the plaintiff to make the investment. This second test is subjective, and like all subjective tests, has inherent in it the danger that the claimant, with the benefit of hindsight, will tend to exaggerate the role played by the statements or reports in his decision. Such claims should be viewed with skepticism and the court should remember that the onus of proof remains on the plaintiff throughout to show cause and effect relationship between the error and the decision.

To date, however, courts seem inclined to find liability even where the reliance has been indirect. A case in point is Raritan River Steel Co. v. Cherry, Bekaert where the successful plaintiff did not receive copies of the



financial statements but relied on a Dun and Bradstreet credit report which was based in part on the financial statements. Even more troubling are some of the recent cases where class actions have been initiated against accountants. In U.S. case, Zatkin v. Primuth 551 F. Supp. 39 (1982 Cal.), a shareholder commenced action on his own behalf and on behalf of "all others similarly situated." Theoretically, such an action would be inappropriate since each plaintiff would have to establish that he in fact relied on the financial statements to his detriment. The auditors argued that for this reason, it could not be held liable to a class of shareholders. The Court rejected this contention:

"Under California law, an inference of reliance will arise as to an entire class, if the trial Court finds that material misrepresentations were made to the class members. Even if plaintiff were required to plead reliance in an action for negligent misrepresentation, the allegations of Zatkin's complaint are sufficient. In In re Equity Funding Corporation of America Securities Litigation, the Court held that an 'allegation of purpose and effect,' coupled with the clear materiality of misrepresentations alleged, satisfies the reliance and causation requirements imposed on pleadings that assert fraud claims in California.

"Furthermore, the Restatement (2d) of Torts 552 supports liability of accountants to public shareholders. There are no California cases which rule on the precise issue raised by [the auditors]."

One Canadian case has indirectly addressed these issues. In Dupuis v. Pan American Mines Ltd. et al. (1979) 7 B.L.R. 288 (Quebec Superior Court), the accountant was negligent in the preparation of a financial statement which the accountant knew would be included in a prospectus issued by P Ltd. The plaintiff had purchased \$900,000 worth of shares in P Ltd. Within a year P Ltd. was delisted and the Plaintiff lost his entire investment. The Court found little direct reliance on the financial statements included in the prospectus:

"The impression the Court gained listening to the testimony of the relatively few plaintiffs who mentioned the prospectus in their evidence, was that they read it very superficially; and what most impressed some of those who said they read it and gave it as a reason for their buying the stock, was the geologist's report of the fact that persons who seemed to be closely associated with the legendary Howard Hughes were officers of the company. Moreover in most cases, plaintiffs acknowledged that they were influenced to buy the stock by newspaper articles, or the advice of friends such as Steve Schwartz and Sam Katz."

and later:

"The plaintiff did not testify that he would not have bought the stock if he had known the information contained in the balance sheet and the prospectus on the above two points were not true. I think he should have stated so clearly if such were the case and not leave the Court to guess."

Nevertheless, the trial judge concluded that the plaintiff would not have purchased the stock if the true facts had been known and allowed him to recover his loss against the auditors.

In spite of such decisions, the requirement of reliance could become the chief protection of accountants against seemingly open-ended liability to third parties. If the courts are prepared to limit claims to cases of direct and substantial reliance and to scrutinize such claims carefully, it will go a long way toward satisfying the concerns of chartered accountants. While they might have to accept exposure to large classes of potential claimants, such exposure would seldom lead to a finding of liability. Furthermore, this approach to limiting liability has the added advantage that it does not require any arbitrary restriction on the classes of potential claimants.

### (3) The Measure of Damages

The doctrine of negligent misrepresentation subjects the accountant to the standard tort measure of damages--the claimant is entitled to be put in the position he would have been but for the accountant's negligence. In the case of shares purchased in reliance on erroneous financial statements, the claimant is entitled to recover the difference between the price paid for the shares and the actual value of the shares at the date of purchase. The fact that the shares might decline in value following the purchase is irrelevant to the question of damages unless such decline can be used as some evidence of the value of the shares at the date of purchase. It is not therefore sufficient for the claimant to show that the company later went out of business and the shares became valueless (as was done in Dupleis); the claimant must show the loss generated at the date of purchase.

Strict application of this rule will greatly limit the claims of parties who have supposedly purchased shares in reliance on financial statements. Unless an error is very fundamental, it should have little or no impact on the price of the stock. In an article entitled "The Potential Impact of Knowledge of Market Efficiency on the Legal Liability of Auditors", James A. Anderson, assistant professor of accounting at Washington University, St. Louis, goes so far as to suggest that there is little relationship between the results of an audit and the price of stock. In his view, information contained in the financial statements has generally been anticipated by the market and that the price of shares has reacted to such information before the statements are actually published.

The situation becomes more difficult in the case of creditors or depositors. Where the accountant has issued financial statements which erroneously show the company to

be in a better financial situation than it really is, one could objectively determine that the chances of the company repaying the loan or deposit were somewhat less than the chances if the financial information had been correct. Seldom, however, can it be said that the company was so insolvent that there was no chance whatsoever of repaying the loan or deposit. Theoretically such circumstances only permit recovery where the reduction in the probability of repayment is so substantial that it can be said that the loan or deposit would not have been made in the first place. Even then, the claimant would only be able to recover the difference in the value of the loan or deposit at the time it was made (generally the face value of the loan or deposit less a reasonable deduction to reflect risk) less the actual value of the loan or deposit (face value less an increased degree of risk to reflect the weaker financial status of the company).

Unfortunately, there seems to have been a tendency to confuse the causal relationship question, which applies to reliance, with the assessment of damages. In most cases, the courts have returned the claimant's entire investment on the assumption that the investment would not have been made but for the negligence of the accountant without enquiring into the actual value of the investment at the time that it was made. Such decisions have the effect of subjecting the accountant to liability for any decline in value subsequent to the date that the investment was made. Perhaps these decisions can be supported to some degree by the argument that the reliance on the negligent information may continue and impact on the decision to hold the investment. While there may be some merit to this approach, it compounds the problems inherent in determining the various factors that impact on any investment decision.

#### (4) Disclaimers

When all else fails, parties facing large potential liability generally turn to disclaimers. Disclaimers are seldom satisfactory, both because of the uncertainties which surround their enforcement, and because they tend to exempt liability of every conceivable kind rather than to identify those liabilities which the party relying on the disclaimer should reasonably be prepared to accept, and to exclude the balance. Furthermore, accountants may find that the widespread use of disclaimers will lead to legislative control or to controls imposed by the accounting bodies themselves.

A statement of the Council of Institute of Chartered Accountants in England and Wales issued in November, 1983 goes so far as to suggest disclaimers as one of the steps members might take to reduce the risk of legal actions being brought against them by clients or third parties. Nevertheless, the statement acknowledges that in certain circumstances, the disclaimers may be ineffective or inappropriate, particularly since they will tend to impair the status of a practising accountant by indicating a lack of confidence in his professional work, or because it would be contrary to legislative intent. Nevertheless, if the courts or the legislatures do not provide some reasonable protection for accountants, one can reasonably anticipate that they will turn to the use of disclaimers in an effort to limit their losses.

#### (5) Legislative Intervention

There also exists the possibility that the legislators may step in to limit the liability of accountants to third parties. Should they choose to do so, they will face the same difficulties drawing the outer limit of liability that the courts have already encountered. Such legislative

intervention would probably result in rules that are more arbitrary than anything the courts would develop. For example, the German approach has been to limit claims arising out of an audit to a multiple of the fee charged for the audit.

One also wonders whether legislation protecting accountants is likely to gain popular public approval. If anything, the trend of legislation appears to have been in the direction of placing the accountant in a position where he has greater responsibility to the public and correspondingly greater exposure to the public should he fail to carry out his duties.

One minor legislative change has obvious merit. Accountants should at the very least be allowed to incorporate so that only their business assets are at risk. This is a protection that has been offered to other businessmen engaged in high risk ventures, and there is no reason why it should be denied to accountants. While incorporation is not an answer in itself, it is certainly one protection that can be offered without offending the public interest.

#### CONCLUSIONS

Both the "reasonable foresight" test which has gained acceptance in England and New Zealand, and the "knowledge of the class" test which has gained acceptance in Canada, are broad enough to provide recovery for groups suffering loss in reliance on financial statements and reports prepared by accountants.

On the negative side, both tests place no meaningful limitation on the classes of third parties that may make claims against accountants. Furthermore, these tests,

based as they are on the concept of reliance, fail to deal with many situations where the accountant is placed in the role of watchdog of the public interest, and accountants should reasonably anticipate that when such situations are addressed they will see their potential liability to third parties expanding even further.

The areas of reliance and damages offer an opportunity to restrict the liability of accountants to third parties without departing from existing legal principles or drawing arbitrary limits on the classes of potential claimants. As such, both areas deserve far more detailed consideration than they have yet received.

While other areas such as disclaimers and legislative controls can be used to restrict liability, they will probably provide arbitrary and therefore unsatisfactory results for all parties concerned. It is to be hoped that the courts will provide a more reasonable solution before the accounting profession is forced to embrace these alternatives.