ARGUING A BUSINESS TORT AGAINST AUDITORS

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ABSTRACT

The term 'auditor' originates from the expression auditor, which in Latin, it means 'to listen'. Nonetheless, when scrutinising the duties and obligations of auditors, it reveals that they do not merely listen. They also examine and report to the company, on its accounts. Moreover, the scope of these duties and obligations has amplified over recent years. This is due to the changes in the corporate landscape which encompasses the business world. Fundamentally, judgments have been pronounced by the courts across jurisdictions with regards to auditors' liability in tort. This can be seen in the historic English decision of Re Kingston Cotton Mill Co (No 2) [1896] 2 Ch 673, whereby Lopes LJ stated that "...auditors are watchdogs but not bloodhound…" Additionally, it can be observed in the ingenious statement of Cardozo CJ in the American decision of Ultramares Corporation v Touche (1931) 174 NE 441 whereby he stated that to hold auditors liable results to a case of "…liability of an indeterminate amount for an indeterminate time to an indeterminate class…" In the midst of these legal pronouncements, it is pertinent to determine the liability of auditors under tort in Malaysia, which was distilled in 1967. Essentially, the current legal framework governing auditors must be reassessed in the wake of the scandals involving auditors both in the domestic and international forefront. The study then explores the appropriate litmus test in determining a claim for tort against auditors. A comparative study is also carried out as regards to the legal position in United Kingdom, Australia and New Zealand to determine the approach taken by the courts. Fundamentally, principles of business law have to play its role effectively to ensure that the interests of all parties who have a stake in the matter are well- balanced with the liability of auditors.

Keywords: Auditors, Tort, Duty of Care

Sub-Theme: Corporate Governance

INTRODUCTION

This study examines auditorsô legal position under the principles of tort in relation to existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, government and members of the public (for the purposes of this study, these persons and bodies are considered as stakeholders with the exception of shareholders). The study then proceeds to analyse the elements required to establish tortious liability *i.e.* duty of care.

LEGAL BACKGROUND

The Malaysian legal position governing auditors has a close link to the English legal position and the Australian legal position governing auditors. This is because the Companies Act 1965 (CA 1965) was adopted from the English Companies Act 1948 and the Australian Uniform Companies Act 1961 (Craig & Diga, 1996). Thus, references will be made to the decisions made in the United Kingdom and Australia. Moreover, since Malaysia is a commonwealth country, references will also be made to the decisions of other commonwealth countries. Nonetheless, it should be noted that commonwealth countries used to place much reliance on the English principles but this is not the case in most aspects (Joshi, 2004). Hence, to derive a comprehensive view on the issue governing auditorsô liability under tort, references will also be made to cases decided by the courts in non-commonwealth countries.

As regards to the legislature in Malaysia, it has outlined the role, duties and obligations of auditors in ÷the Companies Actø. Nonetheless, it did not deal on the subject of auditorsô liability. Thus, the matter has to be dealt with by the courts. However, the cases decided by the Malaysian courts are very few. Furthermore, the cases did not lay down a principled approach to auditorsô liability under tort. Currently, the company is the only party, which is likely to succeed in an action against the auditors if the auditorsô report is untrue (Woon, 1997). This is because the courts have treated the shareholders and stakeholders as third parties since they are not a party to the contractual relationship between the auditors and the company. Hence, if the shareholders and stakeholders wish to bring an action against the auditors, the only course of action is under the tort of negligence.

This is on the basis that the auditors made negligent statements which have caused loss to the shareholders and stakeholders. Be that as it may, the elements of negligence must be satisfied in order to attach liability on the auditors *i.e.* duty of care. On the other hand, clear tests and formulae must be formulated by the courts in order to make it clear to the shareholders and stakeholders as to the requirements to establish a tortious liability on auditors. Fundamentally, the law of tort imposes a liability based on the considerations of public policy without regard to the intention of the parties (Prosser & Keaton, 1984).

THE IMPORTANCE OF DUTY OF CARE

Auditing is a compulsory requirement for every company and the auditorsô report must be lodged as required by S. 165 CA with the relevant regulatory body *i.e.* Companies Commission of Malaysia (CCM). This shows that the legislature is aware of the information value of the audit process (OøSullivan, 1993) and the auditorsô report. Nonetheless, if duty of care is not owed by the auditors to the shareholders and stakeholders, then a pertinent question raised concerns the true value of the auditorsô report. Furthermore, the concern is also whether the auditors will carry out their role, duties and obligations effectively. In International Mortgage Co v John P Butler Accountancy Corp (1986) the Canadian court found that ñevery one is responsibleé for the result of his acts [and]é for an injury occasionedé by his want of ordinary careé we refuse to accept the premise that in the absence of a duty, a person is free to be as negligent as they choose.ò In the context of auditing this is highly relevant. This is because if the auditors do not owe a duty of care it tantamount to allowing the auditors to be negligent but not liable.

Thus, the essential question is whether the auditors should owe a duty of care to the shareholders and stakeholders (Gossman, 1988). It was rightly asked whether the risk of loss should fall on the negligent client or the negligent auditors (Leibman & Kelly, 1992). The issue is also whether it is in the public interests that auditors should only consider the interests of the company and not the interests of any of the shareholders and stakeholders. It was raised in Rusch Factors v Levin (1968) as to why innocent parties be forced to carry the weighty burden of auditorsô professional malpractice. The innocent parties include the shareholders and stakeholders who may not know how to read financial statements. They believe on the statement made by the accountants of the company and the report made by the auditors. They will then make certain decisions as regards to the direction of the company on the basis that the company is financially sound.

THE DEVELOPMENT OF DUTY OF CARE

It should be noted that there is a growing trend as regards to whether duty of care should be owed by auditors (Gwilliam, 1987). This is because in the English decision of Donoghue v Stevenson (1932) Lord Macmillan correctly stated that the ñcategories of negligence are never closedò. There could be new situations arising to meet the needs of the society. Thus, in the context of auditing, the needs of the shareholders and stakeholders must be taken into account. Nonetheless, the element of duty of care in the context of auditing must be properly understood. In the English decision of Heaven v Fender (1883) Lord Esher observed that whenever a person is placed in circumstances where if he did not use ordinary skill and care in his conduct, he would cause danger to another person, then he owes a duty of care to use the ordinary skill and care to avoid the danger. If that is the requirement as regards to person with ordinary skill and care, then it follows that in situations where a person has more than ordinary skill and care i.e. professional skill and care, should owe a duty of care too.

Hence, in the context of auditing, auditors do not use ordinary skill and care since they are professionals. Auditors exercise professional skill and care. If the auditorsô report contains an untrue statement, this can cause danger to all those relying on the report *i.e.* the shareholders and stakeholders. It can cause a huge damage especially if it is a listed company, public company or even if it is a private company if there is heavy reliance on the report. In the early years, the English courts found that auditors do not owe a duty of care to the shareholders and stakeholders because they were considered as third parties. In Candler v Crane Christmas & Co Ltd (1951) the Court of Appeal found that in the absence of fraud, there cannot be a claim for negligent misstatement. The court made it clear that no duty of care is owed by the accountants to any person other than the client.

Nonetheless, what the court failed to realize is that a finding of fraud requires an intention to deceive on the part of the auditors. The court did not consider that in some situations the auditors may not have had the intention to deceive. It could have been a situation where the auditors did not exercise proper care and therefore the auditorsô report contained a misstatement. In such a case, it is not fraud. To attach liability only if it is a case of fraud is restricting the possibility of attaching liability on auditors.

In a matter involving MAN Group of companies, they brought an action against the defendant DaimlerChryslerõs subsidiary company Freightliner for ƺ350 million for acquisition of a company from Freightliner. The defendant attached Ernst & Young as a defendant. Freightliner argued that the auditors should have detected fraud and therefore should be liable. Moore-Bick LJ found that there is no duty of care owed to a company which exercised an acquisition and therefore the auditors are not liable for the losses (The Lawyer, 2005). The decision is seen as a judicial reassurance that well-established principles governing auditors will remain as that. (Curd

& OôConnell, 2006). Furthermore, to attach liability only in relation to a client is restrictive as they could be others who rely on the auditorsô report *i.e.* the shareholders and stakeholders. Furthermore, owing a duty to a client is under contract law. Hence, the decision will not allow the law of negligence governing auditors to develop. Essentially, to negate a duty of care on the grounds that shareholders and stakeholders are third parties is unsatisfactory. This is because there are also other aspects which must be looked at to determine whether a duty of care should be owed to shareholders and stakeholders.

If the rule of privity is applied strictly, it is in favour of the auditors since the only person who can bring an action is the company. On the other hand, if the privity rule is relaxed, equity is done in favour of the shareholders and stakeholders. Fundamentally, there is an apparent trend to expand the definitions of third parties who are privy to the audit contract (Dopuch, 1988). Therefore, if a person makes a statement knowing that it will be relied upon due to his skills and expertise, such persons should not be exonerated from liability on the ground of lack of privity (Rohatgi, 1981). Most importantly, shareholders and stakeholders are not mere incidental users of the auditorsô report. It should be noted that the law concerning negligent misstatements has undergone significant changes (Krishnan, 1998) since the case of Candler v Crane Christmas & Co Ltd (1951). The judgment of Lord Morris of Borth-y-Gest in Hedley Byrne & Co Ltd v Heller & Partners Ltd (1964) is of importance here. The court found that independent of contract, there may be circumstances where the information given creates a duty to be careful. This means that the court has in mind the interests of the shareholders and stakeholders.

Notably, Lord Devlin stated that there could be cases in the future where a new and wider proposition will be needed, which is quite independent of contract. Hence, it can be seen that the judges have begun looking beyond the traditional concept of contractual relationship. The court has realized that statements made by a person can have an effect and impact on others *i.e.* shareholders and stakeholders. Hence, the House of Lords overruled the Court of Appealôs judgment in Candler v Crane Christmas & Co Ltd (1951). The House of Lords in Hedley Byrne & Co Ltd v Heller & Partners Ltd (1964) found that where there is a special relationship between the maker of the statement and another person, whereby one person knows that the other might rely upon his skill and judgment, a duty of care will be owed by the maker of the statement, to the person relying on the statement. Most importantly, the maker of the statement knows who will rely on the statement. This is to establish the special relationship between the maker of the statement and the recipient of the statement.

Notably, the court in stating that there could be relationships which go beyond contractual relationships, the court meant the ôspecial relationshipö. Thus, although the auditors on one hand and the shareholders and stakeholders o the other hand do not have a contractual relationship, there is a special relationship. This is because the criteria needed to establish special relationship can be satisfied. This is because the auditors are experts in their own field; the shareholders and stakeholders do rely on the auditorsô report to make informed decisions; and the auditors are aware that the shareholders and stakeholders will rely on their report in the current corporate atmosphere. Furthermore, the House of Lords held that a duty of care was owed to specific third parties known to be relying on the statement made. Observably, the courts have begun to extend the scope of the duty of care that can be owed to the shareholders and stakeholders. Nonetheless, the duty of care is only owed to specific stakeholders. Furthermore, the element of reliance and knowledge of reliance on the part of the auditors were imported to ensure that the auditors do not owe a duty of care to the whole world.

It should be noted that the decision of Hedley Byrne does not involve auditors. However, in the context of auditing, auditors do make a statement. It is not a mere statement but a professional statement from a professional person. Additionally, the shareholders and stakeholders will be relying on the report since the auditors possess requisite professional skill and judgment.

The principle of Hedley Byrne & Co Ltd v Heller & Partners Ltd (1964) was applied in the Malaysian case of Mooney & Ors v Peat, Marwick, Mitchell & Co & Anor (1967). Raja Azlan Shah (as he then was) remarked that there can be a relationship which is equivalent to a contract. The relationship can either be general or it is created ad hoc. What the Lordship had in mind was that there can be relationship which is close enough that it may be viewed as similar to a contractual relationship although it may not squarely fall within the meaning of a contractual relationship per se. On the other hand, there was a concern is whether a duty of care should be extended to auditors (Lewis & Cheah, 1997). This is because it could be a case of opening up the floodgates of litigation. This was succinctly pointed in the American case of Ultramares Corporation v Touche (1931) whereby Cardozo CJ stated that auditors will be liable for an indeterminate amount for an indeterminate time to an indeterminate class if they were to owe a duty to persons other than the company.

However, there are cases in the US whereby the American courts have moved far beyond, to expand auditorsô duty (Brecht, 1989). This can be seen especially in Rusch Factors v Levin (1968) whereby the US Federal court rejected Ultramares case by stating that ñThe wisdom of the decision of Ultramares has been doubtedé and this Court shares the doubt.ò Furthermore, as pointed out by the Office of Fair Trading in the UK that even I there is unlimited liability, it did not cause the auditing firms to withdraw their auditing services (Baker, 2004). The decision of Ultramares was also criticised by the court in New Zealand. Woodhouse J in the Court of Appeal decision of Scott Group Ltd v MacFarlane (1978) felt that if a duty of care is not attached, this is in favour of the auditors. The auditors may take their role, duties and obligations lightly.

Another fear raised in Ultramares is that if duty of care is imposed on auditors, other professions will also face the same consequences. This fear is unfounded as the other professions are not akin to the profession of auditors. The role, duties and obligations of auditors are not the same as the other professions. Every profession serves different needs of the society. On the other hand, some of the other professions such as solicitors, doctors, surveyors and valuers have already been attached with liabilities as a result of the development of the law governing professional negligence. Hence, it is not justifiable that auditors are treated differently from other professions in terms of liability. Hence, in International Mortgage Co v John P Butler Accountancy Corp (1986) the Canadian court remarked that there must be imposition of liability regardless of the defendantôs profession.

RESTRCITING THE SCOPE OF DUTY OF CARE

In later years, the English court in JEB Fasteners v Marks, Bloom & Co (1983) found that duty of care was owed to limited classes of third parties known to be relying on the auditorsô report. Observably, the courts have extended the scope of auditorsô duty of care further. Previously, the duty of care was only owed to specific third parties as opposed to the extended duty of care *i.e.* limited classes of third parties. The court found that auditors owe a duty of care to third parties whose reliance on the statements can reasonably be foreseen as a consequence of their dealing with the company. Thus, it is no longer based on whom the auditors knew that have relied on the report. Although there was a growing trend to extend the scope of the duty of care, in a subsequent case, the House of Lords made a retreat. The test of reasonable foresight was rejected in Caparo Industries plc v Dickman & Ors (1990) by Lord Bridge. The House of Lords laid down three criteria to establish a duty of care by auditors namely foreseeability of damage by the auditorsô report, proximity of relationship between the auditors and the aggrieved party and it must be fair, just and reasonable for the law to impose a duty on one party for the benefit of the other party.

Moreover, auditors will only owe a duty of care if they are aware that their reports have been used by a particular person (Rachagan, 2002). Additionally, the auditors must also have knowledge on the purpose of relying on the report. Nonetheless, the House of Lords did not address the issue whether the auditors may state that they were not aware of the reliance. The court also stated that the three criteria were merely labels and that there is a possibility of the criteria overlapping with each other. Hence, the concern is whether it is considered criteria. Additionally, the House of Lords made it clear in Caparo Industries plc v Dickman & Ors that auditors do not owe a duty of care to shareholders individually or the third parties. This is because the purpose of the auditorsô report is to enable shareholders to exercise informed control of the company. It is not to enable individual shareholders to buy more shares with a view to profit. Nonetheless the court agreed that the auditorsô report is not to solely enable shareholders and debenture holders to have an informed supervision and appraisal of the companyôs management.

The Cadbury Report agreed with the findings of the House of Lords that it is not possible to broaden the boundaries of the auditorsô duty of care (Para 5.32, Cadbury Report, 1992). Additionally, the committee recommended that such a legal position should not be altered by statute at present time. In Para 6.19 of the Hampel Report, it was stated that there should not be any change in law. In fact it should be left best practices. The point to be noted is that the Cadbury Report was made in 1992 and the committee used the term ôin present timeö. It does indicate that the committee is aware that the legal position could change in future years. This is based on the manner capital market operates and the way other countries deal with such a situation. Furthermore, it should be noted that all the financial scandals involving auditors took place after 2002. Thus, the committee took a conservative view perhaps because it opined that the auditing profession is free from any scandals.

This is questionable as it is a limited meaning to the usage of auditorsô report (Kinross, 1991). Nevertheless, even if there are reliable financial statements, shareholders are unlikely to monitor the management of the company (Oviatt, 1988). Furthermore, Lord Oliver of Aylmerton felt that a single statement may be repeated endlessly with or without the permission. Therefore, the auditors cannot be made to owe a duty of care in every such situation. This point is not agreeable. This is because the auditorsô report is not a statement which will be repeated again and again differently. The report will remain intact as it has been prepared. Furthermore, the function of an auditorsô report must be distinguished from the statements made by the advisers. The statements made by the advisers could be repeated differently in different context. The auditorsô report is available at the CCM for public inspection unlike those statements made by advisers. Furthermore, the report which is lodged at CCM is meant for shareholders and stakeholders. Observably, the court has adopted a narrow and restrictive approach to whether auditors owe a duty of care to the shareholders and stakeholders.

Be that as it may, the position of post-Caparo can be seen in the case of James McNaughten Paper Group v Hicks Anderson & Co (1991) that auditors do not owe a duty of care if they reasonably believe that the user of the report will seek independent advice. This point is questionable because there is no basis for the auditors to form an opinion that independent advice will be sought by the shareholders and stakeholders. This is because in the first place it was argued by the court that the auditors are not aware who are the persons relying on the report. Furthermore, even if the shareholders and stakeholders seek independent advice that should not absolve the auditors from ensuring that their report is true and accurate. In Morgan Crucible Co Plc v Hill Samuel & Co Ltd (1991) the English Court of Appeal found that there is a proximate relationship between a target companyœs auditors and a takeover bidder. The court found that there is a duty of care owed because the auditors were aware that the takeover bidder would rely on the auditorsô report. The decision is different from Caparoœs case because in Caparo, there was no bidder at the time the auditorsô report was prepared.

On that point, it can also be argued that when the auditors prepare their report to be tabled at the general meeting, they are aware that the Board of Directors will rely on the report to make certain decisions as regards to the direction of the company. Moreover, the shareholders of the company will also make certain decisions based on the report. Additionally, since the report will be available for inspection at CCM, stakeholders will also rely on the report. Thus, it is not just the takeover bidders who will rely on the report. It should be noted that the decision of Caparo was not followed by Rolfe J of the Supreme Court of New South Wales in Columbia Coffee and Tea Pty Ltd v Churchill and Ors (1992). The court found that the approach taken by Caparo was restrictive. In Daniels v Anderson (1995) the Australian court found that the auditors were aware of certain irregularities and deficiencies in the accounting records. Furthermore, there were also inadequate internal controls in the company. The court found that the auditors owed a duty of care to the Board of Directors in the sense that they should have informed the directors of the weaknesses of the internal controls. The Australian High Court in Esanda Finance Corp Ltd v Peat Marwick Hungerfords (1997) held that mere allegation that it was reasonably foreseeable that a third party might rely on audited financial statements was not by itself sufficient to establish that a duty of care existed.

THE WIDER APPROACH TO DUTY OF CARE

On the other hand, the courts in New Zealand have adopted a wider approach as to whether auditors owe a duty of care to third parties. In Scott Group Ltd v MacFarlane (1978) the Court of Appeal held that the auditors owed a duty of care to persons whom they knew or ought to have known would rely on the lodged accounts, which they had audited. Furthermore, the fact that the auditorsô report is available at the registry, a duty of care is owed to takeover bidders even if they are unknown to the auditors. This is so as long as the takeover bid is reasonably foreseeable. As far as the legal position in US is concerned, recent judicial decisions in the US appear to be expanding auditorsô liability to third parties as in Rossenblum Inc. v Adler (1983), Citizens State Bank v Timm, Schmidt & Co (1983), Credit Alliance v Arthur Andersen & Co (1985) and International Mortgage Co. v John P. Butler Accountancy Corp (1986). This is so although the fear of floodgate of litigation was first raised in the US by the court in Ultramares case.

Essentially, experiences in New Zealand and the US show there is no real floodgate of litigation. Furthermore, the floodgate argument is not good in the long run since the law is stopping the right of the shareholders and stakeholders to bring an action although they have suffered a loss. If the legal position is that the auditors owe a duty of care where they should have been aware that their report will relied upon, then it places a duty on the auditors to determine who are the shareholders and stakeholders who will rely on the report. Essentially, auditors know that there will be certain persons and bodies who will rely upon their skill and judgment. They are well aware of this from the point they are appointed at a companyø annual general meeting. Hence, auditors should owe a duty to all those persons whose reliance is foreseeable (Wiener, 1983). Hence, it is questionable why duty of care should not be attached to auditors where the accounts are prepared and it is known that they will be shown to the shareholders and stakeholders (Baxt, 1993).

On the other hand, the concern is whether the reliance by the shareholders and stakeholders is reasonable. Arguably, the reliance is reasonable since the auditor is not an ordinary person but a professional and skilled person. He is a person who possesses the requisite knowledge and skills to audit companyø financial affairs. Furthermore, he is approved by the Minister of Finance by virtue of S. 8 of the Companies Act 1965 and the auditorø report is available for inspection at the CCM. Consequently, the shareholders and stakeholders will make important decisions based on the auditorø report. It cannot be a case of merely inspecting the report and not making any decisions. Thus, concluding that duty of care is owed to relying parties is not unreasonable (Gwilliam, 1987). Furthermore, it should not be a case where a whole group of shareholders and stakeholders have to bear the loss themselves for the negligence of one person *i.e.* the auditors.

CONCLUSION

The legal principles expounded in cases decided in the UK, Australia and New Zealand are valid. Nonetheless, the approach taken by the courts in UK and Australia is restrictive as opposed to the approach taken by the courts in the US and New Zealand. The fear of the English courts and the court in Ultramares that there will be floodgates of litigation is unfounded. What can be observed is that there are more and more financial scandals involving auditors in recent years since Enron. Fundamentally, if there is a restriction placed on the auditorsô liability to the shareholders and stakeholders, it could cause the auditors to take their role, duties and obligations lightly. Ultimately, the question should be whether the law is concerned of the auditorsô interests or the shareholders and stakeholdersô interests. Fundamentally, the benefit of auditorsô report must commensurate with the cost it can cause *i.e.* whether the auditors should be liable in negligence for a negligent work done. Thus, the Malaysian courts should consider the approaches taken by the courts in New Zealand and the US in protecting the rights of the shareholders and stakeholders.

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