

THE SPECTRE OF INDETERMINATE LIABILITY
RAISES ITS HEAD

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The auditing profession in South Africa has recently received significant attention from the legislature with the promulgation of the Auditing Profession Act 26 of 2005, which repeals the Public Accountants' and Auditors' Act 80 of 1991 (the PAA Act) and makes far-reaching changes aimed at effective oversight of the profession as a whole. The profession has, however, also received the attention of the judiciary, and in a way that may be disconcerting to its members.

In *Axiam Holdings Ltd v Deloitte & Touche* 2006 (1) SA 237 (SCA) the Supreme Court of Appeal addressed an issue relating to an area of the law of major concern to the auditing profession, namely, the ambit of an auditor's liability to a third person based on a misleading audit opinion resulting from the auditor's negligence. This has been an issue plaguing the profession ever since the courts recognized the existence of an action, outside the field of contract, for a negligent misstatement causing financial loss (see *Herschel v Mrupe* 1954 (3) SA 464 (A); *Suid-Afrikaanse Bantoetrust v Ross en Jacobz* 1977 (3) SA 184 (T); *Administrator, Natal v Bizo* 1978 (2) 256 (N) 261; *Greenfield Engineering Works (Pty) Ltd v NKR Construction (Pty) Ltd* 1978 (4) SA 901 (N); *EG Electric Co (Pty) Ltd v Franklin* 1979 (2) SA 702 (EC) and *Administrateur,*

Natal v Trust Bank van Afrika Bpk 1979 (3) SA 824 (A); *International Shipping Co (Pty) Ltd v Bentley* 1990 (1) SA 680 (A) and *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A)). It is a grey area, an area in which the law ‘is developing pragmatically and incrementally’ (as stated by Chadwick LJ in *Coulthard v Neville Russell* [1998] 1 BCLC 143 at 155 and quoted with approval by Navsa JA in *Axiam Holdings* (supra) para 25, and it is ‘pre-eminently an area in which the legal result is sensitive to the facts’ (ibid).

Words are, in the famous dictum of Lord Pearce, ‘more volatile than deeds. They travel fast and far afield. They are used without being expended . . . Yet they are dangerous and can cause financial damage’ (see *Hedley Byrne & Co Ltd v Heller & Partners* [1963] 2 All ER 575 (HL) at 613I–614A). Demarcating the precise ambit of an auditor’s liability in this respect has always been controversial, the central issue being the identification of the circumstances in which an auditor owes a duty of care to a third party. In the context of an auditor’s liability to a client, the finding of a duty of care has been non-problematical owing to the contractual and close relationship between the parties. In the auditor/third party scenario, however, such a relationship is very rare. The danger, of course, of casting the net too wide is the creation of ‘a liability in an indeterminate amount for an indeterminate time to an indeterminate class’, as stated by Cardozo J in *Ultramares Corporation v George A Touche* 74 ALR 1139 at 1145; 225 NY 170; 174 NE 441. In an attempt to avert this danger and to provide some certainty in the law the legislature enacted s 20(9) of the PAA Act (provisions similar to s 20(9) of the PAA Act are to be found in s 46(3) of the Auditing Profession Act), which is effectively a codification of the common law.

In the majority judgment in *Axiam Holdings* (supra) there is an indication that a court could extend an auditor’s liability to a third party beyond what may be the generally perceived boundaries.

The case involved an appeal against the upholding of an exception to a claim against Deloitte, a firm of auditors, based on an allegedly misleading audit report. The 1999 financial statements of The Business Bank Ltd (TBB) reflected a net profit before tax when in fact TBB had suffered a net loss. It was alleged that a bad debt had been omitted and non-existent income included, but despite this Deloitte had negligently given a ‘clean’ audit report. The PSG Bank, relying on the financial statements and the audit report, had allegedly entered into certain agreements on 22 February 2000 with TBB, resulting in PSG’s suffering a huge loss. It was alleged that Deloitte’s negligence was the cause of the loss. The bank ceded its claim to the appellant, who claimed damages from Deloitte amounting to R241 069 222,43.

The appellant alleged that at the time of the negotiations of the agreements:

‘Deloitte knew, alternatively, could in the circumstances reasonably have been expected to know, that the two companies, in deciding to conclude the agreements, would rely on the 1999 statements and Deloitte’s audit opinion and knew, alternatively, could in the circumstances reasonably have been expected to know that the 1999 statements contained the misstatements . . .’ (para 6 in the judgment of Navsa JA)

In the circumstances it was argued that Deloitte owed PSG a duty, prior to 22 February 2000, to warn it that the 1999 statements and the audit opinion were incorrect, alternatively to warn them that it had not conducted the audit properly and that PSG should not rely on the 1999 statements and the audit opinion. It was further contended that Deloitte's failure to issue the warning was negligent and constituted a representation, within the meaning of s 20(9)(b)(ii) of the PAA Act, that the financial statements were accurate.

Section 20(9) of the PAA Act provided:

'Any person registered as an accountant and auditor in terms of this Act shall, in respect of any opinion expressed or certificate given or report or statement made or statement, account or document certified by him in the ordinary course of his duties —

- (a) incur no liability to his client or any third party, unless it is proved that such opinion was expressed or such certificate was given or such report or statement was made or such statement, account or document was certified maliciously or pursuant to a negligent performance of his duties; and
- (b) where it is proved that such opinion was expressed or such certificate was given or such report or statement was made or such statement, account or document was certified pursuant to a negligent performance of his duties, be liable to any third party who has relied on such opinion, certificate, report, statement, account or document, for financial loss suffered as a result of having relied thereon, only if it is proved that the auditor or person so registered —

...

- (ii) in any way represented, at any time after such opinion was expressed or such certificate was given or such report or statement was made or such statement, account or document was certified, to the third party that such opinion, certificate, report, statement, account or document was correct, while at such time he knew or could in the particular circumstances reasonably have been expected to know that the third party would rely on such representation for the purposes of acting or refraining from acting in some way or of entering into the specific transaction into which the third party entered, or any other transaction of a similar nature, with the client or any other person.'

The case involved an exception to the appellant's particulars of claim in which Deloitte contended that on the basis of the appellant's allegations Deloitte did not owe PSG a duty in law and its failure to warn PSG was insufficient in law to constitute a representation within the meaning of s 20(9)(b)(ii) of the PAA Act.

The court *a quo* concluded that the bases of the exception were in the main sound. The exception was dismissed to the extent only that it was based on actual knowledge that the financial statements were misleading (see para 9). On appeal, however, a majority of the Supreme Court of Appeal held that it could not 'be found on exception that the defendant's alleged omission to speak was not wrongful' (para 23) and that '[i]t was premature to decide whether a legal duty could be said to exist' (para 24). The exception was accordingly dismissed. Navsa JA, with Howie P and Jafta JA concurring, handed down the judgment. Cloete JA, with Heher JA concurring, dissented.

The majority conceded that indeterminate liability must be kept in check. Navsa JA said (para 18):

'It is true that decisions by courts on whether to grant or withhold a remedy for negligent misstatement causing economic loss are made conscious of the importance of keeping liability within reasonable bounds. It is universally accepted in common-law countries that auditors ought not to bear liability simply because it might be foreseen in general terms that audit reports and financial statements are frequently used in commercial transactions involving the party for whom the audit was conducted (and audit reports completed) and third parties. In general, auditors have no duty to third parties with whom there is no relationship'

Despite this concession, the exception was dismissed. The gist of the majority's rationale is contained in the following quotation from the judgment of Navsa JA (paras 20, 21 and 22):

'The important factual implication . . . of the particulars of claim is that a reasonable person in the defendant's position would, at the second, or later, stage of the alleged events, have known of the defects in the report. On that basis one is justified in saying that the conclusion could well be drawn at the trial that, possessed of such knowledge, the reasonable person would not have kept silent but have expressed at least a reservation as to the reliability of the report. Although the application of the criterion of a reasonable person concerns the negligence aspect of liability, from which the legal duty element is quite separate, the provisions of s 20(9)(b)(ii) of the Act provide a clear pointer that a negligent representation falling within its terms is indeed wrongful. . . .

Whether the representation by silence alleged in this case does fall within the section's terms depends on whether there was a duty to speak. In other words the duty relied on for there having been a representation will be the same duty relied on for the allegation of wrongfulness. . . .

As to the existence of that duty, a court apprised of all the factors and circumstances . . . could find, on the framework of the allegations made in the particulars of claim, and on final evaluation, that the defendant's ignorance of its negligent report is no bar to concluding that it bore the alleged duty. It must be remembered that we are dealing with a situation where the legal convictions of the community could well consider it unacceptable that an auditing firm which issued a seriously negligent report should escape the legal duty to speak with care concerning that report simply because it was, possibly even negligently, ignorant of the negligence of its report. And what is more, in circumstances in which the latter negligence was something it ought to have known of. . . .'

So, according to the court, an auditor may have a duty to warn a third party about the incorrectness of an audit report even if the auditor is unaware of its incorrectness, if the third party can show that the auditor ought reasonably to have known of the incorrectness. In such circumstances, by not warning the third party the auditor has made the 'representation' referred to in s 20(9)(b)(ii).

Cloete JA, Heher JA concurring, disagreed with the judgment of the majority, pertinent points of the dissenting judgment being:

- It was illogical to impose a duty to speak on an auditor who had no reason to believe that what he or she had done might have been negligent (para 30).
- You cannot disclose what you do not know, and to hold a person liable for what that person ought to have known was to equate constructive knowledge with actual knowledge, which was unacceptable (*ibid*). (Cloete JA relied in this regard on *Universal Stores Ltd v OK Bazaars (1929) Ltd* 1973 (4) SA 747 (A), reliance which was regarded by the majority as 'misplaced' (para 22).)
- Public policy dictated that to impose liability on an auditor in these circumstances raised 'the spectre of limitless liability' and would also place an undue and unfair burden on the auditor (para 31). Cloete JA said (*ibid*):

'The burden would be undue because the third party is not obliged to rely upon what the auditor has done (there is no suggestion of involuntary reliance in *Axiam's* particulars of claim): the third party can appoint its own auditor, or ask the auditor whether it can rely on the accuracy of the audit already done. The burden would be unfair because should the third party make such an enquiry, the auditor would be entitled to refuse to answer; but if the enquiry is not made, the auditor would be obliged nevertheless to issue a disclaimer (which would reflect on its professional competence, and would be completely unnecessary if it had not been negligent) or would be obliged at its own expense to revisit

the audit, on pain of being held liable (perhaps, as in this case, for many millions of rand) to any number of third parties whom the auditor knows or — even worse — ought reasonably to know, will rely on its accuracy. At common law, mere knowledge that the third party did indeed intend to rely on the correctness of the audit or a foreseeable risk that he might, is not sufficient to create a legal duty. The same is true of the statute: para (ii) requires a representation in addition to knowledge (actual or constructive).’

- What s 20(9)(b)(ii) of the PAA Act envisages is that the auditor must, subsequent to the audit, ‘take responsibility to the third party for its accuracy’ (para 32). If silence per se constituted a representation for the purposes of para (ii), then that paragraph would be ‘largely ineffective in curbing the mischief — indeterminate liability — at which s 20(9) is aimed’ (ibid). In this regard Cloete JA said (ibid):

‘A third party in the position of Axiam would be entitled to sue an auditor in the position of Deloitte simply because Deloitte had been negligent in an audit performed for its client and, not having detected such negligence, had not warned the third party, when it had actual or constructive knowledge that the third party would rely on the correctness of the audit. It is to limit such potential liability that para (ii) requires a representation as well as knowledge. It may be that silence can constitute a representation for the purposes of the paragraph (although I confess to some difficulty in appreciating how this can be so); but because an omission is not *prima facie* wrongful, facts which at least *prima facie* establish a duty to speak must be alleged.’

The concerns expressed by Cloete JA regarding the consequences flowing from the view taken by the majority of the court are very real ones, and it may be difficult for a court in the future to allay these concerns without adopting a different view to the majority. The view taken by the majority will be disconcerting to the auditing profession, to say the least.

What may be some consolation to the auditing profession is that it may be difficult for a third party to prove that an auditor, unaware of the incorrectness of the audit opinion, ought reasonably to have become aware of such incorrectness at some time after it was given. As has been said:

‘An auditing firm cannot reasonably be expected to review an audit opinion as a matter of course or to perform spot-checks to determine whether or not audit opinions expressed by it in the past were correct. Unless something material occurs which would alert an auditor to the fact that its audit opinion may be incorrect, it may be difficult to persuade a court that the auditor reasonably ought to have become aware of deficiencies in its report after it was prepared.’ (‘Commentary’ in (2006) 23.5 *Bureau for Mercantile Law Bulletin* 95 at 95.)

It must also, of course, be borne in mind that the court in the *Axiam Holdings* case did not rule on Deloitte’s liability. It merely rejected an exception to the appellant’s particulars of claim; it merely made a finding that a court might, when the matter went to trial, find that liability existed.

What may also provide some solace to auditors is the fact that to date there has been no reported case in South Africa in which an auditor has been sued successfully by a third party for damages caused by the auditor’s negligent misstatement. In the only reported case in which such action has been brought by a third party (*International Shipping Co (Pty) Ltd v Bentley* 1990 (1) SA 680 (A)) the appellant, on the strength of the financial statements of a group of companies, continued to provide financial facilities to the group. It suffered losses as a result and later, when it discovered that the financial statements did not reflect the true financial position of the group, brought an action for damages against the auditor whose ‘clean’ audit report formed part

of the financial statements. The appellant lost the case on the element of causation. The court held that the appellant had failed to prove that the auditor's misstatement had both factually and legally caused the loss suffered. Factual causation had been proved but not legal causation. From a legal point of view 'there was not a sufficiently close connection between respondent's negligence and the loss . . . for legal liability on respondent's part . . .' (at 701H). The case was based on the common law, the provisions of the PAA Act not yet being in force. The duty of care requirement was clearly satisfied, there being, on the facts before the court (see at 694D–I), a direct link between the plaintiff and the defendant.

In his article 'Auditors' liability to third parties' (in two parts in the March and April 1980 issues of *The South African Chartered Accountant* at 102 and 157 respectively), after reviewing the case law both in South Africa and abroad, Stef Naudé makes various submissions regarding the circumstances in terms of the common law in which an auditor would owe a duty of care to a third party. It appears that in the circumstances that were present in the *Axiam Holdings* case, Naudé would not have found that the auditor owed a duty of care to the third party. This is of some significance considering that there is little doubt that when compiling the provisions of the PAA Act aimed at codifying the common law, the legislature placed great store on the views Naudé takes of the common-law position in this article. Naudé says (in the April issue at 165, emphasis original):

'An auditor who, at any time *after* the completion of his duties in respect of the annual financial statements of a client company, *makes a representation* to a third party as to the *correctness* of those financial statements, is liable to the third party if he in fact knew, or ought to have known in the circumstances, that the third party would rely on those financial statements for the purpose of some transaction with the client company or another person.'

To illustrate he uses the following example:

'X asks an auditor for a copy of a client company's completed annual financial statements, informing the auditor that it is needed for purchasing all the company's shares. The auditor shows X a copy, and allows him to make extracts therefrom. Those statements are in fact misleading, and the auditor has been negligent in the performance of his duties. On the facts the auditor makes an implied representation as to the correctness of the annual financial statements, and he is liable for loss suffered by X through reliance thereon.'

One of the foreign cases Naudé refers to in support of his submissions is *Dimond Manufacturing Company Limited v Hamilton* [1969] NZLR 609. In this case, at the time the financial statements of a company were prepared by a firm of accountants, the accountants were unaware that the statements were to be used by possible purchasers of shares in the company. However, later the firm showed the statements to a third party for the known purpose of constructing an offer in reliance on the accounts produced. In deciding that the accountants owed a duty of care to the third party, one sees reasoning by the Court of Appeal which appears to be at odds with that of the majority in the *Axiam Holdings* case. What is of significance is the court's reference to the concept of a 'representation' which, as has been seen, is a requirement for liability laid down by s 20(9)(b)(ii) of the PAA Act. Turner J held (at 636, emphasis original):

'It was argued before us that an accountant who prepares a balance sheet of a company ought to contemplate the possibility that it will be acted upon by possible purchasers of shares, to whom he must therefore owe a direct duty of care, or, in the alternative, that in the special circumstances of this case such a special duty rested upon these accountants. I reject the first of these propositions as a matter of law, and am prepared to hold that in the absence of circumstances bringing possible purchasers of shares into his reasonable contemplation, as persons who will read and rely upon the balance sheet, a public accountant preparing a balance sheet of a company is under no duty of care as to its correctness to such persons.

But the position becomes complicated when we come to the meeting between Mr Meek and Mr Howarth, at which the former personally handed the balance sheet to the latter in the course of the first negotiations between the parties. *Up to this time I for myself would hold that no representation regarding the balance sheet had yet been made by Mr Meek or his partners to any prospective purchaser*, and certainly no representation was made to the appellants by any of the respondents after this interview. But there can, I think, be no doubt that at the interview to which I now refer, by personally producing the balance sheet to him and acquiescing in his copying its figures, Mr Meek made an implied representation to Mr Howarth as to the correctness of the balance sheet, and through him to those associated with him who afterwards became the purchasers of the shares — *viz.* the appellants. It seems to me obvious (and the matter was hardly argued) that the representation made at this point must be that the balance sheet presented the true state of the company's affairs as at its date with a degree of accuracy reasonable in all the circumstances.'

It appears that both Naudé and Turner J would not find a duty of care on the part of an auditor to a third party after the completion of the audit unless the auditor, to use the words of Cloete JA quoted above, 'take[s] responsibility to the third party for its [the audit's] accuracy'. The mere fact that the auditor acquires knowledge (actual or constructive) at some time after the audit that a third party intends relying on the audit would not be sufficient to create a duty of care, and the negligence of the auditor is irrelevant in this determination. Thus it seems that Naudé and Turner J would take the view that in the *Axiam Holdings* case the appellant failed to allege facts that prima facie established a breach of a legal duty, and the exception should have been upheld.

It is of note in regard to reliance on foreign judgments that the court in *Axiam Holdings*, in referring to the time spent by the court a quo and by counsel in discussing dicta in English judgments, adopted a somewhat dismissive attitude. After saying that English law and the law in other common-law countries may provide 'reassurance that we are not out of step with global norms as applied in the commercial world' (para 11 at 244B), the court emphasized that we should not lose sight of what was stated by the Supreme Court of Appeal in *Ministry of Safety and Security v Van Duivenboden* 2002 (6) SA 431 (SCA) para 16:

'What is ultimately required is an assessment, in accordance with the prevailing norms of this country, of the circumstances in which it should be unlawful to culpably cause loss.'