ACCOUNTANTS AND THIRD-PARTY LIABILITY — BACK TO THE FUTURE

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The decision of the English House of Lords in Caparo Industries *v.* Dickman *significantly arrests the heretofore broadening ambit of professional third-party liability. In this article the author critically examines* Caparo *and its judicial aftermath in order to assess how Canadian common law courts are approaching the determination of a public accountant's duty of care to third parties and to identify appropriate self-help strategies which can be employed by accountants, clients and third parties to further restrict or expand the duty parameters.*

La décision de la Chambre des lords d'Angleterre rendue dans l'affaire Caparo Industries *c.* Dickman *restreint de façon significative l'étendue jusqu'ici croissante de la responsabilité envers le tiers. Dans cet article, l'auteur fait un examen critique de l'affaire* Caparo *et de ses conséquences sur les décisions des tribunaux afin d'évaluer comment les tribunaux canadiens de common law abordent la détermination du devoir de prudence de l'expert-comptable envers le tiers. L'auteur mentionne aussi des stratégies d'auto-assistance appropriées pouvant être utilisées par les experts-comptables, les clients ou les clientes et les tiers pour limiter ou étendre davantage les paramètres de ce devoir.*

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I. INTRODUCTION

The nature and extent of their common law duty of care has been a matter of increasing concern to Canadian public accountants. Historically, it was thought that a duty of care in the performance of accounting services was owed exclusively to the client under the aegis of contract law. In 1963, *Hedley Byrne* v. *Heller & Partners*[1] recognized the potential of tort law to allow third-party recovery for the economic loss occasioned by a professional advisor's negligent misstatements. Yet, despite the plethora of case law which followed in its wake, a clear definition of the test to determine precisely to whom a professional advisor owes a duty to advise with due care has proved elusive. In 1976, in *Haig* v. *Bamford*,[2] the Supreme Court of Canada specifically addressed third-party liability in relation to auditors. That decision, coupled with the Court's subsequent adoption of the famous two-stage test set out in *Anns* v. *Merton London Borough Council*,[3] recently caused a leading Canadian tort commentator to suggest that Canadian law was moving briskly forward and that its "ultimate destination will be liability [of public accountants] to all reasonably foreseeable users of such [financial] information."[4] Predictably, placing such emphasis on reasonable foreseeability alone evokes an acute fear of open-ended liability.

The expansionist tendency inherent in these developments was, even more recently, brought to a screeching halt in the U.K. In *Caparo Industries plc* v. *Dickman*,[5] also a case concerning the liability of auditors, the House of Lords laid down a much more restrictive test for determining when a duty of care arises. In what can only be described as a rare event, their Lordships openly and unanimously rejected the two-stage duty test set out by Lord Wilberforce in *Anns*.[6] In Canada, that same test has been applied on numerous occasions by the Supreme

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[1] (1963), [1964] A.C. 465, [1963] 2 ALL E.R. 575 (H.L.) [hereinafter *Hedley Byrne* cited to A.C.].

[2] (1976), [1977] 1 S.C.R. 466, 72 D.L.R. (3d) 68 [hereinafter *Bamford* cited to S.C.R.].

[3] (1977), [1978] A.C. 728, (*sub nom. Anns* v. *London Borough of Merton*) [1977] 2 ALL E.R. 492 (H.L.) [hereinafter *Anns* cited to A.C.].

[4] A.M. Linden, CANADIAN TORT LAW, 4th ed. (Toronto: Butterworths, 1988) at 407. Financial statements normally include the balance sheet, income statement, statement of retained earnings and statement of changes in financial position: *see* M. Calpin, UNDERSTANDING AUDITS AND AUDIT REPORTS (Toronto: Canadian Institute of Chartered Accountants, 1981) at 3 [hereinafter Calpin].

[5] [1990] 1 ALL E.R. 568, [1990] 2 W.L.R. 358 (H.L.) [hereinafter *Caparo* cited to ALL E.R.].

[6] *Supra*, note 3. The final death knell for *Anns* came in *Murphy* v. *Brentwood District Council*, [1990] 2 ALL E.R. 908, [1990] 3 W.L.R. 414 (H.L.). *See* I.N.D. Wallace, *Anns Beyond Repair* (1991) 107 L.Q. REV. 228. *See also* W.S. Schlosser, *What Has Become of Anns?* (1991) 29 ALTA L.R. 673 [hereinafter Schlosser].

Court of Canada and, most recently, on an occasion just prior to their Lordships' decision in *Caparo*.[7]

In the brief interval since *Caparo*, the sheer volume of commentary and judicial citations convincingly attests to its significance in the general development of the law of negligence. The likely breadth of that impact on Canadian negligence law is not the subject of this article. More circumscribed, its purpose is to determine what real changes adoption of the *Caparo* approach makes on the third-party common law liability of public accountants in Canada.[8] The article starts with a brief history of the judicial approach towards the duty of care generally and in the context of negligent misstatement. It then critically examines the *Caparo* decision and its judicial aftermath in order to assess how Canadian common law courts are approaching the determination of a public accountant's duty of care to third parties. The concluding section identifies strategies which should now be considered by third parties, clients and accountants to further expand or restrict that duty.

II. Duty of Care — A Brief History

Prior to 1932, common law courts employed a severely restrictive approach to liability for tortious negligence. In what has been described as an "elaborate classification of duties",[9] courts of the day closely scrutinized the relationship between the parties, the type of plaintiff and the nature and extent of the damage in order to determine whether the facts under consideration were analogous to some previously classified duty situation.[10] The narrowness of this established-categories approach to duty and its seeming inability to adapt to rapidly changing societal demands led to the search for a broader liability test. In *Donoghue*,[11] Lord Atkin set out his famous "neighbourhood" principle of liability in negligence:

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[7] *City of Kamloops* v. *Nielsen*, [1984] 2 S.C.R. 2, 10 D.L.R. (4th) 641 [hereinafter *Kamloops*]; *Central Trust Co.* v. *Rafuse*, [1986] 2 S.C.R. 147, 31 D.L.R. (4th) 481; *B.D.C. Ltd* v. *Hofstrand Farms Ltd*, [1986] 1 S.C.R. 228, 26 D.L.R. (4th) 1 [hereinafter *Hofstrand Farms* cited to S.C.R.]; *Just* v. *B.C.*, [1989] 2 S.C.R. 1228, 64 D.L.R. (4th) 689; *Rothfield* v. *Manolakos*, [1989] 2 S.C.R. 1259, 63 D.L.R. (4th) 449 [hereinafter *Rothfield*].

[8] It appears that Quebec courts have not traditionally been concerned with the duty of care concept. Subject only to issues of causation and foreseeability, Art. 1053 of the *Quebec Civil Code* imposes liability on a defendant, who has committed a fault, to compensate anyone who suffers loss thereby: *see* G.B. Maughan & M. Paskell-Mede, *Auditors' Liability Since Haig* v. *Bamford*, Meredith Memorial Lectures 1983-84, Professional Responsibility in Civil Law and Common Law (Don Mills: Richard De Boo Publishers, 1985) 57 at 61 [hereinafter Professional Responsibility].

[9] *See* the comments of Lord Atkin in *Donoghue* v. *Stevenson*, [1932] A.C. 562 at 569, [1932] All E.R. Rep. 1 at 11 (H.L.) [hereinafter *Donoghue* cited to A.C.].

[10] *See* G.S. Morris, *The Liability of Professional Advisors: Caparo and After* (1991) J. Bus. L. 36 at 37.

[11] *Supra*, note 9.

> 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.[12]

Courts ever since have been concerned with defining the parameters of the "neighbourhood" relationship. Canadian courts, for their part, were quick to apply the foreseeability standard to personal injury and property damage claims but eschewed its application, *inter alia*, in cases of economic loss, owing to the judicial perception that the basis and scope of the duty to avoid causing purely economic loss was different.[13] Prior to 1963, for example, it was still generally accepted law that an accountant was responsible for negligence only to his client.

Hedley Byrne[14] represented a breakthrough. The facts are well known.[15] Although the plaintiffs were unsuccessful, the decision established a new liability for negligent misstatements which cause economic loss. All five law lords recognized that a duty could be imposed in certain circumstances for negligent words in the absence of contract and without a fiduciary relationship. But their Lordships refused to found liability on the "neighbourhood" principle of *Donoghue*,[16] preferring instead to emphasize that the duty would only arise where there was a "special relationship" between the parties. Not surprisingly, the law lords were unwilling to lay down precise criteria for determining when a special relationship comes into existence and, thus, when a duty of care for advice or words arises. Noteworthy, in the immediate context, is that their Lordships endorsed the dissenting judgment of Denning L.J. in *Candler* v. *Crane, Christmas & Co.*[17] wherein he stated that accountants owe a duty:

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[12] *Ibid.* at 580.

[13] *See, e.g., Foster Advertising Ltd* v. *Keenberg* (1987), 35 D.L.R. (4th) 521, [1987] 3 W.W.R. 127 (Man. C.A.), *leave to appeal den'd* (1987), 80 N.R. 314 (note), [1987] 4 W.W.R. xvi (note). For a complete discussion *see* B. Feldthusen, *Economic Loss in the Supreme Court of Canada: Yesterday and Tomorrow* (1991) 17 CAN. BUS. L.J. 356.

[14] *Supra*, note 1.

[15] In *Hedley Byrne*, the defendant bank answered a request by another bank for financial information concerning one of the defendant's customers. In particular, the defendant was asked to verify that its customer would be good for an advertising contract of £8,000 to £9,000. On the strength of the defendant bank's favourable, albeit negligent, response, the plaintiff placed orders on behalf of the customer for which they became personally liable, and when the customer went into liquidation, suffered economic loss. The House of Lords dismissed the appeal on the basis of a disclaimer clause which read: "For your private use and without responsibility on the part of the bank and its officials."

[16] *Supra*, note 9.

[17] [1951] 1 ALL E.R. 426, [1951] 2 K.B. 164 (C.A.) [hereinafter *Candler* cited to ALL E.R.].

> ....to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts....[but that duty is not] extended still further so as to include strangers of whom they have heard nothing....[18]

The seminal Canadian case following upon *Hedley Byrne* is the 1976 Supreme Court of Canada decision in *Bamford*.[19] The Court was concerned with the liability of a firm of chartered accountants which had negligently prepared an audited financial statement for a corporate client. The accountants knew that the statement would be used by the company, *inter alia*, in its search for outside investors. The plaintiff, who was completely unknown to the accountants at the time the financial statement was prepared, ultimately, on its strength, invested in the company. A majority of the Supreme Court of Canada, speaking through Dickson J., as he then was, found that the appropriate test for liability in the circumstances was grounded in the accountant's actual knowledge of a limited class of persons who would use and rely on the financial statements. His explanation is important not only for its pivotal role in the Canadian evolution of the doctrine enunciated in *Hedley Byrne*, but also for its discourse on the evolution of the accounting profession itself:

> 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 changes in the role and responsibilities of the accountant, and in the reliance which the public must place upon his work. The financial statements of the corporation, upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.
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> 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.....From the authorities, it appears that several possible tests could be applied to invoke a duty of care on the part of accountants *vis-à-vis* third parties: (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. It is unnecessary for the purposes of the present case to decide whether test (i), the test of foreseeability, is or is not, a proper test to apply in determining the full extent of the duty owed by accountants to third parties. The choice in the present case, it

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[18] *Ibid.* at 434.
[19] *Supra*, note 2.

> seems to me, is between test (ii) and test (iii), actual knowledge of the limited class or actual knowledge of the specific plaintiff. I have concluded on the authorities that test (iii) is too narrow and that test (ii), actual knowledge of the limited class, is the proper test to apply in this case.[20]

Following *Hedley Byrne*, Commonwealth courts are seen to have extended the scope of the "special relationship". In the process, its underlying basis has shifted from the defendant's "voluntary assumption of responsibility", to the plaintiff's "reasonable reliance" and, finally, to the more universal tests of foreseeability and proximity.[21] The problem, of course, with employing any of these tests is that it still requires a policy determination as to what should be the scope of liability.[22] In consequence, judicial reference to policy considerations became more frequent.[23] The apogee was reached in *Anns*[24] when Lord Wilberforce set out his single principle, two-stage test of liability in negligence which included an express reference to policy:

> Through the trilogy of cases in this House — *Donoghue* v. *Stevenson* [1932] A.C. 1, *Hedley Byrne & Co. Ltd* v. *Heller & Partners Ltd* [1964] A.C. 465, and *Dorset Yacht Co. Ltd* v. *Home Office* [1970] A.C. 1004, 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 negative, 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.[25]

Taken literally, this test treats the terms "proximity" and "neighbourhood" as synonymous and relates both concepts to the principle of

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[20] *Ibid.* at 475-76.

[21] *See* M.F. James, *Negligent Misstatement: The Special Relationship* (1989) 133 SOL. J. 1016 at 1017.

[22] Lord Pearce, in *Hedley Byrne*, *supra*, note 1 at 536 acknowledged this inevitability when he stated:

> How wide the sphere of the duty of care in negligence is to be laid depends ultimately upon the court's assessment of the demands of society for protection from the carelessness of others.

[23] *See* C.R. Symmons, *The Duty of Care in Negligence: Recently Expressed Policy Elements — Part I* (1971) 34 MOD L. REV. 394.

[24] *Supra*, note 3.

[25] *Ibid.* at 751-52.

reasonable foreseeability as set out in *Donoghue*.[26] *Anns* is more expansionist, however, insofar as the balance is shifted towards liability unless negatived by policy considerations.[27] Its practical effect is to render almost any actual sequence of events foreseeable, leaving any limitation on liability to the vagaries of *ad hoc* policy assessments freed from precedential constraints. In the words of Lord Templeman in *CBS Songs Ltd* v. *Amstrad Consumer Electronics plc*:[28]

> Since *Anns v. Merton London Borough Council*....put the floodgates on the jar, a fashionable plaintiff alleges negligence. The pleading assumes that we are all neighbours now, Pharisees and Samaritans alike, that foreseeability is a reflection of hindsight and that for every mischance in an accident-prone world someone solvent must be liable in damages.[29]

Concern, similar to that acknowledged by Dickson J. in *Bamford*,[30] over the potential of the foreseeability test to impose on the provider of professional services "liability in an indeterminate amount for an indeterminate time to an indeterminate class"[31] hastened the search for an effective limiting formula. Successive English cases attempted to introduce further refinements on *Anns*. In *Governors of the Peabody Donation*

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[26] *Supra*, note 9. *See, e.g.*, *Scott Group Ltd* v. *McFarlane*, [1978] 1 N.Z.L.R. 553 (C.A.) [hereinafter *Scott Group*], where it was held that an auditor *prima facie* owes a duty to all those whom he ought reasonably to foresee might rely upon his report.

[27] *Donoghue*, *supra*, note 9, on the other hand, requires policy to justify an extension into further areas of liability: *see* G. Williams & B.A. Hepple, FOUNDATIONS OF THE LAW OF TORT, 2nd ed. (London: Butterworths, 1984) at 77.

[28] [1988] A.C. 1013, [1988] 2 ALL E.R. 484 (H.L.) [hereinafter *Amstrad* cited to A.C.].

[29] *Ibid.* at 1059. Thus, *Anns* was used to permit a claim by the purchaser of a modest home against a building society. The building society had used an independent firm of surveyors, whose report negligently described the house as needing no "essential repairs", when in fact the chimney was in grave danger of collapsing and did subsequently collapse, leading to the action. The purchaser relied on the report of the evaluators, even though it contained a disclaimer of liability: *Smith* v. *Eric S. Bush*, [1989] 2 ALL E.R. 514, [1989] 2 W.L.R. 790 (H.L.) [hereinafter *Smith*]. In the accounting context, it was applied to support the existence of a duty of care on the part of corporate auditors to potential providers of financial support to the company: *see JEB Fasteners Ltd* v. *Marks, Bloom & Co.*, [1981] 3 ALL E.R. 289, [1982] COM. L.R. (Q.B.) where, notwithstanding that the action ultimately failed on causation principles, Woolf J. accepted the view that the auditors owed a duty of care predicated on the foreseeability of reasonable reliance by the plaintiff. *See also* J.A. Smillie, *The Foundation of the Duty of Care in Negligence* (1989) 15 MONASH U.L. REV. 302 at 303-04 [hereinafter Smillie]; Schlosser, *supra*, note 6 at 684.

[30] *Supra*, note 2 at 481.

[31] *Ultramares Corp.* v. *Touche*, 174 N.E. 441 at 444 (N.Y. 1931), Cardozo C.J.N.Y. [hereinafter *Ultramares*]. *See, e.g.*, the comments of Lord Oliver in *Caparo*, *supra*, note 5 at 593:

> To apply as a test of liability only the foreseeability of possible damage without some further control would be to create a liability wholly indefinite in area, duration and amount and would open up a limitless vista of uninsurable risk for the professional man.

Fund v. *Sir Lindsay Parkinson & Co. Ltd*,[32] it was emphasized in the House of Lords that the *Anns* test was not a comprehensive test of universal application for determining the existence of a duty of care. To it should be added a requirement that the duty also be "just and reasonable" given all the circumstances of the case.[33] For its part, the Privy Council in *Yuen Kun Yeu* v. *A.G. of Hong Kong*[34] asserted that a duty of care had to be supported by a close and direct relationship between the parties. In *Al Saudi Banque* v. *Clark Pixley*,[35] separation of the concepts of foreseeability and proximity[36] was the preferred means to avoid an expansion of liability under *Anns*, whereas in *Rowling* v. *Takaro Properties Ltd*[37] it consisted in displacing the *prima facie* duty bias in *Anns* with a pragmatic inquiry requiring "careful analysis and weighing of the relevant competing considerations."[38] This search culminated in *Caparo*. A film documentary on that decision in the context of the general development of negligence law could well be titled "Back to the Future."

III. *CAPARO* — THE FACTS AND THE DECISIONS

Caparo arose out of incidents that took place in 1984. Fidelity plc, a public company, manufactured electrical equipment. In May of that year the directors of Fidelity issued preliminary results for the financial year ending March 31, 1984. These results were well short of market anticipation and, in consequence, the company's share price suffered a dramatic reversal rendering it vulnerable to a takeover bid. Soon thereafter the plaintiff began to purchase shares in Fidelity. As a shareholder, it received a copy of the audited accounts prior to the annual general meeting. In reliance on these accounts, Caparo purchased more shares in Fidelity and in due course made a successful takeover bid. Upon taking control it soon discovered that Fidelity was worth much less than it had expected. Caparo alleged that it would not have purchased further shares and bid for the company had it known the true state of affairs or, at any rate, it would not have made so high an offer. Caparo sued Fidelity's auditors, Touche Ross, claiming that the firm had been negligent in certifying the audited statements showing a pre-tax profit of £1.3 million when, in fact, there had been a loss exceeding £400,000.

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[32] (1984), [1985] A.C. 210, [1984] 3 ALL E.R. 529 [hereinafter *Peabody* cited to A.C.].

[33] *Ibid.* at 241, Lord Keith (Lords Scarman, Bridge, Brandon and Templeman concurring). A variation on the same theme is the assertion that the duty be supported by common sense and ordinary reason: *see, e.g., Minories Finance Ltd* v. *Arthur Young*, [1989] 2 ALL E.R. 105 at 110, [1988] F.L.R. 345 at 352 (Q.B.).

[34] (1987), [1988] A.C. 175, [1987] 2 ALL E.R. 705.

[35] [1989] 3 ALL E.R. 361, [1990] 2 W.L.R. 344 (Ch.D.).

[36] "This view holds that while [foreseeablity and proximity] are related and will often overlap, they are nevertheless separate and distinct....[with the latter being the] wider and more demanding concept....": *see* Smillie, *supra*, note 29 at 310.

[37] (1987), [1988] A.C. 473, [1988] 1 ALL E.R. 163 (P.C.) [hereinafter *Takaro Properties* cited to A.C.].

[38] *Ibid.* at 501.

The case was tried on a preliminary point of law as to whether or not the auditors owed Caparo a duty of care either as a potential investor or as an existing shareholder in the circumstances alleged. The trial judge held that they did not. The Court of Appeal, by a majority, held that the auditors owed a duty in tort to shareholders, but not to potential investors.[39] In consequence, the majority held that Touche Ross owed a duty to Caparo but only from the time it had become a shareholder in Fidelity. In the process, the Court attempted to synthesize recent pronouncements on the duty question and formulated a new three-part test of duty: first, Caparo was clearly a foreseeable plaintiff, that is, notwithstanding that Caparo's identity was specifically unknown to them, it was reasonably foreseeable to the auditors that, as a shareholder, Caparo might rely on the audited accounts in deciding whether or not to purchase additional shares in Fidelity; second, Caparo was a sufficiently proximate plaintiff, that is, there existed between auditor and shareholders a direct and close relationship because the latter are members of a limited class to whom auditors are bound to report; third, it was just and reasonable on a policy basis to impose a duty of care on auditors to shareholders in these circumstances. On appeal by the auditors to the House of Lords, their Lordships (Lords Bridge, Roskill, Ackner, Oliver and Jauncey) unanimously allowed the appeal, holding that in the absence of special circumstances, auditors owe no duty of care to third parties who rely on financial statements.

IV. *Caparo* — Analysis of the Decision

A. *Duty by Analogy*

Caparo is important for its general observations about the tort of negligence as well as its specific holding. The decision initially evoked a sigh of relief in professional circles[40] but a mixed reaction, at best, from academic commentators.[41] Clearly, the language employed by the law lords in their respective speeches suffers from imprecision. All we know with certainty is that their Lordships were unanimous in rejecting the *Anns*-inspired notion of auditor liability predicated on the single *prima facie* test of reasonable foreseeability. To quote Lord Roskill:

> The submission that there is a virtually unlimited and unrestricted duty of care in relation to the performance of an auditor's statutory duty to

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[39] [1989] 1 All E.R. 798, [1989] 2 W.L.R. 316 (C.A.), *rev'g* [1988] B.C.L.C. 387 (Q.B.).

[40] *See, e.g.*, R. Martin, *Categories of Negligence and Duties of Care: Caparo in the House of Lords* (1990) 53 Mod. L. Rev. 824 at 828; O. Martin, *Professional Responsibility and Morgan Crucible* (1991) 7 P.N. 37 at 38.

[41] Critical commentary was of various minds, ranging from approval, *see, e.g.*, T. Weir, *Statutory Auditor Not Liable to Purchaser of Shares* (1990) Cambridge L.J. 212 at 214 (describing the decision as "quite right"), to concern: *see, e.g.*, P. Marshall, *Auditors' Duties: A Narrow Approach* (1990) 1 L.M.C.L.Q. 478 at 481 (describing the approach as "unduly restrictive").

> certify a company's accounts, a duty extending to anyone who may use those accounts for any purpose such as investing in the company or lending the company money, seems to me untenable. No doubt it can be said to be foreseeable that those accounts may find their way into the hands of persons who may use them for such purposes or, indeed, other purposes and lose money as a result. But to impose a liability in these circumstances is to hold, contrary to all the recent authorities, that foreseeability alone is sufficient....[42]

However, precisely what is necessary in order to determine whether a person ought to be liable for giving negligent advice and to whom is less clear. Their Lordships did signal a return to the "established categories" approach to determining the existence and scope of duty, strongly endorsing the approach of Brennan J. of the High Court of Australia in *Sutherland Shire Council* v. *Heyman*, that:

> the law should develop novel categories of negligence incrementally and by analogy with established categories, rather than by a massive extension of a *prima facie* duty of care restrained only by [policy] considerations.[43]

This duty by analogy test requires an analysis of the factors which were treated within the "established category" or "pocket of case law"[44] as relevant to the existence, scope or non-existence of a duty in order to deduce lower-level principles which can be applied to the instant case.[45] But precisely which "pocket" are we to resort to? What degree of deviation, if any, is permissible to render present circumstances "analog[ous] with established categories?" Taken to its logical extreme, the approach represents a *reductio ad absurdum*.[46] New categories of duty will demand recognition and essential criteria for established categories will surely require ongoing redefinition.[47] What is to guide us?

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[42] *Caparo*, *supra*, note 5 at 582.

[43] 60 A.L.R. 1 at 43-44 (Aust. H.C.) as cited by Lord Bridge in *Caparo*, *supra*, note 5 at 574. *See also ibid.* at 582, Lord Roskill, and at 586, Lord Oliver.

[44] This was the nomenclature used by J. Stapleton, *Duty of Care and Economic Loss: A Wider Agenda* (1991) 107 L.Q. REV. 249 at 295.

[45] Professor Weir, *supra*, note 41 at 213, best summarized the approach in the following language:

> [t]he categories of negligence may not be closed, but they are discrete, not reducible to examples of a statable principle. Cases in the individual categories have common factors, but the categories themselves have no common denominator.

[46] As aptly stated by Professor D. Howarth, *Negligence After Murphy: Time to Re-Think* (1991) 50 CAMBRIDGE L.J. 58 at 70-71:

> If the only justification for saying that a situation was a duty-situation is that it had been declared to be such on a previous occasion, the question arises as to what justified the decision to treat the situation as a duty-situation the first time that it arose. By definition, the first time that it arose, there was no specific authority for the decision "on those precise facts", and if such authority is the only justification for a decision that a duty exists, the first case must therefore have been wrongly decided.

[47] *See* Smillie, *supra*, note 29 at 317.

B. *Proximity*

The salient feature common to all of the speeches in *Caparo* is an emphasis on the importance of proximity. None of their Lordships endeavoured to define it, except in the vaguest way.[48] Each, in fact, emphasized that the concept was merely a "label"[49] to justify a process of reasoning which was clearly "pragmatic".[50] Yet, in the final analysis, each of their Lordships utilized the concept as a convenient control mechanism to restrict auditors' third-party liability.

After carefully reviewing the "pocket" of cases represented by *Hedley Byrne* and its progeny, two very specific control valves were identified. Realizing that both the circulation of, and type of reliance placed upon, financial statements can be entirely beyond the specific contemplation and control of auditors,[51] the law lords unanimously declared that in order to determine "proximity" in such cases it is necessary to examine the auditor's knowledge at the time a financial statement is prepared regarding (1) the *type of person* who will be relying upon it and (2) the *purpose* for which it is prepared. The requisite proximity will only be established if it is determined that the auditor knew that the statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class and that the plaintiff suffered financial loss relying upon the negligently prepared statement for the purpose for which it was prepared.[52] In *Caparo*, ensuing discussion focused directly on the specific purpose of the stat-

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[48] Collectively, the endeavour comprises a conspiracy of obfuscation. Lord Jauncey, *supra*, note 5 at 602, describes proximity as "the circumstances in which the law considers it proper that a duty of care should be imposed on one person towards another." Lords Oliver, Bridge and Roskill respectively, refer to it at 585 as "a description of circumstances", at 574 as "features of different specific situations" and, at 582 as "different factual situations which can exist in particular cases" from which, as also noted by each in turn, courts conclude "pragmatically" whether a duty of care exists and, if so, its nature and extent.

[49] *Ibid.* at 599, Lord Oliver.

[50] *See generally ibid.*

[51] In the words of Lord Bridge, *ibid.* at 576:

> ....a statement [may be] put into more or less general circulation and may foreseeably be relied on by strangers to the maker of the statement for any one of a variety of different purposes which the maker of the statement has no specific reason to anticipate.

[52] The difficulty of proving reliance/causation should not be underestimated. In the typical commercial transaction, the investor or creditor often relies on many other factors in addition to financial statements: *see* B.A. Post, *Comment on* Rosenblum *v.* Adler (1983-84) 29 VILL. L. REV. 563 at 582 [hereinafter Post]. For Canadian examples in the auditing context, *see Toromont Industrial Holdings Ltd* v. *Thorne, Gunn, Helliwell & Christenson* (1975), 10 O.R. (2d) 65, 62 D.L.R. (3d) 225 (H.C.), *rev'd in part* (1976), 14 O.R. (2d) 87, 73 D.L.R. (3d) 122 (C.A.); *Royal Bank* v. *Aleman*, [1988] 3 W.W.R. 461, 57 ALTA L.R. (2d) 341 (Q.B.). *See generally* J.E. Sexton & J.W. Stevens, *Accountants' Legal Responsibilities and Liabilities* in PROFESSIONAL RESPONSIBILITY, *supra*, note 8, 88 at 103-04 [hereinafter Sexton & Stevens].

utory audit.[53] The law lords were unanimously of the view that the auditor's statutory duty to report on the company's financial statements is owed exclusively to shareholders *as a class* for the purpose of enabling them to exercise control over the management of the company and not to assist individual shareholders or investors-at-large to make informed judgments on whether to obtain, retain, reduce or increase shareholdings.[54] In the words of Lord Oliver, it was:

> difficult to believe....that the legislature, in enacting provisions clearly aimed primarily at the protection of the company and its informed control by the body of its proprietors, can have been inspired also by consideration for the public at large and investors in the market in particular.[55]

There is demonstrable revisionism in this determination of the parliamentary intention behind the statutory audit provisions. Professor Howarth makes a compelling argument that the law lords were less than accurate in their account of the history of companies legislation.[56] In his view, substantiated elsewhere,[57] there is "little doubt that the [present] requirement to publish audited company accounts was inspired by a desire to protect not shareholders collectively but investors."[58] It is equally arguable that the *Caparo* concept of auditor responsibility is out of step with commercial reality and defeats the expectations of lenders and investors:

> The ability to rely upon audited accounts is an essential feature of modern commercial life. Particularly in the case of a public company.... audited accounts are used hardly at all by shareholders acting *en bloc*

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[53] This is because the auditors had a statutory duty to provide the financial statements to Caparo shareholders at the annual meeting: *see Companies Act* (U.K.), 1985, c. 6, s. 236, the text of which is contained in the speech of Lord Jauncey, *supra*, note 5 at 605. In Canada, most audits are "statutory audits" required by corporations or securities law. Audits other than statutory audits are carried out to meet the needs of particular users of financial statements and include the audits of unincorporated entities, such as partnerships and proprietorships, and audits in connection with business acquisitions: *see generally* Calpin, *supra*, note 4 at 13.

[54] The distinction between shareholder investors and investors-at-large favoured by a majority of the Court of Appeal was rejected. Lord Oliver's reaction was typical. He called the distinction "unreasonable" and referred to the "entirely capricious results" it would produce: *supra*, note 5 at 599. At the same time there was some suggestion that auditors may owe a duty of care to shareholders selling existing shares at an undervalue in reliance on the audited accounts as distinguished from shareholders purchasing additional shares at an overvalue. Lord Oliver, *ibid.* at 601, found some merit in this contention, while Lord Bridge, *ibid.* at 580, expressly reserved judgment on the question of liability in such a case. The distinction has been criticized: *see, e.g.*, A. Mullis & K. Oliphant, *Auditors' Liability* (1991) 7 P.N. 22 at 24 [hereinafter Mullis & Oliphant].

[55] *Supra*, note 5 at 584.

[56] *Supra*, note 46 at 86.

[57] *See* Mullis & Oliphant, *supra*, note 54 at 26.

[58] *Supra*, note 46.

> to control the company and its management, but they are used by a wide range of creditors and individual or corporate investors.[59]

What, then, prompted this result?

C. *Policy*

The emphasis in the speeches on "proximity" as the label of choice to explain why the Caparo shareholders failed to establish a duty by analogy conceals the underlying policy considerations motivating the decision. Each of the speeches makes express reference to the "floodgates" argument, *viz.*, the fear of exposing public accountants to excessive liability of indeterminate amount for an indeterminate time to an indeterminate class.[60] This, perhaps, best explains why their Lordships ascribed such a "narrow" purpose to the statutory audit. Another rationale discernible from two of the speeches is that exposing public accountants to unprecedented and unlimited liability is best left to a legislative rather than judicial impetus.[61] Additional "policy" considerations were clearly referenced but unarticulated in two of the speeches.[62] Finally, a careful review of all speeches reveals consistent reference to the underlying importance of fairness/reasonableness in the pragmatic rationalization process.[63] This, it is suggested, is an additional "label" or judicial euphemism to capture the importance of policy considerations in determining the existence and scope of duty.

It has been judicially asserted that courts are largely unable to formulate anything more than a very broad view of the societal and

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[59] *Caparo: The Cloud Behind the Silver Lining* (1990) 105:1159 ACCOUNTANCY 1, as cited by Mullis & Oliphant, *supra*, note 54 at 26. The dissonance is perhaps even more acute in the case of many small, private companies where management and majority shareholders are seldom mutually exclusive: *ibid. See also* W. Bishop & S. Carne, "Accounting for Nothing" *The Financial Times [of London]* (15 November 1990) 54 [hereinafter Bishop & Carne]. American commentators have expressed similar observations: *see, e.g.*, D.D. Hallett & T.R. Collins, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements* (1968) 44 WASH. L. REV 139 at 177-78 [hereinafter Hallett & Collins].

[60] All of the speeches refer directly or by adoption to the classic warning of Cardozo C.J.N.Y. in *Ultramares*, *supra*, note 31 at 444. *See Caparo*, *supra*, note 5 at 576, Lord Bridge, at 582, Lord Roskill, at 585, 591 & 593, Lord Oliver and at 603, Lord Jauncey. Chief Justice Cardozo's warning, however, has been criticized by some American commentators as excessive and unwarranted on the basis that a strict foreseeability rule would in any event be tempered by the necessity to prove reliance and causation: *see, e.g.*, Post, *supra*, note 52 at 567-68.

[61] *Caparo*, *supra*, note 5 at 578, Lord Bridge, and at 582, Lord Roskill.

[62] Lord Bridge stated, *ibid.* at 592, "I discern no pressing reason of policy which would require such an extension [of auditor liability] and there seems to me to be powerful reasons against it". Lord Oliver, *ibid.* at 598, stated that he could "see no reason in policy....why it should be either desirable or appropriate that [auditor liability] should be extended....".

[63] *Ibid.* at 574, 581, 585 & 602.

economic consequences of their decisions and are, therefore, "more concerned with what appears to be fair and reasonable than with wider utilitarian calculations."[64] Nevertheless, the paucity of discussion in *Caparo* is unfortunate and in sharp contrast to the American experience where courts have openly discussed the policy implications of expanding liability. From a policy standpoint, expansion is consistent with the public's expectations of audits,[65] with recognition of the moral blame attached to auditor misconduct[66] and with the primary objective of the law of negligence, namely, to shift the risk of loss from the innocent and injured party to the party responsible for the loss.[67] Imposition of a broader duty also provides a financial deterrent for negligent conduct[68] thereby encouraging accountants to exercise greater diligence,[69]

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[64] *Morgan Crucible Co. plc* v. *Hill Samuel Bank Ltd*, [1990] 3 ALL E.R. 330 at 335 (Ch.), Hoffmann J., *rev'd* [1991] 1 ALL. E.R. 148 (C.A.) [hereinafter *Morgan Crucible*].

[65] It is well recognized in the United States that audits are prepared primarily for the benefit of third-party users: *see* A.G. Besser, *Privity? — An Obsolete Approach to the Liability of Accountants to Third Parties* (1976) 7 SETON HALL L. REV. 507 at 531-32. Dubbed "public watchdogs" by the United States Supreme Court, auditors have assumed a role of public trust predicated on objectivity and independence from the client: *see* A. Simmons, *International Mortgage Co. v. John P. Butler Accountacy Corp.: Third Party Liability — Accountants Beware* (1986-87) 18 PAC. L.J. 1055 at 1059 [hereinafter Simmons]. The profession itself has acknowledged the importance of this role: *see* 2 CCH A.I.C.P.A., *Professional Standards: Code of Professional Ethics*, E.T. para. 5104. In the Canadian context, *see* the comprehensive analysis contained in *"Expectation Gap": Report of the Commission to Study the Public's Expectations of Audits* (Toronto: Canadian Institute of Chartered Accountants, 1988).

[66] *See, e.g., Biakanja* v. *Irving*, 49 CAL. 2D 647, 320 P.2D 16 (Cal. 1958). *See also International Mortgage Co.* v. *John P. Butler Accountancy Corp.*, 177 CAL. APP. 3D 806, 223 CAL RPTR. 218 (Cal. Ct App. 1986) [hereinafter *International Mortgage* cited to CAL. APP.].

[67] *See, e.g., Rosenblum, Inc.* v. *Adler*, 93 N.J. 324 at 351, 461 A.2D 138 at 152 (N.J. 1983) [hereinafter *Rosenblum* cited to N.J.].

[68] *See, e.g., International Mortgage, supra*, note 66 at 820. However, an American tendency to control increased liability exposure through evasive behaviour rather than increased audit care has been noted: *see* J.A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform* (1988) 86 MICH. L. REV. 1929 at 1959-60 [hereinafter Siliciano].

[69] *See, e.g., Rosenblum, supra*, note 67 at 341. It should be noted that other strong incentives already exist, namely, the significant economic stake in establishing and maintaining a reputation for quality audit work: *see* Siliciano, *ibid.* at 1953; and the disciplinary sanctions for breach of the comprehensive self-regulatory regimes of accounting professional associations. In the latter context, however, exposure to civil liability has been identified as one of the best incentives for a profession to effect stronger self-regulation: *see* Hallett & Collins, *supra*, note 59 at 177.

promotes efficient loss spreading[70] and elevates the cautionary techniques utilized by the accounting profession.[71] On the other hand, it is also likely to increase the time expended in the performance of accounting services. This will trigger a predictable negative impact on the timeliness of the financial information generated.[72] It is equally likely to increase the cost of professional liability insurance[73] and reduce its availability,[74] and to increase the cost of accounting services[75] which, as a result, may become less generally available.[76] Additionally, it

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[70] *See, e.g., Rusch Factors, Inc.* v. *Levin*, 284 F. SUPP. 85 at 91 (Dist. R.I. 1968) [hereinafter *Rusch Factors*]. Arguably, this is accomplished by placing the risk of loss on auditors who in turn spread the loss to clients and the ultimate consuming public or purchase insurance to cover such losses: *International Mortgage*, *supra*, note 66 at 820. The validity of the assumption that accountants are best able to bear the risk of loss has been questioned. The unavailability and prohibitive cost of liability insurance in American jurisdictions adhering exclusively to the foreseeability standard has hit smaller accounting firms hardest: *see* Simmons, *supra*, note 65 at 1067; *see also*, J.L. Kinsella, *Protecting the Auditor from Unwarranted Third-Party Liability: Rethinking the Indemnification Issue* (1984) 35 SYRACUSE L. REV. 763 at 789 [hereinafter Kinsella]. Conversely, increased fees make it more difficult for smaller companies to afford audited financial statements and thereby decrease their access to capital markets: *ibid.* *See* J.G. Fleming, *The Negligent Auditor and Shareholders* (1990) 106 L.Q. REV. 349 at 351 [hereinafter Fleming]. The assumption has also been challenged on the basis that the typical third party in accounting cases is a commercial concern which shares the accountant's ability to spread throughout its own consumer base the losses it incurs relying on a negligent audit: *see* Siliciano, *supra*, note 68 at 1972. For further in-depth discussion of loss spreading, *see* G. Calabresi, THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (New Haven: Yale University Press, 1970) at 46-47.

[71] *See Rusch Factors, ibid.*; *Rosenblum*, *supra*, note 67 at 350. *See generally*, Post, *supra*, note 52.

[72] *See Rosenblum*, *supra*, note 67. *See also* Siliciano, *supra*, note 68 at 1963. Alternatively, it would produce "evasive behaviour" on the part of accountants, a term used to describe activity which seeks to limit liability by means other than increased investments in care, for example, disclaimers: Siliciano, *ibid.* at 1960.

[73] The number and frequency of third-party claims against accounting firms has risen dramatically in the United States and has resulted in some of the largest monetary judgments ever awarded by the American judiciary: *see* Kinsella, *supra*, note 70 at 763-64. The magnitude of the problem is illustrated by figures which show that judgments and settlements of lawsuits for the eight largest certified public accounting firms for the period 1980-86 totalled in excess of $180 million. In consequence, insurance for all firms has become limited and prohibitively expensive: *see* S.H. Collins, *Malpractice Prevention and Risk Management* (1986) 162 J. OF ACCOUNTANCY 52 [hereinafter Collins].

[74] It has been noted that small and medium-sized American accounting firms are experiencing an insurance shortage: *see* Simmons, *supra*, note 65 at 1067. The New York Court of Appeals favoured this policy argument to negative expanded third-party liability: *see Credit Alliance Corp.* v. *Arthur Anderson & Co.*, 65 N.Y.2D 536, 483 N.Y.S.2D 435 (N.Y. App. Div. 1985). *See also William Iselin & Co.* v. *Landau*, 71 N.Y.2D 420, 527 N.Y.S.2D 176 (N.Y. 1988).

[75] Due to the increased costs of effecting insurance, accountants would be forced to raise fees substantially: *see* Simmons, *supra*, note 65 at 1067.

[76] The inability of smaller companies to afford review services would eliminate marginal accounting firms from the market: *see* Kinsella, *supra*, note 70 at 789.

promotes "free ridership" on the part of reliant third parties[77] and decreases their incentive to exercise greater vigilance and care[78] and, as well, presents an increased risk of fraudulent claims.[79]

In the post-*Caparo* context, the foregoing considerations can no longer be viewed as communally constituting a discrete test to negative, in appropriate circumstances, a *prima facie* duty established by foreseeability alone or by the combination of foreseeability and proximity. Rather, they are to be assessed as a positive and inherent part of the proximity analysis itself and inextricably linked to judicially defining in the individual circumstances of an increasing variety of accounting situations, the parameters of the identifiable class of user and the width of purpose for which given financial statements are prepared. However, such an assessment involves, by necessity, an element of judgment and for that reason leaves little alternative in the short run to expensive and protracted litigation to resolve the competing policy considerations requisite to setting such class and transactional boundaries.[80]

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[77] Lord Bridge gave some recognition to this policy consideration. In *Caparo*, *supra*, note 5 at 576, he asserts:

> To hold the maker of a statement to be under a duty of care in respect of the accuracy of the statement to all and sundry for any purpose for which they may choose to rely upon it is....to confer on the world at large a quite unwarranted entitlement to appropriate for their own purposes the benefit of the expert knowledge or professional expertise attributed to the maker of the statement.

Of course, the alternative to free ridership is to increase the onus on third parties to seek independent advice which will often result in a needless duplication of services, albeit with concomitant direct contractual protection against accounting negligence.

[78] Siliciano, *supra*, note 68 at 1948, notes that a rule allowing third-party recovery for all foreseeable harm "creates incentives for third parties to relax their independent efforts to assess and control the risks inherent in their dealings with the [auditor's] client". In appropriate cases, however, such a failure by the third party to take adequate care can be assessed within the context of contributory negligence: *see* D.L. Menzel, *The Defence of Contributory Negligence in Accountant's Malpractice Actions* (1983) 13 SETON HALL L. REV. 292.

[79] Inspired by the client's judgment-proof status and the auditor's "deep pockets," it is very tempting for third parties to claim or exaggerate reliance on the audit. This invites unfounded and even fraudulent claims: *see* J.J. Elliott, *Expanding Third Party Liability for Accountants: Finding a Middle Ground* (1988) 19 TEXAS TECH L. REV. 171 at 183. Such claims are difficult to test in the adjudicative process owing to the fact that the third party's testimony with respect to reliance will often exclusively consist of an uncorroborated assertion that he relied on the audit rather than other factors in making the decision to deal with the client: *see* Siliciano, *supra*, note 68 at 1947, citing *Blue Chips Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).

[80] It is instructive in this respect to compare the post-*Caparo* English Court of Appeal decisions dealing with third-party liability of auditors: *see Morgan Crucible*, supra, note 64 and *James McNaughten Paper Group Ltd* v. *Hicks Anderson & Co.*, [1991] 1 ALL E.R. 134.

V. *CAPARO* AND CANADIAN PUBLIC ACCOUNTANTS

What effect has *Caparo* had to date in Canada and what effect is it likely to have on an accountant's third-party liability in the Canadian context? In Canada, it was still unclear, prior to *Caparo*, whether *Anns* was an appropriate test to govern cases involving recovery for pure economic loss despite its having been applied on five occasions by the Supreme Court of Canada.[81] It was, for example, held by the Supreme Court of Canada in *Hofstrand Farms* that "proximity" requires a "special relationship" which "would arise in circumstances where the defendant, being so placed that others would reasonably rely on his judgment or skill, knows that the plaintiff will rely on his statements."[82] *Caparo* now provides a convenient opportunity to formally sanction proximity as the appropriate control mechanism in accountant third-party liability cases.[83] Certainly the result in *Caparo* is consistent with the reasoning in *Bamford*.[84] In that case, the crucial finding was this:

> Instructions were issued to the firm of R.L. Bamford & Co, (the accountants), of whom the respondents (defendants) were partners, to prepare the required financial statement and Scholler began a search for an outside investor. *He made it known to the accountants* that he was seeking an investor. The trial judge, MacPherson J., made a crucial finding, not disturbed by the Court of Appeal for Saskatchewan, that the accountants knew, prior to completion of the financial statement, dated June 18, 1965, at the root of the present litigation, that the statement would be used by Sedco, by the bank with whom the company was doing business, *and by a potential investor in equity capital.*[85] [emphasis added]

Mr Haig, although unknown specifically to the auditors at the time of the engagement, was a potential investor and, therefore, a member of a limited and identifiable class of persons whom the auditor knew would rely on the audited statements for the purpose of deciding whether or

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[81] *Supra*, note 7. In the most recent case, *Rothfield*, all of the justices applied the *Anns* test as restated by Wilson J. in *Kamloops*. *See* Schlosser, *supra*, note 6, for a complete discussion.

[82] *Supra*, note 7 at 238. It was precisely this sort of reference which led Mr Justice Harradence, delivering the judgment of the Alberta Court of Appeal in *B.P.I. Resources Ltd* v. *Merrill Lynch Canada Inc.* (1989), 95 A.R. 211 at 228, 67 ALTA L.R. (2d) 97 at 120, to conclude:

> There is debate as to what Lord Wilberforce meant in respect of this first branch, i.e., whether foreseeability of damage in itself is sufficient to raise a prima facie duty of care or whether a relationship of proximity must first be established before foreseeability of damage gives rise to a duty of care. In *Kamloops*, supra, Wilson J., for the majority, suggests that the reasonable foreseeability test is perhaps too broad.

[83] *See generally* B. Cheffins, *Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow* (1991) 18 CAN. BUS. L.J. 118.

[84] *Supra*, note 2. Remarks to the contrary are, indeed, puzzling. *See, e.g.*, Fleming, *supra*, note 70 at 350.

[85] *Supra*, note 2 at 470, Dickson J. Martland J. attached particular importance to this finding in his concurring opinion, *ibid.* at 484.

not to invest. That actual knowledge was sufficient, in the view of the Supreme Court, to establish the auditor's duty of care. Whether or not mere foreseeability of loss in the absence of that specific knowledge would have sufficed was not addressed.

Since *Caparo*, the issue has arisen. Lower Canadian courts, using the proximity analysis, have readily adopted *Caparo*'s more restrictive approach to a public accountant's duty. It is possible to formulate from *Caparo* and its Canadian progeny to date the following specific propositions on the parameters of requisite proximity. Third-party liability will only arise if:

> 1(a) the accountant directly supplies the financial information to a third party, *or*
> 1(b) the accountant knows that the financial information is intended to be supplied to a third party, *and*
> 2(a) the third party is specifically identified, *or*
> 2(b) the third party is a member of an identifiable class of persons for whose benefit the information is known to be supplied, *and*
> 3(a) the third party relies upon the financial information for the specific purpose/transaction for which it was produced, *or*
> 3(b) the third party relies upon the financial information for a purpose/transaction of the type for which it was produced.

The distinction between 1(a) and (b) recognizes that while direct communication of financial information from the accountant to the third party is not required,[86] the accountant's knowledge that the information will be supplied to a third party is essential to establishing liability.[87] Thus, in *MacPherson* v. *Schacter*,[88] the plaintiff sued a firm of accountants alleging that she had relied upon their negligently prepared financial statements in deciding whether or not to purchase an interest in a housing co-operative. Proximity was absent from the outset because the accountants had no knowledge that co-operative shares were for sale and that the financial statements would be provided to anyone other than the company and its shareholders.[89]

The distinction between 2(a) and (b) recognizes, as does *Bamford*, that specific identification of a third party is not a prerequisite to establishing an accountant's liability. It is sufficient if the accountant knows that the third party is a member of a limited group or class that the financial information was intended to reach and influence. Two problematic issues may, however, arise. The first occurs in circumstances where the financial information is redirected from a specified

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[86] It will always suffice. *See, e.g., Hongkong Bank of Canada* v. *Touche Ross & Co.* (1987), 18 B.C.L.R. (2d) 55 (C.A.).

[87] The *Caparo* approach requires the accountant to know that the financial information is to be supplied to a specific third-party user or limited group of identifiable third-party users. Whether the accountant acquires this knowledge from his client or elsewhere would not appear to be of consequence.

[88] (1989), 1 C.C.L.T. (2d) 65 (B.C.S.C.).

[89] *See also Dixon* v. *Deacon Morgan McEwan Easson* (1989), 64 D.L.R. (4th) 441, [1990] 2 W.W.R. 500 (B.C.S.C.) [hereinafter *Dixon*].

third party to another third party similarly situated. For example, take the case where an accountant is engaged to prepare audited financial statements for the purpose of assisting the client to obtain a $1 million loan from Bank A. Suppose that, without the accountant's knowledge, the client instead uses the audited statements to secure a similar loan from Bank B. If the audit was negligently performed and Bank B, relying on the unqualified audit opinion, suffers a financial loss, the accountant's potential liability will, it is suggested, depend upon whether or not, in the circumstances, the "identifiable class of persons" in 2(b) is specifically limited to Bank A. In other words, was the specific identity of Bank A regarded by the accountant and client as a matter of material importance? An objective test can and should be applied to this determination.[90] Of course, if the transaction but not the bank had initially been specified, any financial institution could potentially recover under the combination of propositions 1(b), 2(b) and 3(a).

The second potentially problematic issue concerns the outer limits of a "limited group or class". *Caparo* correctly recognizes that a public accountant's risk of liability should be quantifiable in part by reference to his or her knowledge of the number and character of the persons who will rely on the information generated. The potential difficulty, which can only be resolved by reference to policy considerations, is highlighted by contrasting the comments of MacCallum J. of the Alberta Court of Queen's Bench in *Akhtar* v. *MacGillivray & Co.*[91] with those of Boyd J. of the British Columbia Supreme Court in *Kripps* v. *Touche Ross & Co.*[92] In *Akhtar*, members of the public at large had been invited in a prospectus to make loans to a mortgage company on the security of promissory notes, the value of which depended upon an asset valuation. Following the collapse of the mortgage company, the plaintiffs alleged, *inter alia*, negligence against the auditors in the preparation of the financial statements which had appeared in the prospectus. Although the action was dismissed on causation grounds, Mr Justice MacCallum expressed some doubt as to whether proximity could extend to an extremely numerous class:

> Proximity is easy to establish when the investors are members of a very limited class as in *Haig* v. *Bamford* (1976), 9 N.R. 43, 72 D.L.R. 68 (S.C.C.). It is a good deal more difficult to establish when the investors are members of the public at large to whom had been extended an invitation to purchase the notes in question.[93]

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[90] Although the law lords in *Caparo* spoke for the most part in terms of the auditor's subjective knowledge, there is no suggestion of a conscious departure in the context of auditor's liability from the objective test pervading other aspects of negligence law — what the resonable person should have known in the circumstances. *See also* Mullis & Oliphant, *supra*, note 54 at 29.

[91] (1990), 112 A.R. 242, 77 ALTA L.R. (2d) 337 (Q.B.) [hereinafter *Akhtar* cited to A.R.].

[92] (1990), 52 B.C.L.R. (2d) 291 (S.C.) [hereinafter *Kripps*].

[93] *Supra*, note 91 at 268.

In *Kripps*, debentures were offered for sale to the public by way of several prospectuses all of which contained audited financial statements asserting compliance with generally accepted accounting principles. In fact, the statements failed to provide for certain expected losses. The plaintiffs, having lost their investment when the superintendent issued a cease trading order, sued the accountants for negligence in the preparation of the financial statements. In refusing the accountant's application to strike out the plaintiff's claim as disclosing no reasonable cause of action, Madame Justice Boyd emphasized that a finding of sufficient proximity will vary with the facts and then focused on the auditor's knowledge of the purpose of the transaction. Adopting the following passage from the judgment of McColl J. in *Surrey Credit Union* v. *Willson*,[94] she held that, notwithstanding the potentially large class of persons who would obtain the prospectuses, it was not too large and unidentifiable a class to form the foundation of a relationship of proximity between the parties:

> In my view, once the defendants knew the purpose for which the consent to use the audited statements was being sought, they could no longer say that debenture purchasers were strangers. The debentures were being offered for the sole purpose of attracting capital....The defendants were auditors of international reputation. They knew the circumstances and purpose for which consent was sought.[95]

Even applying this more generous standard, proximity would not encompass that larger class of the "public at large" who might reasonably be expected sooner or later to have access to the financial information and foreseeably take some action in reliance upon it. *Dixon*[96] is illustrative. There, the plaintiff invested $1.2 million in the shares of a public company relying, in part, on an extract from the audited financial statements. Shortly after he purchased his shares, trading was halted by the Ontario Securities Commission after it was discovered that the company's financial statements should have shown a substantial loss rather than a net profit. When trading resumed, the share price fell sharply and the plaintiff sued, *inter alia*, the auditors to recover his losses. Here was a pure foreseeability case. The plaintiff had no communication with the auditors and the extract of the audited statements that he relied upon had not even identified the auditors. Madame Justice Huddart, applying *Caparo*, struck out the action as against the auditors on the basis that, foreseeability aside, there was an insufficient degree of proximity between the parties.

Caparo also correctly recognizes that a public accountant's risk of liability should be quantifiable in part by reference to the accountant's knowledge of the purpose for and extent of the transaction for which his

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[94] (1990), 73 D.L.R. (4th) 207, 49 B.C.L.R. (2d) 102 (S.C.) [hereinafter cited to D.L.R.].

[95] *Ibid.* at 212.

[96] *Supra*, note 89.

or her services are engaged. The distinction between the requisite specificity of knowledge of the purpose/transaction in 3(a) and (b) is potentially an important one. To date, however, it has not arisen in Canadian post-*Caparo* case law because the purpose/transaction for which the financial information was relied upon by plaintiffs was specifically known to the accountants[97] or was clearly outside the purpose/transaction parameters.[98] The language in *Caparo* does, however, offer some support for the broader test of requisite knowledge contained in 3(b). Lord Bridge speaks of the auditor's knowledge of a purpose "specifically in connection with a particular transaction or transactions of a particular kind."[99] To Lord Oliver, it is essential that the auditor possess knowledge of a purpose "whether particularly specified or generally described."[100] Lord Jauncey, on the other hand, is less generous. In his view, the particular purpose has to be the "very transaction" for which the statement is provided.[101] If the aim of the proximity requirement is to put some quantifiable limits on the ambit of potential liability by relating it to the *known* risks assumed by the public accountant in his or her engagement, this aim, it appears, is in no way compromised by acceptance of the wider proposition in 3(b). The proposition is also consonant with the American "substantially similar transaction" test which does not require that the operative transaction be identical in all of its minute details with the one intended:

> There may be many minor differences that do not affect the essential character of the transaction. The question may be one of the extent of the departure that the maker of the representation understands is to be expected. If he is told that the information that he supplies is to be used in applying to a particular bank for a loan of $10,000, the fact that the loan is made by that bank for $15,000 will not necessarily mean that the transaction is a different one. But if the loan is for $500,000 the very difference in amount would lead the ordinary borrower or lender to regard it as a different kind of transaction. The ordinary practices and attitudes of the business world are to be taken into account, and the question becomes one of whether the departure from the contemplated transaction is so major and so significant that it cannot be regarded as essentially the same transaction. It is also possible, of course, that more than one kind of transaction was intended.[102]

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[97] In *Caparo*, *supra*, note 5 at 589, Lord Oliver was alone in expressly acknowledging that inferential knowledge was sufficient. *Compare* the comments of Lord Bridge at 576, and those of Lord Jauncey at 605.

[98] *See, e.g.*, *McGauley* v. *B.C.* (1990), 44 B.C.L.R. 217 (S.C.).

[99] *Caparo*, *supra*, note 5 at 576. His Lordship even provides a specific example of the latter — "in prospectus inviting investment".

[100] *Ibid.* at 589.

[101] *Ibid.* at 605, where he adopts the words of Lord Denning in *Candler*, *supra*, note 17. There is nothing in Lord Roskill's brief speech to suggest that anything less than knowledge of the specific purpose will suffice: *Caparo*, *supra*, note 5 at 582.

[102] American Law Institute, RESTATEMENT OF THE LAW OF TORTS (2D), para. 552 at 137-38. *See also Anderson* v. *Aronsohn*, 184 P. 12 (1919).

VI. POST-*CAPARO* STRATEGIES

Given *Caparo*'s imperative that proximity must exist between the accountant and third-party user of his or her work before the accountant is forced to bear the economic cost of negligence, and given the narrowness of the parameters of proximity derived from *Caparo* and its Canadian progeny to date, hindsight suggests certain aggressive self-help strategies may be employed by third parties and clients to expand an accountant's third-party liability exposure. At the other end of the spectrum, defensive strategies should be considered, in appropriate circumstances, by public accountants to further reduce their potential third-party liability.

In general, third parties should make it a condition of any relevant transaction with the client that the client's public accountant state in writing that the financial statements generated by audit and review engagements[103] can be relied upon for the purpose(s) specified. Specifically, lenders should make it a condition of their loans that the borrower's auditor confirm in writing that the lender may rely on the auditor's present and future audited statements.[104] Investors in negotiated share purchases or friendly takeover bids should similarly seek written assurances from the company's auditors that the financial statements form a basis upon which the acquisition is being negotiated.[105] Likewise, unsecured substantial trade creditors may wish to seek appropriate assurances.

Clients, for their part, should insist on a clause in the engagement letter requiring the accountant to provide on a timely basis and at the

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[103] Reviews are to be distinguished from audits. In the latter case, the objective is for the public accountant to express an opinion on the fairness of the financial statement in accordance with generally accepted accounting principles or, in special circumstances, another appropriate disclosed basis of accounting, consistently applied. *See* Canadian Institute of Chartered Accountants, CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS HANDBOOK (Toronto: 1968) para. 5000.01 [hereinafter C.I.C.A. HANDBOOK]. The objective of a review engagement is for the public accountant to add a measure of credibility to the subject matter being reported on by assessing whether the information presented is plausible within the framework of appropriate criteria: *ibid.* at para. 8100.08. Audits and reviews, on the other hand, are distinguished from compilation engagements wherein a public accountant receives information from a client and arranges it into the form of a financial statement but provides no expression of assurance whatsoever: *ibid.* at para. 9200.03. Given the limited nature of an accountant's involvement in compilations, it would be unrealistic for third parties to seek a similar stipulation because of the accountant's inability in most cases to determine whether the compilation would serve a specific intended purpose.

[104] In England, banks have done just this in response to *Caparo*: *see* O. Martin, *supra*, note 40.

[105] *See* Bishop & Carne, *supra*, note 59. Hostile takeovers, on the other hand, have become more risky owing to the seeming inability of the hostile bidder to rely on the fact that the financial statments and audit opinion have been prepared in accordance with generally accepted auditing standards and generally accepted accounting principles. There are, however, indications that this may not be so in respect of financial statements prepared for shareholders after the hostile takeover bidder is identified. *See Morgan Crucible*, *supra*, note 64.

client's direction these kinds of letters of assurance to third parties unless there are reasonable grounds for withholding the same. Future transactions between clients and third parties can be facilitated and expedited as a result. Third parties will take comfort on subsequently being provided with the assurance knowing that requisite proximity can be established providing the financial statements and assurance are relied[106] upon for the purpose contemplated. Conversely, if the accountant fails without just cause to provide the necessary assurances, the client is also protected in respect of any additional expenses incurred owing to that failure.

The first strategic lesson for public accountants derived from *Caparo* is the importance of the engagement letter. *Ex post*, it is the evidentiary starting point in determining the parameters of proximity with respect to an accountant's knowledge of potential plaintiffs or transactions. *Ex ante*, it is a useful device to permit the accountant to specifically circumscribe the "identifiable class of persons" who can rely on the financial statements or "transactions of the type" in which the statements can be relied upon. In this context, it should be noted that present *CICA Handbook* recommendations indicate the advisability of expressly including in a review engagement letter any restrictions on the financial information's use and acknowledgment of an undertaking by the client that if the public accountant's association with the financial information is to be communicated to third parties, then the accountant's report will be attached to that information.[107] The third party's burden of proof will be difficult to discharge where the accountant has specified in writing his or her understanding of who might rely on the financial statements and for what purpose and the third party is not within the enumeration. The accountant will generally be protected because such an agreement between the accountant and client can only be enlarged after the time of the engagement with the accountant's consent or by virtue of an express or implied undertaking of a duty of care towards the third party. The engagement letter might even go further and prohibit additional distribution of the financial statements without the written authorization of the accountant[108] and should, in any event, contain a statement that the engagement letter constitutes the entire agreement. Liability avoidance and good practice management dictates that when subsequent enquiries are directed to the firm, the response should be timely, preferably in writing and should explicitly inform the client and/or third party of the relevant provisions of the engagement letter and the intent of the accountant to rely on those provisions.[109] Even where an accountant is seized with knowledge of third-party users and/or

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[106] Reliance/causation issues may be problematic. *See supra*, note 52.

[107] *Supra*, note 103, para. 8100.13.

[108] *See* Sexton & Stevens, *supra*, note 52 at 105.

[109] *See* G. Spellmire *et al.*, ACCOUNTANTS' LEGAL LIABILITY GUIDE (Orlando: Harcourt Brace Jovanovich, 1990) at 11.21. The authors go on to suggest that a master correspondence file should specifically be kept for this purpose and that memos of telephone enquiries should be likewise included.

uses, he or she may nevertheless still be able to limit responsibility through disclaimer clauses.

Caparo's second strategic lesson for public accountants is that ignorance is, indeed, bliss. If the intention is to limit potential third-party liability, one may legitimately question how proactive the accountant should be in ascertaining for non-audit engagements if the client will be providing the financial statements to any third party or, if so, in ascertaining the identity or type of third party to whom they will be provided.[110] In the same vein, effort expended to determine within a broad range of potential purposes the specific purpose for which a third party needs the financial statements is questionable.

Further defensive strategies that public accountants will want to consider are to decline to provide letters of assurance to third parties and/or to disclaim responsibility to reliant third parties. In England, in the immediate aftermath of *Caparo*, many accounting firms refused to provide assurances.[111] In the longer term, however, this strategy may be unsatisfactory depending upon competitive pressures and the client's ability to effect a change of accountants. A disclaimer clause, on the other hand, may be effective even if the third party approaches the accountant directly and clearly specifies the nature of the transaction. In *Hedley Byrne*, for example, the defendant bank supplying the reference escaped liability because it expressly provided the reference "without responsibility on the part of the bank."[112] In jurisdictions with a foreseeability-based liability rule, responsibility disclaimers are predictably popular[113] notwithstanding the obvious practical problems associated with their use.[114] *Caparo*'s rejection of the foreseeability rule in

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[110] In audits, the anticipated distribution of the financial statement is an inherent risk factor to be considered by an auditor in establishing the extent of requisite audit testing in the circumstances: *see, e.g.*, Sexton & Stevens, *supra*, note 52 at 101. Audit risk is the risk that the auditor will fail to express a reservation in his or her audit opinion on financial statements that are materially misstated. *See* C.I.C.A. HANDBOOK, *supra*, note 103, para. 5130.09. Inherent risk, a component of risk, is lower if, *inter alia*, the financial statements are to be given limited circulation.

[111] *See* Bishop & Carne, *supra*, note 59.

[112] *Supra*, note 1 at 468. *Compare Sodd Corp.* v. *Tessis* (1977), 17 O.R. (2d) 158, 79 D.L.R. (3d) 632 (C.A.), where an accountant trustee-in-bankruptcy was held liable to a third party for a negligent misrepresentation in the absence of a disclaimer. It should be noted that in England a disclaimer of liability is now "a notice which purports to exclude liability for negligence" within the *Unfair Contract Terms Act 1977* (U.K.), 1977, c. 50 and is, therefore, ineffective unless it satisfies the requirement of reasonableness. *See Smith*, *supra*, note 29. Civil liability aside, provincial rules of professional conduct prohibit association by a public accountant with a financial statement that he or she knows, or should know, is false or misleading, whether or not the association is subject to a disclaimer or responsibility. *See* C.I.C.A. HANDBOOK, *supra*, note 102, para. 9200.04.

[113] In the United States, the accounting profession has latched onto the strategy of responsibility disclaimers with alacrity: *see* Siliciano, *supra*, note 68 at 1960. *See also* Collins, *supra*, note 73 at 64.

[114] As Cooke J. recognized in *Scott Group*, *supra*, note 26 at 581, "some auditors, naturally jealous of their professional reputation, would hesitate to announce such a disclaimer."

favour of stringent proximity requirements will probably militate against a wider use of disclaimers here. Similarly, *Caparo* obviates any necessity to limit in the public accountant's communication accompanying the financial statements the person or class of person who are entitled to rely on the financial statements, another popular limitation device in the foreseeability rule jurisdictions.[115]

VII. CONCLUSION

Ever since *Hedley Byrne* recognized the tortious liability of professionals, Canadian public accountants have had to function under the spectre of broadening liability. Underlying this development is the simple question of determining who has the legal right to rely on financial information generated by public accountants. In fashioning a response, *Caparo* would lead us conveniently back to the future. It negatives any *Anns*-inspired duty of care predicated exclusively on reasonable foreseeability and mandates a return to the "established categories" approach in determining the existence and scope of a duty of care in negligence law. Once a pocket of analogous case law has been identified, *Caparo* requires an examination of the proximity issues exclusive to that category of cases. It also asserts that policy considerations will continue to play an important role. In consequence, it is tempting to suggest that under the aegis of "duty by analogy" and a return to "established categories", all their Lordships accomplished in *Caparo* was to inject the additional requirement of proximity between the foreseeability and policy branches of the *Anns* test. The suggestion, however, falls well short of the mark. *Caparo*'s mandate of analogical reasoning narrows considerably the framework within which policy considerations are operative. Also, they are not superimposed *ex post facto* to negative a duty but are considered as part of the proximity analysis in order to determine whether a duty of care arises in the first place.

In the context of third-party liability and Canadian public accountants, the *Hedley Byrne* principle as applied in *Bamford* provides, under the *Caparo* rubric, an acceptable basis for analogy. In proximity terms, *Caparo* asserts that a public accountant who uses his or her expertise to render a service which involves giving an audit opinion should be liable for a want of due care in rendering that opinion to persons or types of persons whom the auditor intends directly or indirectly to receive it but only insofar as those persons use the opinion for the purpose or type of purpose which the auditor intends. In short, in the area of auditors and

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[115] *See* Siliciano, *supra*, note 68 at 1960. *See also Rosenblum*, *supra*, note 67. In Canada, this may not have been popular in any event given the C.I.C.A. suggested standard forms of audit and review engagement reports: C.I.C.A. HANDBOOK, *supra*, note 102, paras 5400.07 & 8200.04. With respect to compilation agreements, the C.I.C.A. HANDBOOK recommends that the "Notice to Reader" should normally state a specific intended purpose but should caution readers that the statement may not be appropriate for their purposes: paras 9200.21 & 9200.23.

third-party liability, what *Bamford* did from a proximity standpoint was to bring Canadian common law past an "actual identity" test to a "limited class user" test. *Caparo*, for its part, restricts proximity much further by appending a "limited use" test.

Canadian courts to date have been quick to embrace *Caparo*'s mandate in this area. The consideration of policy, as part of the proximity analysis, requires a delicate balance between the need to hold public accountants to a standard that recognizes their contemporary role in commercial affairs with the need to protect them from liability which unreasonably exceeds the bounds of their real undertaking. But what is the "real undertaking" in any given factual context? In the short run, judges will have ample opportunity to expand or restrict third-party liability within *Caparo*'s dictates by broadly or narrowly determining the purpose for which the financial information was generated and, to a lesser extent, the parameters of the "limited class" of user of the information. Public accountants, in an effort to limit their third-party liability exposure, will find it tempting to employ self-help strategies aimed at circumscribing this judicial formulation. Absent invoking their own self-help strategies, many third parties accessing financial statements will find that professional goodwill and the accounting profession's self-regulatory disciplinary sanctions now constitute the primary incentives to due care. For their sake, one can only hope that will be enough.