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'TODAY'S PLAINTIFF - TOMORROW'S DEFENDANT

A PROPER ALLOCATION OF LIABILITY'

by

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Why is it that, more often than not, a corporate collapse, or large loss is followed by a court action in which a partner in one of the Big Six, acting as liquidator, or official manager, brings the action against the auditors, very likely another of the Big Six? I suggest that it is partly a manifestation of the phenomenon of the expectation gap, a consequence of insurance and of a principle of procedural and substantive law known as the rule of Solidary Liability. Why is it that the primary agents of the loss, or at least those who allowed it to happen, do not stand shoulder to shoulder as defendants with the defendant auditors? I refer of course to the directors and senior management. Once again the explanation lies partly in insurance, this time lack of it, and defects, or at least supposed defects, in the procedural and substantive law.

That having been said, it is now painfully evident that the accounts of the companies around the world which have provided the most spectacular examples of company collapses and which have been certified by the most eminent firms of accountants have been neither true nor fair. How did this come about? How should the blame be apportioned? What may be done to avoid a recurrence?

At the centre of the controversy are difficult questions concerning the role of the accounting profession in performing audits, the role of a statutory audit, the conceivably limitless scope of an auditor's liability to non clients who may come to read and rely on audit reports, and, if thought appropriate, the limitations to be imposed on auditors' liability. Again, in relation to directors what should be the standard of care exacted from a director? Should there be any distinction drawn between executive and non-executive directors? There are, as well, important questions as to the attribution to a company of the negligence of its senior management in the performance of their duty. Many of these questions I have addressed in my judgment in AWA v Daniels and I do not intend to repeat what I have there written. Again, the topics are so large that even a series of papers would necessarily fail to address them in sufficient depth.

The purpose of my contribution is therefore a modest one. It is to fuel a debate and hopefully serve as an agent of change. Inappropriate allocation of loss is personally unjust to the defendant. It is socially damaging, increases transaction costs, and most likely, dare I say, encourages even larger legal bills. The Cadbury Committee on the Financial Aspects of Corporate Governance identified present day concerns as to the "low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected. The underlying factors were seen as the absence of a clear framework for ensuring that directors kept under review the controls in their business, together with the looseness of accounting standards and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards." The opinions and suggestions which follow, even if expressed categorically, should be regarded as much more tentative than they may sound.

The expectation gap is well known as a phenomenon, although the remedy for it has so far eluded auditors and the community. A primary reason for its existence I believe, is that the community and shareholders no longer consider a corporation for what it is. Historically, companies as an institution started off as risk takers. However, with slogans like "People's Capitalism" the expectation has become that a company will always pay a steady, or even increasing dividend, and hopefully even show a capital gain to the shareholder. Certainly no-one would suggest that the so-called entrepreneurial spirit, exhibited in the last decade, is to be commended, or repeated, in its full blown manifestation. Nonetheless, it is equally true that it needs to be appreciated that, consistently with honesty and sound corporate governance, a corporation needs to embark, from time to time, on risk taking ventures. These may lose money, possibly a great deal of money. It is not for nothing that bonds used to be thought the only safe form of trustee investments. Where Parliaments and courts frequently go wrong is in trying to provide for risk free business. To sue the auditor for losses incurred in ill advised business ventures is hardly appropriate. Yet, concurrently with today's concepts of companies as solid, and shares as safe investments, run the expectation that, somehow or other, auditors should stand as insurers of the company's financial performance. There has been a marked tendency to blame the auditor for the failure of directors and senior management to adequately and properly supervise the business or even to warn against unsound business decisions. Needless to say that is no part of the auditing function.

A somewhat more debatable question, which again bears on the expectation gap concerns the responsibility of the auditor for fraud detection and reporting. The profession believes fraud detection to be a secondary objective, the general public believes it to be the primary objective.

Again, there is a lack of understanding of the interrelationship between the duties of directors and of auditors in relation to accounts. In some cases, management, through a proper system of internal controls is in a much better position to detect fraud, or to prevent it, than the auditors. This is made clear by the relevant Statement of Auditing Practice, AUP 16, par 4:

> "The responsibility for the prevention and detection of fraud and error rests with management through the implementation and continued operation of an adequate system of internal control."

It is interesting to note that in its Draft Report the Cadbury Committee pointed out (par 4.26), that an effective internal control system was a key aspect of the efficient management of a company and accordingly recommended that the directors in their report make a statement as to the effectiveness of their system of internal financial control and that the auditors should report on it.

The Report of the Commission to Study the Public's Expectations of Audits (June 1988), commissioned by the Canadian Institute of Chartered Accountants, reveals a belief that, if fraud is being perpetrated by the management, the auditors bear a greater responsibility for its detection (par 7.9, p 95). At the same time, it may be more difficult to detect fraud at that level, as management are in a better position than other employees to circumvent or override the company's internal controls. Despite this, the auditors are seen as (par 7.22, p 97):

> "the first line of defence, along with the auditors, against management fraud. In cases where the directors participate in fraudulent financial

reporting, the auditor may well be the sole line of defence."

There is a lack of understanding of exactly how far the auditor assumes responsibility. An obligatory letter of engagement, to which I will refer later, between the company and the auditor would go a long way towards resolving this problem.

There is a further contributing cause to the expectation gap. Historical accounting, which is the prescription of present day Accounting Standards, will always be an inadequate tool for investment decisions. Yet that is what the public generally expect accounts to be. Historical accounts frequently do not reflect current conditions.

What is the purpose behind the legislative requirement for the carrying out of an annual audit and the circulation of accounts? For whose protection were these provisions enacted, and what object were they intended to achieve? The legislative provisions require that the directors annually give an account of their stewardship to a general meeting of shareholders. This is the only occasion in each year on which the general body of shareholders is given the opportunity to consider, to criticize, and to comment on the conduct by the Board of the company's affairs, to vote on the directors' recommendation as to dividends, to approve or disapprove the directors' remuneration, and if thought desirable, to remove and replace all or any of the directors. One would have thought that it could not be said with any accuracy that the purpose of making audited financial information available is solely to assist those interested in attending general meetings of the company, or to allow an informed supervision and appraisal of the stewardship of the company's directors, because preference shareholders, for example, have no right to vote and debenture holders may not have an interest of the same nature as shareholders.

There is no agreement between the highest courts in England and the United States on what is the purpose of the statutory audit. In England, the House of Lords, in Caparo Industries plc v Dickman 1990 2 AC 605 took the view that the original, central and primary purpose was to enable those with proprietary interests in the company, such as shareholders, or noteholders, to make an informed exercise of their rights and powers. It was aimed at shareholders as a body, not as individuals, for the purpose of enabling them to scrutinise the conduct of the company's affairs, not to make investment decisions.

The role of the statutory auditor was one of the main points considered in Caparo. Lord Oliver said (p 630)

> "What is the purpose behind the legislative requirements for the carrying out of an annual audit and the certification of the accounts? For whose protection were these provisions enacted and what object were they intended to achieve? It is

the auditor's function to ensure, as far as possible, that the financial information as to the company's affairs ~~prepared~~ by the directors, accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."

Lord Bridge expressed the same concept thus (p626):-

> "The shareholders of a company have a collective interest in the company's proper management and insofar as the negligent failure of the auditor to report accurately upon the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors of management are corrected the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interests of the company itself and loss suffered by the shareholder, eg by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders."

Lord Jauncey put it slightly differently (p662):-

> "The purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their

> voting rights, if so advised, and to influence future policy and management."

It follows that, in the opinion of the Law Lords, the purpose of the statutory audit is to provide a mechanism to enable those having a proprietary interest in the company, or being concerned with its management or control, to have access to accurate financial information about the company for a limited purpose only. Provided that those persons have that information, the statutory purpose is exhausted.

It was a similar approach which influenced Millett J in Al Saudi Banque v Clark Pixley 1989 3 AER 361. The Judge held that the auditors owed no duty of care to a bank which lent money to the company regardless of whether the bank was an existing creditor or a potential one.

It was because the Law Lords took the view that accounts were certified by the auditors for this limited purpose that they concluded that there was no breach and no duty to third parties, and indeed, not even to shareholders in so far as their investment activities were concerned. Is this a correct assessment? Are accounts, in fact, to be tagged as having such a limited purpose?

Of necessity, on the view taken in England, outsiders, be they creditors, suppliers or employees are not entitled to rely on the auditor's certification of the accounts in their decision making. On the other hand Chief Justice Burger, writing for the Supreme Court of the United States, said in United States v Arthur Young & Co (1984) 465 US 805, 817:-

> "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."

In the context of loss distribution it is of interest to note the justification for the views of the Law Lords, put forward by Lord Oliver. In contrast to manufacturers who are able to distribute the cost of accidents among countless consumers, the auditor is limited to one client at a time. Insurance, if available at all, would become prohibitively expensive and lead to a shrinkage of the service, which is of substantial public benefit in providing access to information for a wide segment of the market. The same concern as to the absence of availability of, or high cost of, insurance was explored at length by the Supreme Court of California in a very recent judgment, on 27 August 1992, in Bily v Arthur Young & Co. The majority judgment examined in great detail the justification for denying to third parties the right to sue where they acted or refrained from acting on the basis of incorrect audited accounts. As Professor

Fleming pointed out, the cost has to be borne by the client, while third party investors are free riders of a benefit without paying for it.

Commentators have argued that the views expressed in Caparo should be rejected for Australia. As Professor Baxt suggested, shareholders who receive the audited accounts obviously use them to decide whether or not to remain shareholders, or perhaps to buy additional shares. He suggests that the provisions of the Australian legislation should return a different answer from Caparo. Gay and Schelluch pointed out ("The Auditor's Liability to the Company, Shareholders and Third Parties" (1991) 9 Company and Securities Law Journal 59) that the Corporations Law requires accounts to be prepared in accordance with Approved Accounting Standards. Australian Accounting Standard AAS5 in par 7 explicitly identifies the users of financial statements as including "present and potential providers of equity or loan capital and creditors". Statement of Accounting Concepts 2 further elaborates by identifying the most common users as resources providers, recipients of goods and services, parties performing a review or oversight function as well as management and governing bodies. The authors suggest that (p 62):

> "the audit report could not add credibility to financial statement representations nor add value to such statements through its quality control role if the auditor could not be subjected to individual user action in case of negligence".

They also point to the rights conferred by the Trade Practices Act and the State Fair Trading Acts.

There seem to be two choices for Australia. One is to leave it to the courts to work out, on a case by case basis, the extent to which persons, other than the actual clients, should be entitled to make claims against auditors based on inaccurate information included in audited accounts. The other is for Parliament to endeavour to anticipate and make unnecessary a likely stream of litigation by laying down appropriate principles. In other circumstances this might seem an unrewarding task for Parliament to assume. However, as will emerge later in this discussion, and indeed as I pointed out in the judgment in AWA, there are other associated areas in which legislative reform is clearly necessary. Not only that, but there are concealed in the question as to the direction to be taken in the development of the law, major issues of policy in relation to the function of audits, the protection of investors, the duties of directors, the availability and desirability for full insurance of auditors and directors which need to be addressed as matters of national economic and social policy. These are matters in which the commercial community, insurers and professional bodies must be, not permitted, but required to make a full input. Until, if ever, Australian courts permit non parties to an action to file briefs for the assistance of the Court, as is done in the United States in the form of Brandeis briefs, it is difficult for courts to be satisfied that they are in possession of all relevant information and points of view required for a correct assessment and reconciliation of the competing interests. Indeed, the Chief Justice of Australia, Sir Anthony Mason has argued strongly in a recent lecture "Law and Economics" [17 Monash U.L.R. 167 (1992)] that (p174):-

> "Curial proceedings in Australia are also an obstacle to the use of economic analysis. Our version of the adversary system has not devised procedures to facilitate the use of such materials. Unlike the United States, we do not make use of the Brandeis brief procedure. And there is a strong apprehension that a contest and debate about economic issues will add to the length and cost of litigation (already a matter of great public concern) without any confident assurance that the result will be worthwhile."

In Bily (supra), the majority in the California Supreme Court said:

> "The dissent acknowledges, as we do, the complexity of the problem before us and the necessity of a legislative process of study, debate, experimentation, and careful rulemaking. In view of the nature of the problem, we refrain from endorsing a broad and amorphous rule of potentially unlimited liability that has been endorsed by only a small minority of the decided cases. As we recently stated: 'In the absence of clear legislative direction we are unwilling to engage in complex economic regulation under the guise of judicial decision making.' (Harris v. Capital Growth Investors XIV (1991) 52 Cal. 3d 1142, 1168 & fn. 15)"

The minority was also conscious of the weighty considerations calling for evaluation in saying:

> "In defining the scope of duty in negligence cases, courts must balance competing concerns. The burden imposed by the duty should bear some reasonable relation to the moral fault of the negligent party and should not be so onerous that those held liable are unwilling or financially unable to engage in socially beneficial activity. On the other hand, tort liability is itself socially beneficial to the extent that it provides both an incentive for due care, thereby preventing avoidable injuries, and compensation for those who have been injured. Courts should not define a legal duty so narrowly as to preclude these positive effects of tort liability, as the majority has done in this case.
>
> Lenders and investors use the reports prepared by independent auditors so widely, and rely on them so heavily, that it is difficult to conceive how our complex modern capital markets would function if they were no longer available or no longer able to inspire confidence. In weighing the competing policy considerations that factor into a decision defining the scope of the accountant's duty in this context, a court must seek to fashion a rule that, without making the provision of auditing services prohibitively risky, ensures that the quality of those critically important services will be maintained at a high level. Such a rule is necessary so that lenders and investors will continue to have confidence in audited financial reports and so that the usual and foreseeable users of audit reports will receive fair compensation when they have been victimized by the occasional failure of an accountant to meet prevailing professional norms."

Later, the minority said:

> "How heavy is the burden to accountants and what are the consequences to the community when the law makes accountants liable to foreseeable users of audit

opinions? These are serious questions, deserving serious consideration. They should be answered on the basis of facts, not speculation. Yet the record before the court includes no competent evidence that would be helpful in addressing these issues. Absent a reliable and satisfactory basis for decision, this court can make no informed judgment on these issues and should not invoke these considerations in support of a rule that denies liability in derogation of the fundamental principle making persons liable for all foreseeable consequences of their negligence."

The fact remains that, as Professor Ebke remarked (<u>"In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities"</u> 79 Northwestern U. L.R. 663 (1984):

> "Since reliability of financial data is essential in a society that depends upon market activity for resource allocation, clarification of the statutory purposes of financial disclosure, standards of auditors' performance and third parties' expectations is of vital necessity."

Again, the expectations of clients may not be realised because of the absence of letters of engagement. It is surprising how often clients and auditors fail to enter into letters of engagement. Of necessity, letters of engagement cannot provide for each and every eventuality and have to leave some grey areas to allow for the unforeseen, the need to follow up, the need to investigate. Nonetheless, within those constraints, I would have thought it would narrow the expectation gap if specifications for the audit were sought and provided. As Gay and Pound point out (<u>"The Role of the Auditor in</u>

Fraud Detection and Reporting" (1989) 7 Company & Securities Law Journal 116):

> "more emphasis is currently being placed on the communication of the objectives and limitations of an audit in an effort to reduce the present 'expectation gap'. There is also pressure being exerted on the auditor to formally report on internal control. Further, there can be no doubt that the auditor has a duty to report fraud when aware of it, despite any practical difficulties. This reporting function has even been extended to breaches of company policy which may result in losses being incurred. The audit committee may well have an important role to play in this communication or reporting process."

I would suggest that the dispute in AWA, which appears to have cost the parties at least $15 million to date, might have been avoided had the obligations of the auditors been clearly spelt out in a letter of engagement.

The clear specification of what the client required and expected of the auditor would run in tandem with another feature of the engagement of auditors today. It is one of the strange ironies that, concurrently with audits going out to tender and the resultant expectation of decreased audit fees, there is an expectation of a higher quality product. It is claimed that tenders are simply the working out of a competitive market. Although every auditor may be expected to deny this, I would be surprised if the lower price did not result in a lower quality product.

Responsibility for the preparation of accounts giving a true and fair view of the company's financial state is placed fairly and squarely on the shoulders of the directors. They are required to certify to this effect. The directors' accounting obligations complement the auditor's obligation and provide the basis for the exercise of the auditor's functions. The study by the Canadian Commission to Study the Public's Expectations of Audits showed that this distinction is not well understood by the investing public. A survey of investors revealed that 29% of the respondents thought that the auditors prepared the financial statements, with another 14% ambiguously stating that the accounts were prepared by an accountant. 49% thought that the accounts were prepared by either management (37%) or the Board (12%) (p 152). It is hardly surprising then, that the auditors are often blamed for errors in accounts, even though the directors bear the primary responsibility for their preparation.

Following AWA the complaint was made that, by voluntarily accepting in their internal manuals a requirement to report on deficiencies in internal controls, the Big Six have somehow imposed upon themselves a more rigourous standard than would otherwise be applicable. The answer to that has been given by Moffitt J in Pacific Acceptance Corp Ltd v Forsyth (1970) 92 WN (NSW) 29. He pointed out (p74) that the court, applying the law which by its content expects such reasonable standards as will meet the circumstances of today, takes standards and practices adopted by the profession to meet current circumstances as providing a sound guide to the court in determining what is reasonable. The internal manuals are the best evidence of the standards and practices adopted by a large segment of the profession.

The role of the auditors is to provide an independent report to the members on the proper preparation of the balance sheet and profit and loss account and as to whether those documents give a true and fair view respectively of the state of the company's affairs at the end of the financial year and of the company's profit and loss for that year. In carrying out this duty the auditor is paid by the company and works closely with management, and to some extent, with the directors. Nonetheless the auditor is employed by the company to exercise professional skill and judgment for the purpose of giving an independent report on the reliability of the company's accounts to the shareholders.

As Vaughan Williams J said in Re Kingston Cotton Mill Co 1896 1 Ch 6, 11:-

> "No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them."

The shareholders of a company have an investment in the company's proper management, and insofar as a negligent failure of the auditor to report accurately on the state of the company's finances, deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book, and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. Once again, theory far exceeds any realistic assessment of what shareholders in practice do.

One indication of the difference in approach permissible to directors and to auditors is shown by what Mr Justice Moffitt said in Pacific Acceptance (supra) p70. He accepted that an auditor may properly rely a great deal on inquiries made and explanations sought of the company's staff and management at the appropriate level but, prima facie, this is in aid of his vouching and checking procedures and not in substitution for them. In appropriate cases it may be reasonable to go no further as a result of an explanation, even although there are other documents that could be inspected. In the case of decisions on isolated matters, in an otherwise regular situation, he thought one should be slow to criticise the auditor's decision. A non-executive director is much more able to rely on information given or supplied by management. There is not the same duty to check and to vouch the information supplied by management. If management is seen to be trustworthy and reliable, then directors may proceed on that hypothesis. That is not the case with auditors whose function is truly to check.

The difference is brought ~~out~~ by the example given by Romer J in Re City Equitable Fire Insurance Co Ltd [1925] Ch 407. A question arose concerning a material deed of collateral security for a loan made by the company to its general manager which the chairman of directors assured the auditor, contrary to the fact, was held in the company's safe. Although Romer J held the auditor justified in accepting the assurance of the chairman on other matters, because of a justified belief in his trustworthiness, he held the auditor's duty was to inspect the deed for himself. The assurance of the chairman was no excuse for failure of the auditor to perform the prima facie duty to inspect. This conclusion was confirmed on appeal. In contrast, non-executive directors are entitled to rest on the assurance of the chairman without the need to check.

The reason for the difference is functional. It is well brought out in an article by Professor Redmond ("The Reform of Directors' Duties" (1992) 15 UNSWLJ 86.) The author in turn draws heavily from Professor Eisenberg, a leading US authority in the field. If the author will forgive me for borrowing a large passage from his article (p 107):-

> "This formulation casts directors in the role not of managers but of monitors with an obligation to oversee the conduct of the corporation's business and, for that purpose, to take reasonable steps to keep abreast of the information that flows to the

board as a result of monitoring procedures and techniques:

> 'Typically, the duty to monitor is satisfied not, or not primarily, by direct observation, but by installing or reviewing the adequacy of information systems by which salient information concerning the conduct of a corporation's business will flow to the board, or to reliable executives or third-party professionals acting on the corporation's behalf and subject to the ultimate responsibility of the board' (Eisenberg)

The duty to monitor, rather than to manage, becomes part of the general duty of care applicable to different corporate types and distinct director and officer roles. Thus in <u>Francis v. United Jersey Bank</u> [87 NJ 15; 432 A2d 814 (1981)] the New Jersey Supreme Court imposed negligence liability upon a non-executive director in a family company who had taken no steps to oversee the management by active directors who had comprehensively misappropriated moneys belonging to clients of the corporation. The court held [p 822]:

> 'Directors are under a continuing obligation to keep informed about the activities of the corporation. ... Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements.
> Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. Thus, if Mrs Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to staunch the flow of blood.'

> The second specific element of the duty of care under the American Law Institute formulation is a duty to follow up reasonably on information that has been acquired and which should raise cause for concern. This obligation (the duty of inquiry) is in addition to the oversight obligation. Unlike that obligation, however, it is engaged only by some information or event triggering the obligation. It arises thus:
>
> > 'the duty [of care] includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefore. The extent of such inquiry shall be such as the director of officer reasonably believes to be necessary.'
>
> This duty of inquiry will in the ordinary instance be triggered by information acquired under procedures and systems established to ensure compliance with the directors' oversight obligation."

The consequences of the corporate excesses and collapses of the 80's are slowly working their way through the courts. On the civil side the most obvious manifestation has been the rash of actions against the auditors of failed companies and companies which suffered huge losses. It may be said that this is nothing new. The litigation against the auditors of <u>Cambridge Credit</u> in respect of accounts for the early 70's stands as mute testimony for the proposition that an auditor has for long been a readily identifiable likely target following upon corporate collapse, or a large corporate loss. Nonetheless, the very size and number of the claims made pose in more acute form than ever the question of proper allocation of liability for a failure by a number of organs of corporate government to exercise proper control over the conduct of the companies' business and its finances and ultimately to alert shareholders to the facts which eventually led to financial disaster.

It is easy enough to understand why the auditor has always been a readily identifiable defendant in litigation of this kind. The auditor was the only likely defendant carrying sufficient insurance to make it likely that a verdict would be satisfied in an amount approaching the quantum of the loss.

Whilst the likely absence of insurance, or insurance in a sufficient amount, may explain why the auditor is nominated by the plaintiff as the sole defendant, it does not explain why, in the past, auditors failed to join in the action the directors and perhaps some members of senior management of the company who failed to put in place the necessary control and safety measures to avoid the loss occurring and failed to detect the defalcations and misdeeds which caused the loss. Again, it was received wisdom that, no matter how neglectful of the affairs of the company the directors and management may have been, thereby facilitating, or allowing the loss to occur, the company was free of all blame and could recover damages in full without any discount for the negligence of its directors and officers. It is necessary to take a fresh look at the whole problem of the inter relationship between the duties of directors, management and auditors.

Whilst I do not intend to revisit the features of this problem which I have discussed in AWA, it is appropriate that I make one point. Following the judgment in AWA some commentators believed that it embraced a relaxation of directors' duties as exemplified in some recent decisions in other courts. That belief is dangerous and should be dispelled. The efforts of judges in Victoria and South Australia to highlight the need for directors to take an active interest in the activities and financial affairs of their companies is in no way cut down by anything that was said in AWA. The non-executive directors of that company did take steps to lay down a policy and, on at least two occasions, interviewed the auditors with respect to the financial ventures. They were not the passive sleeping directors in Morley and Group Four nor did they fail to have regard to what the auditors told them as did Mr Eise. The recognition in AWA, that in a large company, day-to-day decision making belonged to management had nothing to say to the affairs of the tobacco business under consideration in Morley.

The shareholders of the company are in truth and in law its owners. However, they are too numerous or, in the case of institutional shareholders, too passive, or in the case of others, too unskilled, to carry out the day-to-day management of their company. Customarily by the

Articles of Association the responsibility for that day-to-day management of the company is entrusted to its directors.

The truth of the matter is that, in any reasonable sized company today, the directors are unable to carry out the day-to-day management of the company either. That is a task which is more often than not carried out by senior management and those below them. The executive directors maintain, or at least should maintain, an overall supervision of management but non-executive directors fulfil a very different task altogether. In these circumstances it becomes more important than ever that the shareholders receive an additional measure of protection. It is in a sense a paradox that although it would be an undoubted fact that the non-executive director of today devotes considerably more time and energy to the affairs of the company than the directors of yester-year, and may I say, in so doing, simply responds to the dictates and requirements of the law, they have less opportunity of obtaining a detailed knowledge of the company's activities by reason of the very magnitude and far-flung operations which many of them carry on.

Interestingly, the point about the importance of management was brought out by Moffitt J in <u>Pacific Acceptance</u> but appeared to be overlooked by Lord Oliver in <u>Caparo.</u> Moffitt J pointed out that auditors are appointed to safeguard the interests of the shareholders and to check on the directors, <u>and through them, on management</u>. Auditors cannot properly perform an audit without communication from and to management in appropriate cases. The auditors perform their duty to the company and safeguard the interests of the shareholders by making the communication, properly called for, to the appropriate level of management, or the directors, during the course of the audit with an appropriate report to the shareholders at the annual general meeting.

Liability for negligent acts is regarded as a means of shifting a loss from one who suffered it originally to another or others. It is not often that judges recognise this function of the law as openly as Mr Justice Richardson did in <u>Gartside v Sheffield Young & Ellis</u> 1983 NZLR 37, who said:-

> "In so far as an action in negligence may be viewed in social terms as a loss allocation mechanism there is much force in the argument that the costs of carelessness on the part of the solicitor causing foreseeable loss to innocent third parties should in such a case be borne by the professionals concerned for whom it is a business risk against which they can protect themselves by professional negligence insurance and so spread the risk rather than be borne by the hapless individual third party."

Unfortunately, even where insurance is available lower levels of cover and higher deductibles mean that in the event of liability even an insured defendant is faced with increasing costs at both ends of the claim.

Viscount Simmonds, repeatedly, said that insurance has no bearing on the imposition of liability. (Davey v New Merton Board Mills 1959 AC 604, 627; Lister v Romford Ice and Cold Storage Co Ltd 1957 AC 555, 572). Whilst legal orthodoxy is undoubtedly on his side it would be idle to assert that judges are unaware of the fact that the defendants are insured, particularly against third party traffic risks, and just as futile to pretend that the law has not altered to take into account the spreading of insurance. In the United States, courts have gone even beyond such simple awareness and many courts and commentators would agree that, if loss distribution, rather than deterrence, is the principal aim of the law of torts, the lack of insurability should be considered an important factor in its own right as a reflection of the difficulties that face enterprises forced to become self insurers, by the unavailability of insurance on the market. This open approach has yet to acquire respectability and acceptance in Australia although many of the controversial cases lend themselves very easily to such an analysis. The lecture by Chief Justice Mason to which I have earlier referred makes a strong case against taking economic considerations into account.

The modern tendency of the Cour de Cassation in France to make where possible each and every member of a group liable in solidum for the damage caused by one of them who cannot be discovered can ~~also be~~ attributed to modern insurance practice. Originally none of the members of the group was held liable and this was explained by reference to the theory of causation which prevailed at that time. Then the courts changed their policy and had recourse to a multitude of causal and non-causal concepts to justify this change. It is only rarely however that one finds an open allusion to the insurance factor which must have played a dominant role in this judicial turn about. An example is the case where it is impossible to discover which of a group of hunters caused damage. Where they are not covered by private insurance they will all be made liable. Before this principle came in, two hunters insured with the same insurance company, negligently discharged their guns but only one pellet hit the victim. Since it was impossible to discover from which gun it had come the court, ignoring the tendency prevailing at the time to hold both defendants responsible, refused to hold either of them liable to the plaintiff. Nevertheless it obliged their common insurer to indemnify the victim in the amount specified by the terms of the insurance contract most favourable to the insurer. The plaintiff was thus compensated even though neither of the defendants was held liable for his hurt.

Rush Factors Inc v Levin 284 F. Supp 85 (1968) shows that American courts have economic considerations very much in mind. Thus the court asked rhetorically (p91), is not the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession which can pass the cost of insuring against the risk on to its customers who can in turn pass the cost on to the entire consuming public?

The criterion of liability is the existence of a finding of fault. Because of the requirement to find fault the purpose of an award of damages includes compensation, punishment, deterrent, prevention of unjust enrichment, allocation of moral blame, distribution of losses, and minimisation of risks. It is a fundamental concern of the common law that a plaintiff should be able to recover the full amount of his or her loss, any possible unfairness to defendants being subordinate to the principle. Traditionally compensation of a plaintiff has been regarded as of paramount importance. Civil damages are designed to restore the plaintiff to the same position enjoyed before the defendant's wrongful act was committed. This generalisation of course is misleading if taken too far. Professors Kornhauser and Revesz (<u>Sharing Damages Among Multiple Tortfeasors</u> 89 Yale L.J 831 (1989)) give the example of a constructor who builds a dam 90ft high when 100ft was required. The constructor is liable only for losses caused by floods that would have been prevented by a 100ft dam. There is no obligation to pay for losses caused by floods that would have occurred even if the dam had been 100ft high.

The process of arriving at compensation is beset with two grievous burdens. First, as a general rule the plaintiff has to show some "fault" on the part of the defendant. The community and transactional costs of that exercise are getting to be such that the whole principle should be re-submitted to questioning. The determination of the amount of the compensation again proceeds on a false assumption. There is no scientific measurement of the appropriate amount yet the inquiry proceeds as though there was. On these difficulties the law has encrusted further refinements which, in many ways, today lie at the heart of the problems of loss allocation.

As the standard of the hypothetical reasonable man became the yardstick of comparison the study of the law of negligence was transformed into the study of the type of mistakes the reasonable man would not be allowed to make. This was a significant change of emphasis. Not only were the standards becoming more and more difficult to attain, fault was also increasingly confused with error. Such confusion however is conceptually unfortunate, for fault presupposes, or in its original sense presupposed, the choice whereas many of the errors which our courts treat as faults are inevitable and unavoidable. For example a study conducted by the Department of Transportation of the USA has shown that in Washington a "good driver" ie one who has not committed an accident in the preceding four years commits on average more than nine errors of four different natures in five minutes of driving. In these instances this type of inevitable error makes a moral and educational value of a fault based system meaningless insofar as it makes people responsible for faults for which they cannot be reproached. But the confusion of the two concepts is not only intellectually untidy it has other disadvantages as well. For one thing it weakens the limiting ability of the notion and so puts extra and often unwarranted pressure on the other elements of liability. For another it lays upon the courts the often difficult and always expensive task of having to decide issues which do not call for legal but wider policy reasoning. The English Court of Appeal in Whitehouse v Jordan 1980 1 AER 650, a medical negligence case, paid great attention to the wider repercussions of the tendency to equate negligence with error. Whilst deserving plaintiffs are assisted it also encourages inaction on the part of doctors fearful that the slightest error might attract the full rigour of the law. It also increases insurance premiums which in turn affect the quantum of some of the awards.

In Rosenblum v Adler 461 A 2nd 138 (1983) the New Jersey Supreme Court took account of the fact that accountants were able to obtain insurance against third party claims under Federal Securities laws and considered that the same or similar protection would be available for common law negligent misrepresentation claims in the context of coming to the view that there should be liability for negligent misrepresentation by auditors vis-a-vis purchasers of stock. Further the court said (p152):-

> "The imposition of a duty to foreseeable users may cause accounting firms to engage in more thorough reviews. This might entail setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue. Much of the additional cost incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers."

In the <u>Citizens State Bank v Timm Schmidt & Co</u> 335 N.W 2d 361 (1983) the Wisconsin Supreme Court said (p365):-

> "If relying third parties, such as creditors, are not allowed to recover, the cost of credit to the general public will increase because creditors will either have to absorb the cost of bad loans made in reliance on faulty information or hire independent accountants to verify the information received. Accountants may spread the risk through the use of liability insurance."

Academic writers have questioned the court's view that such liability will have a significant deterrent effect and that it will improve the quality of audit reporting.

The majority in <u>Bily v Arthur Young & Co</u> pointed out that there was no empirical data supporting these prognostications (p 54). They doubted that a significant and desirable improvement in audit care would result from an expanded rule of liability.

It is self evident that the acts, or omissions, of two or more persons may give rise to the same loss or damage. These persons may all be defendants, or they may include a plaintiff who is partly responsible for its own loss. The present law is unsatisfactory in a number of respects. This is due partly to the piecemeal fashion in which the law has evolved.

Initially, negligence on the part of the plaintiff was sufficient to doom any proceedings to fail. It is only within the last fifty years that legislation was introduced to allow for an apportionment of fault as between a plaintiff and a defendant. That however still left intact the difficulties posed where there was more than one wrongdoer on the defendants' side of the record.

Initially, if a plaintiff chose one wrongdoer as a defendant, without claiming against any of the others, and the wrongdoers were jointly and severally liable, not only was the plaintiff entitled to recover from that defendant the whole of the damage suffered, but as well, that defendant was unable to obtain any contribution from any of the other wrongdoers. Once again, it was only in the last fifty years that injustice was cured by legislation. Unfortunately, the remedial legislation is defective in a number of respects. For one, contribution may only be recovered from other tortfeasors, not from those who have committed a breach of contract. That difficulty could be readily overcome by legislation if so desired.

One unfortunate feature of actions for contribution, in some cases, is that the very multiplicity of parties may make settlement more difficult. It requires only one stubborn defendant to ensure what may be a long and expensive hearing has to be undertaken notwithstanding the willingness of all other parties to settle.

The common law found difficulty in apportioning blame. It regarded a shared liability as an indivisible obligation. Those who shared the obligation were each fully responsible for the entire loss. In the case of both joint, and joint and several liability, the concurrent wrongdoers were said to be liable in solidum. Each of the wrongdoers was responsible for the whole of the damage. The plaintiff could therefore enforce judgment against whichever defendant the plaintiff chose. In practical terms, one defendant might be made to pay the entire award, while another escaped scot free. This rule remains a fundamental of the law of civil liability.

Self evidently, a plaintiff will always choose a defendant against whom it is easiest to prove a case, and as well, a defendant who has a deep pocket. Although this defendant may be entitled to seek, and recover, contribution from other wrongdoers in tort, that will be little consolation if the other wrongdoers do not have the where-with-all to satisfy a verdict. In other words, the defendant may be forced to pay the whole of the amount of the verdict to the plaintiff and be unable effectively to recover from all or any of the co-wrongdoers. It is difficult to understand why, as a matter of simple justice, the burden of poverty stricken wrongdoers should be left to be carried entirely by a defendant, whilst the plaintiff recovers in full. This apparent injustice is aggravated where the degree of fault of the defendant, as contrasted with those of other concurrent wrongdoers, is relatively minor. To illustrate the point, let it be assumed that a plaintiff is taken to hospital where he undergoes an operation in which numerous doctors and nursing staff participate. The operation is not a success. The CAT scan which had originally been carried out was not properly executed, the operation was planned on an incorrect basis, the inaccuracy of the result of the CAT scan was not identified by any of the participants in the operation. Furthermore the administration of the anaesthetic during the operation was also inefficient and contributed to the patient's demise. Assume that none of the doctors are insured. The estate of the deceased patient sues the hospital on the basis that it was responsible for the acts of omission and commission of the nursing staff. One would imagine that the degree of fault to be attributed to the nursing staff and therefore to the hospital, would be minor compared to that of the various doctors concerned. Yet, in the scenario contemplated, the whole of the loss may be left with the hospital, or rather, its insurer. Such a result would fail to accord with elementary notions of justice.

I have deliberately chosen an illustration away from the field of discussion. That was for a number of reasons. One of them was simply to illustrate the universality of the problem. It is intended to demonstrate that there is an acute need for reconsideration of the rule of solidary liability. That has been recognised by the fact that the subject has been considered by the Law Reform Commissions of Ontario in Canada, in England and in Scotland, in New South Wales, and in New Zealand. A great deal of what has gone before comes from the through Discussion Paper that Commission has issued. No recommendation has yet been put forward by any of these bodies to resolve the operation of the rule of solidary liability. That is because the nature of fault and responsibility, as well as the objectives of the common law system of civil liability, excite fundamental, philosophical, questions which the community does not appear to be ready to tackle. It is only necessary to point to the fate of the recommendation for no fault liability in accident compensation to vindicate the proposition just put. Yet, the questions posed are in many ways at the heart of the difficulties confronted by auditors.

As Fleming put it (<u>The Law of Torts</u> 7th Ed p 243), it was only in the middle of this century that the "inveterate predilection of the common law mind for assigning occurrences to a single responsible cause" was replaced by a recognition that responsibility for so-called indivisible losses should be apportioned when that would promote the ends of justice.

It has been recognised by many judges, and all the Law Reform Commissions around the world which have addressed the problem, that the mechanisms of apportionment and contribution, both between defendants and in respect of the plaintiff's responsibility for a loss, are inadequate. The New Zealand Law Commission raised a question very pertinent to the position of auditors in its Preliminary Paper No 19 intituled "Apportionment of Civil Liability" where it said (p16):-

> "Are there circumstances where one person's obligations to another are such that the latter is not expected to take any active step to look after his or her own interests, but instead is entitled to rely entirely on the first party's behaving in a certain manner?"

The Commission asserts that examples it gives "demonstrate that the current rule in relation to the effect of plaintiff fault are more dependant on categorisation of the cause of action than any coherent policy based on notions of causation or fairness." (p17).

With the exception of British Columbia, all Commonwealth jurisdictions deriving their legal systems from England, have retained, in some case on the recommendations of Law Reform Commissions which examined the question, the joint and several liability rule. In the United States a different view has recently prevailed. This change occurred between 1976 and 1987. Thirty three States had either abolished or substantially limited in solidum liability, either by legislation, or by judicial decision. In some case, the abolition was only in respect of non economic losses. In other cases, the abolition or modification was with respect to particular deep pockets such as local authorities or certain professionals. In yet another category, there was a retention of joint and several liability, but abolition where the plaintiff's fault exceeded a specific degree for example, fifty percent, or greater than the fault of each defendant. The most far reaching change is a system of several liability under which each defendant bears only its own proportion of the plaintiff's damage. The practical divisibility of losses is acknowledged in contribution and in reduction of damages for contributory fault. Under this system it is the plaintiff who bears the loss of an insolvent or unavailable defendant in multiple party claims as indeed the plaintiff has to do at the present time where there is only one defendant. It is right to point out that notwithstanding the apparent fairness of the system of several liability no

Law Reform Commission has recommended that a change to it should be made.

Whilst it may seem more fair that a wrongdoer be made responsible for a proportionate share only of the plaintiff's loss, that may be unfair to the plaintiff, and it is arguably inefficient in that it may require assessment of the share of liability of the wrongdoer who is not before the court, and re-assessment of that apportionment at a later time.

I have earlier said that a number of Law Reform Commissions including the New South Wales Law Reform Commission have conducted inquiries into the problems of joint and several liability. Due to lack of resources that inquiry has not to date been completed. It cannot be cost effective that inquiries into the same topic, in similar legal systems, should be conducted independently in various countries. Surely the sensible course is to recognise that there is a problem in all common law countries and to pool resources to arrive at the most sensible solution.

In New South Wales, it is proposed to take a bludgeon to one aspect of the problem I have been discussing in the form of the Professional Liability Bill 1992. An earlier version lapsed when Parliament was prorogued. It is proposed to introduce the new Bill shortly. In essence, what the proposed Act does is to put a cap on the entitlement of a person who has suffered loss as a result of the negligence of a professional person. Thus, there will be no curial determination of what damage had been suffered by the plaintiff, if it passes the limit specified. That will certainly remedy the situation from the point of view of the professional person, for present purposes, the auditor. However it may mean that badly damaged clients will be left without a remedy. This approach clearly fails to bring any finely honed principle of fairness to the solution of the problem. As well, it invites avoidance and evasion, which will be clearly available to ingenious legal minds. The principle of capping damages was submitted to critical analysis by Monroe and Wellington, "An Analysis of the Effects of Limiting Auditors' Liability; A Laboratory Investigation Using Experimental Markets." Their conclusion was that a limited liability rule resulted in a significant increase in the number of instances where an audit service below a due standard was delivered. Of course the authors were handicapped by the fact that the conclusions were based on sparse material and on contracting theory and experimental economics. The authors concede the room for error due to a number of factors. Nonetheless the conclusion should serve as a warning even to the intended beneficiaries. I would suggest that a review of principles of comparative fault are far more likely to yield a fair result than the artificial capping of liability, disabling a plaintiff from recovering full compensation.

There is another problem with the proposed Bill which I mention with some hesitation. A cornerstone of the scheme is compulsory insurance to ensure that a successful plaintiff does in fact receive the money which it is permissible to award. There are now a rash of disputes before the courts where directors, involved in legal proceedings of one kind or another, arising from their office as directors, have found their insurers disclaiming liability. The disclaimer is based on alleged non disclosure, not by the directors concerned, but by other directors whom the same policy purports to cover. It would be the ultimate irony if a plaintiff, having obtained the maximum permissible under the proposed Act, were then to fail to recover even that amount. I see no reason why the same problems might not apply to auditors as well.

In what I said I have been endeavouring to identify some areas for concern. I can only conclude, as I have begun. Clearly there are problems that need resolution and a failure to confront them in the near future will be bad for auditors as a profession, company directors as a class but most importantly for the commercial community whose activities they support.

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