

# THE RATIONALE FOR THE RECOVERY OF ECONOMIC LOSS IN NEGLIGENCE AND THE PROBLEM OF AUDITORS' LIABILITY

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*[This article reassesses the system of liability that is applicable to auditors. The argument developed in this article is made up of three steps. The first step involves an analysis of the evolving principles defining the basis for recovery of pure economic loss for negligent misstatement. The conclusion to this analysis is that there is a tentative recognition of a new model of legal responsibility that can provide an equitable and rational basis for the recovery of pure economic loss in the tort of negligence. The second step is to show that the system of liability applicable to auditors is the result of the interaction of the tort of negligence with the statutory scheme regulating the disclosure of financial information by companies. The conclusion to this step in the argument is that the problem of excessive levels of liability is the result of the interaction of these two bodies of law. The third step in the argument is that in order to produce a system of liability for auditors, in which there is a rational connection between fault and liability, there must be a modification of the way in which the tort of negligence interacts with the statutory scheme regulating the disclosure of financial information. It is argued that reform of the law should produce a system of liability which has two characteristics. The first is that the system of liability should be formulated with reference to the actual services provided by auditors. The second characteristic is that the resulting system of liability should produce outcomes which are consistent with the effective regulation of companies and securities markets.]*

Introduction .....	815
I Recovery for pure economic loss in the tort of negligence.....	821
A The problem of defining the 'damage'.....	822
B Reliance and the definition of the 'damage' ....	827
C Assessment of damages .....	834
D Conclusion .....	839
II Auditors' liability.....	841
A Is there a problem with auditors' liability? .....	843
B Disclosure of financial information required by the Corporations Law.....	845
C The nature of the services provided by auditors in the statutory scheme of disclosure.....	849
D The system of auditors' liability .....	853
E Conclusion .....	860
III A proposal for reform .....	862
A Proposal to re-define the 'damage' .....	864
B Assessment of proposal for reform .....	865
C Conclusion .....	866

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## INTRODUCTION

One of the most controversial issues giving rise to debate in the law of torts is that of the level of liability of professionals.<sup>1</sup> Amongst the professions generally there is an increasing awareness of the presence of the law of tort. With this increasing awareness has come a substantial body of criticism concerning the level of liability imposed on professionals.<sup>2</sup> Often the criticism is in the form of the claim that the intrusiveness of the law of tort has led many professionals to adopt defensive practices with the intention of avoiding liability.<sup>3</sup> This criticism is also made in the related form that tortious liability has caused major disruption to the insurance markets resulting in either the lack of availability of insurance or to an increase in the cost of insurance.<sup>4</sup>

The concern about the level of liability imposed on professionals is one of the issues which has encouraged a substantial body of academic literature to question the overall rationale of the law of tort.<sup>5</sup> In addition to this very wide

<sup>1</sup> See, eg, Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, Inquiry established by federal A-G, Mr Michael Lavarch, and NSW A-G, Mr John Hannaford (1994) ('Report of Stage One, *Inquiry into the Law of Joint and Several Liability*') (Report of Stage Two of the Inquiry was released on 3 February 1995); NSW A-G's Department, Issues Paper, *Tort Liability in New South Wales* (1989); NSW A-G's Department, Issues Paper, *Limitation of Professional Liability for Financial Loss* (1989) ('Issues Paper, *Limitation of Professional Liability*'); NSW A-G's Department, Discussion Paper, *Professional Liability, Regulation, Insurance and Risk Management* (1990) ('Discussion Paper, *Professional Liability*'); Companies and Securities Law Review Committee, *Report to the Ministerial Council on the Civil Liability of Company Auditors* (1986) ('*Civil Liability of Company Auditors*'); Cth Department of Human Services and Health, *Compensation and Professional Indemnity in Health Care — An Interim Report* (1994) ('*Compensation and Professional Indemnity in Health Care*').

<sup>2</sup> See Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, above n 1, 8-12; see also, eg, *Compensation and Professional Indemnity in Health Care*, above n 1, para 8.104: 'It is certainly the case that over the last five years there has been a dramatic increase in the subscription rates paid to MDO's by many Australian doctors'; Carolyn Sappideen, 'Look Before You Leap: Reform of Medical Malpractice Liability' (1991) 13 *Sydney Law Review* 523, 523-8 (moderate level of increase in number and severity of claims).

<sup>3</sup> See, eg, Issues Paper, *Limitation of Professional Liability*, above n 1, para 5.2.2: defensive practices of professions generally; *Civil Liability of Company Auditors*, above n 1, para 104: defensive practices of auditors; *Compensation and Professional Indemnity in Health Care*, above n 1, paras 6.38-6.41: changes in the practice of providing information to patients in response to, amongst other things, fear of litigation; Sappideen, above n 2, 541-2: medical practitioners.

<sup>4</sup> This is a highly contentious subject of debate: see generally George Priest, 'The Current Insurance Crisis and Modern Tort Law' (1987) 96 *Yale Law Journal* 1521; Werner Ebke, 'In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities' (1984) 79 *Northwestern University Law Review* 663, 680-93; but see Steven Croley and Jon Hanson, 'What Liability Crisis: An Alternative Explanation for Recent Events in Product Liability' (1990) 8 *Yale Journal on Regulation* 1. See also Issues Paper, *Limitation of Professional Liability*, above n 1, para 4.3: 'It would appear that there has been a serious decrease in the level of professional indemnity cover offered while at the same time there has been a substantial increase in the premiums and deductibles.'; Discussion Paper, *Professional Liability*, above n 1, para 1.7; *Compensation and Professional Indemnity in Health Care*, above n 1, paras 8.104-8.111: rising costs of subscription to MDO's for doctors may be explained by reference to a number of factors other than an increase in the levels of litigation; *Civil Liability of Company Auditors*, above n 1, paras 103-6.

<sup>5</sup> See, eg, Leslie Bender, 'An Overview of Feminist Torts Scholarship' (1993) 78 *Cornell Law Review* 575; Nancy Weston, 'The Metaphysics of Modern Tort Theory' (1994) 28 *Valparaiso University Law Review* 919; Izhak Englard, *The Philosophy of Tort Law* (1993); Stephen Perry, 'The Moral Foundations of Tort Law' (1992) 77 *Iowa Law Review* 449; Richard Abel, 'Torts' in David Kairys (ed), *The Politics of Law: a progressive critique* (1990); William Landes and

ranging debate there have been a number of proposals to reform the law of tort by placing limits on the level of damages for which professionals are liable.<sup>6</sup> These proposals have generally been concerned to overcome practical problems such as the prevalence of defensive practices or the costs of insurance.<sup>7</sup> The primary argument in this article is that these practical problems are signs of significant inadequacies in the system of liability applicable to auditors.

This debate concerning the appropriate levels of liability for various professionals centres around a very old problem in tort law.<sup>8</sup> This is the problem of providing an explanation for the relationship between a person's acts and that person's legal liability to pay damages for the losses caused by those acts. The general rationale supporting a requirement that a person compensate another for the losses caused by that person's acts is that that person was at fault. The problem of ascertaining when a person is at fault and of defining those losses for which that person should be legally responsible is an enduring one that continues to underpin the development of tort law.

In the latter part of the nineteenth century Oliver Wendell Holmes was faced with the fundamental problem of defining the meaning of fault in the context of a changing society in which fault could no longer be defined with reference to particular, recognised standards of morality. Holmes responded to the problem in the following way:

But while the law is thus continually adding to its specific rules it does not adopt the coarse and impolitic principle that a man acts always at his peril. On the contrary, its concrete rules, as well as the general questions addressed to the jury, show that the defendant must have had at least a fair chance of avoiding the infliction of harm before the defendant becomes answerable for such a con-

Richard Posner, *The Economic Structure of Tort Law* (1987); Marc Feldman, 'The Intellectual Ordering of Contemporary Law' (1992) 51 *Modern Law Review* 980; Neil Komesar, 'Injuries and Institutions: Tort Reform, Tort Theory and Beyond' (1990) 65 *New York University Law Review* 23; David Rosenberg, 'The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Torts System' (1984) 97 *Harvard Law Review* 851; Don Dewees and Michael Trebilcock, 'The Efficacy of the Tort System and its Alternative: A Review of the Empirical Evidence' (1992) 30 *Osgoode Hall Law Journal* 57.

<sup>6</sup> See, eg, Professional Standards Act 1994 (NSW) (received Royal Assent on 12 December 1994). The NSW A-G is in the process of establishing the Professional Standards Council. See also Working Party of the Ministerial Council for Corporations, *Professional Liability in relation to Corporations Law Matters* (June 1993); review of law of joint and several liability as an alternative to the capping of liability; *Civil Liability of Company Auditors*, above n 1, 37; capping of liability for auditors; Discussion Paper, *Professional Liability*, above n 1, 2; capping of liability for professionals; Bill Small, 'Limiting Auditors' Liability' (1994) 3 *Butterworths Corporation Law Bulletin* 46.

<sup>7</sup> See, eg, Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, above n 1, 8-11, 26-7; Discussion Paper, *Professional Liability*, above n 1, paras 1.7-1.12; 2.1-2.8; *Civil Liability of Company Auditors*, above n 1, paras 257-62;

<sup>8</sup> Cf Peter Cane, *Tort Law and Economic Interests* (1991) 10: 'The basic aim of this book is to examine the law of tort to see in what ways and under what circumstances it protects and vindicates economic interests'. This project is fundamentally different to the one proposed in this article. While Cane has set out to give an exposition of the law, this article, without the same breadth and depth of coverage, identifies one of the themes in the current law and argues that this is the way in which the tort of negligence should develop. The former project requires an analysis of all of the approaches to protecting economic interests. While Cane sets out to identify the existing boundaries between the law of tort and other categories of law, this article puts forward a principled way of defining the boundaries of the tort of negligence.

sequence of his conduct. And it is certainly arguable that even a fair chance to avoid bringing harm to pass is not sufficient to throw upon a person the peril of his conduct, unless, judged by average standards, he is also to blame for what he does.<sup>9</sup>

The connection between fault and liability that was proposed by Holmes was an objective standard in two senses. The first sense was that a defendant should only be liable for those consequences which he/she could have avoided. Underlying this proposition was the assumption that it was possible for the observer to predict the nature of the harm which would be produced by specific acts. Holmes argued that 'the known tendency of the act under the known circumstances to do harm may be accepted as the general test of conduct'.<sup>10</sup> The second sense was that the conduct had to be wrong as judged by 'average standards'. Both the predicability of events and the possibility of making judgments based on 'average standards' were central to establishing the connection between the defendant's fault and the particular consequences for which the defendant would be liable.

In the late twentieth century it is no longer possible to use such notions of objectivity to give content to a conception of fault. The degree of predicability of events underlying Holmes' 'general test of conduct' is no longer an accepted part of the way in which it is possible to know or understand the world. It is no longer possible to accept that any form of knowledge has an ultimate grounding in truth or reality. In the place of knowledge supported by an objective reality there has been a multiplication of ways of knowing and understanding the world.<sup>11</sup> The immediate consequence of the rejection of this notion of 'objectivity' is the relative difficulty in defining when a person should be responsible for his/her acts.<sup>12</sup> Nor is it possible to rely on a notion of 'objectivity' defined in terms of 'average standards' to define the standards of conduct to determine whether a particular person is at fault, and hence legally responsible, for the losses caused by that person's acts. Rather, there has been a general recognition of a need for law to be responsive, or to embody 'reasonable

<sup>9</sup> Oliver Wendell Holmes, *The Common Law* (M DeWolfe Howe (ed) 1963) 129.

<sup>10</sup> *Ibid.*

<sup>11</sup> See, eg, Margaret Davies, *Asking the Law Question* (1994) 226. In describing the impact of postmodernist philosophies, Davies argues that:

The point of all of this is that Lyotard points out that in the latter half of this century there has been a loss of faith in the idea of a "metanarrative". Appeal to a higher, universal, domain of thought is no longer seen as an effective or necessary way of validating knowledge. There has been a multiplication of methods, of forms of knowledge, and of technologies, as well as a collapsing of the traditionally clear boundaries between areas of scientific investigation, giving us a glimpse of a potentially infinite number of new areas of thought.

<sup>12</sup> In the provision of medical services it is accepted that the current state of knowledge only makes it possible to say with a specified degree of probability that particular acts will produce particular results. As is well known this has produced a wide ranging debate about the capacity of the law of tort to operate in this area with any degree of justice and fairness: see, eg, *Compensation and Professional Indemnity in Health Care*, above n 1; Sappideen, above n 2. See also Elizabeth Adeney, 'The Challenge of Medical Uncertainty: Factual Causation in Anglo Australian Toxic Tort Litigation' (1993) 19 *Monash University Law Review* 23; *Hotson v East Berkshire Area Health Authority* [1987] 1 AC 750: the use of probabilistic measures to overcome uncertainty in the context of the provision of health care.

standards of fairness or fair dealing in our relationships and dealings with others'.<sup>13</sup>

A response to the problem of determining appropriate levels of liability for professionals therefore requires the development of an understanding of a new model of legal responsibility which is not dependent upon either of these notions of objectivity. This is central to the recognition of pure economic loss as an actionable head of damage because the characteristic feature of pure economic loss as a form of harm is that a person's acts may bear an indeterminate relationship with the consequences of those acts. The central thesis of this article is that there is the tentative recognition of a new model of legal responsibility. It is a relational or constitutive model of legal responsibility. One author has described a constitutive model of responsibility as one where 'the ascription of responsibility ... is a two-sided operation oriented simultaneously toward both the object and the subject of responsibility'.<sup>14</sup>

It is the central argument of this article that in the tort of negligence there is the tentative development of a relational model of legal responsibility through a recognition that the elements of the tort of negligence are inter-dependent.<sup>15</sup> In particular that, where the harm caused is pure economic loss, the identification of the 'damage', which is the gist of the action, is dependent upon the characterisation of the duty of care. The identification of the 'damage' is in this sense dependent upon the characterisation of the specific risk or harm which the plaintiff and the defendant both understand to be the object of the duty of care. The recognition that the elements of the duty of care and the identification of the 'damage' are mutually inter-dependent is one way of establishing a rational

<sup>13</sup> Paul Finn, 'Statutes and the Common Law' (1992) 22 *University of Western Australia Law Review* 7, 16. The recognition of the need for law to be responsive has been a pervasive part of the debate about the most effective approaches to regulation of human conduct: see, eg. Ian Ayres and J Braithwaite, *Responsive Regulation Transcending the Deregulation Debate* (1992). For a specific instance of the rejection of the use of 'average standards' as the sole basis for the determination of the standard of care in the tort of negligence, see *Cook v Cook* (1986) 162 CLR 376.

<sup>14</sup> Meir Dan-Cohen, 'Responsibility and the Boundaries of the Self' (1992) 105 *Harvard Law Review* 959, 964. This article argues that it is necessary to develop a new paradigm of responsibility. Dan-Cohen argues (959-60) that the constitutive paradigm is an alternative paradigm of responsibility to the dominant conception of responsibility which he calls the free will paradigm. The free will paradigm, according to Dan-Cohen, is founded on a practice of 'blaming' that is supported by an assumption of 'the agent's capacity to choose her actions freely'.

<sup>15</sup> There is sufficient common ground between actions brought under the Trade Practices Act 1974 (Cth) or under the various Fair Trading Acts and those brought in the tort of negligence for the general analysis developed in this article to apply equally to both forms of action. In an action under s 52 it is necessary to establish that the particular statement or conduct is misleading and deceptive to a particular section of the public: see Russell Miller, *Annotated Trade Practices Act* (15th ed, 1994) para 815.30. Where the misleading or deceptive conduct is in the form of a prediction or opinion the plaintiff will have to establish that the prediction was made in circumstances where the maker of the statement had 'no reasonable grounds for the belief'. In an action for damages it is necessary for the plaintiff to establish that the plaintiff suffered loss or damage by relying on the misleading and deceptive conduct: see Miller, para 815.68. Finally, the measure of damages in an action brought under s 52 will be that in tort: see Miller, para 1380.35. The combined effect of each of these requirements is that an action for damages brought under s 52 of the Trade Practices Act 1974 (Cth) will be subject to similar limitations as an action brought in the tort of negligence.

connection between fault and responsibility.<sup>16</sup> This is because the characterisation of the defendant's fault and the identification of the harm suffered by the plaintiff are inter-dependent terms and both are defined with reference to the relationship between the plaintiff and the defendant.

One particular consequence of the recognition of this model of legal responsibility is of immediate relevance and significance to the argument developed in this article. This is the importance of distinguishing between a plaintiff's total loss and the 'damage' which would be the basis for the plaintiff's action in tort. A plaintiff may have several causes of action arising out of the single loss. This is because the 'damage' will be defined with reference to the duty of care owed by the defendant to the plaintiff. Each defendant would therefore be responsible for the particular 'damage' caused by that defendant's breach of duty. This means that it would not be possible for a number of defendants to be jointly and severally liable for the 'damage' sustained by the plaintiff.<sup>17</sup>

This analysis of the operation of the doctrine of joint and several liability is quite different to the approach adopted by the Inquiry into the Law of Joint and Several liability. This Inquiry was established for the purpose determining whether it was possible to reform the law of joint and several liability to introduce a system of proportionate liability for those cases where the damage was pure economic loss.<sup>18</sup> A reform to the law of joint and several liability to introduce a system of proportionate liability would require that the plaintiff

<sup>16</sup> This article is based on the proposition that it is important for the law of tort to develop so that there is a 'rational connection between fault and liability'. It is not part of this argument that such a system of liability is the only rational *system* of liability. There are a number of 'rational systems of liability', eg, a scheme of solidary liability in which the defendant chosen by the plaintiff bears the risk of seeking contribution from the other defendants. This is a rational *system* of liability but it would not be one in which there was a rational *connection* between that defendant's fault and liability. The claim in this article is only that the system of liability for professionals should be one that embodies a rational *connection* between fault and liability.

<sup>17</sup> The doctrine of 'solidary' or 'joint and several' liability is that common law doctrine which provides that a plaintiff may recover the full amount of the damages from any one of several concurrent defendants who are each liable to the plaintiff for the same damage: see, eg, Glanville Williams, *Joint Torts and Contributory Negligence* (1951) para 1. The doctrine of solidary or joint and several liability (in which the plaintiff has a separate cause of action against each defendant) has no application to defendants who are *jointly* liable because in this instance a plaintiff only has one cause of action against each of the defendants in relation to the particular damage: see Rosalie Balkin and Jim Davis, *Law of Torts* (1991) 898. There are three categories of joint liability — (1) vicarious liability, (2) where a duty is imposed jointly on two or more persons, and (3) where persons take 'concerted action to a common end'. See also Williams, paras 4-5; NSW Law Reform Commission, Report No 65, *Contribution Among Wrongdoers: Interim Report on Solidary Liability* (1990) paras 11-12; Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, above n 1, 6.

<sup>18</sup> Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, above n 1. The terms of reference were:

To consider whether it is desirable and feasible to alter the present rules on joint and several liability having regard to:

- legislation on proportional liability in Australian and comparable overseas jurisdictions;
- reports recommending for or against an alteration of the rules on liability; and
- other relevant matters.

The inquiry is to consider in particular the issue of professional liability and is not to examine the operation of the rules on joint and several liability in relation to personal injury claims.

recover, as part of a separate action, that proportion of the total loss for which each defendant is individually responsible.<sup>19</sup> It is for this reason that it has been argued that the introduction of a system of proportionate liability would be an effective response to the excessive levels of liability faced by some professionals.<sup>20</sup> This approach does not address the problem of providing a coherent or principled explanation of the way in which the system of proportionate liability will work. It is the central argument in this article that it is not possible to provide such an explanation without considering the underlying basis and rationale for the recovery of pure economic loss in the tort of negligence.<sup>21</sup>

This article is made up of three parts. The first part of the article focuses on the rules defining the recovery of pure economic loss in the tort of negligence. The argument in this part is that the tort of negligence has tentatively recognised a relational model of legal responsibility by recognising that the identification of the 'damage' is dependent upon the formulation of the duty of care. The second part of the article focuses on the system of liability for auditors. The argument in this part is that the source of the disproportionate level of liability imposed on auditors is an inherent flaw that is caused by the failure to define the 'damage' caused by auditors with reference to the nature of the actual services provided by auditors to clients and to third parties. The source of this flaw is the interaction of the statutory regime for the disclosure of financial information with the common law which creates a disjuncture between the formulation of the duty of care and the identification of the 'damage'. This disjuncture between the formulation of the duty of care and the identification of the 'damage' has prevented the use of common law principles and methods to retain a connection between the extent of the auditor's fault and the auditor's liability.

The final part of the article includes a proposal for reforming the system of liability for auditors. The basis for the proposed system of liability for auditors is a change in the definition of the 'damage' that is sustained by a plaintiff as a result of an auditor's negligence. This proposal is formulated with reference to two criteria. The first is that the proposed system of liability must produce outcomes in which there is a rational connection between fault and liability. The second criteria is that the new system of liability created by this change must produce outcomes which are consistent with the effective regulation of companies and of securities markets. There is no claim in this part of the article that the suggested proposal for reform is the only way to comply with these two criteria. However it is argued that the reforms suggested in this proposal do indicate the

<sup>19</sup> Ibid 6. The definition of proportionate liability is in the following terms: 'If parties are regarded as proportionately liable, the liability of each is in all circumstances limited to the extent to which that party is considered responsible for the loss'.

<sup>20</sup> Ibid 8-9; 26-27.

<sup>21</sup> See, eg, *AWA Ltd v Daniels (No 2)* (1992) 9 ACSR 383. In this case the court was required to apportion responsibility between executive and non-executive directors, senior management and the auditors where there had been some failing by all of the parties. Rogers J had great difficulty apportioning responsibility. He stated (399) that '[i]n the circumstances the best allocation I can make as between the plaintiff and the defendants ... is plaintiff 20% and defendants 80%'.

kind of changes which will be required to reform the current system of liability for auditors.

## I RECOVERY FOR PURE ECONOMIC LOSS IN THE TORT OF NEGLIGENCE

This part of the article focuses on the development of the principles in the tort of negligence for defining the circumstances in which a plaintiff can recover pure economic loss. The central theme of this part is that the recognition of the use of a relational model of legal responsibility provides a way of analysing when, and to what extent, a plaintiff should be able to recover pure economic loss in the tort of negligence. In this context the recognition of a relational model of legal responsibility is the recognition that the 'damage', which is the gist of the action in negligence, may be defined with reference to the harm or risk the prevention of which was the object of the defendant's duty of care. It is the recognition of this mutual inter-dependence between the formulation of the duty of care and the identification of the damage which ensures that there is a rational connection between fault and liability. In this sense the overall argument in this part is that a necessary element of a system of liability in which there is a rational connection between fault and liability will be one where each of the elements of the tort of negligence are mutually inter-dependent and are formulated with reference to the particular relationship between the parties.

A broader argument in this part is that the recognition of a relational model of legal responsibility is central to the problem of defining the boundaries of the category of law known as the tort of negligence. A category of law which constitutes a system of liability which exposes defendants to an indeterminate level of liability will necessarily be a category of law which has no clear boundaries. The argument in this part is that there is a limited and defined role for the tort of negligence where the damage is pure economic loss. In this sense the establishment of a rational connection between fault and liability is an essential part of the process of defining the boundaries of the tort of negligence.<sup>22</sup>

This part is made up of three sections. The first section is an analysis of the problem of identifying the damage where the harm caused is pure economic loss. The second section is an analysis of the way in which the identification of the 'damage' is dependent on the precise definition of the duty of care owed by the defendant to the plaintiff. This section focuses on the way in which the definition

<sup>22</sup> See, eg, *Hawkins v Clayton* (1988) 164 CLR 539, 584 (Deane J) (*Hawkins*):

The law of contract and the law of tort are, in a modern context, properly to be seen as but two of a number of imprecise divisions, for the purpose of classification, of a general body of rules constituting one coherent system of law. Where rules classified in different divisions would otherwise conflict or compete, an essential function of the whole system is to avoid, resolve or rationalise such conflict or competition, not to induce or preserve it.

See also David Partlett, 'Roaming in the Gloaming: the Liability of Professionals' (1992) 14 *Sydney Law Review* 261; cf Jay Feinman, 'The Jurisprudence of Classification' (1989) 41 *Stanford Law Review* 661.

of the duty of care and the identification of the damage are mutually inter-dependent elements in determining the nature and extent of the defendant's legal responsibility to the plaintiff. The third section is an analysis of the principles relating to the assessment of damages. The purpose of this section is to establish that the principles for assessing damages may also be treated as being dependent upon both the characterisation of the duty and the identification of the damage. The overall picture is that it is possible to conceive of the tort of negligence as a set of mutually inter-dependent elements which are all defined with reference to the particular nature the relationship between the plaintiff and the defendant.

#### A *The problem of defining the 'damage'*

The traditional set of reasons given for either limiting or not allowing recovery for pure economic loss in the tort of negligence was succinctly expressed by Cardozo CJ in *Ultrameres Corp v Touche, Niven & Co*<sup>23</sup> Cardozo CJ stated that liability for pure economic loss in the tort of negligence had the potential to expose defendants to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate class'.<sup>24</sup> As a statement of the problem it is however an unhelpful one because it provides no focal point for an analysis of the reasons why there are limitations on the right to recover pure economic loss. This part of the article therefore begins with a particular form of indeterminacy as the starting point for an analysis of the basis for the common law's treatment of pure economic loss as a problematic head of damage. The particular starting point is the traditional one in all negligence actions, that is, the problem of defining the damage which is the gist of the action.

In *Mahony v J Kruschich (Demolitions) Pty Ltd*, the High Court defined the difference between 'damage' and 'damages' in the following terms:

In negligence, 'damage' is what the plaintiff suffers as the foreseeable consequence of the tortfeasor's act or omission. Where a tortfeasor's negligent act or omission causes personal injury, 'damage' includes both the injury itself and other foreseeable consequences suffered by the plaintiff. The distinction between 'damage' and 'damages' is significant. Damages are awarded as compensation for each item or aspect of the damage suffered by a plaintiff, so that a single sum is awarded in respect of all the foreseeable consequences of the defendant's tortious act or omission.<sup>25</sup>

The identification of the initial 'damage' is crucial to the distinction being drawn by the Court. It is only after the 'damage' is identified that it is possible to assess the 'damages' by identifying each 'item or aspect' of the damage suffered. In an action to recover to pure economic loss the problem lies in identifying the 'damage'.

<sup>23</sup> 174 NE 441 (1931).

<sup>24</sup> Ibid 444; see also Harold Luntz and David Hamby, *Torts — Cases and Commentary* (3d ed, 1992) para 16.1.3, 813.

<sup>25</sup> (1985) 156 CLR 522, 527 (Gibbs CJ, Mason, Wilson, Brennan and Dawson JJ).

In an action to recover pure economic loss for a negligent misstatement the element of 'proximity' or of 'reliance' is the 'special' element that is required to establish the existence of the duty of care.<sup>26</sup> The 'reliance' by the plaintiff on the defendant, usually in the form of reliance on information supplied by the defendant, does not of itself cause the 'damage'. The economic loss is only sustained by the plaintiff when the plaintiff's initial transaction, entered into on the basis of reliance on the defendant, combines with later events to produce economic loss. The initial reliance on the information supplied by the defendant affects the quality of the plaintiff's decision making process but it does not produce actual loss. The loss only occurs at a later point in time when the inadequacy becomes evident and when the inadequacy produces an economic loss to the plaintiff.<sup>27</sup>

It is possible to argue that the 'damage' is sustained when the plaintiff relies on information supplied by the defendant and as a result makes a decision that they would not have made had they been aware of the quality of the information supplied by the defendant. One author has described this kind of 'damage' as being an interference with the 'plaintiff's autonomy'.<sup>28</sup> He has argued that:

The loss that constitutes the gist of the action in undertakings cases is not the economic loss itself, but rather the deprivation of an opportunity to follow a course of action that would have been preferable to the one the plaintiff was induced by the defendant to take.<sup>29</sup>

The deprivation of the opportunity to follow a course of action that would have been preferable involves an interference with the plaintiff's personal

<sup>26</sup> See *Jaensch v Coffey* (1984) 155 CLR 549, 586 (Deane J); *Sutherland Shire Council v Heyman* (1985) 157 CLR 424, 461-2 (Mason CJ): element of reliance; 494-8 (Deane J) (*Sutherland Shire Council*); *San Sebastian Pty Ltd v The Minister* (1986) 162 CLR 340, 354-7 (Gibbs CJ, Mason, Wilson and Dawson JJ) (*San Sebastian*); *Burnie Port Authority v General Jones Pty Ltd* (1994) Aust Torts Reports ¶ 81-264, 61,113-4 (Mason CJ, Deane, Dawson, Toohey and Gaudron JJ).

<sup>27</sup> See, eg, *Wardley Australia Ltd v State of Western Australia* (1992) 175 CLR 514, 527 (Mason CJ, Dawson, Gaudron and McHugh JJ): 'In many instances the disadvantageous character of the agreement cannot be ascertained until some future date when its impact upon events as they unfold becomes known or apparent' (*Wardley*). See also *San Sebastian* (1986) 162 CLR 340, 353-4.

<sup>28</sup> Stephen Perry, 'Protected interests and undertakings in the law of negligence' (1992) 42 *University of Toronto Law Journal* 247, 289. See, eg, *State of Western Australia v Bond Corp Holdings* (1991) 28 FCR 68, 87: '[T]he assumption of a significantly greater than represented risk is a compensable loss in the context of s 82'; *reversed sub nom Wardley* (1992) 175 CLR 514; cf *Sellars v Adelaide Petroleum NL* (1994) 120 ALR 16, 30 (Mason CJ, Dawson Toohey and Gaudron JJ): 'loss of a commercial opportunity which had some value establishes the existence of a loss and damage for s 82(1) of the Trade Practices Act'; 37 (Brennan J): 'loss of a valuable commercial opportunity [is treated as] "loss" and "damage" in s 82(1) of the [Trade Practices] Act'. See below n 77 for discussion of assessment of damages.

<sup>29</sup> Perry, above n 28, 292. Perry analyses the negligent misstatement cases as 'undertakings' cases. He defines an undertaking in the following terms (281): 'An undertaking by one person A to perform a service for another person B is conduct engaged in by A that A knows or should know could reasonably be taken by B as indicating that A intends B to believe that B may rely on A to perform the service in question'. Note that the requirement that the plaintiff 'was induced by the defendant' does not, according to Perry, require subjective intent. Perry states (282) that 'as always in the private law what ultimately matters where the perception of one person's intention by another is concerned is, for reasons of fairness between the parties, not actual intention but the objective manifestation of intention'.

autonomy in the sense that 'a person controls aspects of his life, and determines their shape'.<sup>30</sup> This approach to defining the 'damage' in negligent misstatement cases has not been adopted in Australia.<sup>31</sup>

Deane J explored this problem of identifying the 'damage' in pure economic loss cases in *Sutherland Shire Council v Heyman*. In this case the Heymans had purchased a house in the Sutherland Shire which had inadequate foundations. When the inadequacy of the foundations was noticed by the Heymans they brought an action against the Council in respect of the Council's failure to inspect the foundations of the house with reasonable care. In considering the nature of the plaintiff's claims, Deane J stated that:

Moreover, even if the inadequacy of the foundations could be seen as material, physical damage to the building, it would be damage to property in which a future purchaser or tenant had no interest at all at the time when it occurred. Loss or injury could only be sustained by such a purchaser or tenant on or after the acquisition of the freehold or leasehold estate without knowledge of the faulty foundations. It is arguable that any such loss or injury should be seen as being sustained at the time of acquisition when, because of ignorance of the inadequacy of the foundations, a higher price is paid ... than is warranted by the intrinsic worth of the freehold or leasehold estate that is being acquired. Militating against that approach is the consideration that, for so long as the inadequacy of the foundations is neither known nor manifest, no identifiable loss has come home: if the purchaser or tenant sells the freehold or leasehold estate within that time, he or she will sustain no loss by reason of the inadequacy of the foundations.<sup>32</sup>

In this passage Deane J clearly identifies the basic problem in assessing damages in cases involving pure economic loss. The decision to purchase a house, without knowledge of the faulty foundations, produces no loss. This loss only occurs when the faulty foundations become evident. Deane J continued by stating that:

The alternative, and in my view preferable, approach is that any loss or injury involved in the actual inadequacy of the foundations is sustained only at the time when that inadequacy is first known or manifest. It is only then that the actual diminution in the market value of premises occurs.<sup>33</sup>

As noted by Deane J the loss or 'damage' is produced by the events subsequent to the purchase of the house. These include the knowledge that the house

<sup>30</sup> Ibid 289 quoting Joseph Raz, *The Morality of Freedom* (1986) 144. See also Perry, 'The Moral Foundations of Tort Law', above n 5.

<sup>31</sup> See, eg, *Wardley* (1992) 175 CLR 514, 527 (Mason CJ, Dawson, Gaudron and McHugh JJ): '[W]e disagree with the statement that "the risk of loss itself is a category of loss"'. The characterisation of 'damage' as one of interference with personal autonomy is however the basis for the proposal for limiting the liability of auditors which is included in part three of this article. On the approach to the definition of 'damage' in economic loss cases see, eg, *Sutherland Shire Council* (1985) 157 CLR 424, 486 (Brennan J): 'Liability in tort is for damage done, not for damage merely foreseeable or threatened or imminent'; 502 (Deane J): 'the common law of negligence should also be seen as extending to cases involving mere economic loss, that is to say, economic loss which is not consequential upon ordinary physical injury'.

<sup>32</sup> (1985) 157 CLR 424, 504-5.

<sup>33</sup> Ibid 505.

has inadequate foundations and the consequent impact that this knowledge has on the market value of the house. On this analysis a claim for pure economic loss has two distinct steps. The first is a decision based on flawed information and the second is the loss produced as a result of subsequent events.<sup>34</sup>

The recognition that the 'damage' in pure economic loss cases occurs at the point at which the inadequacy of the foundations becomes manifest creates further complications when assessing 'damages'. If the damage is sustained when there is a diminution in the market value of the premises the damages are not assessed on the basis of the reduction in the market value of the house. To assess the damages as the reduction in the market value of the house would be to aggregate two quite distinct kinds of damage. The first form of the damage is the loss sustained by the Heymans when it was established that their house had faulty foundations. The measure of damages to compensate for this damage may be that suggested by Deane J in *Sutherland Shire Council*, that is, the cost of repairing the foundations. The second kind of damage is the loss (or gain) which flowed from change in the market value of the house. The risk of gain or loss in the value of the house had been assumed by the Heymans when they purchased the house. If the damages were assessed with reference to the change in the market value of the house there would be an aggregation of damage for which the defendant Council were responsible, that is, the cost of repairing the house, with damage for which the Council could *never* be responsible.<sup>35</sup>

The aggregation of these two forms of 'damage', and the assessment of the damages on the basis of the reduced value of the house, is at the heart of the indeterminacy problem in two related ways. First, if the defendant is liable for all the losses caused by subsequent changes in the market the extent of the damages payable by the defendant would depend on events which the defendant could not assess at the time of giving the information to the plaintiff. If the Sutherland Shire Council were found to be liable for the diminution in market value of the house at the particular time when the inadequate foundations became manifest the Council would be liable to pay damages which were determined by changes in the residential property market which it could not assess at the time when the Heymans bought the house. If this were the case there would be a lack of proportionality between the extent of the defendant's responsibility for the harm

<sup>34</sup> See *Caltex Oil (Australia) Pty Ltd v The Dredge 'Willemstad'* (1976) 136 CLR 529. In this context the decision in *Caltex* may not be as far removed from the negligent misstatement cases as seems to be the case. In *Caltex*, the act of the dredge produced the need for Caltex to make a decision about transporting its oil related products. The decision which Caltex was required to make produced an immediate economic loss, ie, the extra costs imposed by having to ship the oil by road. The only difference with the negligent misstatement cases is that the negligent act produced the immanent need to make a decision which would necessarily produce economic loss whereas in the negligent misstatement cases the plaintiff sustains loss after relying upon information produced by the defendant.

<sup>35</sup> *Sutherland Shire Council* (1985) 157 CLR 424, 504; see also *Ziel Nominees Pty Ltd v VACC Insurance Co Ltd* (1975) 7 ALR 67 in Marcia Neave, Chris Rossiter and Margaret Stone, *Sackville and Neave Property Law: Cases and Materials* (5th ed, 1994) 253: risk passes to purchaser on making of the contract, eg, after the making of the contract the purchaser of property is not entitled to take the benefit of an insurance policy taken out by the vendor.

sustained by the plaintiff and the amount of damages for which the defendant would be liable. The problem with such a result would be that it would be difficult for suppliers of information to structure their activities so that they could assess in advance the degree of risk to which they were exposed.

This aggregation of losses for the purposes of identifying the ‘damage’ is at the heart of the problem of indeterminacy in a second sense. Such an aggregation of losses would allow for recovery in tort of ‘losses’ which are dealt with in other ways in other parts of the legal system.<sup>36</sup> One simple example of this the problem is the possible conflict between the branches of the common law of tort and contract. The opinion of Lord Scarman in *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd*<sup>37</sup> is often quoted as an example of an expression of concern about the impact of an expanding tort of negligence:

Though it is possible as a matter of legal semantics to conduct an analysis of the rights and duties inherent in some contractual relationships including that of banker and customer either as a matter of contract law when the question will be what, if any, terms are to be implied or as a matter of tort law when the task will be to identify a duty arising from the proximity and character of the relationship between the parties, their Lordships believe it to be correct in principle and necessary for the avoidance of confusion in the law to adhere to the contractual analysis: on principle because it is a relationship in which the parties have, subject to a few exceptions, the right to determine their obligations to each other ...<sup>38</sup>

In *Sutherland Shire Council*, Deane J in somewhat broader terms expressed a similar concern when, after concluding that the circumstances in which a person would be under a duty of care to avoid causing another economic loss would be ‘special’, his Honour stated that:

Indeed in a competitive society, the infliction of pure economic loss upon another will commonly be a concomitant of the successful pursuit of personal advantage by way of lawful conduct in that there can be discerned, in many

<sup>36</sup> On economic loss see, eg, *Sutherland Shire Council* (1985) 157 CLR 424, 465-76 (Mason J), 490-2 (Brennan J), 494-5, 502-5 (Deane J): intrusion of law of tort into settled area of law where purchaser of house accepts risks inherent in the purchase of a house; *Hawkins* (1988) 164 CLR 539, 546 (Mason CJ and Wilson J): ‘The consequences for other cases that may flow from a different conclusion could be far-reaching’; John Fleming, *The Law of Torts* (1992) 178-82. See also *Norsk Pacific Steamship Company Limited v Canadian National Railway* [1992] 1 SCR 1021, 1138 (McLachlin J): need for limits on recovery of pure economic loss to allow for certainty in allocation of commercial risk; 1172-4 (Stevenson J); 1054-62 (La Forest J dissenting): role of contract in allocating risks in relational economic cases. See also Perry, ‘Protected interests and undertakings’, above n 28, 302-5. On statutory bodies, see *Sutherland Shire Council* (1985) 157 CLR 424, 438-9 (Gibbs CJ), 468-70 (Mason J), 484-6 (Brennan J), 499-501 (Deane J): application of the policy/operation distinction where the defendant is a statutory body. On criminal law, see *Gala v Preston* (1991) 172 CLR 243, 254 (Mason CJ, Deane, Gaudron and McHugh JJ), 272-4 (Brennan J), 277 (Dawson J), 290-2 (Toohey J): relation between duty of care in tort and the interaction with the criminal law.

<sup>37</sup> [1986] AC 80, 107.

<sup>38</sup> But see *Hawkins* (1988) 164 CLR 539, 544-6 (Mason CJ and Wilson J), 574-5, 584-6 (Deane J), 594 (Gaudron J): professional liability may arise out of both tort and contract — there was difference of view as to whether tortious liability could be greater than duties imposed by operation of contract. See also *Waimond Pty Ltd v Byrne* (1989) 18 NSWLR 642, 651-4 (Kirby P), 665 (Hope A-JA); 658-9 (Mahoney JA): dissenting as to duty of care of solicitor to client in absence of a contractual obligation.

commercial and financial transactions, a correlation between the attainment of personal gain for one's self and the sustainment of economic loss by another.<sup>39</sup>

The expression of these concerns is an acknowledgment that the legal system sets up a range of mechanisms for allocating resources. These mechanisms use a number of different forums for decision making that include the Parliament, securities markets, companies and regulatory law. In the context of this array of decision making processes the relatively unsophisticated process for determining tortious liability is clearly inappropriate one for making a wide range of decisions about the allocation of resources. Partlett in a recent article highlights one aspect of this problem:

Nevertheless, the presence of negligence (at the castle gate as it were) has prompted a shift in the form of analysis in the law. Once, when liability was governed certainly by contract, fairly precise formal liability rules predominated. Liability was reflexive to those rules. In contrast, the gravitational pull of negligence immediately imposes a strong policy element. Contract rules are no longer justifiable merely because they have stood judicial testing and are internally consistent. Rather, they must be examined in light of the policy perspectives wing sitting beneath the aegis of negligence. Reflexive application of rules is replaced by judicial decision-making weighing factors dictated by policy goals.<sup>40</sup>

The problem is therefore to identify a way of defining the 'damage' in pure economic loss cases which overcomes both of these kinds of indeterminacy. In the first instance this means identifying a way of defining the 'damage' so that it is possible for there to be a rational connection between the defendant's fault and the plaintiff's 'damage'. In the second instance this means identifying a definition of the 'damage' in a way that establishes the basis for a system of liability in tort which is integrated into, and not in conflict with, the rest of the legal system. The following section sets out to establish that the tort of negligence has tentatively recognised the basis for a definition of the 'damage' which does overcome both of these kinds of indeterminacy. The central argument in this section will be that this definition of the 'damage' will be one which is dependent upon the characterisation of the duty of care.

#### B *Reliance and the definition of the 'damage'*

This section and the following section outline one of the ways in which the common law has developed in response to the problem of indeterminacy discussed in the preceding section. As noted in that section the problem of indeterminacy, where the damage is pure economic loss, is a specifically legal problem because it is closely related to the problem of defining the boundaries of the tort of negligence in relation to the other categories of law which make up the legal system. The argument which follows is that the 'damage' which is the basis for a negligence action is defined in terms of the specific risks to which a

<sup>39</sup> (1985) 157 CLR 424, 503.

<sup>40</sup> Partlett, above n 22, 266.

particular plaintiff is exposed by defendant's breach of duty. In this sense the 'damage' is defined with reference to the particular relationship between the plaintiff and the defendant and is therefore unique to the terms of that relationship. This approach to the definition of the 'damage' excludes the possibility that two defendants can be *severally* liable for the same 'damage' where that 'damage' is pure economic loss. The only circumstance in which two defendants could be liable for the same 'damage' is hence where the defendants are *jointly* liable.<sup>41</sup>

(i) *The nature of the duty of care*

In *San Sebastian* the High Court confirmed that the element of reliance plays 'a prominent part in the ascertainment of a relationship of proximity' in negligent misstatement cases.<sup>42</sup> The element of reliance in negligent misstatement cases has always included an element of mutuality, that is, the plaintiff relies on information in order to make a decision about whether to enter into a particular transaction *with the knowledge and the explicit or implicit acceptance of the defendant*.<sup>43</sup> The defendant's knowledge of the plaintiff's reliance on information provided by the defendant includes knowledge of the particular transaction being considered by the plaintiff. Knowledge of the particular transaction is central to both the establishment of the existence of reliance by the plaintiff and to the definition of the 'damage'.

In *Hedley Byrne & Co Ltd v Heller & Partners Ltd*, Lord Reid stated that:

I can see no logical stopping place short of all those relationships where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstances required, where it was reasonable for him to do that, and where the other gave information or advice when he knew or ought to have known that the inquirer was relying on him.<sup>44</sup>

This statement has given rise to some debate as to whether there are any formal rules limiting the circumstances in which the plaintiff can be said to have 'relied' upon the defendant for the purpose determining whether the defendant is

<sup>41</sup> See above n 17.

<sup>42</sup> (1986) 162 CLR 340, 354-7 (Gibbs CJ, Mason, Wilson and Dawson JJ).

<sup>43</sup> The element of 'proximity' will not require actual reliance *and* an actual assumption of responsibility. Proximity will, in negligent misstatement cases, have elements of reliance by the plaintiff and some acknowledgment of responsibility by the defendant: see *Sutherland Shire Council* (1985) 157 CLR 424, 462 (Mason J):

It is natural, therefore that the plaintiff's *foreseeable and reasonable reliance* on the defendant's statement has been a constant feature of the cases in which a defendant has been held liable for economic loss sustained as a result of negligent misstatement (emphasis added);

498 (Deane J):

[Proximity] may reflect an assumption of responsibility by one party of a responsibility to take care to avoid or prevent injury, loss or damage to the person or property of another or reliance by one party upon such care being taken by the other in circumstances where the other party knew or ought to have known of that reliance.

See also *San Sebastian* (1986) 162 CLR 340, 357-8 (Gibbs CJ, Mason, Wilson and Dawson JJ).

<sup>44</sup> [1964] AC 465, 486.

the subject of a duty of care.<sup>45</sup> Irrespective these differences concerning the definition of 'reliance' there is one common element to a finding that the plaintiff 'relied' upon the defendant. This is that the 'reliance' by the plaintiff on the information supplied by the defendant relates to a specific and identifiable transaction the nature of which is understood by both parties. In *Caparo Industries plc v Dickman*, Lord Bridge, after referring to a line of cases which included *Hedley Byrne & Co Ltd v Heller & Partners Ltd* and *Candler v Crane Christmas & Co Ltd*,<sup>46</sup> stated that:

The salient feature of all these cases is that the defendant giving advice or information was fully aware of the nature of the transaction which the plaintiff had in contemplation, knew that the advice or information would be communicated to him directly or indirectly and knew that it was very likely that the plaintiff would rely on that advice or information in deciding whether or not to engage in the transaction in contemplation.<sup>47</sup>

In *Wardley*, Mason CJ, Dawson, Gaudron and McHugh JJ expressed a similar view when they stated:

Economic loss may take a variety of forms and, as Gaudron J noted in *Hawkins v Clayton*, the answer to the question when a cause of action for negligence causing economic loss accrues may require consideration of the precise interest infringed by the negligent act or omission. The kind of economic loss which is sustained and the time when it is first sustained depend upon the nature of the interest infringed and, perhaps, the nature of the interference to which it is subjected.<sup>48</sup>

It is the awareness of the specific transaction, or of the precise interest of the plaintiff, which ties together the plaintiff's reliance upon the defendant in deciding to enter into the transaction and the actual 'damage' sustained by the plaintiff as a result of entering into that transaction. In *Hedley Byrne & Co Ltd v Heller & Partners Ltd*, the defendant owed no duty of care to the plaintiff because the defendant's disclaimer effectively communicated to the plaintiff the limited quality of information being supplied by the defendant. In this sense the disclaimer was effective not only because the plaintiff did not rely on the advice given by the defendant bank but also because the plaintiff did not sustain any

<sup>45</sup> See, eg, *Mutual Life & Citizens' Assurance Co Ltd v Evatt* [1971] AC 793 (Privy Council), 804 (Lord Diplock, majority judgment): the provider of information needs to be in the 'business or profession of giving advice'; 811 (Lord Morris and Lord Reid dissenting). Lord Diplock rejected the view of Barwick CJ in *Mutual Life & Citizens' Assurance Co Ltd v Evatt* (1970) 122 CLR 556, 573: '[T]he duty of care ... cannot be limited to the case of persons professing to have special access to information, special skill or judgment in some area.'; but cf *San Sebastian* (1986) 162 CLR 340, 356: formulation of Barwick CJ given qualified support; see also *Norris v Sibberas* [1990] VR 161, 171-2: duty not limited to persons whose business or profession includes giving of advice but it would not be reasonable to rely on someone without special skills or advice.

<sup>46</sup> [1951] 2 KB 164. See also *Glanzer v Shepard* 233 NY 236 (1922).

<sup>47</sup> [1990] 1 All ER 568, 576 ('*Caparo*').

<sup>48</sup> (1992) 175 CLR 514, 527; reference to *Hawkins* (1988) 164 CLR 539, 600-1 (Gaudron J) (other footnote omitted).

'damage'.<sup>49</sup> The provision of the disclaimer provided the plaintiff with the opportunity to decide whether to bear the risk of relying on the information provided by the bank or to choose to pursue other (more costly) methods of obtaining more reliable information.<sup>50</sup>

Knowledge of the use which a plaintiff will make of advice given by the defendant is central to an action in negligence for recovery of pure economic loss because this knowledge allows both the plaintiff and the defendant to assess the level of risk to which the plaintiff is exposed in the particular transaction. An ability to assess the degree of risk to which the plaintiff is exposed is central in defining the nature of the plaintiff's cause of action because this knowledge is crucial to any finding that the defendant either implicitly or explicitly assumed responsibility for the giving of the advice. It is also crucial to any finding that a plaintiff actually 'relied' upon this advice in determining whether to enter into the transaction. Finally this knowledge is also central in identifying the 'damage' which the plaintiff will sustain as a result of a breach of duty by the defendant. The 'damage' will only be that part of the plaintiff's total loss which represents the transformation of the particular risk, which was the object of the duty of care, into an actual loss.

(ii) *The nature of the duty of care and the identification of the 'damage'*

This section sets out to show that the evolving tort of negligence has acknowledged the importance of the interaction between the identification of the 'damage' and the characterisation of the duty of care in cases involving pure economic loss. The interaction between these two elements of the tort of negligence is complicated because the problem of precisely identifying the 'damage' has often been addressed without reference to the formulation of the duty of care. This is because the need to identify the 'damage' has arisen in cases where it has been necessary to identify *when* the 'damage' was sustained for the purpose of deciding whether a plaintiff's cause of action was statute barred. As already noted there is some uncertainty as to whether the 'damage' is sustained when the plaintiff enters the transaction in reliance upon advice supplied by the defendant or whether the 'damage' is sustained when the loss actually crystallises as a result of later events.<sup>51</sup> The source of the difficulty in these cases may

<sup>49</sup> *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, 486, 492-3, 504, 511, 533, 540. In those cases where there has been an attempt to use a disclaimer, and where a duty was nevertheless found to exist, the basis of the duty has been that the defendant had full notice of the use to which the information would be put: see, eg, *BT Australia Ltd v Raine and Horne Pty Ltd* [1983] 3 NSWLR 221; *Smith v Bush* [1990] 1 AC 831. See also Luntz and Hambly, above n 24, 16.2.7.

<sup>50</sup> *San Sebastian* (1986) 162 CLR 340. In this case the plaintiff was not able to rely upon the information provided by the planning authorities because of the discretion which these bodies retained to alter the plan: see (1986) 162 CLR 340, 359 (Gibbs CJ, Mason, Wilson and Dawson JJ), 373 (Brennan J). In this sense the right of the planning authorities to alter the proposed plan operated in the same way as the disclaimer in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465.

<sup>51</sup> See above nn 32-3. *Sutherland Shire Council* (1985) 157 CLR 424, 505: damage sustained when inadequacy becomes manifest; see also *Hawkins* (1988) 164 CLR 539, 587-8 (Deane J): damage *may* be sustained at the point of time when loss becomes manifest; 600-1 (Gaudron J):

be that there is no general rule which can be used to identify the precise point at which the 'damage' is sustained where the loss is pure economic loss.<sup>52</sup>

Irrespective of whether it is possible to identify any general rule to deal with the problem of identifying *when* a plaintiff suffers 'damage' there is an underlying consistency in approach to defining which of the losses can be characterised as the plaintiff's 'damage'. There is a consistency in the approach that requires that the plaintiff's reliance upon the defendant be in relation to a specific risk the extent and nature of which is understood by both of the parties. The 'damage' is then defined as the loss which is produced when this risk is transformed into an actual loss. The identification of the damage in a specific instance will then depend upon the nature of the risk which the plaintiff has been exposed to as a result of reliance by the plaintiff upon the defendant's advice.

The case of *L Shaddock & Associates Pty Ltd v Parramatta City Council* is an example of where a plaintiff was exposed to the risk of purchasing an asset which was of no use to the plaintiff. In this case the plaintiff relied on information supplied by the Council for the purposes of deciding whether to purchase a specific block of land. It was because the defendant understood that the information was to be used by the plaintiff in deciding whether to purchase the land that the defendant was able to comprehend the significance of the request for information by the plaintiff.<sup>53</sup> The significance of the information supplied by Council to the decision of the plaintiff to purchase the land allowed the Court to define the 'damage' sustained by the plaintiff as the purchase of land which was 'useless for the purpose for which it was acquired'.<sup>54</sup> Where the relationship

occurrence of damage dependent upon the 'precise interest infringed by the negligent act or omission'; *Wardley* (1992) 175 CLR 514, 529-30 (Mason CJ, Dawson, Gaudron and McHugh JJ): plaintiff may not sustain loss or damage until that loss is ascertained; *Pullen v Gutteridge Haskins & Davey Pty Ltd* [1993] 1 VR 27: economic loss sustained when inadequacy became manifest. But cf *L Shaddock & Associates Pty Ltd v Parramatta City Council [No 1]* (1981) 150 CLR 225, 236 (Gibbs CJ), 254 (Mason J): damage sustained when plaintiff entered into the transaction and purchased the land. See also *Rentokil Pty Ltd v Channon* (1990) 19 NSWLR 417; Michael Tilbury, *Civil Remedies: Remedies in Particular Contexts* (1993) vol 2, 395-6. In relation to the time when damage is sustained in an action brought under s 82(1) of the Trade Practices Act 1974 (Cth), see *Wardley* (1992) 175 CLR 514, 532-3 (Mason CJ, Dawson, Gaudron and McHugh JJ), 539 (Brennan J), 542 (Deane J), 556 (Toohey J): where loss is a contingent loss is when actual loss is sustained. See generally J Heydon, 'Damages under the Trade Practices Act' in Paul Finn (ed), *Essays on Damages* (1992) 42.

<sup>52</sup> See, eg, *Wardley* (1992) 175 CLR 514, 527 (Mason CJ, Dawson, Gaudron and McHugh JJ), 537 (Brennan J), 541 (Deane J), 554-5 (Toohey J): lack of general rule for either actions for negligent misstatement or actions brought under s 82 of the Trade Practices Act 1974 (Cth). See also J Heydon, 'Damages under the Trade Practices Act' in Finn, above n 51, 64.

<sup>53</sup> (1981) 150 CLR 225, 230 (Gibbs CJ), 242 (Stephen J), 252-3 (Mason J): it was crucial that the information provided by the Council was part of the process for conveying titles to property (*Shaddock*).

<sup>54</sup> The particular risk to which the plaintiff was exposed was the purchase of an unsuitable block of land. The general economic risk associated with the decision of the plaintiff to make this kind of investment is not part of the 'damage' because the plaintiff chose to bear this risk by choosing this kind of investment rather than an alternative form of investment, eg, an investment through the Australian Stock Exchange in a company that is a large scale property developer. See also *Gates v City Mutual Life Assurance Society Ltd* (1986) 160 CLR 1 (*Gates*). In *Gates* the damage was defined as the overpayment for a policy of insurance because the plaintiff only relied on the representative of City Mutual for the purpose of deciding whether to purchase the *particular* insurance policy that was supplied by City Mutual. The plaintiff could

between the defendant's duty of care and the 'damage' sustained by the plaintiff can be described in these terms the related problems of defining the timing of the damage and the assessment of damages can be formulated in the way which reflects this relationship. In this instance the complete failure of the transaction means that it is possible and desirable to identify the point at which damage was sustained as the time when the plaintiff purchased the land in reliance upon advice supplied by the defendant.<sup>55</sup>

This principle will apply where the 'damage' may be defined as the exposure to a loss which is conditional upon the occurrence of a later, defined event. In *Wardley*, the State of Western Australia asserted that it relied upon advice given by Wardley Australia and as a result gave an indemnity which it would not otherwise have given. The risk to which the State of Western Australia was exposed was that it would be required to make good the indemnity. In this sense the misrepresentation was a primary factor leading up to the decision of the plaintiff to give the indemnity in circumstances where defendant was aware that the advice would be used for precisely this purpose. The 'damage' in this instance is then the amount actually required to be paid under the indemnity because without the advice given by Wardley Australia the State of Western Australia would not have given the indemnity. In these circumstances it was found that the 'damage' sustained at the time when the amount of the contingent loss under the indemnity was finally ascertained.<sup>56</sup>

The requirement that the 'damage' be defined as the specific risk which was the object of the defendant's duty of care is also applicable where the 'damage' is defined in terms of the loss of a valuable commercial opportunity. In *Sellers v Adelaide Petroleum NL*, the High Court accepted the principle that the loss of a valuable opportunity could be characterised as 'loss' or 'damage' for the purposes of an action initiated under s 82(1) of the Trade Practices Act 1974 (Cth).<sup>57</sup> In this case the misrepresentation was made by the defendant with the knowledge that Adelaide Petroleum NL would rely on that representation by not completing a similar, but ultimately more advantageous agreement with a third party. The 'damage' in this case was defined as the loss of the opportunity to complete the agreement with the third party. In this sense the defendant knowingly exposed the plaintiff to the specific risk of losing the benefit of that

not establish that he relied on the information supplied by the representative of City Mutual to determine whether to purchase a policy of the kind promised by that representative, ie, the plaintiff was unable to establish that he would have sought out this kind of policy from another insurer. For a critical analysis of *Gates*, see Australian Law Reform Commission, Discussion Paper No 56, *Compliance with the Trade Practices Act 1974*, paras 3.7-3.8: 'The Commission is not convinced that the decision in *Gates* gives rise to a need for legislative direction as to assessment of damages'.

<sup>55</sup> *Shaddock* (1981) 150 CLR 225, 254-5 (Mason J); see also 236 (Gibbs CJ). Stephen and Aickin JJ agreed with Mason J. Murphy J agreed with Gibbs CJ and Mason J as to the quantum of damages. See also, eg, *Kyogle Shire Council v Francis* (1988) 13 NSWLR 396: provision of information to the plaintiff in circumstances where the defendant was aware of the importance of the information to the decision making process of the plaintiff (*Kyogle Shire Council*).

<sup>56</sup> See above n 51. See also *Norwest Refrigeration Services Pty Ltd v Bain Dawes (WA) Pty Ltd* (1984) 157 CLR 149.

<sup>57</sup> (1994) 120 ALR 16, 26-8 (Mason CJ, Dawson, Toohey and Gaudron JJ), 33-5 (Brennan J).

agreement. The 'damage' did not however include the 'loss of opportunity' to make the subsequent profits which the plaintiff would have earned had the plaintiff been able to enter into the agreement with the third party.

In all of these cases there is an identification of the precise loss which the plaintiff has sustained as a result of the breach of duty by the defendant. The damage which the plaintiff sustains is dependent upon characterisation of the specific risk to which the plaintiff was exposed. The right to recover this damage from the defendant is then dependent upon the capacity of the plaintiff to establish reliance on the defendant, or an assumption of responsibility by the defendant, in relation to that particular risk. In this sense the characterisation of the duty of care and the identification and timing of the damage are unique to the particular relationship between the plaintiff and the defendant.

It is important to note that a 'unique' definition of damage for which each defendant is responsible does not preclude the possibility of two defendants being jointly liable for the same damage.<sup>58</sup> It remains possible for two defendants to be 'jointly' liable for the same 'damage'. An example of a case in which two defendants may be jointly liable for the same economic loss is *The Dredge 'WH Goomai' v Australian Oil Refining Pty Ltd.*<sup>59</sup> In this case two defendants were potentially liable for the economic loss sustained by the two plaintiffs. The defendants were the owners of the dredge 'W H Goomai' and the Maritime Services Board. The Maritime Services Board had contracted with the owners of the dredge to complete the dredging work which caused the plaintiffs to suffer the damage. The owners of the dredge and the Maritime Services Board would be joint tortfeasors because each had taken 'concerted action to a common end' in the form of the contract to complete the dredging works.<sup>60</sup>

This unique definition of the 'damage' in actions to recover pure economic loss also involves drawing a clear boundary between losses that relate to the defendant's negligence and those losses for which the plaintiff is responsible. This process of reasoning is central in determining the nature and extent of the role of the tort of negligence. Tort law will require that a defendant compensate the plaintiff where the plaintiff relies upon the defendant for the giving of certain advice. On the other hand it is not the function of this area of law to compensate the defendant for losses which arise when ordinary investment risks are transformed into actual losses. A person who wishes to reduce these risks will have to specifically pay for someone else to manage exposure to these risks.<sup>61</sup> The

<sup>58</sup> See above n 17.

<sup>59</sup> (1989) Aust Torts Reports ¶ 80-241.

<sup>60</sup> Balkin and Davis, above n 17, 898. As joint tortfeasors each of the defendants would be liable for the damage sustained by the plaintiffs. Joint tortfeasors are in all jurisdictions entitled to claim contribution: see, eg. Law Reform (Miscellaneous Provisions) Act 1946 (NSW) ss 2(1)(a), 5(1)(a), (b), and (c).

<sup>61</sup> See, eg. Burton Malkiel, 'A Random Walk Down Wall Street' in R Romano, *Foundations of Corporate Law* (1992) 32-3. This claim is based on Modern Portfolio Theory which embodies the 'time honoured maxim that diversification is a sensible strategy for individuals who like to reduce their risks'. A person who is unable to hold a fully diversified portfolio will buy an interest in a financial intermediary which is large enough to hold a diversified portfolio. For an indication as to the increased use of financial intermediaries, see Robert Clark, 'The Four

definition of this boundary in this way ensures that there is a degree of proportionality between the defendant's responsibility for the 'damage' sustained by the plaintiff and the extent of the defendant's liability to pay damages to the plaintiff. This is because it is possible for the defendant to assess the level of damages payable to the plaintiff as a result of the giving of the negligent advice or information. This in turn ensures that the defendant has the opportunity to ascertain the level of risk associated with the giving of such advice. The following section elaborates on the way in which the principles of assessment of damages define the boundary between damages for which the defendant is liable and losses arising out of those risks for which the plaintiff is ultimately responsible.

### C *Assessment of damages*

The central argument of the previous section was that the 'damage' in economic loss cases has been defined in relation to the specific risks which were the object of the duty of care owed by the defendant to the plaintiff. It is the purpose of this section to establish that the principles for assessing damages are directed at assessing the value of the losses sustained by the plaintiff as a result of the transformation of the specific risk into actual 'damage'. In this sense the overall aim of this section is to establish that the principles for assessing damages are consistent with the principles for defining the extent of the duty of care and for identifying the damage. The integration of each of these elements is essential if there is to be a rational connection between the degree of the defendant's fault and damages for which the defendant is held to be liable. In addition the integration of each of these elements is essential in defining the boundaries of the tort of negligence so that this tort does not intrude into areas of conduct which are regulated by other legal norms.

The principle for assessing damages in cases where the damage is pure economic loss is the same as for other kinds of damage. This principle has been expressed in the following terms:

In principle, the object of compensation in tort is to restore plaintiffs to the position which they would have been in if there had been no tort. There is no doubt that this, the restoration of the status quo ante, is the meaning which generally attaches to the principle of compensation in this context.<sup>62</sup>

Stages of Capitalism: Reflections on Investment Management Treatises' (1981) 94 *Harvard Law Review* 561, 564:

The third stage of capitalism ... is the age of the portfolio manager, and its characteristic institution is the institutional investor, or financial intermediary. As the second stage split entrepreneurship into ownership and control, and professionalised the latter, so the third stage split ownership into capital supplying and investment, and professionalised the investment function.

<sup>62</sup> Tilbury, above n 51, 393 (footnotes omitted). See also *Gates* (1986) 160 CLR 1; *Wardley* (1992) 175 CLR 514.

The difficulty with this statement of principle is as Kirby A-CJ noted in *Kyogle Shire Council* that 'it tends to beg the question which it is offered to answer'.<sup>63</sup>

Where the 'damage' is defined as the purchase of an asset that is unsuitable and no longer of use to the plaintiff damages are assessed by calculating the amount by which the value of the asset has been diminished by the breach of duty. In these cases damages are assessed as the difference between the amount that the plaintiff actually paid for the asset and the actual value of the asset at the time of purchase.<sup>64</sup> In *Wardley* the principle supporting this approach to the assessment of damages was expressed in the following way:

In a case such as the present, it may safely be assumed that the plaintiff is entitled to recover 'a sum representing the prejudice or disadvantage [the plaintiff] has suffered in consequence of his altering his position under the inducement' of the misleading conduct or 'the actual damage directly flowing from' that conduct, to take up and adapt well known statements of the measure of damage applicable in an action of deceit.<sup>65</sup>

The plaintiff is compensated for holding an asset of lower value because it was the plaintiff's reliance on the defendant which led the plaintiff to purchase the asset.

In addition to these immediate losses a plaintiff is entitled to recover some of the consequential losses which arise because the plaintiff has purchased an unsuitable asset. There is some uncertainty as to the full extent of consequential damages which a plaintiff may recover in these circumstances. It is central to the argument developed in this section that the losses which a plaintiff may recover are *only* those losses which are closely related to the specific risk which was the object of the defendant's duty of care. It is important to note that the losses which a plaintiff is entitled to recover do not include the lost opportunity to earn the profits which the plaintiff would have earned had the plaintiff purchased another more suitable asset.

In *Shaddock* damages were assessed to include the costs associated with the purchase and holding of the land which was unsuitable for re-development because it was affected by road widening proposals. In *Shaddock*, Mason J stated that:

<sup>63</sup> (1988) 13 NSWLR 396, 404. See also *Tilbury*, above n 51, 393.

<sup>64</sup> See *Wardley* (1992) 175 CLR 514, 530. See also, eg, *Shaddock* (1981) 150 CLR 225, 236-7 (Gibbs CJ), 254-5 (Mason J); *Kyogle Shire Council* (1988) 13 NSWLR 396, 414 (Mahoney JA), 417-9 (Clarke JA). See also *Smith v Bush* [1990] 1 AC 831, 849 (Lord Templeman), 856 (Lord Griffiths): economic loss assessed at the time of purchase; *Potts v Miller* (1940) 64 CLR 282.

<sup>65</sup> (1992) 175 CLR 514, 526, quoting *Toteff v Antonas* (1952) 87 CLR 647, 650 (Dixon J) and *Clark v Urquhart* [1930] AC 28, 68. This approach is identified by Mason CJ, Dawson, Gaudron and McHugh JJ as being the common law measure of damages in cases involving misrepresentations giving rise to pure economic loss. Their Honours accepted that 'the common law measure of damages will in many cases be the appropriate guide' to actions brought under s 82(1) of the Trade Practices Act 1974 (Cth) where the plaintiff suffers economic loss based on a breach of s 52.

Consequently, the appellants' loss includes, not merely the diminution in value of the land, but also the expenses of acquisition and retention for a reasonable time, expenses which would not have been incurred had the respondent not been negligent.<sup>66</sup>

However in *Kyogle Shire Council*, a majority of the Court suggested that in addition to losses arising out of acquisition and retention of the land a plaintiff could recover the amount of the profits that the plaintiff would have earned if the plaintiff had been able to invest the money, which was tied up in the unwanted and unsuitable land, in another venture which would have earned those expected profits.<sup>67</sup> One consequence of the recognition that a plaintiff could recover the loss of profit which the plaintiff would have earned is that one of the primary differences between the assessment of damages in torts and contracts would be removed.<sup>68</sup>

The approach to the assessment of damages proposed by Kirby A-CJ in *Kyogle Shire Council* would introduce an element of indeterminacy into the assessment of damages in the tort of negligence because there would be no way of defining the boundary between the 'damage' for which the defendant was responsible and the inherent risks in the investment which were the ultimate responsibility of the plaintiff. There is however a well recognised approach to the assessment of damages in tort which ensures that there is a way of establishing a rational and proportionate relationship between the extent of the defendant's fault and the extent of the defendant's liability.

<sup>66</sup> (1981) 150 CLR 225, 255; see also 236-7 (Gibbs CJ). Stephen and Aickin JJ agreed on this aspect of the reasoning of Mason J, and Murphy J (256) agreed with Mason J as to the assessment of quantum of damages.

<sup>67</sup> (1988) 13 NSWLR 396, 406 (Kirby A-CJ), 417 (Clarke JA). Kirby A-CJ accepted that the plaintiff had established that if he had not bought the particular block of land he would have bought another block, subdivided and earned a profit. Clarke JA (417-8) found that the plaintiff had not established which particular contract the plaintiff would have entered into and, as a result, had not proven that he would have earned a particular profit. He was therefore only entitled to damages assessed as the difference between the amount paid for the land and the actual value of the land at the time of the sale. Mahoney JA (414) agreed with Clarke JA. Kirby A-CJ relied upon *dicta* in *Gates* (1986) 160 CLR 1, 13 (Mason, Wilson and Dawson JJ) that '[i]f that reliance has deprived him of the opportunity of entering into a different contract for the purchase of goods on which he would have made a profit then he may recover that profit on the footing that it is part of the loss which he has suffered in consequence of altering his position under the inducement of the representation'. In *Kyogle Shire Council* the defendant's misrepresentation exposed the plaintiff to the risk of purchase of unsuitable land not to the loss of a valuable commercial opportunity to make a profit on the development of that land. But cf *Rentokil Pty Ltd v Channon* (1990) 19 NSWLR 417. The damages were assessed with reference to the value of the property at the time of the trial not at the time at which the plaintiff relied upon the defendant's statement and purchased the house. Assessment of the damages with reference to the value of the property at the time of the trial allowed the plaintiff to gain the benefit of the change in the market value of the property which was consistent with the approach of the Court of Appeal in *Kyogle Shire Council* (1987) 13 NSWLR 396. See also Tilbury, above n 51, 395-6.

<sup>68</sup> *Kyogle Shire Council* (1988) 13 NSWLR 396, 406 (Kirby A-CJ):

[T]he two branches of the law of contract and tort are coming together. It also shows that, although it is for the plaintiff to establish in his action in tort, what he would have done, if he does so by evidence, and if, thereby he proves opportunities which he has necessarily foregone, the measure of his damages will include provisions for those losses.

See also John Keeler, *Damages for Economic Loss*, paper delivered at 27th Australian Legal Convention, Adelaide (1991) 6-7.

This was the approach to the assessment of damages adopted by the High Court in *Hungerfords v Walker*.<sup>69</sup> In this case the plaintiffs brought a claim against their accountants in relation to tax that was overpaid. It was accepted that the plaintiffs were entitled to those losses. In addition they claimed further damages for loss of use of the money in the period for which the tax was overpaid. In particular the plaintiffs claimed that they were unable to pay off existing loans because they did not have access to these funds. In their joint judgment Mason CJ and Wilson J stated that:

The cost of borrowing money to replace money paid away or withheld, in consequence of the defendant's breach of contract or negligence, is directly related to the wrong ... Likewise, opportunity cost should not be considered as being too remote when money is paid away or withheld.<sup>70</sup>

The plaintiffs in this case were able to recover as damages the opportunity cost of having to borrow funds to cover the amount which was withheld because of the defendant's negligence. The cost of having to borrow funds was closely related to the plaintiff's reliance on the defendant because an immediate consequence of this reliance was that the plaintiff had to retain a higher level of debt throughout the relevant period.<sup>71</sup> In this sense the costs associated with retaining a higher level of debt are closely related to the nature of the plaintiff's reliance on the defendant accountants. However there is no such close relationship with respect to the profit the plaintiffs would have earned on any other more profitable investments which they would have made if they had had access to these funds during the period in which the tax was overpaid.<sup>72</sup> The plaintiff is ultimately responsible for the risks associated with making or not making the profits which may or may not arise from such investments. In particular the plaintiff is responsible for choosing to expose him/herself to the risk of not being able to make these profits by relying on particular pieces of information.

This approach to the assessment of damages has been adopted in those cases where the plaintiff receives an asset of lesser than expected value as a result of reliance on the defendant. In many of these cases the inadequacy which causes the reduction of the value of the asset may remain hidden for some time.<sup>73</sup> In these cases it is more likely that the time of occurrence of the damage will be at the time when the inadequacy becomes evident.<sup>74</sup> The measure of damages in

<sup>69</sup> (1989) 171 CLR 125.

<sup>70</sup> *Ibid* 145-6; Brennan and Deane JJ (152) agreed with Mason CJ and Wilson J; Dawson J gave a dissenting judgment.

<sup>71</sup> Mason CJ and Wilson J went on to state that there was no difference between a claim for the cost of borrowing money to replace money paid away and the lost interest which would have been received on the money had the plaintiffs had the use of the money.

<sup>72</sup> *Ibid* 150-1 (Mason CJ and Wilson J): the trial judge had assessed damages on the basis that the plaintiffs would have paid off their most expensive loans — Mason CJ and Wilson J expressed the view that damages should be calculated with reference to ordinary market rates.

<sup>73</sup> See, eg, *Sutherland Shire Council* (1985) 157 CLR 424; *Gates* (1986) 160 CLR 1; *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465.

<sup>74</sup> See, eg, *Sutherland Shire Council* (1985) 157 CLR 424, 504-5; *Pullen v Gutteridge Haskins & Davey Pty Ltd* [1993] 1 VR 27: economic loss sustained when inadequacy became manifest. See also above n 51.

these cases may not represent the amount by which the inadequacy diminishes the value of the asset at the point at which the inadequacy becomes apparent. Rather it may be the measure of damages needed to remedy the defect. For example, in *Sutherland Shire Council* it seems that the damages to which the plaintiff would have been entitled would have been the costs associated with remedying the defect in the house which the plaintiffs had purchased.<sup>75</sup> As with cases such as *Shaddock*, there will be no recovery by the plaintiff for lost profits which arise because of the loss of the use of the asset by the plaintiff.<sup>76</sup>

This approach to the measure of damages is also applicable to those cases where the 'damage' can be defined as the loss of a valuable commercial opportunity. In *Sellars v Adelaide Petroleum NL*, the High Court recognised that loss of a valuable commercial opportunity could constitute 'damage' or 'loss' for the purposes of s 82(1) of the Trade Practices Act 1974 (Cth).<sup>77</sup> In *Sellars* the valuable commercial opportunity was the opportunity to enter into an agreement which was lost when the plaintiff relied on the defendant's misrepresentation. The risk that the plaintiff would lose the valuable commercial opportunity by not entering into the particular agreement was the specific risk which the plaintiff was exposed to when the defendant negligently made statements with the knowledge that the plaintiff would rely on those statements by not entering into that agreement. The plaintiff was not however entitled to recover those profits which the plaintiff had expected to earn once the relevant agreement had been implemented.<sup>78</sup> This 'loss of opportunity' to earn profits is quite a different category of loss.<sup>79</sup>

The distinction between those losses which are closely related to the specific risk which was created by the plaintiff's reliance on the defendant and those that are too remote provides a way of resolving the problem in *Kyogle Shire Council*. In *Kyogle* the plaintiff would it seems have invested the money in another

<sup>75</sup> (1985) 157 CLR 424, 504 (Deane J).

<sup>76</sup> See *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465: damages would have been the amount expended by the plaintiffs on behalf of their client which they were unable to recover in the liquidation, with no recovery for the lost profits which the plaintiff would have made had the plaintiff been able to make another successful investment; *Gates* (1986) 160 CLR 1: cost of remedying the defect was to return the 'extra' amount paid on the insurance policy — no compensation for the amount which the plaintiff would have received on the insurance policy which the representative promised to the plaintiff; *Norwest Refrigeration Services Pty Ltd v Bain Dawes (WA) Pty Ltd* (1984) 157 CLR 149, 162: plaintiff recovered amount of insurance under the policy had it been valid but not for loss of use of the money that would have been due under the contract of insurance.

<sup>77</sup> (1994) 120 ALR 16: see above n 57 and accompanying text.

<sup>78</sup> *Ibid* 30-1: The lost opportunity was measured by discounting the value of the commercial opportunity. The amount of the discount reflected the probability that the commercial opportunity would, in the ordinary course of business, not have been realised.

<sup>79</sup> But see *Northern Territory of Australia v Mengel* (1994) Aust Torts Reports 61,172. In this case the plaintiff was awarded damages on the basis of commission by the defendant of the tort defined in *Beaudesert Shire Council v Smith* (1966) 120 CLR 145. In this case it seems that the 'damage' was not defined as the loss of opportunity to move the relevant cattle (with damages being assessed with reference to the costs which this movement restriction created). Rather, the 'damage' was defined as the loss of opportunity to sell the cattle at a particular time when cattle prices were high (with damages being assessed with reference to the prices which the cattle would have been sold at the relevant time).

project if he had become aware that the land in question was unsuitable for subdivision. The defendant Council's negligence did not prevent the plaintiff from making another investment. It did however increase the cost of obtaining capital to pursue another investment. Applying the principles outlined in *Hungerfords v Walker*, the plaintiff would have been able to recover the extra financing costs associated with the purchase of another block of land but would not have been able to recover the expected profits on this investment.<sup>80</sup>

A distinction between the losses that are closely related to the specific risk which was the object of the duty of care and the subsequent loss of opportunity to earn profits from the use of an asset is central to any attempt to provide a coherent rationale for recovery of pure economic loss in tort. Where the 'damage' is defined with reference to the specific risk which is the subject of the defendant's duty of care to the plaintiff there will be a distinction between those losses which are the responsibility of the plaintiff and those damages which are the responsibility of the defendant. It is the function of the principles relating to the assessment of damages to value the specific 'damage' which is the subject of the duty of care.

The aim of this section of the article has been to show that the principles relating to the assessment of damages are dependent upon the other elements of the tort of negligence. The application of this flexible set of principles for assessing damages is dependent upon both the formulation of the duty of care and the identification of the damage. The mutual inter-dependence of each of these elements is an essential part of the way in which the tort of negligence operates so as to establish a rational connection between the nature of the defendant's fault and the extent of the defendant's liability.

## D Conclusion

The primary aim of this part of the article has been to re-assess the operation of the tort of negligence in those cases where the harm caused is pure economic loss. The central argument of this part is that the tort of negligence can be the basis for a system of liability in which there is a rational connection between the defendant's fault and the extent of the defendant's liability. Implicit in this claim is that the creation of a rational connection between fault and liability is central to drawing the boundaries of the tort of negligence. The drawing of the boundaries of the tort of negligence is essential if the tort of negligence is to have any role in that part of the legal system which is concerned with allocating pure economic loss amongst the various interested parties.

<sup>80</sup> The approach to assessing damages in negligent misstatement cases leads to outcomes that are similar to those reached in cases where negligent acts cause pure economic loss: see, eg, *Caltex Oil (Australia) Pty Ltd v The Dredge Willemstad* (1976) 136 CLR 529, 531. The damages claimed by the plaintiffs in this case included the extra costs associated with transporting the oil around Botany Bay by road. The damages did *not* include the lost profits which resulted from reduced capacity to transport oil by road rather than by pipeline across Botany Bay.

The re-assessment of the operation of the tort of negligence in this article is founded upon the acknowledgment of the tentative recognition in the common law of a relational model of legal responsibility. A relational model of legal responsibility is based on the recognition of the need to define all of the elements of legal responsibility with reference to the nature of the relationship between the parties. A relational model of legal responsibility is a response to the problem of the lack of any objective measures for identifying either the duty of care or the damage caused by a breach of that duty. The lack of any of these objective measures is an endemic part of the problem of assessing when and to what extent any particular party can recover pure economic losses. It has thus been the aim of this part to show that where the claim is for recovery of pure economic loss the tort of negligence is a system of law in which the elements of the duty of care, the identification of the 'damage', and the assessment of damages are interdependent in the sense that each must be defined in terms of the other and that each must be defined with some reference to the expectations of *both* of the parties to the action.<sup>81</sup>

In particular this part has set out to show that liability for pure economic loss in negligence is based on the need to identify the specific 'damage' the prevention of which is the object of the duty of care owed by the defendant to the plaintiff. The identification of the specific damage, which is dependent upon the definition of the nature and extent of the duty of care, is then the reference point for the assessment of the damages. The interaction of each of the elements ensures that the quantum of damages is tied to the nature of the duty of care owed by the defendant to the plaintiff. It is this interaction of the elements of the tort which produces a system of liability in which the extent of the liability of the defendant to pay damages will be proportionate to the extent of the defendant's fault in causing those damages. It is also this interaction between the elements of the tort which makes it possible to define the boundaries of the tort of negligence so that the tort of negligence can be integrated into the wider legal system which includes other categories of law that allocate pure economic losses in a variety of different ways.

The broader argument developed in this part is that it is important to re-assess the operation of the tort of negligence in order to develop a limited, but legitimate, role for the tort of negligence in cases involving recovery of pure economic loss. The role will be a legitimate one in that there is a right to obtain compensation in those cases where there is an implicit or explicit adoption of

<sup>81</sup> This argument adopts the understanding of 'proximity' as a 'category of broad reference': see Prue Vines, 'Proximity as Principle or Category: Nervous Shock in Australia and England' (1993) 16 *University of New South Wales Law Journal* 458, 471-6. In addition it adds two further propositions to this approach to understanding the application of the term 'proximity'. The first is that the content of proximity, as a particular interpretation of 'social responsibility' will be reflected in the application of all of the elements of the tort of negligence and not just the element of the duty of care. The second proposition is that the interaction of each of the elements of the tort along with the principle of 'proximity' will produce outcomes in which there is a degree of proportionality between the extent of the fault of the defendant and the extent of the defendant's liability to pay damages.

responsibility for the allocation of certain losses between the parties. In the absence of such carefully defined limits the tort of negligence will intrude into areas of conduct that are already regulated by other sophisticated bodies of law. Such intrusion will have the effect of producing overall outcomes that are both arbitrary and unpredictable. As part three of this article will argue it is the failure to define a limited role for the tort of negligence, and the consequent expansion of the tort of negligence into areas of conduct already regulated by other bodies of law, which is source of the problem of excessive levels of liability for auditors.

In *Kyogle Shire Council*, Mahoney JA argued that:

There is, in a sense, an element of injustice if the plaintiff cannot recover profits he would have made on the resale of the land. The fact that the plaintiff did not derive the profits was the direct result of the falsity of the representation which negligently the Council made and the fact that he would not gain those profits was a matter which the defendant must be taken to have contemplated as the result of the falsity of that representation.<sup>82</sup>

This intuitive sense that the narrow approach to the assessment of damages in negligent misstatement cases achieves an unjust result may or may not be sustained by further analysis. However irrespective of further analysis it should be clear that the injustice is not caused by the failings or otherwise of the tort of negligence. The injustice, if there be one, is related to Deane J's comment in *Sutherland Shire Council* that '[i]n a competitive society, the infliction of pure economic loss upon another will commonly be a concomitant of the successful pursuit of personal advantage by way of lawful conduct'.<sup>83</sup>

## II AUDITORS' LIABILITY

The central theme of this part of the article is that the system of liability for auditors produces excessive levels of liability because it is the result of the interaction of a statutory regime regulating the disclosure of financial information by companies with the liability principles embodied in the common law. The statutory regime regulating the disclosure of financial information is a body of public law established with a view to enhancing the 'public interest' by defining the conditions within which all companies must operate. By contrast the common law is a body of 'private law' concerned with the relations between individual persons. The current system of liability for auditors draws on both of these bodies of law by taking the duties which are imposed on auditors from the statutory regime regulating the disclosure of financial information and using these duties as the basis for determining the level of liability imposed by the common law. The result of this process of reasoning is that the auditor's duty of care is formulated without any reference to either the actual services provided by auditors or to the 'damage' caused by the auditor's breach of duty.

<sup>82</sup> (1988) 13 NSWLR 396, 412.

<sup>83</sup> (1985) 157 CLR 424, 503.

It is this disjuncture between the formulation of the duty of care and the identification of the damage which has exposed auditors to indeterminate levels of liability. It has been accepted that once the duty of care, which is founded on the statutory duties placed on the auditor, is found to exist the auditor is responsible for all the losses which are causally related to any negligent act committed by the auditors. Thus an auditor may be required to compensate a plaintiff company for all the losses accumulated over the period in which no remedial action was taken because of the auditor's failure to inform the plaintiff company of the particular problem. The underlying problem with the system of liability for auditors has therefore been a set of absolute statutory duties on the one side and the probability that breach of those duties will produce indeterminate levels of liability on the other side. In this context, there is no principled way in which the ordinary methods of the common law can be used to identify the 'damage' caused by auditors' negligence.

The first section of this part of the article sets out to establish that the system of liability for auditors produces excessive levels of liability. There are three further sections in this part that set out to explore the nature of this problem. The second section gives a brief review of the statutory regime regulating the disclosure of financial information by companies. The third section provides an analysis of the nature of the services actually provided by auditors when fulfilling the duties imposed on them by the Corporations Law. The fourth section is an account of the way in which the current system of liability for auditors has defined the 'damage' caused by the breach of these duties.<sup>84</sup> The gist of the analysis in this section is that the process for identifying the 'damage' caused by the breach of these duties is inherently flawed and that there is no easily identifiable way in which ordinary common law methods can be used to modify this process.

The final part of this article includes a proposal for introducing a proportionate system of liability for auditors through a statutory definition of the 'damage' which is the basis of a cause of action against an auditor. There is a need for a statutory definition of either the 'damage' or the 'damages' in the system of liability for auditors because the choice as to the appropriate levels of liability is one that involves consideration of relatively open-ended matters of policy. There is no principled way of deciding that the auditors' proportionate level of responsibility for a corporate collapse should be at any particular amount or figure. The only basis for resolution of this will be through a consideration of all

<sup>84</sup> There will be no separate discussion of the way in which the Trade Practices Act 1974 (Cth) modifies the system of liability for auditors: see above n 15; see also David Godsell, *Auditors' Legal Duties and Liabilities in Australia* (1993) 141-8. Godsell argues that as auditors provide opinions about the financial statements prepared by the client company, a plaintiff who suffers damage by relying upon the auditor's opinion will have to establish that the auditor did not have a reasonable basis for reaching the particular opinion. While a more detailed analysis of the application of s 52 actions for auditors may be required, the assumption adopted in this article is that s 52/82 actions under the Trade Practices Act 1974 (Cth) will not extend *liability* for auditors beyond that created by the tort of negligence.

of the relevant policy issues by the Commonwealth Parliament. The proposal in the final part presents one way in which these policy issues may be addressed.

A *Is there a problem with auditors liability?*

The question of whether the general level of professional liability is too high is a controversial one that is dependent on consideration of a number of factors. One relevant factor is that for some professions the damage which is the source of liability is personal injury while for others the damage is pure economic loss. The factors relevant to deciding upon the levels of liability in both categories cases are fundamentally different.

In the case of the auditing profession, where the damage is pure economic loss, there can be little doubt that there is a gap between the measure of an auditor's responsibility for damage sustained and the level of damages for which auditors may be liable.<sup>85</sup> The basis for this claim can be established by reference to a recent example of an action against an auditor. In the case of *AWA Ltd v Daniels*,<sup>86</sup> the plaintiff company (AWA Ltd), sought to recover from the auditors the full amount of the losses sustained by AWA as a result of trading in foreign exchange markets. The full extent of the losses from this trading arose in part because AWA had no effective system of control in place to monitor its trading on foreign exchange markets. The auditor was found liable for these losses because of a failure to inform the board of irregularities in the foreign exchange trading and because of a failure to inform the board of the lack of any effective system of internal control to monitor the foreign exchange trading.

There is little doubt that the auditors in this case were 'negligent' or careless. The real problem though was that the auditor was potentially liable for all the losses sustained by the plaintiff company. In *AWA Ltd v Daniels*, Rogers J stated that:

The second, to me, surprising feature of the plaintiff's case is the proposition that, even though it would seem that senior management had permitted Koval to conduct the company's FX trading with a complete lack of supervision, without regard to elemental principles of internal control, without a proper system of books and records, none of that should be taken into account in allocating fault because it was the duty of the auditors to draw to the attention of the board of directors the failure of management to maintain proper records and to implement proper principles in internal control. I cannot accept that a corporation is entitled to abdicate all responsibility for proper management of the fi-

<sup>85</sup> Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, above n 1, 8-9; see also David Hill, 'The liability of auditors after the Tricontinental Settlement' (1994) 3 *Butterworths Corporation Law Bulletin* 44: comment on the settlement of the Tricontinental case for \$136m. For a recent account of the increasing number and increasing amount of claims against auditors in the United States, see Julie Faussie, 'Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession' (1994) 28 *Valparaiso University Law Review* 1041.

<sup>86</sup> (1992) 7 ACSR 759.

nancial aspects of its operation and then, when loss is suffered, to seek to attribute the entirety of the blame to its auditors.<sup>87</sup>

In this passage Rogers J identifies two ways in which the current system of liability produces a gap between an auditor's overall responsibility for the harm caused and the extent of the auditor's legal liability to pay damages. The first is that the auditors are only one of the parties that are responsible for the damage sustained. The role of auditors in the system of corporate regulation is defined by the Corporations Law to include responsibility for making various reports but does not include any capacity to make any of the operative decisions about the investment of corporate funds.<sup>88</sup> In this context there does not seem to be any good reason why auditors, even if they have been negligent, can possibly be liable for *all* of the losses of the company.<sup>89</sup>

The second element of the problem identified by Rogers J arises out of His Honour's comment that 'I cannot accept that a corporation is entitled to abdicate all the responsibility for proper management of the financial aspects of its operation'. This comment raises the fundamental question of which of the parties should be responsible for bearing those ordinary commercial risks which are beyond the control of any of the parties. These are those risks encompassed by such events as economic cycles which produce losses that are not *caused* by any of the participants in the company. The body of company law defines a structure which makes directors ultimately responsible for making investment decisions and defines a process for allocating those losses between stakeholders in the company. In this context there is a real question as to whether the stakeholders in the company should be able to shift these losses on to an auditor who has no part in making the management decisions which led to the losses in question.<sup>90</sup> Indeed much of the concern about allowing recovery for pure economic loss in tort arises because of a concern that it is no part of the role of tort law to allocate losses of this kind.

The gap between the extent of the auditors' responsibility for the loss and the extent of the auditors' liability for the loss is a cause for concern. First, there is concern that, where the harm caused is pure economic loss, it is not consistent with the overall rationale of the tort of negligence to impose liability upon a

<sup>87</sup> Ibid 833-4; see also *ibid* 877: discussion of reform of the doctrine of solidary liability.

<sup>88</sup> Corporations Law, Schedule 1, Table A, reg 66: 'Subject to the Law and to any other provision of these regulations, the business of the company shall be managed by the directors ....'; see *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34; Paul Redmond, *Companies and Securities Law — Commentary and Materials* (2nd ed, 1992) 236-43.

<sup>89</sup> See, eg, *A Research Study on Financial Reporting and Auditing — Bridging the Expectation Gap*, Report Commissioned by the Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia (1993) para 1003: "'expectation gap" should be used to describe the difference between the expectations of users of financial reports and the perceived quality of financial reporting and auditing services delivered by the Accounting Profession' (*Research Study on Financial Reporting and Auditing*); Godsell, above n 84, 16: The accounting profession 'needs to identify and resolve the various misconceptions among its clientele and user interest groups by attempting to re-educate the public and users of audit services insofar as their current expectations are unreasonable'.

<sup>90</sup> See, eg, Corporations and Securities Law Review Committee, Discussion Paper No 3, *Civil Liability of Company Auditors* (1985) 16-7, 19.

defendant which is disproportionate to the level of the defendant's responsibility for the loss.<sup>91</sup> Second, there are some practical concerns that are external to the operation of the law of tort and centre around the cost and availability of insurance.<sup>92</sup> There is a strong argument that under the current system of liability auditors are required to provide companies with a form of insurance against losses in a market in which it is not clear that client companies, or other users of information, wish to pay for such insurance.<sup>93</sup> In addition there is the further problem that there is some evidence that the market for the provision of third party insurance will fail to provide insurance cover at all or alternatively will provide insurance at a cost out of proportion to the risk being covered by the insurance policy.<sup>94</sup>

The following sections of this part of the article set out to explain why the interaction of the common law with the statutory regime for the regulation of financial disclosure has produced an excessive level of liability for auditors.

### B *Disclosure of financial information required by the Corporations Law*

This section gives a brief overview of the regulation of the disclosure of financial information provided for in the Corporations Law. One element of this scheme of regulation is the statutory duties which are imposed on auditors. In order to understand the nature and extent of these duties it is important to place these duties in the wider context of the regulation of the disclosure of financial information generally.

The Corporations Law sets up an extensive scheme regulating the disclosure of financial information by companies. The most basic requirement is that a company must keep 'such accounting records as correctly record and explain its transactions ... and financial position'. These accounting records must be kept so that '(i) true and fair accounts of the company can be prepared from time to time; and (ii) its accounts can be conveniently and properly audited in accordance with this Law'.<sup>95</sup> At the end of each financial year a company's directors are required to prepare a profit and loss statement and a balance sheet.<sup>96</sup> In addition to these statements which must be prepared by individual companies

<sup>91</sup> See above nn 41-50 and accompanying text; see also, eg, Report of Stage One, *Inquiry into the Law of Joint and Several Liability*, above n 1, 26-7; Report of the Working Party of the Ministerial Council for Corporations, *Professional Liability in relation to Corporations Law Matters* (June 1993) 40-3 ('*Professional Liability in relation to Corporations Law Matters*'); Small, above n 6.

<sup>92</sup> See above n 4.

<sup>93</sup> See, eg, Victor Goldberg, 'Accountable Accountants: Is Third-Party Liability Necessary?' (1988) 27 *Journal of Legal Studies* 295, 304: 'Such market evidence suggests that rational third parties would not want to buy *any* financial product that conditioned recovery on the accountant's fault, given the costs of producing the assurance'; cf Bruce Chapman, 'Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law' (1992) 20 *Canadian Business Law Journal* 180, 198-202: liability in tort would be effective in increasing the quality of the work of auditors.

<sup>94</sup> See, eg, Priest above n 4; Ebke, above n 4; but cf Croley and Hansen, above n 4.

<sup>95</sup> Corporations Law sub-ss 289(1)(a) and (b).

<sup>96</sup> Corporations Law ss 292-3.

groups of companies are required to produce a consolidated profit and loss statement and a consolidated balance sheet.<sup>97</sup>

These financial statements are required to comply with regulations included in Schedule 5 of the Corporations Law. Schedule 5 includes a scale of ascending requirements for companies depending upon the level of 'public involvement'.<sup>98</sup> In addition all companies 'in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decision about the allocation of scarce resources' are required by the Corporations Law to comply with the relevant accounting standards.<sup>99</sup> If directors are of the view that the financial statements compiled in accordance with these requirements do not give a 'true and fair view' of the companies financial affairs the directors may provide such extra information as is needed for the accounts to give a true and fair view. The financial statements must be audited and a copy of the auditors report is to be attached to the financial statements.<sup>100</sup>

The directors of the company are required to present these financial statements to the company's annual general meeting. In addition to the profit and loss statement and the balance sheet, directors are also required to present copies to the annual general meeting of the directors' report, the directors' statement and the auditor's report.<sup>101</sup> Every member is entitled to a copy of these financial statements.<sup>102</sup> Within one month of the annual general meeting every company must submit an Annual Return to the Australian Securities Commission. This includes basic information about the status of the company, the identity of its

<sup>97</sup> This requirement is formally imposed on an 'economic entity' by Corporations Law ss 295A-B. Section 294A states that the definition of an 'economic entity' is that included in the relevant Accounting Standard. Accounting Standard AASB 1024 defines an 'economic entity' as a group of entities comprising the parent entity (defined to mean an entity which controls another entity) and each of its subsidiaries (defined to mean an entity which is controlled by a parent entity). The definition of *control* included in AASB 1024 is 'the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with in achieving the objectives of the controlling entity'. Accounting Standard AASB 1026 requires the parent entity of each economic entity to produce a Statement of Cash Flows.

<sup>98</sup> Corporations Law s 297.

<sup>99</sup> The quoted portion is the definition of 'Reporting Entity' found in Statement of Accounting Concepts ('SAC') 1. Section 298 of the Corporations Law requires that financial statements comply with applicable accounting standards. The applicable accounting standards are formulated by the Australian Accounting Standards Board which was established by Part 12 of the Australian Securities Commission Law. AASB 1025 requires that only 'reporting entities' comply with applicable accounting standards.

<sup>100</sup> Corporations Law s 296.

<sup>101</sup> Corporations Law s 316; an annual general meeting is required to be held: Corporations Law s 245. A directors' statement must include a statement that in the directors' opinion the financial statements give a 'true and fair view of the company's state of affairs': s 301. A directors' report includes information as to the identity of directors, the proposed payment of dividends and likely developments which may affect the company's operations or results: s 304. For a brief summary of the matters on which the auditor is to report, see below nn 111-6.

<sup>102</sup> Corporations Law s 315.

directors, its registered office, and its share capital.<sup>103</sup> Public companies are required to file copies of their financial statements with the annual return.<sup>104</sup> When lodged with the Australian Securities Commission the financial statements formally become available to the public.

In addition, there is further regulation of disclosure of financial information by the Corporations Law for public companies which are listed on the Australian Stock Exchange ('ASX'). The Corporate Law Reform Act 1994 (Cth) has enhanced the disclosure requirements for listed public companies and certain other companies.<sup>105</sup> Listed companies and certain other entities are required to lodge financial statements every six months with the ASC.<sup>106</sup> The Act allows the directors of a company to choose either to have the half yearly reports audited or to have the auditor include a statement which reaches a conclusion as to 'whether ... any matter has come to the auditor's attention that causes the auditor to believe that they are not drawn up' so as to give a true and fair view.<sup>107</sup> In addition, 'disclosing entities' which include listed companies are required to notify the ASX immediately 'of any information of which it becomes aware that a reasonable person would expect to have a material effect on the price of or value of the securities of the company'.<sup>108</sup>

Within this overall scheme of regulation of financial disclosure all companies except exempt proprietary companies are required to appoint an auditor.<sup>109</sup> The auditors when appointed are required to make a report to the members of the company on the financial statements which are presented to the annual general meeting of the company.<sup>110</sup> An auditors report is required to report on a range of matters including:

- whether proper accounting records have been kept;<sup>111</sup>

<sup>103</sup> Corporations Law s 335; Corporations Regulations 1990 (Cth) reg 3.8.01. The annual return also contains some basic financial information about the company for all companies other than exempt proprietary companies who have had their accounts audited: reg 3.8.01(r). An exempt proprietary company is in general terms a proprietary company no share of which is owned by a public company: ss 69, 116.

<sup>104</sup> Corporations Regulations 1990 (Cth) reg 3.8.02.

<sup>105</sup> Corporate Law Reform Act 1994 (Cth) (received Royal Assent on 4 March 1994). Those parts of Schedules 1 and 2 dealing with periodic reporting were proclaimed on 1 July 1994. Those parts of Schedules 1 and 2 dealing with 'continuous disclosure' were proclaimed on 5 September 1994.

<sup>106</sup> Ibid ss 50A, 111AO, 292, 293, 293A. See also s 111AC: definition of 'disclosing entity'; s 317A: requirement to lodge accounts with the ASC. These provisions commenced operation 1 July 1994.

<sup>107</sup> Ibid s 331AA.

<sup>108</sup> ASX Listing Rule 3A(1). All 'disclosing entities' (s 111AC) whose securities are listed on a securities exchange are, by s 1001A, required to comply with this Listing Rule. Failure to comply with s 1001A is a criminal offence, may be the subject of orders to the company to comply with the Listing Rule (ss 777, 1114) and may be the subject of an action to recover damages under s 1005. Schedules 1 and 2 (which include s 1001A) of the Corporate Law Reform Act 1994 (Cth) were proclaimed on 5 September 1994.

<sup>109</sup> Corporations Law ss 325-7.

<sup>110</sup> Ibid s 331A.

<sup>111</sup> Ibid s 331E(2)(b).

- whether the financial statements are drawn up so as to comply with applicable accounting standards;<sup>112</sup>
- whether the financial statements are properly drawn up so as to comply with the requirements of the Corporations Law, that is, give a true and fair view of the company's state of affairs;<sup>113</sup>
- whether the consolidated accounts of the economic entity comply with the requirements of the Corporations Law;<sup>114</sup>
- whether the financial statements include any defects and irregularities, and if so to form an opinion, after investigation, as to the nature of the deficiency;<sup>115</sup> and
- whether there has been any contravention of the Corporations Law.<sup>116</sup>

An auditor *must* form an opinion on each of these matters and *must* report to the company's members. An auditor may not in any way disclaim responsibility for the content of the report to members. In this sense the duties imposed on auditors are mandatory duties.

As this brief overview indicates the regulatory scheme for the disclosure of financial information is both detailed and complex. At its simplest level the rationale for this complex scheme of regulation is that the disclosure of financial information will allow participants in the securities markets to make informed and effective investment decisions about the allocation of scarce resources.<sup>117</sup> This scheme for regulation does not therefore attempt to determine how companies invest their funds rather it sets out to expose the decisions of companies to the full view of the participants in the securities markets who are in a position to assess the effectiveness of those decisions. The traditional rationale is summed up in the often used quote of Louis Brandeis that '[s]unlight is said to be the best of disinfectants, electric light the most efficient of policeman'.<sup>118</sup>

<sup>112</sup> Ibid ss 298, 331B(1)(c), 332A.

<sup>113</sup> Ibid s 331B(1)(a).

<sup>114</sup> Ibid s 331B(1)(b).

<sup>115</sup> Ibid ss 331D, 331E

<sup>116</sup> Ibid s 332(10); see Australian Securities Commission Practice Note 36.

<sup>117</sup> See, eg. Redmond, above n 88, 47-9, 96-8; Mark Blair, 'The Debate Over Mandatory Disclosure Rules' (1992) 15 *University of New South Wales Law Journal* 177, 192-3; Christian Meier-Schatz, 'Objectives of Financial Disclosure Regulation' (1986) 8 *Journal of Comparative Business and Capital Market Law* 219, 219-26; Ebke, above n 4, 670-5. See also Caparo [1990] 2 AC 605, 625-6 (Lord Bridge).

<sup>118</sup> Redmond, above n 88, 801. See also speeches of the federal A-G, Mr Michael Lavarch, in relation to proposals to introduce continuous disclosure in the Corporate Law Reform Bill 1993 (Cth) when he stated that '[t]he old judicial aphorism that "sunlight is the best disinfectant" in the context of corporate disclosure simply meant that entities raising funds from the public should disclose enough information about their affairs to enable investors to make informed investment decisions': quoted in William Paterson, (1993) 26 *Butterworths Corporation Law Bulletin* [489], 360.

C *The nature of the services provided by auditors in the statutory scheme of disclosure*

The statutory scheme requiring disclosure of financial information is a scheme designed to regulate the flows of information between companies and securities markets. The statutory scheme is not designed to define the circumstances in which auditors and others will be legally responsible for the losses caused by their negligence. A determination of the appropriate system of liability for auditors cannot be founded solely on the basis of a number of mandatory duties which are imposed on auditors. Civil liability must be dependent upon the way in which information provided by auditors is actually used because liability should be dependent upon the way in which potential plaintiffs actually use, and rely upon, the information provided by auditors. The primary test for a system of liability for auditors should be whether or not this system of liability is consistent with the actual role of auditors in the statutory scheme requiring disclosure of financial information. The purpose of the following section is to define with some precision the actual role of auditors in this scheme of regulation.

The first step towards defining the functions of auditors is to identify the rationale for this system of compulsory disclosure of financial information. There is an informed debate about the role of the statutory scheme of disclosure in providing the information which shareholders must use in making decisions about the value of a company's securities. The widespread acceptance of at least a semi-strong form of the Efficient Capital Markets Hypothesis<sup>119</sup> has led some commentators to question the value of a system of compulsory, or mandatory, disclosure of financial information. In particular these commentators have considered the possibility that without a system of mandatory disclosure, securities markets would continue to operate efficiently.<sup>120</sup>

The responses to these claims about the effectiveness of a system of mandatory disclosure have focused on the ways in which this system of disclosure has affected the cost and availability of information. In particular various commentators have argued that the system of mandatory disclosure has reduced the cost of obtaining, processing and verifying information.<sup>121</sup> One particular problem

<sup>119</sup> The semi-strong form of the Efficient Capital Markets Hypothesis asserts that all publicly available information will be taken into account when prices of securities are determined by securities markets: see, eg, Blair, above n 117, 184:

The empirical evidence to date tends to support the view that securities markets exhibit semi-strong form efficiency in the sense that they react quickly to publicly released information, setting prices in an unbiased and systematic manner to reflect the information content of the disclosures.

The use of the term 'publicly released information' includes all information which is released by the company and is not restricted to information which is available to the public: see Ronald Gilson and Reiner Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549, 569: 'rapid price equilibration does not require widespread dissemination of information, but only a minority of knowledgeable traders who control a critical volume of trading activity'; see also 549-65; 569-72: role of professionally informed traders in impounding information in prices; Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 297.

<sup>120</sup> See, eg, Easterbrook and Fischel, above n 119, 276-83.

<sup>121</sup> This terminology as used by Gilson and Kraakman, above n 119, 594-5.

which may arise without a system of mandatory disclosure is that certain kinds of information may be underproduced because the suppliers of information would not be able to secure the full benefits of producing the information.<sup>122</sup> In this context some commentators have argued that the primary justification for the statutory system of mandatory disclosure is that this mandatory system defines the standards setting out the quantity and quality of information which all companies have to disclose.<sup>123</sup> A further argument is that a system of mandatory disclosure reduces the overall cost of obtaining, processing and verifying information.<sup>124</sup>

The role of the auditor in this system of mandatory disclosure is essentially one of verifying that accounting records have been kept and that the financial statements presented to an annual general meeting comply with the relevant accounting standards and with the other requirements included in the Corporations Law.<sup>125</sup> In verifying that the financial statements do give a 'true and fair view' of the company's financial position the role of the auditor has been described as that of a 'reputational intermediary'.<sup>126</sup> As an independent third party the auditor adds value to the information by verifying that the information produced by the company reaches certain defined standards of quality.<sup>127</sup> This is one of the primary ways in which the system of mandatory disclosure reduces the cost of verification which would otherwise face users of information produced by companies.

There are some important qualifications to the role of the auditor as an 'reputational intermediary'. The first is that participants in the market receive

<sup>122</sup> This is primarily because information is characterised as a 'public' good. A public good is one where the use of the information by one person does not reduce the overall supply available for others and where the owners of the information cannot exclude those who have not paid for the good from using the good. The traditional example of a public good is a system of national defence: see Blair, above n 117, 189-190. The status of financial information as a public good will mean that companies will not provide a range of information unless all companies are required to do so. This is because they will not be able to obtain the benefits of releasing the information and may sustain losses if they give away information which gives a competitive advantage which is not supplied by all other companies: see Easterbrook and Fischel, above n 119, 290-2.

<sup>123</sup> Easterbrook and Fischel, above n 119, 300-8.

<sup>124</sup> Gilson and Kraakman, above n 119, 638:

Mandatory disclosure might still have created substantial savings for informed traders by collectivising some of the costs of acquiring, processing, and verifying information that traders had independently expended prior to the [introduction of a system of mandatory disclosure by the Securities Exchange Act 1934]. In short, a plausible explanation of the effects of the 1934 Act is that it increased the *net* returns to informed traders rather than their gross returns, through savings on investment in information rather than through increases in trading profits.

<sup>125</sup> Auditors have a limited role in detection fraud: see Corporations Law s 332(10). See also *Research Study on Financial Reporting and Auditing*, above n 89, paras 1051-2; G Gay and G Pound, 'The Role of the Auditor in Fraud Detection and Reporting' (1989) 8 *Company and Securities Law Journal* 116, 117: 'The view of the auditing profession today is that the auditors' responsibility for the detection of fraud is secondary to the primary duty to report on whether the accounts of the company are "true and fair" or present fairly the company's financial position and the results of its operations'.

<sup>126</sup> Gilson and Kraakman, above n 119, 607 n 166; Easterbrook and Fischel, above n 119, 289-90.

<sup>127</sup> Gilson and Kraakman, above n 119, 603: on 'signalling'.

information about the company from a variety of sources before it is released in a formal way to shareholders at each annual general meeting. The second is that there are a number of other ways in which participants in the securities market can verify the accuracy of the information available to them. Each of these factors has the effect of reducing the extent of the role of the auditor as the person responsible for verifying the accuracy of financial information held by participants in the market.

Participants in the financial markets receive information from a number of sources prior to the formal release of financial statements by companies. Formal financial statements do not provide investors with *new* information.<sup>128</sup> The system of mandatory disclosure does not equalise access for all investors to new information. There are many ways in which information reaches the securities markets. Informed traders continue to have access to information not provided to the public generally and informed traders can make more immediate use of the information which is generally available.<sup>129</sup> The immediate consequence of this is that when auditors verify the accuracy of the information provided to shareholders at each annual general meeting they are for the most part verifying the quality of information already in circulation.

The second factor tending to limit the role of auditors as 'reputational intermediaries' is that there are a wide range of ways of verifying the accuracy of information available to participants in securities markets. The first among these is that *all* participants in the securities markets are forced to rely on the effectiveness of a company's system of corporate governance. It is the directors who are ultimately responsible for preparing accounts and for providing information to shareholders and others.<sup>130</sup> There is very little evidence that either shareholders, directors or managers wish to improve the system of corporate governance by providing auditors with increased powers and responsibilities.<sup>131</sup>

Companies can, in addition to the appointment of auditors, choose to use other forms of reputational intermediaries including underwriters and investment banks. These intermediaries use their reputation to signal the accuracy of the

<sup>128</sup> See above n 119 on the role of 'informed traders'; see also Blair, above n 117, 184-6.

<sup>129</sup> See above n 119.

<sup>130</sup> Corporations Law ss 292-3; 296-9: each of the relevant duties is imposed on the *directors* of the company. See also Brian Cheffins, 'Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow' (1991) 18 *Canadian Business Law Journal* 118, 123; Paul Ruttman, 'Corporate Governance and the Auditor' in D Prentice and P Holland (eds), *Contemporary Issues in Corporate Governance* (1993) 60-4.

<sup>131</sup> In the wide ranging debate about the appropriate form of 'corporate governance' for large public companies the focus has been on the role of the 'institutional investor': see, eg, *Relational Investing*, Conference organised as part of the 'Institutional Investor Project' by the Centre for Law and Economic Studies, Columbia University School of Law, New York, May 6-7 (1993). There has been relatively little discussion of the more extensive use of auditors as part of a more effective system of corporate governance. For a discussion of the costs and the benefits of the use of auditors as part of the system regulating companies and securities markets, see Reinier Kraakman, 'Gatekeepers: The Anatomy of a Third Party Enforcement Strategy' (1986) 2 *Journal of Law, Economics and Organisations* 53.

relevant information provided by the company.<sup>132</sup> In specific circumstances companies may choose to provide specific warranties concerning the accuracy of the information on which they are encouraging a bargaining party to rely. In addition users of information may choose to rely on information supplied by credit rating agencies who use their reputation to signal the accuracy of the information that they provide.<sup>133</sup> Finally some companies may have 'purchased' over a period of time a reputation for providing accurate information.<sup>134</sup>

The wide availability of information and the wide range of ways of verifying existing information both indicate the limits on the role of the auditor as an reputational intermediary. Both of these factors indicate that users of information will often rely on information not verified by an auditor at all or will seek to use alternative means of verifying existing information which is available.<sup>135</sup> In either case the auditor is only one of the parties upon whom a user of information relies when making decisions about whether to enter into a particular transaction.

There are two general propositions to be drawn from this broad ranging analysis of the role of auditors in the scheme regulating the disclosure of financial information. The first proposition is that auditors are 'reputational intermediaries' which have the function of verifying information that is already available to participants in the market. The second proposition is that auditors are not the only persons or institutions fulfilling this role in the market for information.

This brief analysis of the nature of the services provided by auditors as part of the system regulating the disclosure of financial information highlights the importance of distinguishing between the goals of this regulatory regime and the functions of the common law. The statutory regime defines the outlines of the market for information. The duties imposed on auditors required them to provide a relatively specific set of services as part of the regulation of the market for

<sup>132</sup> Kraakman, above n 131, 95-100: an assessment of use of reputation as a strategy to monitor corporations issuing securities.

<sup>133</sup> See, eg, J Coleman, 'Letter', *Australian Financial Review*, 24 October 1991 in Redmond, above n 88, 129:

The notion that any competent banker or professional lender would find the publicly disclosed accounts of an exempt proprietary company of interest, let alone useful, before deciding whether or not to provide finance is, frankly, bizarre .... Nowadays, such lenders demand up-to-date accounts directly and in even the soundest of businesses directors' personal guarantees are almost mandatory. Other creditors, such as suppliers of goods and services, ought to make their own inquiries. The reputable credit reference agencies are well-equipped to handle such matters on their behalf.

<sup>134</sup> See generally Gilson and Kraakman, above n 128, 602-9.

<sup>135</sup> See, eg, *Columbia Coffee & Tea Pty Ltd v Churchill* (1992) 29 NSWLR 141: auditors owed a duty of care to the plaintiffs but the plaintiffs were unable to establish actual reliance on the formal financial statements. See also Robert Baxt, 'The Liability of Auditors — The Pendulum Swings Back' (1990) 8 *Company and Securities Law Journal* 249, 256. In reference to the decision in *Caparo* [1990] 1 All ER 568, Baxt argues that:

Caparo in my view would have great difficulty in establishing this if the facts as pleaded were the only facts that would have been relied on .... Such an investor would generally have to show that it had relied on other information as well in reaching a decision to make a take-over offer worth millions of dollars.

information. These duties are not imposed on auditors for the purpose of, or with reference to, determining the nature or extent of the liability of auditors with respect to the breach of any of these duties. By contrast the common law is concerned with compensating a particular person for losses caused by a particular breach of duty. The fundamental failure of the common law, which is discussed in the following section, is that the common law has not found a way of identifying the 'damage' caused by breach of duty by an auditor.

#### D *The system of auditors' liability*

The last two sections have given a brief introduction to the regulation of the disclosure of financial information by companies and have identified the role of auditors as 'reputational intermediaries'. The following sections establish that there is a disjuncture between the formulation of the duty of care and the identification of the damage for which auditors are liable. The final section of this part argues that this disjuncture creates an indeterminate level of liability which cannot be removed using ordinary common law methods and principles.

This article is concerned with the common law liability of auditors arising out of the reports which auditors must make in relation to the financial statements produced by companies as part of their ongoing disclosure requirements that are imposed by the Corporations Law.<sup>136</sup> Auditors are exposed to two kinds of common law liability arising out of losses sustained following the disclosure of information in these financial statements. The first kind is liability to the client, that is, the company whose accounts are being audited. Liability of this kind to the client may be in either contract or in tort. The second kind of liability is liability to third parties who sustain a loss as a result of reliance on the auditor's report in making a financial decision. This kind of liability arises out of tort and is a form of liability for negligent misstatement. The following sections briefly outline the state of the law in relation to both of these kinds of liability.

##### (i) *Liability to clients*

The changes in the source of liability of auditors to their clients have reflected the wider changes in the role of the law of torts and of contract. The liability of an auditor to a client was thought to arise out of contract alone.<sup>137</sup> In this sense the liability of auditors to their clients followed the model of liability of profes-

<sup>136</sup> Corporations Law, Parts 3.6-3.7: see above nn 111-6 and accompanying text. In addition to common law liability auditors, along with other professionals, are subject to liability in relation to the issue of prospectuses. This area of liability of professionals is also being considered as part of the overall review of professional liability: see *Professional Liability in relation to Corporations Law Matters*, above n 91. Liability is imposed on those professionals responsible for making statements in a prospectus: see Corporations Law, Division 4 of Part 7.11, ss 1005-6, and the available defences in ss 1007-11. This liability is similar in nature to the liability of auditors to third parties: see below nn 157-67 and accompanying text.

<sup>137</sup> See, eg, *Pacific Acceptance Corporation Ltd v Forsyth* [1970] 92 WN (NSW) 29, 47: 'The cause of action in each case is for breach of contractual duty of the defendants as auditors.'

sionals more generally.<sup>138</sup> Consistent with recent developments in the common law, the liability of auditors to their clients now arises independently in both contract and tort.<sup>139</sup> In the recent decision of *AWA Ltd v Daniels*, Rogers J stated that:

In my view, the position of the auditors amply justifies the conclusion that they have a concurrent liability in contract and in tort. In *Johnson v Perez*<sup>140</sup> Wilson, Toohey and Gaudron JJ said: 'The trend of modern authority is to apply the common law of negligence to professional relationships.'<sup>141</sup>

The application of the tort of negligence to auditors has produced a scheme of liability in tort and contract in which the duties arising independently in tort and contract are coextensive. This is important because there is some uncertainty when the tort of negligence is applied to other professions as to whether the duties imposed by the tort of negligence are more extensive than those arising out of the operation of contract.<sup>142</sup>

The auditor's statutory duty to report to the company's shareholders is a personal duty which may not be delegated.<sup>143</sup> In *Dominion Freeholders v Aird*, an auditor brought an action claiming contribution from the client company's accountant on the basis that the auditor relied upon incorrect information supplied by this person when making the statutory report to the company's shareholders. In concluding that the auditor had no cause of action, Wallace P stated that:

[T]he statutory duties of the auditor in relation to the balance sheet and profit-and-loss account and other accounting records are very responsible *personal* duties. It is *his* opinion which must be set forth in *his* report. I do not wish to embark on the unprofitable subject of the full nature and extent of an auditor's duties, but I can certainly say that it seems out of the question that he should

<sup>138</sup> *Groom v Crocker* (1939) 1 KB 194, 205: 'The relationship of solicitor and client is a contractual one .... It was by virtue of that relationship that the duty [of skill and care] arose, and it had no existence apart from that relationship'.

<sup>139</sup> *Hawkins* (1988) 164 CLR 539, 543-7 (Mason CJ and Wilson J), 548 (Brennan J, who considered the duty of care in tort in addition to duties arising out of the contract), 574-7, 582-6 (Deane J), 592-4 (Gaudron J, who did not need to consider the issue of whether duties in tort and contract are concurrent). See, eg, *BGJ Holdings Pty Ltd v Touche Ross & Co (a firm)* (1988) Aust Torts Reports ¶ 80-152, 67,365-7: duties in tort and contract are concurrent for auditors.

<sup>140</sup> (1988) 166 CLR 351, 363.

<sup>141</sup> (1992) 7 ACSR 759, 857.

<sup>142</sup> Cf *Hawkins* (1988) 164 CLR 539, 582-6 (Deane J): the duty of care in tort imposed a more extensive duty on the defendant than the terms of the contract; *with* 544-5 (Mason CJ and Wilson J): duty in tort is no more extensive than in contract. See also *BGJ Holdings Pty Ltd v Touche Ross & Co (a firm)* (1988) Aust Torts Reports ¶ 80-152, 67,367: 'circumstances arising out of the conduct of the audit may give rise to a duty of the auditor in tort (if not in contract)'. See also *Tai Hing Cotton Ltd v Liu Chong Bank Ltd* [1985] 2 All ER 947 (Privy Council): duties imposed by common law in commercial relationships not to be more extensive than those arising out of contract. Note that this question is separate from the other incidents arising out of concurrent duties in tort and contract, eg, the operation of different limitation periods in tort and contract, the availability of the defence of contributory negligence, or the availability of rights of contribution: see, eg, *AWA Ltd v Daniels* (1992) 7 ACSR 759, 841-54: contributory negligence; 856-76: contribution.

<sup>143</sup> See above nn 111-6: auditors duties as specified in the Corporations Law.

fulfil the statutory duty and express his opinion as to whether the balance sheet is true and fair by relying upon and adopting the opinion of another on that very matter.<sup>144</sup>

In complying with this personal duty auditors are required to reach a level of knowledge about the company's state of affairs. In *Pacific Acceptance Corporation Ltd v Forsyth*, Moffit J outlined the kind of knowledge that an auditor would be expected to build up in an audit in the following terms:

Once it is accepted that the auditor's duty requires him to go behind the books and determine the true financial position of the company and so to examine the accord or otherwise of the financial position of the company, the books and the balance sheet, it follows that the possible causes to the contrary, namely, error, fraud or unsound accounting are the auditor's concern. ... If, as Pollock MR did, one were to cast aside the watchdog and bloodhound metaphors and prefer to say, as did Sargant LJ, 'the duty of an auditor is verification and not detection'<sup>145</sup> then it is true to say the process of verification cannot properly be carried out except by a procedure that takes account of the possibility that the affairs examined may not be true, due to errors, innocent or fraudulent, appearing in the records.<sup>146</sup>

In a similar way Rogers J explicitly defined the relevance of the auditor's knowledge of failings in the company's accounting system in *AWA Ltd v Daniels* when he stated that '[t]he first question is whether the auditors were entitled to do nothing regarding the absence of internal controls, which they had noted and recognised in June 1986'.<sup>147</sup> It is the knowledge which an auditor is required to possess in order to comply with the relevant statutory duties which creates the necessary proximity between the auditor and the company.

The satisfaction of the requirement of proximity is determined with reference to the statutory duties imposed on auditors. The element of proximity in actions brought by client companies against the auditors is satisfied when auditors have access to knowledge which, if provided to the company, would have prevented the company from sustaining damage. Some actions against auditors by client companies are for the losses sustained by the client company as a result of the auditor's failure to qualify the company's accounts.<sup>148</sup> Other actions are for failure of the auditor to bring defects to the notice of senior management,<sup>149</sup> or to

<sup>144</sup> (1966) 67 SR (NSW) 150, 156-7.

<sup>145</sup> *In re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407, 509 (further references omitted). See *In re Kingston Cotton Mill Co (No 2)* [1896] 2 Ch 279, 288: auditors are to adopt the role of a 'watchdog' rather than a 'bloodhound'.

<sup>146</sup> (1970) 92 WN (NSW) 29, 63-4. The source of the duty in this case was found in contract. The process of determining the nature and extent of the duty follows a process similar to that of establishing the 'proximity' between the parties. In both cases the statutory duties imposed on auditors (see above nn 111-6) are the basis for either the implied contractual term or for the tortious duty of care.

<sup>147</sup> (1992) 7 ACSR 759, 835.

<sup>148</sup> See, eg, *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29; *Simonius Vischer & Co v Holt* [1979] 2 NSWLR 322; *Alexander v Cambridge Credit Corporation* (1987) 9 NSWLR 310.

<sup>149</sup> See eg, *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29; *Arthur Young and Co v WA Chip and Pulp Co Pty Ltd* [1989] WAR 100.

bring to the notice of the board of directors the failure of senior management to respond appropriately to the knowledge of the defects which have been brought to their attention by the auditor.<sup>150</sup> The use of the statutory duties to determine whether there is sufficient proximity between the client and the auditor means that the auditor's duty of care is defined without reference to the harm caused by that breach of duty.

The only limit on the extent of an auditor's liability is the requirement that there be a sufficient causal connection between the breach of duty and the damage. The test of causation applied here is that the damage must be 'caused or materially contributed to' by the defendant's breach of duty.<sup>151</sup> This characteristic of the element of causation is particularly relevant for auditors because it will often be the case that there will be a causal connection between the auditor's breach of duty and the plaintiff company's damage in the sense that the damage would have been prevented if the auditor had complied with their duty of care. In addition the causation requirement will itself be considered in the context of the extent of the auditors duty of care to prevent the very kind of losses which will ordinarily be sustained as a result of the breach of those duties.<sup>152</sup> The requirement that the plaintiff establish a causal connection between the breach of duty and the damage will not prevent auditors from being exposed to an amount of liability which is disproportionate to the extent of their fault. The element of causation serves only to define the outer boundaries of the extent of liability by requiring that the breach of duty be 'a cause' of the damage.

This element of causation will not provide a way of apportioning blame between auditors and plaintiffs even if probabilistic approaches to causation are adopted.<sup>153</sup> The use of probabilistic approaches to causation is associated with the recognition that the 'loss of a chance' may be sufficient damage to initiate a cause of action in negligence. Where a defendant negligently causes the plaintiff

<sup>150</sup> *AWA Ltd v Daniels* (1992) 7 ACSR 759, 841:

The fact of the matter is that any inquiry following upon a disclosure on 22 September [to the board of directors] of the defects in the system of operations known to the defendants would have brought to light the fact that the approximate value of open contracts at that stage was \$750m. The FX market would not have moved with greater rapidity than the directors would have done once they learnt that fact. Accordingly I am satisfied that the plaintiff has proved negligence of the defendants and that the negligence was a cause of the loss suffered.

<sup>151</sup> See *March v Stramare (E and MH) Pty Ltd* (1991) 171 CLR 506, 515 (Mason CJ): 'must be determined by applying common sense to the facts of each particular case'; 523 (Deane J): causation test is the 'common sense idea of what is meant by saying that one fact is a cause of another'; 524-5 (Toohy and Gaudron JJ agreed with Mason CJ); *but* cf 532 (McHugh J): 'but for' test is the test for causation but is to be applied in a 'practical commonsense way'. See *AWA Ltd v Daniels* (1992) 7 ACSR 759, 838: applying commonsense approach to causation.

<sup>152</sup> See, eg, *March v Stramare (E and MH) Pty Ltd* (1991) 171 CLR 506, 518 (Mason CJ):

As a matter of both logic and common sense, it makes no sense to regard the negligence of the plaintiff or a third party as a superseding cause ... when the defendant's wrongful conduct has generated the very risk of injury resulting from the negligence of the plaintiff or a third party and that injury occurs in the ordinary course of things.

See also 521 (Deane J).

<sup>153</sup> See, eg, Perry, above n 28; John Fleming, 'Probabilistic Causation in Tort Law' (1989) 68 *Canadian Bar Review* 661; Michael Tilbury, *Civil Remedies* (1990) vol 1, 71, para [3065]. See *Hotson v East Berkshire Area Health Authority* [1987] AC 750. There has been no general acceptance of the notion that loss of an opportunity may amount to 'damage': see above n 31.

to lose a chance of making a gain,<sup>154</sup> or negligently causes the plaintiff to lose an opportunity to make a recovery,<sup>155</sup> it will only be possible to value the lost opportunity if there is some relatively certain valuation of that lost opportunity. The problem in applying this approach to auditors is that it is difficult to assess the value of the lost opportunity to the company that is caused by an auditor negligently failing to make a proper report to the company. It will be difficult to assess the value of this lost opportunity because of the range of causes of the loss sustained by the company. Inevitably the value of this lost opportunity will depend upon an assessment of the degree of the auditor's overall responsibility for the actual loss. As the final section of this part of the article notes, this is not an assessment which is easy for a court to make using ordinary common law techniques and principles.<sup>156</sup>

The system of liability for auditors therefore creates a disjuncture between the formulation of the duty of care and the identification of the damage. As a result of this disjuncture the common law methods and principles which create a rational connection between fault and liability are not available to prevent auditors being exposed to an indeterminate level of liability.

*(ii) Liability to third parties*

Unlike client companies third party users of financial statements are not in a contractual relationship with the auditor. The claim by a third party user of a financial statement against an auditor of financial statements is in the form of a claim to recover pure economic losses for negligent misstatement. The range of third party plaintiffs to whom an auditor may owe a duty of care is therefore potentially indeterminate. By contrast with the liability to clients the problem of the indeterminate plaintiff is added to the problem of the indeterminate level of liability to which auditors are potentially exposed. In general terms the common law has responded to the problem of the indeterminate plaintiff by limiting the possible range of third parties to whom a duty of care may be owed by an auditor. However the system of liability of auditors in relation to third parties still retains the underlying problem of an indeterminate level of liability to this reduced number of plaintiffs.

The element of the tort of negligence which has been the focus of consideration for identifying the determinate plaintiff in cases dealing with the liability of auditors to third parties is the element of the duty of care.<sup>157</sup> The leading case in

<sup>154</sup> See, eg, *Sellars v Adelaide Petroleum NL* (1994) 120 ALR 16; see above n 57.

<sup>155</sup> *Hotson v East Berkshire Area Health Authority* [1987] AC 750.

<sup>156</sup> See, eg, *AWA Ltd v Daniels (No 2)* (1992) 9 ACSR 383.

<sup>157</sup> See, eg, Godsell, above n 84 (Ch 3, 'Duty of Care'); Robert Baxt, 'Modern Company Auditor: A Bloodhound Without Teeth or a Watchdog without Eyes' (1986) 24 *Osgoode Hall Law Journal* 667; Baxt, above n 135; Chapman, above n 93; Cheffins, above n 130; Martin Davies, 'The Liability of Auditors to Third Parties in Negligence' (1991) 14 *University of New South Wales Law Journal* 171; Martin Davies, 'Auditors' Liability to Third Parties: *R Lowe Lippmann Figdor and Franck v AGC (Advances) Ltd*' (1993) 1 *Torts Law Journal* 114; Ebke, above n 4; Michael Mills, 'The Expectation Gap and Auditors' Responsibilities' (1990) 20 *University of Western Australia Law Review* 538; Kevin Nicholson, 'Third Party Reliance on Negligent Advice' (1991) 40 *International and Comparative Law Quarterly* 551; Benny S

defining the duty of care is the House of Lords decision in *Caparo*.<sup>158</sup> In *Caparo*, the House of Lords decided that an auditor owed no duty of care to either investors (general users of third party users of financial statements) or shareholders of the auditor's client company. There were two reasons for this limitation on the extent of the duty of care owed by auditors to third parties. The first was that the defendant auditor had not been aware of either the particular plaintiff who would use the information, or of the precise transaction in which the information would be used. Lord Bridge argued that a statement made by an auditor pursuant to their statutory duties, that was put into general circulation, did not identify with any degree of certainty either the particular plaintiff who would rely on the statement or the particular use to which that statement would be put.<sup>159</sup> The second reason was that the purpose for imposing the statutory duties on auditors was to ensure that shareholders would be in a position to exercise an informed vote at the company's annual general meeting and not to provide shareholders with a personal right of action against the auditor.<sup>160</sup>

The post-*Caparo* cases dealing with the liability of auditors to third parties have set out to define the circumstances in which the particular plaintiff will be sufficiently close to the auditor for the auditor to be subject to a duty of care to that plaintiff. These cases have sought to define the necessary relationship of proximity, or reliance, that is required to establish a duty of care between an auditor and a third party.<sup>161</sup> The underlying problem for courts in applying the proximity requirement has been that the auditor's duty to report has been imposed on the auditor by the Corporations Law.

There have been a number of decisions in Australia which have sought to define the circumstances in which an auditor will be subject to a duty of care to a third party. In the most recent case of *Esanda Finance Corporation Ltd v Peat Marwick*,<sup>162</sup> the Full Court of South Australia considered and perhaps qualified the approach of Brooking J in *R Lowe Lippmann Figdor and Franck v AGC (Advances) Ltd*<sup>163</sup> and rejected the reasoning adopted by Cole J in *Columbia*

Tabalujan, 'Case Note: *R Lowe Lippmann Figdor and Franck v AGC (Advances) Ltd*' (1993) 19 *MULR* 229.

<sup>158</sup> [1990] 2 AC 605.

<sup>159</sup> *Ibid* 620-1. See also above nn 46-50 and accompanying text.

<sup>160</sup> *Ibid* 626-7. Lord Bridge found that the purpose behind the statutory requirements requiring the preparation of accounts was *not* to give general third party users of financial statements a cause of action against the auditor.

<sup>161</sup> *R Lowe Lippmann Figdor and Franck v AGC (Advances) Ltd* [1992] 2 VR 671, 679-81: application of the reasoning in *San Sebastian* (1986) 162 CLR 340 to conclude that the only circumstances in which it would be possible for an outside investor to rely upon an audit report attached to a company's financial statements would be where there was an intention to induce reliance. See also *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1993) Aust Torts Reports ¶ 81-243, 62,503: an intention to induce reliance is not an essential element in a claim by a third party to establish that the auditor owed a duty of care to the third party; *Columbia Coffee & Tea Pty Ltd v Churchill* (1992) 29 NSWLR 141, 171: intention to induce not an essential and discrete element of reliance in negligence misstatement.

<sup>162</sup> (1994) Aust Torts Reports ¶ 81-265.

<sup>163</sup> *Ibid* 61,155 (King CJ), 61,165-6 (Olsson J).

*Coffee and Tea Pty Ltd v Churchill*.<sup>164</sup> In this case the plaintiff was a creditor who had relied on the company's audited financial statements in making an investment. King CJ concluded that:

In cases such as the present where the plaintiff is not a member of the company to whom the auditor has a statutory obligation ... but has relied upon the audit report in investing in the company or entering into financial dealings with it, it seems to me that, in the absence of some feature indicating an assumption of responsibility to the plaintiff to exercise care in relation to the preparation of the audit certificate, an auditor is not under a duty of care to the plaintiff unless the auditor intended to induce the plaintiff to act in reliance on the audit certificate.<sup>165</sup>

This judgment seems to confirm that actual subjective intention to induce reliance by the auditor is not an essential element in establishing a duty of care owed by an auditor to a third party. Although the state of the law is somewhat uncertain, the reasoning in *Esanda Finance Corporation Ltd v Peat Marwick* seems to suggest that an auditor may owe a duty of care to a third party where the auditor is aware that a particular party will use the auditors report for a specific purpose in an identified transaction.<sup>166</sup>

The common law has therefore moved towards the position that an auditor will owe a duty of care to a determinate class of third parties. The level of liability to this determinate class of third parties is, as with the extent of liability to clients, potentially indeterminate in the sense that the level of liability need not be rationally connected to the degree of the auditor's fault or responsibility. The duty of care is formulated with reference to the statutory duties and independently of the identification of the damage. As in the case of the auditor's liability to client, the disjuncture between the formulation of the duty and the identification of the damage arises because auditors are unable to disclaim liability for the reports which they are required, by statute, to publish. The result is that a particular determinate plaintiff may rely on an auditor's report for a particular purpose that is known to both plaintiff and auditor but which nonetheless exposes the auditor to an indeterminate or disproportionate level of liability.<sup>167</sup>

<sup>164</sup> Ibid 61,156 (King CJ), 61,166 (Olsson J), 61,157 (Millhouse J, who agreed with King CJ and Olsson J).

<sup>165</sup> Ibid 61,155; 61,166 (Olsson J): assumption of responsibility may give rise to a duty of care; 61,157 (Millhouse J, who agreed with King CJ and Olsson J).

<sup>166</sup> One possible way of defining the element of proximity in these circumstances is that adopted in a recent article where it is suggested that there should be a duty of care owed by an auditor to a third party where the auditor 'knew, or ought to have known' that the third party would rely on the audited financial statements: see Davies, 'The Liability of Auditors to Third Parties in Negligence', above n 157, 194. This test would have the capacity to resolve the difficulties in cases such as *R Lowe Lippmann Figdor and Franck v AGC (Advances) Ltd* where the auditor was aware of the particular third party user and the particular purpose for which the information would be used. See also Baxt, above n 135, 253-6: reliance on auditors' reports will be more reasonable for small investors who have limited access to other sources of information while it will be difficult for large sophisticated investors to establish reliance because of access to numerous other sources of information.

<sup>167</sup> See above nn 49-50 and accompanying text: use of disclaimers in negligent misstatement. See also, eg, *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] 1 All ER 148. In this case the auditor issued a report which stated that a profit forecast produced by the client company had

The liability of professionals, including auditors, for statements made in prospectuses is a particular example of a case where an auditor's duty of care is owed to a determinate class of persons for a known purpose. Liability of professionals may nevertheless still have some of the same characteristics of indeterminacy as in the case of the liability of auditors to the third parties.<sup>168</sup>

### E Conclusion

This part of the article has established a number of basic characteristics about the system of liability for auditors. The first is that auditors are part of statutory regime governing the disclosure of financial information. Within this system of regulation auditors are given certain powers in order to carry out a defined set of responsibilities. As part of this system auditors arguably fulfil the role of providing the services of a 'reputational intermediary'.<sup>169</sup> The second characteristic of this system of liability is that auditors are exposed to an indeterminate or disproportionate level of liability. This system of liability is marked by the disjuncture between the formulation of the duty of care and identification of the 'damage'. The result of this disjuncture between the formulation of the duty and identification of the 'damage' is the inherent difficulty of identifying and valuing the 'damage' that is caused by a breach of duty by an auditor. At the heart of this system of liability is a lack of any proportionality between the services actually provided by auditors as reputational intermediaries and the extent of the liability to which they are exposed.

The system of liability for auditors produces an indeterminate level of liability because of the mis-match between the kind of services provided by auditors and the approach to the identification of the 'damage' caused by an auditor's breach of duty. The 'damage' which is the basis of the cause of action is the result of the bundling together of the outcome of a number of qualitatively different risks that have come to fruition.<sup>170</sup> One particular risk of loss to which the company is exposed is the provision of low quality information by the auditor. There are though a number of other persons whose acts or omissions expose the company

been properly compiled on a basis consistent with the accounting policies normally adopted by the group. The Court of Appeal (154-5, 159) found that each of the directors (and the auditor) 'in making the relevant representations, was aware that Morgan Crucible would rely on them for the purpose of deciding whether or not to make an increased bid, and *intended that they should*' so rely on the relevant representation. The auditor was required by City Code on Take-Overs and Mergers to make this report. Rule 28.3 provided that in all cases other than a forecast made by an offeror offering solely cash 'the accounting policies and calculations for the forecasts must be examined and reported on by the auditors or consultant accountants.' The requirement to issue the statement in this case is therefore analogous to the statutory duty to report on a company's financial statements.

<sup>168</sup> Corporations Law ss 1005, 1006, 1009. See *Professional Liability in relation to Corporations Law Matters*, above n 91: recommendations include the option of permitting auditors to operate as a limited liability company as an alternative to a capping regime.

<sup>169</sup> See above nn 127-8 and accompanying text.

<sup>170</sup> See above nn 51-61 and accompanying text: for there to be a rational connection between fault and liability 'damage' must be defined with reference to the specific risk which is the subject of the duty of care.

to the risk of loss, eg, directors<sup>171</sup> and corporate advisers. In addition the loss finally suffered by the company will, for investors and other stakeholders in the company, be the result of the transformation of the possibility of loss, which was an accepted part of the investment, into an actuality. There are a number of quite different bodies of law concerned with parcelling out responsibility for many of the different kinds of risk which are bundled together in this composite conception of 'damage'.

The law of contract is concerned with defining the exposure of the parties to particular risks which are associated with the transaction which is the subject of the contract.<sup>172</sup> The trade in various securities is concerned with the identification and pricing of certain risks.<sup>173</sup> Securities markets are 'a price setting mechanism, they facilitate the use of securities as collateral for loans, determine the price at which a company is able to issue securities'.<sup>174</sup> A more recent phenomenon is the trade in derivatives.<sup>175</sup> A feature of the trade in derivatives is that they 'allow [for] the decomposition and re-packaging of the risks of other activities and financial instruments to enable better management of the risks involved'.<sup>176</sup> All of the trading in securities takes place in the context of the provisions dealing with the liquidation of companies and with the bankruptcy of individuals. In the case of the winding up of a company, and in the case of a bankruptcy, there is a defined process for the repayment of creditors and shareholders in a specified order of priority.<sup>177</sup>

A composite conception of damage which bundles together a number of risks will necessarily include some which are defined, allocated and priced through any of the above mechanisms. The allocation of these risks is complex and sophisticated. The techniques of the common law in awarding damages to a plaintiff are not sufficiently sophisticated to allocate the full range of risks which are bundled together in this composite conception of 'damage'. Furthermore the central principles underlying the tort of negligence do not provide any rationale for upsetting the genuine expectations created by these other bodies of law. The award of damages to compensate for these composite losses can only have the

<sup>171</sup> See above n 88.

<sup>172</sup> See, eg, Easterbrook and Fischel, above n 119. See also Redmond, above n 88, 96-8: It is possible to conceive of the rules dealing with corporate governance as being a contract in which the parties seek to maximise their returns by minimising agency costs; Partlett, above n 22, 286: 'A plea for the private is to recognise the professional/client relationship as a species of relational contract and to view liability rules as a mechanism to alleviate agency costs'.

<sup>173</sup> Robert Baxt, Harold Ford and Ashley Black, *Securities Industry Law* (4th ed, 1993) 1: A 'security' may refer to property over 'which a creditor, or other obligee, is given rights by a debtor, or other obligor, in order to secure performance of a promise to repay money or of some other undertaking'. See also Corporations Law s 92: definition of 'securities'.

<sup>174</sup> Louis Loss, *Fundamentals of Securities Regulation* (2d ed, 1988) 591-2.

<sup>175</sup> Australian Securities Commission, *Report on Over the Counter Derivatives Markets* (1994) para 6: 'A "derivative" refers to that class of financial contract whose value depends on the values of one or more underlying assets or indexes of asset values.'

<sup>176</sup> *Ibid* para 25.

<sup>177</sup> See generally Corporations Law, ch 5. See also H A J Ford and R P Austin, *Ford's Principles of Corporations Law* (7th ed, 1994) paras 27.460-530. See also *Bankruptcy Act* 1966 (Cth).

impact of bringing the tort of negligence into conflict with rules and understandings that are part of these other areas of law.

The composite nature of the damage suffered by the company therefore precludes any possibility that it would be possible to 'price' the cost of accepting exposure to this damage. This is because of the lack of any rational connection between any specific risk and the damage suffered by the company. The lack of any rational connection between fault and liability will also have a substantial impact on the capacity of insurers to provide insurance in these circumstances.<sup>178</sup> The same problem will forestall any argument which would suggest that tortious liability would be a form of incentive to improve the level of auditing services and hence improve the overall operation of the system of corporate governance.<sup>179</sup>

The disproportionate level of liability which is imposed on auditors is neither justifiable nor manageable. There is no principled way in which the common law alone can modify the system of liability for auditors in order to establish a rational connection between fault and liability. The problem of deciding upon a system of liability for auditors which meets these objectives will require an open-ended analysis of the role and function of auditors and a consideration of the range of different ways of valuing the losses which breaches of duties by auditors produce. The final part of this article puts forward one such proposal for creating a new system of liability for auditors which is based on a relatively narrow characterisation of the role of auditors in the system of corporate governance. Whether or not it is found to be useful it may be a factor in prompting a wider discussion of the role of auditors before proceeding to introduce a reduced scheme of liability for auditors.

### III A PROPOSAL FOR REFORM

This part of the article develops a proposal for reforming the system of liability for auditors. The central aim of this proposal is to create a linkage between the formulation of the duty of care, the identification of the damage and the assessment of damages that will produce a system of liability in which there is a rational connection between an auditor's fault and the auditor's liability to pay damages, that is, a system of liability which establishes a proportionate relationship between an auditor's negligence and the level of damages that the auditor

<sup>178</sup> Priest, above n 4, 1539-41: 'The insurer's function is to aggregate uncorrelated (that is, independent) risks and segregate these risks into separate risk pools'. The segregation of risks into pools means that the risks against which the insurer is providing cover should be of equal value in order to 'reduce the total risk of the set' (1540).

<sup>179</sup> See, eg, Ebke, above n 4, 680-3: liability on auditors is a way of forcing them to assume the risk of their own negligence; Chapman, above n 93, 187-202: considers economic arguments concerning liability of auditors and suggests that from a regulatory point of view tortious liability may be a way of encouraging higher quality auditing and the production of higher quality information. See also Richard Stewart, 'Reconstitutive Law' (1986) 46 *Maryland Law Review* 86, 107: use of liability as a form of economic exchange and transfer to 'discourage socially undesirable conduct'.

will be required to pay.<sup>180</sup> The central feature of the proposal is a re-definition of the 'damage' which is the result of a breach of duty by an auditor. This proposal uses the common law as the model in the sense that the proposal sets out to use the techniques of the common law to draw the boundary between the damage which is the responsibility of the auditor and the losses which are the responsibility of the plaintiff.

The proposal for statutory reform of the law defining the extent of the liability of auditors which is included in this section is founded on two propositions. The first is that the proposal must draw a boundary between the specific risk of harm for which a negligent auditor will be responsible and the losses which are associated with the risks for which the plaintiff and other parties are ultimately responsible. As argued in part three of this article this element is missing from the current system of liability for auditors. The second proposition is that there must be a rational connection between the damages for which auditors are to be responsible and the actual services provided by auditors when they fulfil the duties imposed on them by the Corporations Law. This is necessary to ensure that there is a degree of proportionality between the level of liability and the auditors' overall responsibility for causing the 'harm'.

A further assumption underlying this proposal is that auditors should not be exempted from *all* common law liability to anyone who relies upon their reports. The special characteristic which is the source of the difficulty in applying the tort of negligence to auditors is the special statutory responsibilities which are imposed on auditors. While these statutory responsibilities imposed on auditors do give rise to problems in determining the nature and extent of liability, this in itself is no reason for exempting auditors from all liability. The principles underlying the decision of the High Court in *Sutherland Shire Council*<sup>181</sup> support the view that in applying the tort of negligence to auditors there is a need for the careful modification of, but not the exemption from, the operation of these 'ordinary' common law principles. In this case the Court identified some of the special characteristics of statutory bodies and concluded that these characteristics affected the way in which the tort of negligence would apply to statutory authorities but did not exclude the possibility that a statutory authority could be subjected to a duty of care to prevent specific damage occurring.<sup>182</sup>

In order to create a linkage between the definition of the duty of care, the identification of the damage and the assessment of damages it will be necessary to define the connection between the actual services provided by auditors and the damage which the users of information sustain when auditors are negligent in the provision of these services. The current liability regime for auditors is flawed because it focuses on the economic losses sustained by users of information as a

<sup>180</sup> See above n 19: proportional liability is one where the liability 'of each is in all circumstances limited to the extent to which that party is considered responsible for the loss'.

<sup>181</sup> (1985) 157 CLR 424.

<sup>182</sup> *Ibid* 438-9 (Gibbs CJ), 468-70 (Mason J), 484-6 (Brennan J), 499-501 (Deane J): application of the policy/operation distinction where the defendant is a statutory body.

result of the failure of auditors to comply with their statutory duties.<sup>183</sup> It is only by creating a linkage between the services provided by auditors and the damage caused by the negligence of auditors in the provision of these services that it will be possible to define a boundary between the damage for which auditors are responsible and the losses associated with the risks which are the ultimate responsibility of the users of the information.

#### *A Proposal to re-define the 'damage'*

It is proposed that the following changes to the scheme of liability for auditors be implemented via amendment to the Corporations Law. As argued in Part Three, the source of the problem of liability for auditors arises out of the interaction of the common law and the Corporations Law. As a result any reform to the scheme of liability should be particular to auditors and *not* involve any general changes to the common law. An amendment to the Corporations Law is the best way to achieve reforms to the scheme of liability for auditors without altering existing common law principles providing for recovery for pure economic loss.

It is proposed that there be no amendment to the common law principles defining the circumstances in which an auditor will be found to owe a duty of care to a user of information to avoid causing pure economic loss. Rather the central element of this proposal for reform is the re-definition of the 'damage' sustained as a result of a breach of duty by an auditor. It is proposed that the damage which is the basis of the cause of action against auditors be defined as an interference with the autonomy of the plaintiff, that is, 'the deprivation of an opportunity to follow a course of action that would have been preferable to the one the plaintiff was induced by the defendant to take'.<sup>184</sup> 'Damage' as the 'deprivation of an opportunity' to make a better decision is conceptually quite distinct from the pure economic loss which may be produced when a decision produces subsequent losses. In this sense the deprivation of the opportunity to make a different decision on the basis of better information *is* the 'damage'. The amount or nature of the losses which may result from the decision made on the basis of flawed information is then one of the factors that may be relevant to, but is not determinative of, the measure of the damages.<sup>185</sup>

This definition of 'damage' has not been adopted by the common law as the basis for an action in the tort of negligence.<sup>186</sup> The difficulty with the common law adopting any such definition of the damage is that this would give rise to difficult questions concerning the measure of damages. It would involve an assessment of the nature of the actual services provided by auditors when they fulfil the duties imposed on them by the Corporations Law. As argued in Part

<sup>183</sup> See above nn 149-157, 168-169.

<sup>184</sup> See above nn 28-30.

<sup>185</sup> Perry, above n 28, 308-12: different approaches to the measurement of the damages sustained by the plaintiff.

<sup>186</sup> See above n 49.

Two of this article, assessing the comparative level of responsibility of auditors for losses sustained by companies requires an open-ended analysis of the role and function of auditors. This is not the type of analysis which is typically undertaken by courts.<sup>187</sup> This proposal to re-define the 'damage' which is the result of the breach of duty by an auditor is explicitly based on the characterisation of auditors as 'reputational intermediaries' in a market for information where users of information have access to information through a number of different channels.

Within these parameters it is possible to value the loss of autonomy, that is, the 'damage', sustained by a person who makes a decision on the basis of flawed information. One measure of damages to compensate for this 'damage' is to assess the amount of money which would have been required to place the plaintiff in a position to make the decision on the basis of information of better quality. As the negligence of the auditor will relate to either the provision of flawed information, or to the failure to provide relevant information, a measure of the damages caused by an auditor's negligence is the amount required to obtain the relevant information from an alternative and more expensive source. This has the effect of placing the plaintiff in the position that the plaintiff would have been had the plaintiff been aware of the auditor's negligence.

#### *B Assessment of proposal for reform*

As discussed at the beginning of the part of the article there are two criteria by which to judge this proposal for reform. The first is that it draw a boundary between the damage for which the auditors are liable and the losses associated with the risks for which the users of the information are ultimately responsible. The second is that there be a rational connection between the measure of the auditors damages and the nature of the duty of care owed by the auditor to the users of the information. This second requirement could also be expressed in the form that there be a rational connection between the damages payable by auditors and services provided by auditors.

The proposal meets the first requirement by drawing a boundary between the damage which auditors must provide as compensation to the users of information who suffer loss and the losses associated with the risks for which the users of the information are ultimately responsible. This scheme of liability makes auditors responsible for compensating plaintiffs for the costs of obtaining information from alternative sources had they been aware of the flawed information provided by the auditors. The plaintiff users of information are responsible for the losses which flow from the decision to enter into the particular transaction.

The proposed method of assessing damage must also establish a rational connection between the duty of care owed by auditors to the users of information and the damages for which the auditors would be liable. The proposed measure

<sup>187</sup> See above nn 154-157 and accompanying text.

of damages is the cost to the plaintiff of obtaining similar information to that provided by auditors from another more expensive source. This approach to assessing the damages directly relates to the role of auditors as providers of information. As reputational intermediaries auditors verify the information provided by the client company. A focus on the alternative, more expensive methods of verifying this information creates a rational connection between the auditors' negligence in failing to verify the information and the extent of the auditors' liability to pay damages. This is in contrast to the underlying basis of the current scheme of liability for auditors in which auditors must not only produce the relevant information but in addition they are required to provide a guarantee as to the quality of that information.<sup>188</sup>

### *C Conclusion*

This part of the article has proposed reform of the system of liability for auditors. This proposal includes three elements. The first is to retain the existing common law principles relating to the definition of when an auditor will owe a duty of care to a user of the information provided by the auditor. The second element is a re-definition of the 'damage' which is the gist of the action brought by the user of the information against the auditor. It is proposed that the 'damage' be defined as the 'deprivation of the opportunity' of the user of the information to make a preferable decision because of the flawed information provided by the auditor. This involves a substantial change to the existing law because 'damage' is currently defined as actual physical or monetary loss. This definition of 'damage' does not necessarily require actual loss because the interest being protected by the law is one of personal autonomy, that is, the right of the user of information to make a decision on the basis that the information provided by the auditor meets certain agreed standards. The third and final element of the proposal for reform is that the measure of damages would be equal to the cost to the plaintiff of obtaining information of a better quality from an alternative source. This measure of damages would put the plaintiff user of information in the same position they would have been in had the auditor not have been negligent.

I have argued that this proposal for reform establishes a rational connection between the nature of the auditor's duty of care and the extent of the auditor's liability to pay damages. This is because the proposed measure of liability is consistent with the functions of auditors as reputational intermediaries. In providing a rational connection between the duty of care and the liability to pay damages this proposal also overcomes the central problem with the current system of liability.

This proposal builds upon the intent of Stage Two of the Inquiry established by the Commonwealth A-G and the New South Wales A-G that the current system of auditors' liability is in need of reform. The Inquiry has reported that

<sup>188</sup> See, eg, Goldberg, above n 93.

the doctrine of joint and several liability is one of the major causes of the problem of indeterminate and disproportionate levels of liability for auditors. Stage Two of this Inquiry seems to be focusing on the reform of the doctrine of joint and several liability with a view to the introduction of a system of proportionate liability. The unresolved problem to be determined by Stage Two of the Inquiry is the actual method for defining a system of proportionate liability. The proposal developed in this paper provides a detailed account of how to create a system of proportionate liability without the need to alter the doctrine of joint and several liability.

This proposal for reform is, however, counter-intuitive for anyone who is familiar with the ordinary operation of the law of tort or contract. The law of tort provides that a defendant is liable for the foreseeable consequences of the breach of duty. There are two reasons for qualifying this initial negative response to this proposal for reform. The first is that, as argued in Part One, the law in relation to the recovery of pure economic loss substantially qualifies this general proposition. The second is that this proposal is a remedial proposal in the sense that operation of the ordinary common law principles has already been substantially disrupted as a result of the interaction of the common law with the statutory provisions included in the Corporations Law. The overall aim of this proposal therefore is produce a new system of liability which 'mimics' the operation of the common law in circumstances in which the common law has been irretrievably modified by operation of the Corporations Law.