IN THE HIGH COURT OF SOUTH AFRICA

(ORANGE FREE STATE PROVINCIAL DIVISION)

Case No.: 3955/2001

In the matter between:

RCG TRADE & FINANCE (PTY) LTD Plaintiff

and

MOORES ROWLAND Defendant

CORAM: MUSI, J

HEARD ON: 11 NOVEMBER 2002

JUDGMENT BY: MUSI, J

DELIVERED ON: 12 DECEMBER 2002

[1] This is judgment on an exception taken by the defendant to Claim "A" of the plaintiff''s particulars of claim. It is necessary to briefly set out the facts alleged in the particulars of claim. The introduction to the heads of argument filed on behalf of the excipient gives a concise summary of such facts and I shall, for the sake of convenience, simply adopt that with some modifications where necessary.

[2] The facts alleged are shortly the following:

"2.1 The plaintiff is a finance company;

2.2 The defendant is a firm of accountants and auditors;

2.3 The defendant was the auditor of Peldins (Pty) Ltd ("Peldins"), and in that capacity prepared and issued the 1996-8 annual financial statements for Peldins under cover of an unqualified audit report;

2.4 The financial statements were in fact false;

2.5 The defendant negligently failed to detect that falsity;

2.6 The defendant knew or could reasonably have been expected to know when it prepared the financial statements that:

2.6.1 they would be used by Peldins to induce existing and prospective trade creditors and financiers to maintain credit facilities or extend further credit;

2.6.2 those creditors and financiers would use their claims against Peldins as security in connection with the granting to them of financial assistance by other parties.

2.7 The plaintiff relied upon the Peldins 1996 and 1997 financial statements when it:

2.7.1 acquired by cession the claims of Trade Upfront (Pty) Ltd against Peldins;

2.7.2 lent money to Peldins.

2.8 But for the misstated financial statements, the plaintiff would not have done so, and would have recovered both the amounts paid to Trade Upfront and those advanced to Peldins.

3. The plaintiff pleads that in the circurmstances of the defendant "owed a duty of care to existing and prospective creditors and financiers of Peldins including the plaintiff."

4. The exception is taken on the grounds that:

4.1 in law, these facts are insufficient to establish a duty of care, at common law and having regard to section 20(9) of the Public Accountants and Auditors Board Act 80 of 1991 ("the PAAB Act");

4.2 alternatively, they are insufficient to do so at least in regard to the alternative premise in para 9.2 of the particulars of claim (ie that the defendant did not know but could reasonably have been expected to know the things alleged in paragraph 9.2 of the particulars of claim)."

[3] The essence of the exception is that the averments contained in the plaintiff's particulars of claim will not, if proved, establish what they seek to prove, namely, a duty of care owed by the defendant to the plaintiff. It is an assertion that the facts pleaded do not disclose one particular element/requirement of a delict,

namely, unlawfulness. This is so because this is a claim for compensation for economic loss suffered as a result of negligent misstatement, which was given full recognition in our law in **ADMINISTRATEUR, NATAL v TRUST BANK VAN AFRIKA BPK 1979 (3) SA 824 (A).** Unlawfulness is established when it is found in the particular circumstances of the case that the author of the false statement owed a duty to the recipient thereof not to make such false statement. **ADMINISTRATEUR, NATAL** (*supra*) also made it clear that a finding that there is a duty of care can only be made by the Court based on the particular facts and circumstances of each case. (See also **BAYER SOUTH AFRICA (PTY) LTD v FROST 1991 (4) SA 559 (A) at 568D**; **MINISTER OF POLICE v EWELS 1975 (3) SA 590 (A)**. This case deals with the duty to act positively in order to render an omission unlawful, but the principle is the same).

[4] This raises the question of whether a decision can be made on the existence or not of a duty of care even before evidence is led and the full facts and circumstances of the case known. The question can best be answered with reference to available case law. The Courts have in the past considered the various factors that have to be taken into account in considering the issue. In the particular class of cases like the present one dealing with the liability of accountants and auditors (banks issuing credit references in respect of their clients fall in this category, but I shall refer only to accountants and auditors for the sake of convenience) arising out of the negligent misstatement of the financial position of their clients on which the creditors of the clients have relied to their financial detriment, two factors seem to have crystallised into basic requirements for the existence of the duty of care. These are:

4.1 The proximity of relationship between the auditor and the creditor of his client (hereinafter referred to as the third party). There has to be a direct link or at least a reasonably close link between the two;

4.2 Knowledge on the part of the auditor that the report would be relied upon for the purpose of credit assessment. It would suffice if the auditor could reasonably have been expected to have had such knowledge. Thus in cases where the duty of care was found to exist these two factors are a common denominator. (Compare **INTERNATIONAL SHIPPING CO (PTY) LTD v BENTLEY 1990 (1) SA 680 (A) at 694B-G; STANDARD CHARTERED BANK OF CANADA v NEDPERM BANK LTD 1994 (4) SA 747 (A) at 770C-I; STANDARD BANK OF SOUTH AFRICA LTD v OK BAZAARS (1929) LTD 2000 (4) SA 382 (W) at 397-8** especially at **398H; SIMAN AND CO v BARCLAYS BANK 1984 (2) SA 888 (A) at 913H; BAYER SOUTH AFRICA (PTY) LTD v FROST (*supra*) at**

575A-C).

[5] It will be noted that in some of the cases only one of the two factors is referred to in so many words, but the presence of the other is nonetheless discernible. For example in **STANDARD BANK OF SOUTH AFRICA LTD v. OK BAZAARS (*supra*)** emphasis is laid on the closeness of the relationship (at **p.397**) but it is clear that the defendant in that case was also aware that the report would be relied upon for the particular purpose of assessing credit. Sometimes these factors are not specifically mentioned in the cases but are nonetheless present (**BAYER SOUTH AFRICA (*supra*)**; **SIMAN AND CO**. ***(supra)***). Proximity of relationship and knowledge do not always operate independently of each other but may be conjunctive: the nature and context of the relationship between the relevant parties may provide a basis for the inference of knowledge that the incorrect information would be communicated to and relied upon by the recipient thereof for the particular purpose. Conversely, knowledge of the purpose for which the report was furnished may provide a strong basis for the establishment of a reasonably close relationship between the parties. A typical example of this is to be found in **STANDARD CHARTERED BANK OF CANADA v NEDPERM (*supra*)**. In that case ***Nedperm*** was requested to and issued a credit reference in respect of its client ***Triomf***. Although it did not know specifically of the involvement of ***Standard Chartered*** it knew that the report was sought for the purpose of a credit assessment of its client and this knowledge played an important role in the Court's finding that ***Nedperm*** could reasonably have been expected to know that one or the other creditor of ***Triomf*** would rely on its report and that ***Standard Chartered*** was likely to be the one. This conjunction appears to be what is referred to in English case law as proximity. See **STANDARD CHARTERED BANK OF CANADA (*supra*)** at **772** for an exposition of English law in this regard. This appears to be the context in which the term "proximity" is used in **NPC ELECTRONICS LTD v S TAITZ KAPLAN & CO 1998 (1) All SA 390 (W).**

[6] In the latter case MacArthur, J considered both English and South African case law on the point and held that unlike English law, in South African case law foreseeability of damage is not a requirement for the existence of a duty of care and he concluded at p.404e:

"In the result I have come to the view that proximity and knowledge is a pre-requisite to liability (see also Milner, ***Negligence in Modern Law*** p.39)."

The facts in that case were briefly as follows: The defendant was a firm of accountants and auditors who had issued unqualified audit reports on the financial statements of their client, a group of companies called the Stan Group, which group was a subsidiary of an investment holding company called Milstan. The audit reports were found to have been misstated due to the negligence of the defendant. National Panasonic, which had been a supplier of goods and creditor of the Stan Group, had relied on the false reports when it made available to the Stan Group additional credit facilities and suffered financial loss when it could not recover the money owed to it by the Stan Group due to the liquidation of the latter. The plaintiff company, which had stepped into the shoes of National Panasonic, then sued the defendant on the basis that the defendant owed it a duty of care not to issue the false reports. The Court having stated the pre-requisite for liability as above, found that although the defendant knew that National Panasonic was a major trade creditor of the Stan Group, there was no evidence to suggest that it was reasonably foreseeable that the published audited results would be relied upon to make a credit decision. There could therefore be no duty of care.

[6] In his heads of argument Mr Plewman, for the excipient, referred to the relevant English and South African case law and submitted that it can be deduced from the cases that for a plaintiff to succeed it must be shown that the auditor:

"(1) Specifically contemplated that his report would be presented to a particular bank, and

(2) that it would be used by it in order to decide whether to advance a specific further loan at a particular time."

He elaborated on this in argument before me and cited **NPC ELECTRONICS (*supra*)**. In essence, his submission is to the effect that the proximity requirement of English law has been adopted by our Courts and referred especially to the comments of Corbett, CJ in the **NEDPERM**-case ***(supra)*** at 773 where he came to the conclusion that even if English law were to be applied to the facts of that case a duty of care would be found to exist. It should be noted, though, that Corbett, CJ did not thereby signify that the requirements of English law were being adopted. Otherwise Mr Plewman's formulation of the pre-requisites is open to the following criticism:

(a) If it is found that the auditor specifically contemplated that his report would be presented to a particular bank, that would establish a link between the parties, but such formulation would exclude inferring the link from the circumstances of the case. Again the ***Standard Chartered Bank***-case (***supra***) provides a good illustration. Certainly ***Nedbank***, in that case, did not specifically contemplate that its report would be presented to ***Standard Chartered Bank***. The requisite link was established inferentially from the circumstances of the case.

(b) Audit reports are normally issued once a year and would remain in circulation for the next 12 months or so, at any rate until new reports are issued. During that period a company could engage in a multitude of transactions. It surely will be absurd to expect the auditor to know about each and every one of those transactions, some of which may not have been contemplated at the time the report was compiled. Otherwise it would mean that the company would have to seek the auditor's concurrence in respect of each and every transaction that it proposes to enter into. In my view the cardinal consideration is whether the auditor knew of the specific purpose for which the reports would be relied upon. If he was aware that his reports would be relied upon for purpose of assessing his client's creditworthiness and they are thus relied upon by a third party to its financial detriment, then the auditor would be liable to such third party irrespective of whether he knew of the specific transaction, assuming of course that the requisite link between the third party and the auditor has also been established. Mr Plewman's submission in this regard would have the effect of replacing the common law requirements with the more stringent pre-requisites provided for in section 20(9) of the Public Accountants and Auditors Act, No. 80 of 1999. See **NPC ELECTRONICS** (***supra***) at **405d-e** for an interpretation of that section.

Mr Meyer for the plaintiff, argued, on the other hand, that the existence or not of a duty of care is a matter to be determined with reference to the facts and circumstances of each case; that the factors referred to above are but some of the factors that have to be taken into account. He submitted that the plaintiff has in its particulars of claim alleged facts which, if established by the evidence, will establish liability.

[7] In my view it is discernible in the cases cited above that for a duty of care to be inferred the following must at the very least be present:

(a) A direct link or a reasonably close relationship between the auditor and the third party.

(b) That the auditor knew or could reasonably be expected to have known that the report would be relied upon for the purpose for which it was actually used. This does not mean that other factors do not play a role in the matter nor that the approach that various factors must be considered in order to determine whether the duty of care exists in the circumstances of each case has been abandoned. Indeed, the other factors may be crucial in the establishment of the basic requirements. It is to be noted also that the existence of these basic factors generally has the effect of minimizing or even eliminating the risk of limitless liability with the result that considerations of public policy often do not come into play. Hence in the cases where the duty of care was found to exist it was also found that considerations of public policy would not militate against imposition of liability. Public policy considerations may, however, still play a crucial role in respect of legal causation, in particular whether the loss is too remote or not. (Cf. **INTERNATIONAL SHIPPING CO (*supra*)** at 700i.)

[8] Turning to the facts of the instant case, the relevant averments are set out in paragraphs 9.1 and 9.2 of the plaintiff's particulars of claim. In paragraph 9.1 it is averred that the defendant knew that Peldins, defendant's client, would rely on the financial statements and report to induce existing and prospective trade creditors to advance credit to it and that such creditors would in turn rely thereon for the purpose of deciding whether to advance credit to Peldins. In paragraph 9.2 it is averred that the defendant could reasonably have been expected to know that the statements and reports would be used for the purposes referred to in paragraph 9.1. These averments would, if proved, indeed establish that the defendant knew that the statements and reports would be relied upon for purpose of assessing the creditworthiness of Peldins. But they do not disclose who is the third party that would rely or was likely to rely thereon. There is no hint of any relationship between the plaintiff and the defendant. In effect the particulars of claim aver that the defendant owed a duty of care to creditors of Peldins generally and the plaintiff is being cited as one of such general body of creditors. That raises the spectre of limitless liability that the Courts have previously warned against and would fall far short of the requirements for the existence of a duty of care.

If the averments made in paragraph 9.1 and 9.2 stood alone, one may have been inclined to be cautious in the hope that the evidence may yet establish a link between the parties, but the particulars of claim go further and disclose the basis for the averments in the form of the circumstances set out in paragraph 9.3. Such circumstances do not, however, provide an indication of any link whatsoever. Paragraph 9.3.3 is instructive:

"Creditors and financiers of the nature of those described above would, in accordance with normal and acceptable business practices refer to and consider the contents of Peldins financial statements in the process of deciding whether or not to extend or curtail credit facilities to Peldins;"

This is clearly the foundation of the plaintiff's claim as presently framed.

[9] The provisions of section 19(9) of Act 80 of 1991 cannot avail the plaintiff either. Section 20(9)(b) provides that the auditor is liable only if it is proved, *inter alia*, that he knew that the third party would rely upon the certificate, the report, the statement or the account for the purpose of entering into a specific transaction with the third party. By the third party is not meant third parties generally, but the specific party that actually relied on the report. Furthermore, the auditor must know that the report would be relied upon for the purpose of entering into a specific transaction. See **NPC ELECTRONICS (*supra*)**. All these things have not been alleged in the plaintiff's particulars of claim.

I hold therefore that the particulars of claim in respect of Claim "A" do not disclose a cause of action.

It was agreed in argument that if I should uphold the exception, I could grant the plaintiff leave to amend its particulars of claim.

[10] The following order is made:

1. The exception is upheld with costs.

2. The plaintiff is granted leave to amend the relevant portion of its particulars of claim within 30 days of this judgment.

H.M. MUSI, J

On behalf of Plaintiff: Adv. R. Meyer SC Instructed by: Lovius-Block Attorneys

On behalf of Defendant: Adv. T. Plewman Instructed by: Claude Reid Incorporated