Privy Council Appeal No. 28 of 1992

Deloitte Haskins and Sells *Appellant*

v.

National Mutual Life Nominees Limited *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 10TH JUNE 1993

Present at the hearing:-

LORD KEITH OF KINKEL
LORD BRIDGE OF HARWICH
LORD GRIFFITHS
LORD JAUNCEY OF TULLICHETTLE
LORD MUSTILL

*[Delivered by **Lord Jauncey of Tullichettle**]*

This appeal relates to the duties owed by auditors of a money market operating company to another company acting as trustee for unsecured depositors. Before looking at the relevant facts it is instructive to examine the statutory background against which issuers of securities, which by definition include takers of deposits, operate in New Zealand.

Statutory background.

The relevant statutory provisions are the Securities Act 1978, as amended, ("the Act") and the Securities Regulations 1983 ("the Regulations"). Part II of the Act which is entitled "Restrictions on Offer and Allotment of Securities to the Public" contains a number of relevant provisions. Section 33(2) provides:-

"(2) No debt security shall be offered to the public for subscription, by or on behalf of an issuer, unless -

(a) The issuer of the security has appointed a person as a trustee in respect of the security and both the issuer and that person have signed a trust deed relating to the security; and

(b) A copy of the trust deed has been registered by the Registrar pursuant to section 46 of this Act; ..."

In terms of section 45 every trust deed must "contain all information and other matters that are required to be included therein by regulations" and "shall be deemed to contain all clauses that are prescribed in regulations made under this Act as clauses that are deemed to be contained in a trust deed ...". Section 48 provides that only a trustee corporation or person approved by the Securities Commission may act as a trustee and section 49(1) provides that:-

"Where at any time after due inquiry, a trustee or statutory supervisor of securities is of the opinion that -

(a) The issuer and any guarantor of the securities are unlikely to be able to pay all money owing in respect of the securities when it becomes due; or

(b) The provisions of any deed relating to the securities are no longer adequate to give proper protection to the security holders -

the trustee or statutory supervisor may, in its absolute discretion, apply to the Court for an order or orders under this section."

It is unnecessary to condescend in detail upon the powers given by this section. Suffice it to say that they enable the court to make a wide range of possible orders. Section 50, which is critical for the purposes of this appeal, must be set out in full:-

" 50. **Duty of auditor to report to trustee or statutory supervisor -**

(1) Whenever the auditor of an issuer of debt securities or participatory securities offered to the public furnishes to the issuer or its members or the security holders any report, statement of accounts, certificate, or other document that is required by any Act or by any deed relating to the securities to be so furnished, he shall forthwith send a copy thereof to the trustee or statutory supervisor of the securities.

(2) Whenever, in the performance of his duties as auditor, the auditor of an issuer of debt securities or participatory securities offered to the public becomes aware of any matter that in his opinion is relevant to the exercise or performance of the powers or duties of the trustee or statutory supervisor of the securities, he shall, within 7 business days of becoming so aware, send -

(a) To the issuer, a report in writing on the matter; and

(b) To the trustee or statutory supervisor, as the case may be, a copy of that report.

(3) The auditor of an issuer of debt securities or participatory securities offered to the public shall from time to time, at the request of the trustee or statutory supervisor, furnish to the trustee or statutory supervisor such information or particulars relating to the issuer as are requested and are within his knowledge and are in his opinion relevant to the exercise or performance of the powers or duties of the trustee or statutory supervisor.

(4) Nothing in this section shall affect the duties or liability of any trustee or statutory supervisor."

Finally in the Act section 60(1)(d) provides that every person who acts in contravention of or fails to comply in any respect with any provision of *inter alia* section 50 or any requirement imposed pursuant thereto commits an offence for which he is liable on summary conviction to a fine not exceeding $1,000.

Regulation 24 of the Regulations provides that the clauses set out in the Fifth Schedule thereto shall be deemed to be contained in every trust deed required by the Act. The Fifth Schedule contains three clauses of which the first two are in the following terms:-

"1. **Duties of trustee** -

(1) The trustee shall exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or of the terms of the offer of the debt securities has occurred and, except where it is satisfied that the breach will not materially prejudice the security (if any) of the debt securities or the interests of the holders thereof, shall do all such things as it is empowered to do to cause any breach of those terms to be remedied.

(2) The trustee shall exercise reasonable diligence to ascertain whether or not the assets of the borrowing group that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due.

2. **Right of trustee to obtain information** -

(1) The trustee shall be entitled to receive all notices of and other communications relating to any general meeting of the issuer which any member of the issuer is entitled to receive.

(2) Any representative of the trustee, being a person authorised to act for the purposes of this clause by resolution of the directors or other

governing body of the trustee, shall be entitled to attend any general meeting of the issuer, and to be heard at any such meeting which he attends on any part of the business of the meeting which concerns the trustee as such or the holders of debt securities for whom it is trustee.

(3) The issuer shall from time to time -

(a) At the request in writing of the trustee, make available for its inspection the whole of the accounting and other records of the issuer;

(b) Give to the trustee such information as it requires with respect to all matters relating to such records."

The third clause empowers the trustee and certain other persons to requisition a meeting of securities holders for various purposes.

Facts.

Australasia Investment Company Securities Limited ("AICS") was part of the Australasia Investment Company (AIC) Group and acted as group treasurer. As such it made advances to other members of the group as well as receiving deposits from the public on an unsecured basis. The receipt of these deposits brought AICS within the ambit of the Act and on 5th March 1985 it entered into a trust deed with National Mutual Life Nominees Limited ("NMLN"), AIC Corporation Limited also being a party as guarantor. In terms of that deed AICS was required to render monthly a report certified as true and correct by two directors as to certain matters specified in the Second Schedule and a quarterly report by two directors covering the matters required in the monthly reports as well as any other matters which had in their opinion occurred to affect adversely the interests of the depositors. In relation to the quarterly reports clause 3.5.3 of the Trust Deed provided:-

"The company shall ensure that at the same time as each directors' report required under cl 3.5.2 is delivered there shall be delivered to the trustee a separate report by the auditor stating that he has received the directors' report given under cl 3.5.2 preceding and that so far as matters which he has observed in the performance of their half-yearly duties are concerned they have no reason to believe that these statements made in such report are not correct. The auditor shall not however be required to comment on any estimates or opinions that the directors may give of the future operations of the covenanting group or any member thereof."

Clause 3.5.4 required AICS to deliver to the trustee within two months or such longer period as the trustee might agree after the end of each financial year and half-year copies of

the balance sheets and profit and loss accounts of AICS and of all its subsidiaries for that year or half-year together with certain other financial information. Clause 3.5.5 provided:-

> "The company shall ensure that within two (2) months (or such longer period as the trustee agrees to in any particular case) after each financial year or half-year of the company, there is delivered to the trustee a report by the auditor stating, as at the end of that financial year, or half-year ..."

There then followed a number of matters upon which the auditor was required to report, but for the purposes of this appeal it is necessary only to set out the terms of sub-clauses (e) and (f):-

> "(e) whether or not in the performance of his duties he has become aware that any member of the covenanting group has done or omitted any act which in his opinion contravenes or may contravene this deed and if so giving particulars thereof;
>
> (f) whether or not his audit has disclosed any matter (and if so particulars thereof) calling in his opinion for further investigation by the trustee in the interests of the depositors;"

By clause 3.2.2(c) AICS undertook that it would not without the prior consent of the trustee:-

> "enter into any transaction with any Associate Company other than on a basis which is at least as favourable and secure as in the case of an arms length transaction and on terms and within limits which the directors have approved as being satisfactory and prudent having regard to the interests of the Depositors."

The rights and obligations of NMLN which are relevant to this appeal were:-

(1) Clause 3.6.3 which provided:-

> "The Company shall, as soon as reasonably practicable after a written request to do so is received from the Trustee, give to the Trustee such oral or written information, report, or records, relating to the business and affairs of the Company and its subsidiaries, as the Trustee requests, except that the Company shall not be bound to disclose any trade secret, process or trade information which it is forbidden by contract or otherwise to disclose."

(2) Clause 6.4.1 and 6.4.2 which provided:-

> "6.4.1 The Trustee shall exercise reasonable diligence to ascertain whether or not any

breach of the terms of this Deed or the terms upon which Deposits have been made with the Company has occurred and, except where it is satisfied that the breach will not materially prejudice the interests of the Depositors, shall do all such things as it is empowered to do to cause any breach of those terms to be remedied.

6.4.2 The Trustee shall exercise reasonable diligence to ascertain whether or not the assets of the Company that are or may be available whether by way of security or otherwise are sufficient or likely to be sufficient to discharge the amounts of the Deposits as they become due."

On 5th November 1985 Deloitte Haskins and Sells ("Deloitte") were appointed auditors of AICS and other companies in the group. In early 1986 while preparing the audit for AICS for the year ending 31st December 1985 they became concerned about the collectability of certain associated company loans particularly those to New Zealand Heritage Park Limited and certain Australian companies. After further enquiries they made a report under section 50(2) of the Act on 15th May 1986. AICS however continued to trade and on 11th August 1986 Deloitte as auditor of AIC Merchant Finance issued a further report under section 50(2) which resulted in NMLN, which was also trustee under the AIC Merchant Finance Deed, putting that company into receivership with the consequential liquidation of AICS on 30th August 1986. As a result of the liquidation NMLN incurred a liability to AICS depositors which was settled in December 1988 for $6.75 million.

NMLN then raised the present action against the directors of AICS and Deloitte seeking to recover the $6.75 million. This appeal is concerned solely with the action against Deloitte in which breach of a common law duty in relation to the obligation to report under section 50(2) of the Act remains the only live basis of claim. After a trial lasting 26 days Henry J. found that Deloitte were in breach of their common law duty of care to NMLN by failing to report AICS's probable insolvency by mid-March 1986 [1990] 3 NZLR 641. He apportioned blame for NMLN's loss as to 65% to NMLN and as to 35% to the directors and Deloitte. The Court of Appeal affirmed the judgment of Henry J. (1991) 3 NZBLC 102,259. Before this Board two issues arose, namely (1) whether Deloitte were in breach of a common law duty of care owed to NMLN, and (2) if so, whether such breach caused NMLN's loss.

Duty of care.

Henry J. concluded that Deloitte was in breach of its duty of care to NMLN in failing by mid-March 1986 to issue a report under section 50(2) drawing express attention to certain matters which bore directly upon the probable insolvency at that time of AICS. He found, at page 677, that the only duty owed by Deloitte was in respect of its

reporting obligations under section 50(2). He further concluded, at page 678, that the report of 15th May 1986 failed to draw attention to certain matters including such probable insolvency but treated it as an ineffective remedy for the failure to report by mid-March 1986 rather than as having the effect of a further breach to be considered independently of the earlier one. In reaching these conclusions he held, at page 679, that on the facts which he found proved a prudent auditor would, in knowledge of these facts, have formed an opinion and reported under section 50(2) no later than mid-March 1986. Deloitte's fault lay in not forming the opinion on the information available rather than in failing to report having formed an opinion. He had previously expressed the view, at page 675, that an omission to report might well have a significance as great as reporting or careless reporting and that the principle that there was no liability for an omission had no application because a positive duty to act was undertaken. Henry J. rejected, at page 673, a suggestion that Deloitte were in breach of statutory duty under section 50(2) on the ground that the statute required a report to be made when an opinion on certain matters had been reached whereas Deloitte had not by the relevant dates formed such an opinion. Breach of statutory duty has not been pursued and given that a breach of that section amounts to a criminal offence their Lordships do not find the acceptance of Henry J.'s construction to be surprising.

In the Court of Appeal Henry J.'s conclusion as to the information available to Deloitte was affirmed and Casey J. said at page 102,273:-

> "I agree with the Judge that by early March Mr. Sumpter had ample information to justify the formation of an opinion relevant to the exercise of the trustee's powers; and that having regard to the clear purpose of sec 50 and the nature of that information, a reasonable and prudent auditor would have formed that opinion then, rather than at any later time, and have sent a report accordingly."

Given that the duty under section 50(2) only arose when the auditor had formed an opinion, the effect of the decisions in the courts below was to impose upon the auditor a common law duty more extensive than that imposed by the Act.

Henry J. concluded, at page 691, rightly in their Lordships' opinion, that NMLN were in a position of primary responsibility towards the depositors. Not only did they have power to apply to the court under section 49 of the Act but they had continuing duties to exercise reasonable diligence to ascertain whether or not (i) any breach of the terms of the trust deed had occurred, (ii) the assets of the borrower were likely to be sufficient to repay the deposits as they became due, as well as the right to obtain information from AICS as issuer. By

contrast Deloitte's only powers and duties under the securities legislation were those in section 50. These relative positions must be borne in mind when considering whether or not Deloitte owed NMLN the common law duty found to exist by Henry J. and the Court of Appeal.

There is no doubt that, by reason of the provisions of section 50 of the Act, there was created a relationship of proximity between Deloitte and NMLN. If Deloitte sent a report to AICS and NMLN under section 50(2), they were under a duty to exercise reasonable care in the preparation thereof, knowing that it would be received and relied upon by NMLN (*Hedley Byrne and Co. Ltd. v. Heller and Partners Ltd.* [1964] A.C. 465, *Smith v. Eric S. Bush* [1990] 1 A.C. 831). The issue in this appeal, however, is not whether there was such a relationship of proximity but how far any duties arising out of that relationship extended.

Although section 50(2) creates no statutory duty to form an opinion, is a common law duty so to do nevertheless superimposed thereon? An analysis of the phraseology of sub-section (2) suggests that the auditor's awareness and formation of an opinion thereon are incidental to the performance of his duties as auditor, whether these duties are to be treated solely as those arising under the Companies Act 1955 in relation to the annual accounts of the issuer company or whether they include any reports which he may make in response to the issuer company's demands under the trust deed. In neither event does the sub-section require the auditor to be consistently on watch, rather is that the function of the trustee. Furthermore the inclusion of the words "in his opinion" suggests that it is a subjective rather than an objective test which has to be applied. Had the intention been to apply the test of the reasonably careful auditor these words would have been out of place. This analysis affords no support for the view that the legislature intended the sub-section to impose any duty on an auditor other than to report when he had formed the relevant opinion.

In *Yuen Kun Yeu v. Attorney General of Hong Kong* [1988] A.C. 175 Lord Keith of Kinkel delivering the judgment of the Board said at page 195D:-

> "In these circumstances their Lordships are unable to discern any intention on the part of the legislature that in considering whether to register or deregister a company the commissioner should owe any statutory duty to potential depositors. It would be strange that a common law duty of care should be superimposed upon such a statutory framework."

In the present appeal it would be even stranger that a common law duty of greater scope should be superimposed upon the statutory duty contained in the sub-section. Their Lordships can see no justification for such a course.

The position under section 50(2) is very different from that prevailing under section 166(1) of the Companies Act 1955 where the auditors are required to make a report to the members of the company on the accounts examined by them which report:-

"shall state -

(b) Whether, in their opinion, proper accounting records have been kept by the Company, so far as appears from their examination of those records:

(c) Whether, in their opinion, according to the best of their information and the explanations given to them and as shown by the books of the Company the balance sheet is properly drawn up ..."

Under the latter section a positive duty is imposed on auditors to make a report in which they express an opinion, from which it follows that a failure to form an opinion could constitute a breach of common law duty owed to the members. However under the former section the only positive duty imposed upon an auditor is to send timeously a report after he has become aware of a particular matter and has formed an opinion that it is relevant to the exercise of the powers or duties of a trustee. The duty to report is accordingly contingent and the only omission by the auditor which can at common law give rise to a breach of duty is failure to exercise reasonable care in the preparation of such report when the circumstances requiring its making have arisen.

In their Lordships' view Henry J. was in error in stating, at page 675, that the principle that there was no liability for omission had no application because a positive duty to act had been undertaken. On his own findings the circumstances which would have given rise to the positive duty to report had not yet arisen. For the foregoing reasons their Lordships conclude that the appeal must be allowed.

Causation.

Henry J. found as a fact, at page 655, that as at 31st December 1985 AICS was insolvent on the balance sheet test and remained insolvent throughout 1986. However in concluding that Deloitte's breach of duty was a cause of NMLN's loss of $6.75 million he concentrated solely on NMLN's obligations to depositors existing as at 30th August 1986. At page 687 he said:-

"... the question is whether the giving of an adequate timely report by Deloitte would have avoided National Mutual's liability for the $6.75 million loss suffered by the 30 August 1986 depositors. It is that loss and that loss alone which is under consideration. ...

> I am satisfied that had Deloitte issued an adequate and timely report under s 50(2) National Mutual would have been alerted to the serious position in which AIC Securities then was and taken consequential steps which would have avoided its legal liability to the 30 August depositors."

This approach was endorsed by the Court of Appeal. However in their Lordships' view this was an erroneous approach. The question to be answered is not whether NMLN would, on receipt of an earlier report, have avoided liability to those depositors existing at 30th August 1986 but whether, by Deloitte's failure to report, NMLN suffered a loss which they would not have suffered if Deloitte had reported by mid-March 1986. This necessitates consideration of NMLN's position at both dates. As McGechan J. pointed out in (1991) 3 NZBLC at page 102,292:-

> "I accept NMLN would have acted and probably by the end of March 1986 in some appropriate way. How would NMLN have acted? Predicting corporate conduct, in difficult situations, always has its uncertainties. However, I consider a reasonable conclusion is that NMLN, after inquiries and advice, would have acted to freeze the situation, preventing it worsening. The obvious method would be a voluntary or forced receivership or liquidation, fixing assets and preventing further detrimental intercompany lending and increased liability through additional deposits."

Their Lordships agree that this is the most likely conclusion to be drawn and indeed do not see that NMLN would have had any realistic alternative, consistent with their statutory and fiduciary obligations, but to suspend in some way the operations of AICS. Such suspension would inevitably have caused a run on AICS by depositors with consequent emergence of NMLN's obligations under the trust deed. McGechan J. on the same page also referred to the unchallenged evidence of Mr. Fuller, the New Zealand manager of NMLN, to the effect that if AICS had been closed at 31st March 1986 NMLN would still have been liable for $6.75 million to the depositors. There were other passages in the evidence of Mr. Fuller which supported McGechan J.'s conclusion as to what NMLN would have done had they received a report in mid-March 1986.

It was for NMLN to establish that any breach of duty by Deloitte caused them a loss which they would otherwise not have suffered; in short, that if Deloitte had reported in mid-March 1986, they would have incurred no loss or one less than $6.75 million. Given the prevailing state of insolvency of AICS and the evidence of Mr. Fuller they have wholly failed to prove this. Accordingly, for this reason also, their Lordships will humbly advise Her Majesty that the appeal ought to be allowed and that the respondent ought to pay the appellant's costs of the proceedings before Henry J. and before the Court of Appeal. The respondent must also pay the appellant's costs before their Lordships' Board.