Caparo's Legacy: A Voyage Through Professional Negligence in Malaysia

[1]Junaidah Zeno, [2]Sharija Che Shaari, [3]Ida Shafinaz bt Mohamed Kamil

[1-3]Senior Lecturers in Law, Faculty of Business, Economics and Accountancy
Universiti Malaysia Sabah

[1]Corresponding author's e-mail: junaidah.zeno@ums.edu.my

Abstract

The landmark decision in *Caparo Industries plc v Dickman* [1990] 2 AC 605 is seen as a momentous milestone in the development of negligence claims with far-reaching consequences for how professional negligence is interpreted in various legal systems. The case introduced what is known as the *Caparo test*, which considers foreseeability, proximity, and reasonableness to establish a duty of care. Malaysian courts also recognised and adopted the *Caparo test* while adjudicating claims against professionals, particularly auditors. Accordingly, this paper explores how the Malaysian judiciary embraced and modified the *Caparo test*, particularly in setting legal precedents and defining professional negligence claims via a doctrinal analysis. The paper attempts to enhance understanding of the adaptability of landmark principles in assessing negligence claims against professionals.

Keywords: Duty of Care, Malaysia, Professional Negligence

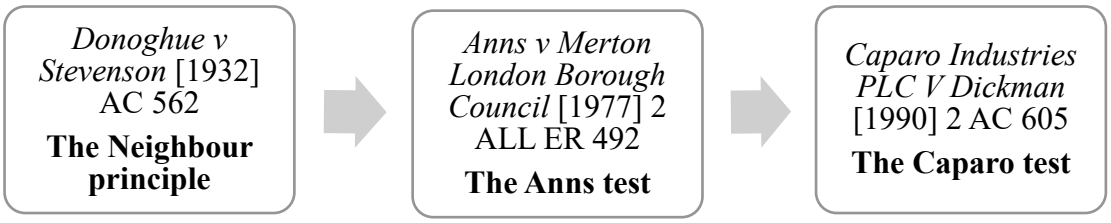
Introduction

Professional negligence involves key actors such as lawyers, doctors and auditors. Malpractice is another term for professional negligence, which refers to an instance of negligence or incompetence on the part of a professional (Garner, 2019). Negligence is the failure to do something that a reasonable man would do or doing something that a prudent and reasonable man would not do (*Blyth V Birmingham Waterworks Co* [1843-60] All ER Rep 478, Alderson, B). Negligence is also defined as '[T]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation' (Garner, 2019). Accordingly, this paper explores the legal aspects of auditors' professional negligence. Auditors have various legal obligations towards their clients and third parties, which may arise from contracts, fiduciary duties, torts, and legislation (Ahmad and Hingun, 2021). Auditors assume a vital role in ensuring the accuracy and reliability of financial information for pertinent stakeholders. Therefore, auditors shall be well informed of their legal obligations and take appropriate steps to mitigate potential risks. Otherwise, auditors may face legal action if they cause financial loss or damage to clients due to their failure to perform duties or deliver services to the standards expected of their profession.

An Overview of the Historical Progression of Negligence Claims

Legal doctrines like the *Neighbour principle*, the *Anns test*, and the *Caparo test* have significantly contributed to the metamorphosis of professional negligence lawsuits. This part analyses how professional negligence claims evolved in light of these established principles.

Table 1: The Historical Progression of the Negligence Test



The Neighbour Principle

Donoghue v Stevenson represents a turning point in negligence claims. In this case, a friend of Mrs. May Donoghue purchased ginger beer from the defendant, Mr. David Stevenson. Mrs Donoghue was unaware that the bottle contained the decaying remains of a snail. This resulted in severe shock and gastroenteritis for her. The ginger beer was purchased by Mrs Donoghue's friend, so there was no contractual relationship between Mrs Donoghue and Stevenson. Nonetheless, the influential judgement of Lord Atkin has shifted the emphasis from formal contractual relationships to a broader concept of foreseeability and proximity via the *Neighbour principle*. This expansion of the duty of care enabled a wide range of negligence claims, as it was no longer limited to situations with a direct contractual connection. The golden rule set by Lord Atkin reads as follows:

> *'The rule that you are to love your neighbour becomes in law, you must not injure your neighbour; and the lawyer's question, Who is my neighbour? receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who, then, in law is my neighbour? The answer seems to be – persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.' (pg. 580)*

Lord Atkin argued that individuals are responsible for taking care of those who could be directly affected by their actions or inactions. This duty is based on foreseeability and proximity, which means that one must take reasonable precautions to avoid actions or omissions that could foreseeably harm their 'neighbour'. The term 'neighbour' refers to anyone who could be affected by one's action in a way that can be foreseen. Even if there is no contractual relationship between the parties, individuals are obligated to take preventive measures not to harm those who might reasonably be affected by their conduct or omission.

The *Neighbour principle* has been a crucial aspect of negligence claims, guiding the determination of whether a defendant has breached their duty of care owed to the plaintiff. However, some cases have raised concerns about the practicality and fairness of the principle, as well as its application in certain circumstances. Lord Reid, for example, expressed reservations about the *Neighbour principle* in *Home Office v Dorset Yacht Co Ltd* [1970] 2 All ER (pg.296-302). He suggested that the *Neighbour principle* may not be the sole criterion for determining a duty of care. Other factors may also be relevant (e.g., foreseeability, public policy and special relations such as the right to exercise control). The case of *Bourhill v Young* (1943) 92 AC also raised queries regarding the extent of the *Neighbour principle*. In this case, a negligent motorcyclist driving at an excessive speed collided with a car and was killed. A pregnant woman nearby the incident heard the noise. She did not witness the accident but suffered fright, resulting in severe nervous shock that prevented her from carrying on her trade

for some time. The woman was eight months pregnant at that time. About a month later, the child was stillborn owing to the injuries sustained by the mother. However, the House of Lords ruled that the woman was not a foreseeable 'neighbour' in the accident. Her safety was not compromised because she was not within the area of potential danger. Thus, the negligent motorcyclist owes her no duty of care. In *Donoghue's* case, a duty of care may exist even if the parties do not have a prior contractual relationship. The present case, however, reflects the ambiguity in defining who qualifies as a 'neighbour', which can be subjective. Despite differing judicial perspectives, the *Neighbour principle* remains a cornerstone of modern negligence law. It established a general duty of care towards those within the vicinity who may be affected by one's actions or omissions while setting a framework for determining liability for negligence. Therefore, despite its limitations, the *Neighbour principle* may serve as a basis for advocating accountability and protection against harm resulting from the negligence of others.

The Anns Test

The case of *Anns v Merton London Borough Council* (1978) AC 728 played an essential role in the development of the duty of care that was derived from the *Neighbour principle*. Its importance is reflected by the introduction of the *Two-Stage test*, known as the *Anns test*. The plaintiff in this case was the owner of a home with structural damage caused by faulty foundations. She sued Merton London Borough Council for negligence and demanded compensation for repair costs. The plaintiff argued that the Council had not performed proper inspections before approving the house's construction. In his ruling, Lord Wilberforce introduced the *Two-Stage tests* to determine whether a duty of care existed. The first stage is for the court to decide on principle whether a duty of care exists. In doing so, the court considers the nature of the relationship between the parties based on the established legal principles and precedents. In addition, the court assesses whether the parties are relatively close (proximity) based on foreseeability.

Once a duty of care is established, the court proceeds to determine whether there are policy considerations that might limit or nullify the duty. This second stage necessitates balancing variables such as foreseeable harm, the dynamics of the relationship between the parties, and public interest. The *Anns test* is a compromise between providing sufficient redress for the claimant and ensuring that professionals are not saddled with liability. The test intended to provide the court with a systematic examination of the duty of care. It incorporates legal precedents and policy considerations for a thorough evaluation. Although the first stage is identical to the Neighbour Principle, the second stage seems to be aimed at limiting claims. The *Anns test* has been criticised due to its imprecise definition of impropriety. It revolves around the issue of whether the standard resembles malfeasance in public office or mere negligence (Feldthusen, 2017). The *Anns test* was also criticised for unilaterally lowering the weight given to anti-duty policy concerns, resulting in an undesired liability increase (Gilead, 2020). Subsequently, the *Anns test* has been refined and modified in *Caparo Industries plc v Dickman*.

The Caparo Test

The *Caparo Industries PLC v Dickman and Others* [1990] AC 605 has established the tripartite test for determining a duty of care in negligence claims. Caparo Industries PLC was a company that experienced considerable financial losses for relying on inaccurate financial reports prepared by the auditors in compliance with the statutory obligations. The company had initiated the purchase of shares in Fidelity Plc a few days before the annual accounts were published to shareholders. Subsequently, in reliance on those accounts, they made further purchases of shares to take over the company. It was later discovered that the report had misrepresented the company's profits, resulting in a loss for Caparo. Caparo then sued the auditors for negligence.

The House of Lords held that the auditors do not owe a duty of care to present or potential shareholders. The auditors' sole duty of care was to the firm's governance. In his ruling, Lord Bridge established three criteria to determine the existence of a duty of care: foreseeable harm, proximity and consideration of fairness and reasonableness. These principles have evolved into the *Caparo test*. First, the defendant must have anticipated the probable injury from their conduct or omission. This necessitates a thorough examination of the circumstances in question. Second, the parties must be within reasonable proximity, considering the nature of their relationship and the presence of a legal duty of care. Third, the duty of care must be fair, just and reasonable. These aspects require a comprehensive evaluation of policy and societal interests.

The *Caparo test* deviates from the *neighbour principle* and the *Anns test*. Both of the latter tests operate on the presumption that a duty of care exists and that damage is foreseeable unless there are compelling contradictory grounds. In contrast, a duty of care is not due under the *Caparo test* unless the conditions of foreseeability, proximity and fairness are met. In essence, the *Caparo test* emphasised a more nuanced and adaptable approach to evaluate a duty of care. It maintains a delicate equilibrium between protecting the claimant's interests and preventing professionals from bearing excessive liability. Arguably, the *Caparo test* significantly altered the landscape of professional negligence claims. The test requires the court to thoroughly evaluate the facts of each case, leading to a more discerning and equitable approach to ascertaining a duty of care.

Methodology

This study analyses the progress of professional negligence claims involving auditors via a doctrinal lens. Materials under scrutiny include English and Malaysian cases and relevant statutes. The doctrinal approaches involve examining laws and established concepts to understand the legal implications associated with allegations of professional negligence against auditors.

Findings and Discussion

Auditors in Malaysia are accorded qualified privilege owing to their commitment to provide impartial reports. The Companies Act 2016 and the Capital Markets and Services Act 2013 shield auditors from legal action for statements or reports made in good faith while performing their responsibilities. However, auditors are not immune to negligence claims. The Court of

Appeal clarified in *Shearn Delamore & Co v Sadacharamani a/l Govindasamy* [2017] 1 MLJ 486 (pg.495) that the level of care anticipated with respect to professionals is that of a reasonable practitioner in that profession, not just an average reasonable man. Similarly, in *Swamy v Matthews & Anor* [1968] 1 MLJ 138 (pg.139), the Federal Court affirmed that any professionals (e.g., accountants, bankers, doctors or lawyers) must exercise the same degree of care and competence as qualified practitioners in their area. Professional negligence claims manifest when a professional fails to provide the expected standard of care that puts their client to detriment, such as physical harm or financial losses. The latter was also known as pure economic loss. However, pure economic loss can be challenging to prove, as it involves demonstrating a direct link between the professional's breach of duty and the client's financial loss.

The general duty of care test established in *Caparo* also recognised negligence claims to include those involving pure economic loss. In *Majlis Perbandaran Ampang Jaya v Steven Phoa Cheng Loon & Ors* [2006] 2 CLJ 1, the Federal Court has to decide if Malaysian law allows for recovery of pure economic loss. While applying the *Caparo test*, the court highlighted that the critical question is not the nature of the damage, i.e., physical or financial, but whether the scope of the duty of care covers the kind of damage claimed by the plaintiff. The court has no hesitation in applying the elements of foreseeability and proximity when deciding whether the local authority is liable for the economic loss suffered by the plaintiffs. The court ruled that each case must be decided on its facts to establish whether a duty of care existed. Therefore, with respect to the third element of the *Caparo test*, the court considered the effect of section 3 of the Civil Law Act 1956, public policy, and the local circumstances. Among others are the local authority's endless duties and responsibilities, its limited resources and manpower, the public's demand, which far outweighs their contributions, and the public's attitude and perspectives. Based on these variables, the court rendered that the local authority is not liable for negligence. In *Co-operative Central Bank Ltd v KGV & Associates Sdn Bhd* [2008] 2 CLJ 545, the Federal Court took the same view that the general duty of care in all negligence claims, including claims for pure economic loss is the three-fold test laid out in *Caparo*.

The High Court applied the *Caparo test* in claims of professional negligence involving auditors in *Ng Wu Hong v Abraham Verghese TV Abraham & Ors* [2011] 6 CLJ 322. The defendants were partners in an audit firm that performed a statutory audit on the accounts of Sarawak Securities Sdn. Bhd. (SSSB) under the Companies Act 1965 (now repealed by the Companies Act 2016). The plaintiff, who was the Chief Executive Officer (CEO) of SSSB at the time, was forced to resign after SSSB suffered RM56 million in losses on its unsecured margin accounts. Following that, the plaintiff filed lawsuits against the defendants. The plaintiff claimed that the defendants, as auditors, were liable for negligent misstatement because their audit failed to disclose the fraud in SSSB. The plaintiff argued that he would not have to resign if the defendants had discovered the fraud. The plaintiff also sought compensation for the loss of his salary, bonus, share options, and related benefits lost due to his resignation. However, the court held that the defendants owed no duty of care toward the plaintiff. It was foreseeable that a responsible CEO would want to read the external audit reports on his company's accounts. These reports provide the shareholders with impartial financial details of the company. In addition, the relationship between the party owing the duty and the party to whom it is owed must be one of 'proximity'. Rather than delegating the duty to the external auditors who had only been hired at the end of the year, the CEO of a sizeable company with internal auditors was obligated to detect and prevent fraud committed by his senior management officers. The

court also evaluates whether it is fair, reasonable, and justifiable for the auditors to be legally obligated to exercise a duty of care on behalf of the CEO. The court recognises that an external auditor's statutory duty is to report to the shareholders impartially on the company's performance. The statutory provisions do not contemplate the CEO using the reports to verify the accuracy of the management accounts. In the current case, the fraud continued unnoticed in 1998, and the defendants approved the audit reports in March 1999. Thus, even if the defendants had discovered the fraud and revealed it in their reports, the plaintiff would not have been able to pursue action based on what happened in the previous year.

The High Court took the same view in *CIMB Investment Bank Bhd v Ernst & Young & Another Case* [2014] 3 CLJ 322. In light of the *Caparo test*, the court held that auditors do not owe a duty of care to the company's clients when performing statutory audits. While foreseeability is a necessary prerequisite, it is insufficient to establish a duty of care by itself. The fact that auditors could foresee third parties would rely on their audit reports is not the decisive factor in determining a duty of care. Proximity is another aspect that warrants consideration. In the present case, there was no close and direct relationship of proximity between the auditors and the third parties (i.e., CIMB and the investors). In particular, the audit reports were not initially and intentionally intended for these third parties. Imposing a duty of care on auditors to third parties is unfair, just and reasonable. The auditors were legally required to prepare annual audit reports to inform company members of the company's transactions and financial position. The audit reports were for limited purposes and were concerned with an internal financial matter on the company's assets and liabilities. It does not deal with assets not owned by the company and is not meant for making investment decisions.

The *Caparo test* does not imply that auditors are absolved of any duty of care towards those relying on their statements. Auditors can still be accountable for professional negligence if they fail to meet their profession's required standards of care, resulting in financial loss or harm to their clients or third parties. Therefore, the *Caparo test* should not be misconstrued as a complete shield against liability for auditors but rather as a framework for determining the existence of a duty of care in negligence claims. In *Tunku Dato' Sri Iskandar bin Tunku Abdullah v Ahmad Kamil Abdullah & 5 Lagi* [2009] 6 CLJ 359, the third defendant (public accountants for the Malaysian Association of Travel and Tour Agents) was found negligent for failing to exercise reasonable care and skill by the standard expected of the discipline when preparing the audited accounts. However, for the third defendant to be liable for the loss or damages suffered by the plaintiff, it had to be shown that the loss was attributable to the third defendant's negligence or breach of duty. In the instant case, the losses suffered were caused by the other defendants' fraudulent acts and were not attributable to the third defendant's negligence. Although the third defendant was found to be negligent, the court only awarded RM1.00 nominal damages.

Conclusion

Professional negligence claims have dynamically and progressively evolved from the *neighbour principle* to the refined *Caparo test*. This legal metamorphosis demonstrates flexible principles adaptable to professional negligence claims in diverse legal systems such as Malaysia. The courts in Malaysia have adopted and implemented the *Caparo test* in matters involving professional negligence. The test provides a more systematic and transparent evaluation by examining specific facts and particulars in each case. It also ensures a balanced

approach to foster fairness and reasonableness by considering the broader social and policy ramifications. Nevertheless, the *Caparo test* does possess some drawbacks. Its broad and flexible features may lead to inconsistent and uncertain application, thus complicating the task of predicting outcomes in professional negligence claims. Reliance on the judiciary to determine the fairness, justice and reasonableness of imposing a duty of care may also lead to divergent analyses and verdicts. As such, continued refinement of the *Caparo test* is crucial. Legislative reforms or standardised precedents and guidelines that specify the parameters for assessing a duty of care in diverse professional contexts are necessary to tackle this issue. Implementing such measures may facilitate legal clarity, foster uniformity in judicial decisions, and strike a balance between safeguarding professionals from excessive liability and holding them accountable for professional negligence.

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