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Livent decision and the scope of auditor liability

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In a significant decision on December 20, 2017, the Supreme Court of Canada provided important guidance on the scope of responsibility of auditors in Canada. The Supreme Court found that Livent's auditor was liable to the corporation due to its negligence in performing an audit and thereby failing to uncover fraud committed by Livent's management. The Supreme Court reaffirmed the general principle established in *Hercules Management Ltd. v. Ernst & Young (Hercules)* that an auditor performing a statutory audit will generally owe its duty of care to the audit client, not to shareholders or other third parties. In the *Livent* case, the Supreme Court found that a court-appointed receiver of an audit client could pursue claims against the auditor, even though the ultimate beneficiaries of the claims are creditors. In allowing the underlying appeal, the Supreme Court also placed some significant limits on the scope of liability of an auditor, and substantially reduced the trial judge's original damages award. The Supreme Court's decision will have significant implications for the auditing profession in Canada, as well as the prosecution of securities class actions in Canada.

For years, the courts in Canada and the United Kingdom have struggled to articulate the scope of an auditor's potential liability at common law, given the numerous stakeholders that may seek to rely on audited financial statements for a range of diverse purposes. At the heart of this jurisprudence, the courts have addressed a fundamental policy question about auditor liability: given the wide circulation and use of audited financial statements, it may arguably be foreseeable that negligence by an auditor could affect the audit client, its shareholders or its creditors. But what responsibility should the auditor bear for negligence and to whom, particularly when financial statements are primarily the responsibility of the company and the directors of the company have committed fraudulent acts? Moreover, would the imposition of liability create a risk of indeterminate liability for an indeterminate class of users of financial statements? In the modern world of commerce, should the auditor be the insurer of last resort, particularly in circumstances of misstatement or fraud?

In the *Livent* decision, the Supreme Court of Canada provided the following important guidance on these questions.

- An auditor owes a duty of care to its audit client in respect of the performance of its statutory audit. Any duty of care in respect of other services or undertakings, such as helping the client solicit investment, will be limited by the specific purpose for which the service is being provided. In *Livent*, the Supreme Court found that the auditor's liability was limited to losses claimed in respect of the statutory audit, and did not extend to other services the auditor provided in connection with an earlier financing.
- With respect to auditor liability to persons other than the audit client, *Hercules* remains the governing law in Canada. Absent special circumstances, there is no duty of care owed by

an auditor to shareholders and persons other than the auditor's client in relation to an audit.

- In the unique circumstances of *Livent*, the Supreme Court found that the auditor performed a negligent statutory audit and that the auditor was held liable for the increase in the company's "liquidation deficit" following the audit, on the basis that, had the management's fraud been disclosed in the audit, Livent would have immediately sought insolvency protection.
- The majority held that on the particular facts of the case, the auditor could not rely on the defences of contributory negligence or illegality based on the non-applicability of the corporate identification doctrine.
- The *Livent* decision suggests that auditors may have an increased risk of liability when negligence in an audit fails to uncover a fraud, particularly where that fraud conceals the true finances of an insolvent company.
- This decision, however, also supports important protections for auditors against misrepresentation claims by shareholders. Shareholders will likely have to pursue misrepresentation claims against auditors under the Ontario *Securities Act* (which are subject to various checks and balances) rather than as common law claims.

Background

This appeal arose from the trial judgment in an action brought by Livent (through its receiver) against Livent's former auditor. Livent claimed that the auditor breached the duty of care to its client in failing to detect financial manipulation and, had the auditor exposed the fraud, Livent would have ceased operations and sought insolvency protection to prevent further diminishment of its assets.

The trial judge found the auditor liable for negligence in respect of two events: (1) providing a clean audit opinion, and (2) providing a comfort letter and approving a press release to assist Livent in obtaining investment. The trial judge held that the damages equalled the difference between Livent's value when the first breach occurred and Livent's value at the time of insolvency. But he reduced the damages by 25% (to about $85 million) to account for losses sustained by Livent's unprofitable theatre business, which he held were too remote.

The Court of Appeal for Ontario upheld the trial judge's award and dismissed the appeal.

The Supreme Court's decision

In a 4-3 decision, the Supreme Court of Canada allowed the appeal in part, reducing the damages to about $40 million. The majority held the auditor liable only in relation to the audit, applying the duty of care analysis strictly to foreclose the claims relating to the investment. Justices Gascon and Brown, writing for the majority, held that the damages could be assessed as the increase in the liquidation deficit of the company following the audit, less the 25% "contingency." They declined to apply the defences of illegality, attribution or contributory negligence on the facts of the case, where the controlling minds of the company were the perpetrators of the fraud.

The minority would have gone much further, finding that the auditor should not be liable for the loss that befell Livent because that loss did not fall within the scope of the auditor's duty of care (as it was not reasonably foreseeable to the auditor), causation had not been

established, and the damages were too remote. Chief Justice McLachlin, writing for the minority, also expressed concern that the majority's approach could make an auditor the underwriter for any losses suffered by a client following a negligent audit report, if the consequences of every decision made by the company thereafter are attributed to the auditor's negligence.

The complex issues of proving damages

Read together, the minority and majority decisions suggest that, as a practical matter, it will often be difficult for plaintiffs to establish the auditor's liability for damages – particularly where it would require proof of what management or the collective shareholders would have done "but for" the negligence. On the facts of this case, the majority inferred that Livent's shareholders would have caused Livent to cease operations if Livent's true financial position (i.e., its insolvency) had been detected by the audit, principally because that was what occurred when the fraud was ultimately disclosed. In most situations, though, there will be complex hurdles in proving that the cause of a non-insolvent company's losses was the auditor's negligence. This suggests that particular risk to auditors may arise when a negligent audit fails to detect a company's underlying insolvency, prolonging the company's life and thereby deepening its insolvency.

Hercules and securities class actions

Although the Supreme Court was deeply divided on key issues, it confirmed that its 1997 decision in *Hercules* remains the law regarding there generally being no duty of care of an auditor to persons other than its client (e.g., shareholders) in relation to an audit. While shareholders may be able to pursue misrepresentation claims against auditors under the Ontario *Securities Act*, those claims are generally subject to checks and balances. For secondary market investors, these usually include damages caps that limit the auditor's liability to the greater of (i) $1 million, and (ii) the revenue that the expert and its affiliates earned from the issuer and its affiliates during the 12 months preceding the misrepresentation. Based on the duty of care analysis in this case and the confirmation that *Hercules* is binding law, it is difficult to see circumstances in which shareholders could use common law negligent misrepresentation claims to circumvent those damages caps.

Conclusion – What does this mean for auditors?

An audit client can sue its auditor in some circumstances for negligence or breach of contract in relation to the audit. It remains to be determined, on the facts of individual cases, what types of damages may be recoverable and what defences may apply. For other services, the potential exposure will be limited by the purpose for which the services were provided.

Shareholders can sue auditors in some circumstances for misrepresentations in prospectuses and other disclosure documents under Parts XXIII or XXIII.1 of the Ontario *Securities Act* (and equivalent legislation). The auditor may be able to rely on statutory defences and other protections, including liability limits for secondary market claims. Absent exceptional circumstances, it seems unlikely that shareholders will be able to advance common law claims against auditors.