

Auditor's Duty of Care to Client Upheld by the Supreme Court of Canada

In *Deloitte & Touche v. Livent Inc. (Receiver of)*,¹ a majority of the Supreme Court of Canada found Deloitte partially responsible for losses suffered by Livent Inc. as a result of a fraud perpetrated by its founders, which the trial judge found Deloitte negligently failed to detect. The result is that Deloitte is liable to Livent in the amount of \$40,425,000, plus costs – a reduction from the initial judgment of \$84,750,000.

Deloitte was Livent's auditor for a period of time in the 1990s. At the time, Livent's founders were engaged in fraudulent accounting practices, resulting in inaccurate financial statements, which allowed Livent to raise the funds required to continue to stage live theatre performances across North America. When the scheme was finally discovered in 1998, Livent collapsed, its assets were liquidated, and its founders were incarcerated. Numerous lawsuits followed, including a claim by Livent's receiver against Deloitte for alleged negligence in audits and other work for Livent.

At trial, Livent alleged that the annual statutory audits performed by Deloitte between 1992 and 1998 were not carried out in accordance with generally accepted auditing standards ("GAAS"), and should not have resulted in clean audits. The plaintiff claimed that by failing to follow GAAS, Deloitte failed to detect and expose the fraudulent activities of management, in turn depriving the directors and shareholders of the opportunity to stop the fraud before its ultimate discovery in 1998. Damages were sought on the basis that if the fraud had been discovered earlier, the company would have ceased operations earlier and would have had a lower deficit at the time of liquidation.

The trial judge made numerous findings of fact, including the following:

- (a) up to the end of 1995, the Deloitte team performed its work appropriately;²
- (b) Deloitte would not have been able to discover the fraud in 1996, and during that time it was lied to and misled about the nature of Livent's transactions by numerous individuals in management;³
- (c) Deloitte had concerns about the accounting related to a transaction in 1997. While the auditors brought their concerns to Livent, they ultimately acceded to Livent's preferred approach, and acted negligently in continuing to act and approving a press release and comfort letter which contained misrepresentations as to the reporting of profit arising from the transaction. The trial judge held that Deloitte knew or ought to have known

¹ The decision can be accessed online at <http://canlii.ca/t/hpdq9>.

² Trial decision (available online at <http://canlii.ca/t/g6g09>) at para. 132.

³ Trial decision at para. 170.

that the documents contained misstatements, should have resigned at the time due to a breakdown in the relationship, and was accordingly liable for damages arising from this date;⁴ and

- (d) Deloitte was negligent in performing the 1997 statutory audit which was finalized in April 1998. The audit plan was inadequate particularly given that there was a change in staffing and that the events in early 1997 indicated potential issues with Livent's accounting. Before the audit was completed, the auditors discovered that Livent's management had deceived them with respect to an element of the earlier transaction, yet did not conduct a further investigation. The trial judge held that this failure to investigate fell short of GAAS and Deloitte's standard of care, and that in the circumstances Deloitte should not have signed a clean audit opinion.⁵

These findings were upheld by the Court of Appeal. At the Supreme Court of Canada, arguments were focused on the findings of liability arising from the 1997 press release and comfort letter, and the 1997 audit.

The Purpose of an Auditor's Work is Critical

The Supreme Court decision is primarily focused on the legal analysis of the existence of a duty of care. As a general rule, for a claim in negligence to succeed, the plaintiff must first establish that the defendant owed her a duty of care.⁶ If there is no duty owed to the plaintiff by the defendant, the plaintiff's claim must fail. The courts have held that a duty of care will arise if two criteria are met: (1) the parties are in a sufficiently "close and direct" relationship that it is fair to impose a duty of care; and (2) it is reasonably foreseeable that the plaintiff will suffer harm if she reasonably relies on the negligent defendant. These two criteria are generally referred to as "proximity" and "foreseeability". If both elements exist, a duty of care exists. The court may then proceed to determine whether there are policy considerations that would negate the existence or imposition of such a duty.

The Supreme Court has provided additional guidance as to how the "duty of care" test is to be applied in cases of negligent misrepresentation or performance of a service. The majority held that the proximity analysis turns on two factors: the defendant's undertaking and the plaintiff's reliance thereon.⁷ Focusing the analysis in this way involves consideration of the scope of the defendant's undertaking, which may limit the defendant's potential liability: a defendant cannot be liable for a risk of injury against which he did not undertake to protect.⁸ Determining the scope of the rights

⁴ Trial decision at paras. 201-209, 241.

⁵ Trial decision at paras. 210-212, 232-236, 240, 242.

⁶ The plaintiff must also establish that the defendant breached that duty of care and that the plaintiff suffered damages as a result.

⁷ SCC decision at para. 30.

⁸ SCC decision at para. 31.

and duties flowing from the relationship between the parties is essential to determining the type of injury that was reasonably foreseeable, and may limit the types of losses that are recoverable.⁹

What flows from this is that the purpose of an auditor's work will be carefully considered in auditor's negligence claims. In this case, Deloitte's work – the scope of its undertaking – was pivotal in determining whether it owed Livent a duty of care, and whether the losses claimed by Livent were reasonably foreseeable. Focusing the analysis in this way also has the potential to limit arguments founded on an alleged general duty to resign, which the Supreme Court did not rule on in any event. Deloitte's work in approving the press release/comfort letter and conducting the statutory audit had different purposes. Those differences were a critical element in the majority's decision to impose liability only in respect of the statutory audit.

The Nature and Purpose of Deloitte's Work: Statutory Audit vs. Press Release

It is well-established in the jurisprudence that an auditor owes a duty of care to corporate clients with respect to the preparation of a statutory audit. The majority confirmed that the purpose of an audit is to protect the company from the consequences of undetected errors or wrongdoing, and to enable shareholders to scrutinize the conduct of the corporation's affairs and take action as warranted. In other words, Deloitte undertook to provide the audit for those purposes, and Livent was entitled to rely on it accordingly. The majority of the Supreme Court upheld the lower courts' findings that Deloitte's negligence in preparing the 1997 audit entitled Livent to recover the losses it suffered from the date of the audit.¹⁰

In contrast, it is not well-established that an auditor owes the same duty of care to its client when it assists in preparing materials in support of a public offering (in this case, the press release and comfort letter). The purpose of assisting with the press release and comfort letter was to help Livent solicit investments. In providing that assistance, Deloitte did not undertake to assist Livent's shareholders in overseeing management, and Livent had no right to rely on Deloitte for that purpose. While the auditor-client relationship was "close and direct", both the majority and minority held that the damages claimed by Livent were not a reasonably foreseeable consequence of Deloitte's negligent assistance in soliciting investors, particularly in the absence of a duty to resign. Accordingly, the Court overturned the lower court decisions which held Deloitte liable for all of Livent's liquidation deficit as of the date of the press release and comfort letter.¹¹

Scope of Deloitte's Liability

One element of the decision which merits consideration is that the majority imposed liability on Deloitte for losses which Deloitte argued were too far removed from the scope of its undertaking or not reasonably foreseeable – in other words, that some of the losses were attributable to Livent's

⁹ SCC decision at paras. 35-36.

¹⁰ SCC decision at paras. 58-66.

¹¹ SCC decision at paras. 50-57.

poor business decisions, as evidenced by its distressed financial position, rather than the 1997 audit. This issue was the primary point of contention between the majority and minority.

The majority held Deloitte liable for Livent's losses from the date of the audit, on the basis that the shareholders' capacity to oversee the conduct of Livent's business was entirely dependent on the statutory audit.¹² The minority view was that Deloitte's duty of care was not so broad as to capture all of the corporation's losses after the date of its misstatement.¹³

While the Supreme Court justices agreed that the law will not support a holding of indeterminate liability, they parted ways in their interpretation of whether Livent's losses could be considered "indeterminate" and therefore unrecoverable. The majority held that Deloitte's liability was not indeterminate, because the claim was temporally limited, advanced by one single claimant (Livent's receiver), and limited in value (the value was significant, but not unlimited or unknowable).¹⁴ The majority rejected the argument that Livent's receiver was standing in the shoes of the shareholders, in light of the corporation's separate legal personality.¹⁵ The minority held that Livent's claim was indeterminate because it gave rise to an unknown scope of potential liability at the time Deloitte took on the engagement and rendered its services.¹⁶

Despite the justices' disagreement on whether the facts of the case gave rise to indeterminate liability, the decision does not appear to affect the general limitation of indeterminate liability. The majority and minority agreed that unlimited auditor liability is a legitimate policy concern. Claims that have been previously recognized as raising the spectre of indeterminate liability, such as shareholder loss claims, will likely continue to fail on that basis, although the legal analysis may now be framed in terms of "undertaking and reliance" rather than "indeterminacy".

¹² SCC decision at paras. 65-66, 82-84.

¹³ SCC decision at paras. 161-166, 169-173.

¹⁴ SCC decision at paras. 43, 67-75.

¹⁵ SCC decision at para. 71.

¹⁶ SCC decision at paras. 164-173.