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SCC Decision: *Deloitte & Touche v. Livent Inc.* Auditor Liability for Negligence

A: Introduction

In *Deloitte & Touche v. Livent Inc. (Receiver of)*, 2017 SCC 63 ("*Deloitte*"), the Supreme Court of Canada released reasons on December 20, 2017 clarifying an auditor's duty of care to shareholders to uncover fraud. The case is a very real reminder of the financial consequences an auditor can face if it fails to uncover or report fraud, as the Courts awarded $40 million in damages against Deloitte.

B: Factual Background

The action was brought by the shareholders of Livent Inc., a public corporation that owned theatre properties and ran live entertainment performances throughout Canada. As the business grew, the executives began to cook their books by: (1) pocketing kickbacks by falsifying or inflating invoices, (2) shifting expenses between accounting periods, doctoring their accounting software to conceal the changes, (3) extending or avoiding amortization to inflate their bottom line, and (4) recording imaginary revenue by entering into loan or financing agreements camouflaged as asset sales. The long-standing fraud was publicly uncovered in 1998, leading to the conviction of executives, the liquidation of the company, and a multitude of lawsuits.

In 1997, prior to the fraud coming to light, Deloitte had identified irregularities in the accounting and reporting by Livent in connection with a particular transaction. Deloitte disagreed with Livent on how those irregularities ought to be reported. Deloitte faced two options: to resign as Livent's longstanding auditor (and report the irregularities to regulatory authorities and the next auditor) or to remain as auditor and capitulate to Livent's views on reporting. They chose the latter, and issued a Press Release/Comfort Letter in 1997 that helped enable the transaction, which the court found to be a negligent course of action.

Shortly thereafter, also in 1997, Deloitte prepared and delivered a Clean Audit opinion despite the irregularities identified, and despite an admittedly high degree of skepticism on the part of Deloitte auditors at the time in regards to Livent's explanation of its contractual dealings.

C: Decision

At trial, it was found that the auditors had been motivated by maintaining a profitable and ongoing relationship with Livent.

The Courts found that Deloitte fell below the standard of care they owed to shareholders in two specific ways: (1) in their approval of a Press Release and provision of a Comfort Letter in 1997, and (2) their preparation and approval of a 1997 Clean Audit opinion. The shareholders argued successfully that they relied upon the opinions of Deloitte such that it took longer for the fraud to be uncovered which artificially extended Livent's lifespan, leading to higher losses in the form of a higher ultimate liquidation deficit.

At the SCC, the majority judgment found that:

- It <u>was</u> reasonable for Livent's shareholders to rely upon the 1997 Clean Audit opinion to aid in overseeing management. In particular, the harm was foreseeable to Deloitte because the purpose of the Audit was (1) to protect the company from the consequences of undetected errors and wrongdoing and (2) to provide shareholders with reliable intelligence enabling oversight. By undertaking the 1997 Clean Audit, Deloitte undertook to assist Livent's shareholders in scrutinizing management conduct. They were negligent as they failed to competently provide this assistance.
- However, it was <u>not</u> reasonable for Livent's shareholders to rely upon the Comfort Letter/Press Release <u>for the purpose</u> of overseeing management because Deloitte never undertook to provide the Comfort Letter/Press Release to aid in overseeing management. As such, it was not reasonably foreseeable by Deloitte that reliance on the Comfort Letter/Press Release would lead to an increase in Livent's ultimate liquidation deficit. It would only be reasonable to rely on the Comfort Letter/Press Release for their intended purposes, which was to help Livent solicit investment funds in relation to a particular transaction.

Ultimately, damages were assessed based on the increase in Livent's liquidation deficit which followed after Deloitte signed off on the 1997 Clean Audit opinion in early April 1998. The amount was quantified to be $40 million dollars.

The majority judgment notes that the liability of auditors for negligently prepared audits is not unlimited because audits are conducted annually; therefore, liability will only arise in the year following the audit. This is a significant finding that helps to limit the potential risks faced by auditors in preparing annual, statutory audits. Further, in these types of cases, the amount of damages is ascertainable and limited by the worth of the corporation in question (which could well be significant depending on the size of the corporation).

D: Implications

Obviously, auditors must take care at all times in the expression of their opinions, especially in the face of business conflicts with their clients. Even absent specifically uncovering evidence of fraud, skepticism and wilful blindness to questionable practices will be indicators of negligence on the part of auditors. Failure of an auditor to discharge their duties with independence from long-standing clients can result in significant loss and exposure to damages.

Please contact us should you wish to discuss the implications of this decision in more detail.

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