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Livent litigation, last act

By Neill May

In the theatrical production industry, there is much attention paid when shows continue to play for long periods. Yet few runs have rivalled the passage of time taken in resolving the litigation between Livent Inc. and its auditors, Deloitte & Touche (now Deloitte LLP). The Supreme Court of Canada has now lowered the final curtain, concluding (in a 4-3 decision) that issuers can obtain recovery from auditors for losses that result from failure to achieve the intended purpose of the auditors' work. Put differently, the company in which the frauds were perpetrated was able to obtain recovery from its auditors. Had I not sworn off puns, I might have said that accountants function in an accrual world.

Given the passage of time, a brief prelude is warranted. Deloitte was Livent's auditor during a period when, to assist with the company's fundraising objectives, its directors manipulated Livent's financial records to significantly overstate revenue and profit. Deloitte never uncovered the fraud, though it did identify irregularities in the reporting of profit from an asset sale. Deloitte continued to serve, assisting in the preparation of a press release that misrepresented the basis for the reporting of the profit, provided a comfort letter for a public offering and prepared a subsequent audit of Livent's financials. The fraud was eventually discovered by new investors, Livent filed for insolvency protection and went into receivership and Livent sued Deloitte. The story divides neatly into acts, though I profoundly lack the talent to put it to music.

The SCC's decision clarifies the scope of auditor liability. In relation to the statutory audit — an annual requirement for all publicly traded issuers — both the majority and the minority determined that a duty is owed by an auditor in preparing a statutory audit, that a core purpose of the audit requirement is to allow security holders to collectively supervise management and to take decisions with respect to the overall administration of the issuer, and that a claim by the issuer for losses resulting from a negligent statutory audit could succeed.

The majority proceeded to conclude that damages were recoverable for the negligent completion of the audit because the company had been exposed to reasonably foreseeable risks that could have been avoided with a proper audit. The minority essentially adopted the same approach, though it differed in the result due to its determination that there was no evidence in this case as to shareholder reliance on the audits or that any such reliance would have caused them to take different actions to prevent the losses.

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By contrast, with respect to the press release and the comfort letter, the SCC determined that Deloitte had not undertaken a duty to Livent's shareholders and could, therefore, not be held liable for failure to take reasonable care in assisting in this regard. Those exercises were done to facilitate the offering, which was in fact completed.

Deloitte argued that it should not be responsible based on the defence of illegality (specifically that Livent cannot recover because it engaged in illegal or immoral conduct) and that, even if the action is not barred for illegality, it should only be partially liable because Livent was contributorily negligent. These defences were rejected, because the fraudulent acts of Livent's directors were not attributable to the company. The purpose of an audit is to provide a means to discover fraud and wrong doing, so denying liability on the basis that the company had engaged in the precise type of conduct that the auditor was engaged to protect would be at a minimum ironic.

Not much focus has been placed on the means of calculating damages, because it is relatively uncontroversial, but an appreciation of the potential magnitude of these awards is critical to understanding the significance of this issue. The measure of damages used in the Livent case was the difference between Livent's value when Deloitte should have resigned (when it discovered irregularities) and Livent's value at the time of insolvency, reduced by 25 per cent to account for contingencies or trading losses, which were too remote to make Deloitte liable. It resulted in an award (before interest) in excess of $40 million.

I'm tempted to comment on how few if any musicals have been successfully done focusing on accounting, but I am reminded of the old adage that people in law firm houses shouldn't throw stones. It is chilling to consider what the consequences would have been if *Rent* had been written by my real estate partners, if *An American in Paris* focused on the landed immigrant issues or if *My Fair Lady* were about talented women on the bench. **CL**

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