CONSULTATION ON AUDITORS’ LIABILITY AND ITS IMPACT ON THE EUROPEAN CAPITAL MARKETS

COMMENTS ON THE COMMISSION STAFF WORKING PAPER

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General Remarks

I write from the perspective of an English tort lawyer who has written previously on the matter of auditors’ liability in English law – in the legal journal *Professional Negligence* and in the comparative study edited by H. Koziol and W. Doralt, entitled *Abschlussprüfer: Haftung und Versicherung* (Springer, 2004). I am the Convenor of the Torts Section of the Society of Legal Scholars, which represents university academic lawyers in the United Kingdom, but I do not write now in that capacity. The views expressed here are my own.

The matter of auditor’s liability in England/the United Kingdom has attracted the attention of official committees on several occasions, notably:

1. *Professional Liability: Report of the Study Teams*, chairman: A. Likierman (1989). This rejected the idea of capping or allowing the courts the power to reduce any damages awarded to a ‘fair’ level. It proposed that auditors should be free to agree with the clients ‘reasonable’ limitations on the former’s possible liabilities. (This was not enacted until after the other reports described below.) It also proposed that the issue of joint and several liability should be further considered by the Law Commission.

2. Law Commission/Department of Trade and Industry, *Feasibility Investigation of Joint and Several Liability* (1996). This concluded that amending the law of joint and several liability to enable auditors to benefit from proportionate liability would be contrary to principle. A particular concern was the unfairness inherent in shifting the risk of one defendant’s insolvency away from the other defendant(s) and onto the claimant. The investigation found no compelling evidence that a system of proportionate liability would be more economically efficient than one of joint and several liability, and expressed concern that its introduction might serve to weaken the incentive on auditors to detect and expose corporate fraud. Considering possible alternative reforms, the report repeated the Likierman report’s call for auditors to be able to limit their liability to clients to agreed levels. Like the Likierman report, it also rejected capping as an option: it cut across the principle that a wrongdoer should remedy his wrong, it would be unfair to non-professional defendants who would remain exposed to full liability, and it would undermine the deterrence objectives of the law. In short, capping represented ‘a pragmatic abandonment of principle’ which simply benefited defendants at the expense of claimants.
3. Department of Trade and Industry, *Company Law Review* (2001). The Department rejected proportionate liability, following the conclusions of the Law Commission (above), but recommended that auditors should be able, subject to a test of reasonableness, to limit their liability contractually with the audited company and (in tort) with third parties.

4. Department of Trade and Industry, *Company Law – Director and Auditor Liability: A Consultative Document* (2003). This paper did not address the question of proportionate liability, which it considered could not be introduced solely in respect of the audit industry but only as part of a major reform of the law of negligence – which lay beyond its scope. But it opened consultation on the earlier recommendation that auditors should be able to limit their liabilities contractually.

5. Department of Trade and Industry, *Company Law Reform (White Paper)* (2005). Following the above consultation (listed as 4, above), the Government concluded that it would be inappropriate to permit the capping of auditors’ liability to a predetermined amount, but it invited stakeholders to discuss other ways in which liability might be limited. In the *White Paper*, it announced that it was persuaded of the benefits of change and proposed legislation to allow shareholders to agree limitations on the liability of auditors.

The last-mentioned reform was enacted by Companies Act 2006, section 534ff.

I find the arguments of the English/U.K. law reform bodies entirely convincing in their rejection of both capping (Options 1, 2 and 3 in the Working Paper) and the replacement of joint and several liability with a system of proportionate liability (Option 4(a)). Both reforms would be contrary to principle, would give auditors preferential treatment as compared with other professionals (and indeed tort defendants generally), and would benefit them at the expense of those injured by their negligence. Neither reform should be introduced unless there is a clear demonstration of overriding political need.

I do not believe that such need has as yet been demonstrated with sufficient clarity. The position of the auditor is adequately protected vis-à-vis the client company by allowing contractual arrangements – on the model of Companies Act 2006, sec. 534ff – whereby the auditor’s liability may be limited to a ‘fair and reasonable’ level (Option 4(b)). I am prepared to accept that greater concerns arise in connection with auditors’ liability to third parties. The Anglo-American common law has for long made plain its reluctance about exposing auditors to ‘liability in an indeterminate amount, for an indeterminate time, to an indeterminate class’ *Ultramares Corporation v Touche* (1931) 174 N.E. 441, 444 per Cardozo J), and has limited such liability to a very considerable extent by denying the existence of a duty of care other than in very exceptional cases (see especially, in English law, *Caparo Industries plc v Dickman* [1990] 2 AC 605). I am prepared to accept that the political necessity for the limitation of liability might be demonstrated insofar as liability to third parties is concerned, as I understand from Annex II of the Working Paper that the majority of Member States currently allow actions by third parties without any restriction equivalent to that inherent in the common law concept of a duty of care. A further consideration here is the difficulty the auditor might face in negotiating any voluntary
limitation of liability with the third party (whose identity, it seems, may even be unknown at the relevant time).

If it is found that such need exists, any departure from established liability norms must be proportionate to the ‘mischief’ that the reform is designed to address. If (as appears to be the case) the driving concern is practical difficulties consequent on the collapse of another Big 4 auditor, the proposed remedy should not go further than is necessary to guard against that risk (i.e. it might warrant a high-level cap to prevent catastrophic liability, but not a lower-level cap whose effect might be to insulate the auditor from the desirable incentive effect of potential liabilities). In determining the levels of liability the Big 4 could be expected to bear, it will be necessary to take into account their annual audit and accounting revenues, and their strong growth in recent years. Of course, any figure adopted will be to some extent arbitrary, but I note that the London Economics study on which the Commission relies states (p. 210) that a claim in excess of EUR500 million could be sustained even after the exhaustion of the resources of the captive insurer. Making allowance for a generous ‘safety margin’, I would suggest that any cap should be set at least as high as EUR250 million.

I would add that I was not impressed by concerns that a high cap would disadvantage mid-tier firms (Working Paper, para. 3.1). The truth is that they would not be disadvantaged at all, but merely denied an advantage which, for reasons (ex hypothesi) of clear political need, was accorded to the Big 4. Avoiding the collapse of a mid-tier firm is not one of the political concerns that can plausibly be advanced for the departure from established tort law norms that is presently being contemplated. Nor was I impressed by the criticisms directed at a ‘one-size-fits-all’ solution (ibid.) The motivating concern here is the possible collapse of one of the Big 4 multinational networks, so the focus in setting any cap should be that level of liability that would threaten their existence, not the diversity of the size of audit risks and other circumstances in different Member States.

Answers to the Specific Questions

Question 1: Do you agree with the analysis of the option of fixing a single monetary cap at EU level?

Of the three capping options, this is the one I would have least objection to – provided that (as argued above) the cap is at the high level necessary to prevent a catastrophic liability which might cause the collapse of another Big 4 auditor. I explain my objection to the other capping options below. On balance, however, I am not convinced that any cap is at present necessary, and would have a strong preference – insofar as liability to the client company is concerned – for the approach based on voluntary contractual arrangements set out under Option 4 of the Working Paper.

Question 2: Would a cap based on the size of the listed company, as measured by its market capitalisation be appropriate?

Again, my general preference is for an approach based upon voluntary contractual arrangements. My particular objection to the current option is that it may lead to what are, in absolute pecuniary terms, relatively low-level caps: if the company is small, it would seem to follow that the cap will be (relatively) low. Additionally, a company
that is close to insolvency will for that reason have a low market capitalisation, again
depressing the level of the applicable cap. Liability in these cases would – as a result
– be too low. This contradicts the principle for which I have contended above: that the
remedy should be proportionate to the ‘mischief’ it is designed to address. If (as
appears to be the case) the driving concern is the collapse of a Big 4 auditor, then
limiting liability to (relatively) low levels in respect of small companies would seem
to be an entirely disproportionate and unnecessary response.

Other concerns here are that Option 2 would cap liability on the basis of a highly
volatile criterion, and that it gives no answer as to the approach to be adopted in the
case of non-listed companies (for which no market capitalisation is available).

**Question 3: Would a cap based on the audit fees charged to the company be
appropriate?**

For reasons broadly similar to those stated in answer to Question 2, above, I would
reject this option too.

**Question 4: Do agree with the analysis of the option of introduction of the principle of
proportionate liability? What are your views on the two ways in which proportionate
liability might be introduced?**

As stated above, I am not in favour of the first way of giving effect to proportionate
liability, viz. by allowing the Courts to award damages only for the portion of the loss
corresponding to the auditor’s degree of fault. This would be contrary to principle,
according auditors preferential treatment as compared with other professionals (and
indeed tort defendants generally), and benefiting them at the expense of claimants
injured by their negligence. This approach would also be incompatible with the main
function of the audit. The reason for having a mandatory external and independent
audit is to provide a level of assurance in respect of the annual reports prepared by
management. The auditor – as gatekeeper – assures that the published reports are
reliable sources of information for investors and creditors. Liability for a negligent
audit which fails to uncover misrepresentations in the annual report should not be
reduced only on the grounds that persons involved such as managers have also acted
negligently – or even intentionally. Any reduction of liability in such a case would
undesirably weaken the incentive on auditors to perform their function of detecting
and exposing errors and misrepresentations.

I am, however, very enthusiastic about the alternative proposal of allowing
proportionate solutions to be negotiated with the company and enshrined in contract –
subject to the mentioned safeguards (approval by shareholders, provision for national
courts to override the agreement if the limitation is not fair and reasonable). This
would allow liability limitations appropriate to the size and other circumstances of the
audited company. It may also help to improve quality in the European audit market in
general as the size of limitations sought by different auditor will provide relevant
information to companies who are the ‘consumers’ of the audit product, and become a
criterion for competition between auditors. Access to larger auditing clients for mid-
sized auditing firms may also be facilitated through the implementation of this option,
consequently reducing the current concentration and lack of choice in the auditing
market.