

SECURITIES ACT AMENDMENTS ADD TO AUDITORS' REGULATORY BURDEN

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The 2008 amendments to the *Securities Act*, outlined on the opposite page, are the latest in a series of substantive regulatory changes that have eroded legal protections for auditors created by Supreme Court of Canada decisions during the 1980s and 1990s.

In effect, these amendments are part of a private-sector compliance regime established by securities regulators. In 2007, when the proposed legislation was debated in the British Columbia Legislative Assembly, the “underlying philosophical basis for the legislation” was declared to be harmonization of securities legislation with that of other jurisdictions. The government also characterized the legislation as providing a new remedy for investors. While it does create such remedies, it also signals a shift in practical responsibility for securities law enforcement to individual investors in the private sector. That shift is in keeping with the crunch on white-collar-crime enforcement resources that has occurred over at least the last 20 years, while the commission of those crimes has proliferated.

The new legislation applies to annual and interim financial statements of reporting issuers, as well as other “core documents” and statements made on the basis of those documents. If those statements are released by a company with an auditor’s consent and contain a misrepresentation, then a person who trades in securities and suffers a loss after that time has a claim for damages against the auditor.

When examined closely, this approach does not depart drastically from Supreme Court of Canada decisions regarding the scope of investors who can make a claim of auditor’s negligence—an investor who sues an auditor must show that the auditor had knowledge of the use to which the statements would be put and consented to that use.

However, there is a startling absence of a fault requirement in relation to auditors and other experts, which would usually be found in the concept of a legal standard of care. Historically, this principle has been critical in the context of claims related to financial statements. The auditor’s representations are not the numbers that comprise the financial statements, rather they are the representations that are made about those numbers, i.e. that they comply with Generally Accepted

Accounting Principles, were fairly presented, and are not misleading. Previously, in a negligence case, the court would be required to find that the financial statements were incorrect *and* that the auditor was negligent in failing to uncover that fact by not taking steps that a reasonably prudent auditor would take in the same circumstances. Under this legislation, it does not seem to matter why the statements were wrong, just that they were.

As well, in the Legislative Assembly, the amendments were described as being designed to provide a remedy for misrepresentations “made by a public company or their authorized representatives” and intended to remedy fraud. This view might ignore the long-standing principle, recorded in virtually every modern audit engagement, that an audit is not intended to detect fraud.

Over the years, the courts have been educated by audit experts on the importance of this limitation and frequently have respected it in negligence claims against auditors. The courts have inserted a logical hurdle that, before being held liable for losses caused by a corporate fraud, the plaintiff must prove that the auditor should reasonably have uncovered the error. Again, that element of fault is not apparent in this legislation.

Nonetheless, the legislation contains several important doses of restraint aimed at reducing the flood of litigation that might otherwise follow from it:

- A misrepresentation can be corrected. If it is, then there is no claim arising from a trade in securities made after the correction.
- There will be no liability to a plaintiff who trades in the security with knowledge of the misrepresentation.
- There is a defence to people who may provide “forward-looking information” with appropriate cautionary language and assumptions.
- There is no liability for a statement made in reasonable reliance on another document filed with the Securities Commission.

Accordingly, the use and timing of engagement limitations, note disclosure, corrections and restatements will have great significance for the risk management strategy of any auditor. These have always been important tools but should be re-examined in light of this new risk.

An additional dose of restraint in the legislation addresses the potentially vast nuisance that might otherwise be created by the new statutory cause of action. The amendments provide that leave must be granted by the court before a lawsuit of this nature can be started. This reverses the normal course of events, in which anybody can start a suit and it is up to the defendant to apply to

the court on difficult standards to have it struck. This threshold may deter or bar some frivolous claims from being carried forward.

The legislation also contains protections in relation to the amount of damages and joint and several liability. While those protections will limit the dollar amount of the risk undertaken in any audit, they do not reduce the risk of a claim being made.

In all, it is clear that this new legislation has the potential to turn the legal regime applicable to auditors on its head. It would seem likely to be used by investors as a sword rather than, or in addition to, traditional negligence claims. The only certainty is that, unlike earlier changes that resulted in reduced litigation in this area, these changes can only result in more litigation and claims against company auditors, as well as increased audit fees for corporations in B.C.