Trends in Anglo-American Tort Law and the Case of Auditors' Liability

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I. Introduction

In this paper I will, first of all, canvass in general terms certain recent intellectual trends in the specific area of Anglo-American common law known as tort law. Given Japan's civilian tradition, readers may know it as the law of delict, which is reflective of the Roman roots of continental Europe's legal systems. I will then focus on a specific and, commercially speaking, important emerging issue in Anglo-American tort law, being whether auditors ought to be held liable to non-contracting parties who have suffered loss as a result of auditors' professional negligence. In reviewing this subject, I will further elucidate my general introductory discussion about one of those trends, which is the emergence of the school of legal understanding known as 'Law & Economics' and its application in English-speaking jurisdictions such as Canada and the United States

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to tort law's doctrines.

From the immediate postwar period to (and including) the 1980s, Anglo-American tort law scholarship was characterized by an association with syntheses of doctrine, with new doctrinal developments and with proposals for 'law reform', which 'reform' the contemporary torts scholar G. Edward White defined as 'the reorganization of doctrine to conform to particular policy imperatives.'[1] The work of William Prosser[2] and Robert Keeton[3] in the United States, Patrick Atiyah[4] in the United Kingdom, John Fleming[5] in Australia and Justice Allen Linden[6] and Lewis Klar[7] in Canada have conspicuously instantiated that form of scholarship. While these scholars have not always found common ground in their opinions on specific issues in tort law or even on tort law's place in contemporary western society, they have nonetheless shared a methodology and, in many respects, the non-ideological stance of confining themselves to describing law's positive expression and espousing changes that, from a policy perspective, they view as desirable. Alternatively put, they agnostically eschew systemic norms.

Now, let me move from the academy to the judiciary, where similar concerns for 'policy' were also at work. As just one example, throughout Anglo-American jurisdictions, judicial treatment of the tort law doctrine of vicarious liability - being the liability of an

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1 G. Edward White, 'The Unexpected Persistence of Negligence, 1980-2000' (2001) 54 Vand. L. Rev. 1337 at 1342.

2 William L. Prosser, *Handbook on the Law of Torts* (1941); and William L. Prosser and John W. Wade, *Cases and Materials on Torts* (1971).

3 Robert Keeton, *Compensation Systems: The Search for a Viable Alternative to Negligence Law* (American Casebook Series, 1969).

4 P.S. Atiyah, *Accidents, Compensation and the Law* (London: Weidenfeld and Nicolson, 1970).

5 J.G. Fleming, *The Law of Torts* (The Law Book Co Ltd, Sydney, 1957).

6 Allen Linden, *Canadian Tort Law* (Toronto: Butterworths, 1977).

7 Lewis Klar, *Tort Law* (Toronto: Carswell, 1991).

employer for the torts of its employees committed in the course of employment - shifted to benefit the plaintiff complaining of an intentional tort committed by an employee. Historically, it had been understood that employers could not be liable for their employees' intentional torts, such misconduct not possibly occurring within the course of employment. Yet, common law courts throughout the late 20th century readily imposed vicarious liability on the employer for damage arising from wholly unanticipated misconduct which seemed to have little connection to the job for which the employee had been hired. Why did this occur? The answer lies in the courts' underlying concern, which was nothing 'legal' as such, but rather policy-driven. Specifically, this policy-driven concern - whose remedy would have traditionally been seen to be the province of legislators, not jurists - was to see that victims of intentional torts, even where those torts are not meaningfully connected to an employer's enterprise, are compensated by the employer. The underlying rationale here is, of course, that an employer is more likely to be able to satisfy a judgment than the tortfeasing employee.

While such policy imperatives have governed much U.S. tort law jurisprudence since the emergence of the 'Realist school' and the judgments of Oliver Wendell Holmes,[8] they did not take hold in the Commonwealth until the pronouncement of the House of Lords in *Home Office v. Dorset Yacht Co. Ltd.*,[9] when tort law began to be conceptualized as what English legal historian David Ibbetson has described as 'an ocean of liability for carelessly causing foreseeable harm, dotted with islands of non-liability.'[10] In *Dorset Yacht*, Lord Reid articulated a conception of tort law in which a case for the defendant's liability no longer falls to the plaintiff to demonstrate on

8 See, generally, Alan Calnan, *A Revisionist History of Tort Law: From Holmesian Realism to Neoclassical Realism* (Durham, N.C.: Carolina Academic Press, 2005).

9 [1970] 2 All E.R. 294 (H.L.) [*Dorset Yacht*].

10 D.J. Ibbetson, *A Historical Introduction to the Law of Obligations* (Oxford: Oxford University Press, 1999) at 192-93.

the facts and law. Instead, he said:

> I think that the time has come when we can and should say that [a duty of care in tort law] ought to apply unless there is some justification or valid explanation for its exclusion....[11]

The defendant's liability is no longer made out on the evidence, then, but is *presupposed*. That is, we presume that the defendant is liable until the defendant demonstrates, on the basis of policy arguments, that liability ought not to be imposed.

From its inception in *Dorset Yacht*, this plaintiff-friendly conception of liability was consolidated by a House of Lords pronouncement which is still observed (in substantial part) in Canada[12] (although not in the United Kingdom or Australia), *Anns v. Merton Borough Council*,[13] where Lord Wilberforce prescribed a two-stage test for the recognition in tort law of a duty of care in these terms:

> [T] he position has now been reached that in order to establish that a duty of care arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather, the question has to be approached in two stages. First one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of persons to whom it is owed or the

11 *Dorset Yacht, supra* note 9 at 297.

12 I have discussed the current state of Canadian law in this area in Russell Brown, 'Still Crazy After All These Years: *Anns, Cooper v. Hobart* and Pure Economic Loss' (2003) 36 U.B.C. L. Rev.159 [Brown, 'Still Crazy'].

13 [1978] A.C.728, [1977] 2 All E.R. 492 (H.L.) [*Anns* cited to All E.R.].

damages to which a breach of it may give rise.[14]

The common law position is therefore understood and described as follows. First, in determining whether a duty of care arises, we are to ignore orthodox legal classifications. As a result, no distinction is to be made between cases of physical damage (whether to person or property) and cases of pure economic loss. Secondly, the imposition of liability is conditioned upon two questions. First, we are to consider whether one might reasonably have contemplated that the defendant's failure to take care may be likely to cause damage. If so, the stage two inquiry is engaged, requiring us to employ policy considerations that negative or reduce or limit the scope of the duty.

Since *Anns* in Commonwealth jurisdictions, and since the emergence of the Realist school in the United States, common law courts and tort law scholars have struggled with these principles, generally relying upon policy considerations as guides to proper adjudication in the light of each case's concrete facts. In response, two schools of tort law scholarship have arisen and have gradually acquired a shared predominance in common law jurisdictions, eclipsing their predecessor phenomenon of pragmatic tort law discourse and its focus on public policy considerations. These are, specifically: (1) formalism grounded in moral philosophy, and (2) Law & Economics.

I now turn to furnishing a concise and critical account of these trends. I have in some of my own scholarship canvassed in some detail the former emergent branch - that of moral philosophy.[15] My analysis of the latter branch, - that of Law & Economics - will therefore be more substantial. Specifically, by using the exemplar of the liability of auditors for professional negligence, I will demonstrate

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14 *Ibid.* at 498.

15 See Brown, 'Still Crazy', *supra note* 12; Russell Brown, 'Justifying the Impossibility of Relational Economic Loss' [Forthcoming (2005) 5 Oxford U. Comm. L.J.]; and Russell Brown, 'Rethinking Privacy: Exclusivity, Private Relation and Tort Law' [Forthcoming (2006) Alta L. Rev.].

that the Law & Economics school of legal understanding has been sourced and its precepts employed by the courts in ways that have led to serious social and economic repercussions. In the result, I will suggest that scholars adhering to this school may fortify their scholarship by incorporating into their analyses a degree of empiricism.

So, I proceed, then, by considering these two contrasting, emergent intellectual trends in Anglo-American tort law.

II. Formalism

In the early 1980s, a body of legal scholarship began to emerge which applied the insights of moral philosophy - and in particular of corrective justice - to the law.[16] Their concern was specific to private law - that area of law which governs private relations, such as tort law, contract law and property law - because they espoused a justification of those areas of law and its institutions for which they claimed the fundamental characteristic of being internal to private law. That internality has two aspects. First, the justification is grounded in formalism's perspective that private law is properly understood and justified with exclusive reference to its own concepts and principles, which operate as an internal intelligibility through which private law is understandable from within.[17] The second aspect of the justification's internality is consequential upon the first: given that private law can be understood and justified with exclusive reference to itself, it cannot be explained with reference to the 'alien language' of other disciplines, such as economics or sociology. Indeed, by grounding their philosophy in corrective justice, and in particular

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16 Jules Coleman, *Moral Theories of Torts: Their Scope and Limits* (1982) 1 Law and Phil. 371; Ernest Weinrib, *Toward a Moral Theory of Negligence Law* (1983) 2 Law and Phil. 37.

17 Here I am generally relying on Ernest J. Weinrib, *The Idea of Private Law* (Cambridge, MA: Harvard University Press, 1995).

in its Aristotelian form with its concept of correlated injury and gain,[18] formalists reject any justification for private law grounded in distributive considerations. Consequently, they stake private law's internal coherence solely on the justificatory structure of corrective justice, and claim for private law an immanent intelligibility. An autonomous construct, it neither requires nor allows for understanding or justification in any terms other than its own. Formalists therefore portray their enterprise as seeking to respect and justify private law discourse in private law's own terms, being the collection of concepts, doctrines and institutions through which it is seen as maintaining coherent legal expression, all within the parameters of corrective justice.

The difficulty is, of course, that, like any other common law device, private law develops over time. As one of the great contemporary formalists puts it, 'subsequent occurrences or the thinking of subsequent jurists may lead to fresh nuances in doctrine or to a re-evaluation of the coherence or plausibility of previously settled law.'[19] What, then, when the thinking of subsequent jurists does not conform to the internal justification as understood by formalists? It is possible, even probable that private law jurists who are responsible for current private law evolution would disagree and embrace external goals - perhaps economic ones such as such as loss-shifting or risk-spreading, or sociologically-inspired schemes of wealth redistribution. Private law is inherently dynamic, evolving through its expression by subsequent jurists. Not every court decision will be consistent with corrective justice, and judicial pronouncements will inevitably arise which disregard the principles that give private law its internal coherence.

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18 See, for a pithy description of these notions of 'loss' and 'gain', James Gordley, 'Tort Law in the Aristotelian Tradition', in David G. Owen, *Philosphical Foundations of Tort Law* (Oxford: Oxford University Press, 1995) 131.

19 Ernest J. Weinrib, *The Idea of Private Law* (Cambridge, MA: Harvard University Press, 1995) at 15.

The formalists' answer is that only certain features of this juristic expression carry legal significance. Since some judicial pronouncements may be 'mistaken' inasmuch as they do not conform to the principles which give private law its internal intelligibility, we are told to look only to that juristic expression which is central to the formalist conception of private law, in the sense that their systematic absence would mean the dissolution of private law in its recognizable form. The 'mistaken' cases, then, amount to inconsistencies for which (subject to their being reconciled or 'smoothed out'[20]), formalists prescribe rejection. In this way, private law is seen as a self-adjusting harmonic device. As to where we draw the line between a case which needs to be 'smoothed out' or rejected as unsound, and a case that is a signpost of private law's internal intelligibility, we are directed back to the yardstick of corrective justice. If a case is free of external considerations and consistent with the essential characteristic of a correlative loss to the sufferer and gain to the doer, it is thus viewed as part of a larger internal coherence.

Formalists' attempt to rationalize and accommodate shifts in private law is, however, limited where such shifts require us to reassess the coherence of private law on its own terms or the viability of corrective justice as an exclusive justificatory structure. Such shifts may not even necessarily espouse or imply a distributive justificatory structure, but nonetheless may be inconsistent with the foundational notion of corrective justice as stripping from the wrongdoer the gain acquired from having interfered with the plaintiff's rights. For example, I have already referred to *Anns* and its effects upon tort law. As a result of *Anns*, Canadian courts have, for over a quarter-century, determined whether or not a duty of care was owed in cases of alleged negligence by exclusive reference to the 'proximity' that existed between the plaintiff and the defendant at the time of the negligent act or omission. This inquiry is to occur irrespective of whether the alleged injury is to a recognized

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20 *Ibid*. at 12.

protected legal interest as understood by formalists, or whether it constitutes an unprotected interest such as pure economic loss. This '*prima facie*' duty of care having been thereby established, it can only be negated by the application of 'policy considerations. (which may or may not be reflective of distributive concerns).

My point is that both this *prima facie* duty and the use of extrinsic 'policy' considerations are wholly antithetical to the Aristotelian conception of duty which formalists espouse, insofar as they require that the plaintiff only demonstrate proximity to the defendant's negligent act, not an injury to a right. As these notions cannot be 'smoothed out' to fit with formalism's internal, coherent conception of private law, formalism requires that we jettison them for more orthodox conceptions of duty. Formalism would not permit us to engage the *prima facie* duty's underlyling doctrine by adjusting the formalist justificatory structure of corrective justice to find a wider pattern of coherence that rationalizes or otherwise accounts for the judicial reasoning behind the *prima facie* duty. Private law's evolution is thus confined to a 2,300 year old Aristotelian straightjacket.

In these circumstances, private law's internality is revealed not as a mere characteristic, but as a value-laden goal. One cannot keep claiming that most of positive law is a mistake without seeming to privilege normatively the bit one claims to be correct. Formalism's weakness, then, is that it not only claims to articulate a way of understanding private law in private law's own terms, but it also purports to define those terms. In doing so, it avoids confronting and having to rationalize doctrines like the *prima facie* duty or any other juristic expression it finds inconvenient - that is, juristic expression which does not conform to private law's internal coherence. 'Internal', therefore, does not refer to what jurists say, but rather the assumptions that formalists make in assessing that juristic expression. So understood, internality is not a mere descriptive term - it is normative. It seeks to perpetuate the justification of corrective justice, to the total exclusion of all others, by subjecting juristic expression to a test of conformance to that justification, even in the

face of significant juristic expression that often ascribes external purposes to private law.

The implications of this normative internalism transcend mere issues of coherence. Inasmuch as it excludes from consideration any doctrine of private law that does not conform to an immanent justification, formalism impedes private law's ability to engender desirable legal doctrines whose norms or principles are inconsistent with corrective justice. Similarly, morally repugnant doctrine would be justified where it conforms to corrective justice. Consequently, where jurists have a choice between a doctrine which is justified with reference to external utilitarian considerations but is desirable, and an abhorrent doctrine that conforms to corrective justice, formalism would require us to choose the latter, sacrificing justice, as determined by externally-based norms of desirability, to a norm of perceived coherence.

Formalism, in short, is limited in its ability to adequately account for the common law's evolution of juristic expression in private law that does not conform to the justification of corrective justice. As a consequence, its central claim - of espousing a theory of private law that is internal to private law - is not made out. While it purports to respect private law as an immanently intelligible device, it is unable or unwilling to rationalize much of private law's juristic expression to the extent it transcends the justificatory structure of corrective justice. In the result, private law's 'internality' is revealed as a normatively-charged objective, achieved through the imposition of criteria that will often be external to juristic expression of private law.

Ⅲ. Law & Economics

'Law & Economics' scholars maintain that economics can, in a positivist sense, inform our understanding of the pecuniary impact of particular legal measures and, normatively, improve decisions about

how to use the law to allocate finite resources efficiently or, as a noted Law & Economics scholar has put it, 'to[do] the best ... with limited resources.'[21] The exercise is essentially predictive and descriptive - that is, forward-looking, assessing the likely consequences of actions by changing the behaviour of organizations or persons - although it on occasion will be retrospective, when trying to explain what occurred in the past.

The predictive, forward-looking aspect of Law & Economics entails a critical behavioural assumption: persons and organizations respond to economic incentives in an economically rational manner. This assumption is at its least controversial when considered in an explicit market context. Consider for example the economics of European Union's common agricultural policy, which has been disastrous both economically for its constitutive members and now politically for the cause of European union. Looking first at the demand side - that is, the impact of consumer purchases - increasing the price of agricultural food products generated little demonstrated change in demand. This would tend to demonstrate that agricultural food products constitute an essential good in respect of which demand is inelastic. That is, consumers will continue to purchase them even when prices increase. The result, however, is quite different when prices are decreased, because demand in those circumstances would generally increase, although the amount of such an increase will be influenced by the extent of the decrease in price. Similar consequences on the supply side of the equation are derived from price changes. Where prices are increased, there is little response, presumably because demand has remained constant. Where prices are decreased, however, supplies will be considerably reduced.

What the European Union policy entailed was a minimum price stipulation, in order to increase European farmers' income. This had

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21 Michael J. Trebilcock, 'An Introduction to Law and Economics' (1997) 23 Monash U.L. Rev. 123 at 125.

the effect, in most cases, of raising prices. While this did not impact demand which, as could have been predicted, was inelastic, it did have the effect of creating incentives among farmers to produce as much as they possibly could, thus oversupplying the market. (The paradigm of this oversupply was the notorious 'butter mountain', but there are many other product-specific examples). To address that oversupply, European policy-makers sought to regulate competing imports. When this failed to address the supply (and farmers' decreasing incomes), European governments aggravated their misguided agricultural policy by guaranteeing purchase of the surplus at the stipulated minimum price, thus adding to the already considerable incentive on the part of farmers to add to the oversupply. The product so purchased was then exported (usually at below the regulated price at which rate the governments had purchased it).

Ironically, Europe's common agricultural policy has been damaging to the second generation of farmers, because these state-subsidized economic returns enjoyed by the prior generation, generated by a system of regulated product pricing, then regulated imports, then guaranteed purchase, have increased the price of agricultural lands. That is, the first generation's returns were capitalized in land values. As a result, the policy has benefited only one generation of farmers, while harming the interests of subsequent generations of farmers, as well as consumers and taxpayers.

Law & Economics scholars would say that this dysfunction could have been predicted with reference to fundamental economic principles. The only variable would have been the problem's magnitude, which could be predicted only by knowing the elasticity of supply and demand. In the same way, they say, this analysis can be applied to purely 'legal' questions, by viewing the legal system as a giant supermarket. For example, if a legislature wishes to reduce commissions of a particular offence, it will tap into the same system of incentives that they would say were skewed by Europe's common agricultural policy. By increasing the penalty for the particular

offence, irrespective of whether the penalty involves a fine or a term of imprisonment, or by adding more police officers to increase the possibility of the miscreant being caught, legislators are increasing the expected cost of the offence to him or her: $EC = LA \times P$ (*where* EC = Expected Cost, LA = Likelihood of Apprehension, P = Penalty).

Even formalists will have to admit that Law & Economics can contribute to a universal appreciation of the law. When allocating scarce resources, it is not particularly helpful to speak merely of 'rights.' Such talk does not help lawmakers make those allocational choices. Even where rights exist that might in their own terms resist Law & Economics' brand of utilitarianism - for example, where the social cost of protecting a person's property exceeds the value of that property to the person and therefore exceeds the benefit of such protection - it is helpful to know the costs associated with that right. No right, after all, is absolute. The right to counsel - a fundamental element of the common law's historical orthodoxy - has pragmatic economic constraints. 'Legal Aid', which is a Canadian term describing state-furnished legal counsel for persons who cannot afford but need such counsel, also carries certain restraints which are rather utilitarian, such as the withdrawal of legal aid for certain 'frivolous' appeals. The point is that efficiency is not necessarily the end of the exercise, but it is a means by which the exercise can be confined, and as such Law & Economics analyses help lawmakers.

For my purposes, however, Law & Economics does have two important weaknesses. First, the economist's goal of efficiency cannot account for the fundamental structure of tort law, by which I mean to refer to the elements that compose a common law tort action: duty of care, breach, causation and damages. Admittedly, it is true that economics can contribute to broader issues relating to tort law (such as alternative liability regimes and accident prevention). Economics might, therefore, contribute to accident prevention by illustrating ways in which projected accident costs and accident avoidance costs might be contrasted through a cost-benefit analsys.

Such a contribution is, however, unhelpful in explaining how tort law operates. An economic analysis of tort law, concerned with incentives to deter negligent conduct would, inevitably, emphasize the tortfeasor. Specifically, it would ask what the tortfeasor will pay, rather than what the plaintiff receives. Alternatively put, the individual entitlements of a plaintiff are determined by reference to the most economically efficient outcome of the dispute with the tortfeasor. While this involves consideration of the plaintiff insofar as the damages to be paid by the tortfeasor should equate to the plaintiff's loss, economic analysis does not require that the damages be paid *to the plaintiff*. That is, the remedial relation between the tortfeasor and the plaintiff is unimportant. Indeed, the tortfeasor could pay damages to anybody, and the economist would be satisfied; all that matters is that he or she has to pay. The plaintiff's interests are thus subsumed into a social benefit, the efficiency of whose effect the economist seeks to maximize.

Both the tortfeasor and the plaintiff, however, have important roles in tort law. The fact that the tortfeasor pays damages *to the plaintiff* is fundamental to tort law's normative precepts. The economist's agnosticism about the recipient of damages is inconsistent with the ordered principles by which tort law operates, such as *restitutio in integrum* - meaning 'restoration to original condition.' This is because restoring *the plaintiff* by way of an award of compensation to put him or her in the position he or she would have occupied but for the tortious action is the first guiding principle of tort law damages. Were, therefore, the *state* to receive the damages instead of the injured plaintiff, such a scheme could not be described as an instance of tort law. Rather, it would resemble a public insurance or compensatory arrangement. While, on economic terms, and assuming the state were to develop a reasonable compensation scheme, this arrangement might work in everyone's interests, my point here is that, economic rationality notwithstanding, it is incompatible with tort law.

Just as efficiency cannot account for aspects of the law of torts,

neither can it account for donative intent - that is, the motivation of a person that is *not* grounded in self interest. Here, then, is the second weakness of Law & Economics. It assumes that persons will inevitably have an incentive to act as rational wealth maximizers. Or, in the language of economics, they assume that every person's 'utility function' will be consistent with maximizing returns from scarce resources.

In such circumstances, the understanding of law advanced by adherents to the Law & Economics school becomes incoherent, because it is based on an incorrect assumption: specifically, that utility functions other than efficiency will never motivate allocational decisions. Of course, this is ridiculous. The entire law of gifts in the common law of property has developed over centuries in response to gratuitous and economically inefficient allocations of wealth and out of judicial concern to facilitate such transfers where they are demonstrated to have been intended as gratuitous (and not contractual) exchanges. Thus a grandparent may give money to his or her grandchildren out of affection and concern for their welfare after he or she dies or is incapacitated. The economically rational thing is to employ that money to his or her own welfare - perhaps to provide the grandparent with a more comfortable retirement or superior medical care. Experience, however, tells us that love of grandchildren, while inefficient, is a powerful force that will often prevail over selfish desires or even needs. My argument here, of course, is that Law & Economics cannot account for the most benign yet nonetheless elemental components of our existence, such as kindness, generosity, philanthropy, or love.

The first weakness of Law & Economics which I have identified speaks to Law & Economics' inherent limitations. Law & Economics cannot explain tort law, and so instead it is reduced to 'improving' it by, as I have already suggested, proposing alternative compensatory schemes or by predicting outcomes. It is a weakness which Law & Economics' adherents, for the most part, acknowledge. The alternative would be to claim that tort law aspires to be efficient,

but such a claim would be reckless, since there is precious little judicial commentary to support it.

The second weakness of Law & Economics, however, ought to grab legal economists' attention, because it is a problem that, at least at an abstract, theoretical level, is reparable. That is, by adopting a rigourously empirical stance, the observations of legal economists as to the impact of law on social wealth, and their prescriptions for improved efficiency, would allow us to make judgments based on advice that is truly informed. Most of the first generation Law & Economics scholars such as Posner and Epstein either do not worry themselves with the facts, or else they engage in armchair empiricism. Happily, there is now a second generation of Law & Economics scholars emerging who recognize the importance of incorporating into pure economic theory the coldwater reality of empiricism, particularly as derived from behavioural studies.[22] In addition to being a mere happy development, however, it is also a necessary one for the intellectual integrity of the Law & Economics project. This is because while an indifference to facts is also characteristic of other legal theories, Law & Economics' adherents make not merely a normative, explanatory claim on their analyses of law, but also a positivist and predictive claim and, as such, they ought to be able to ground their analyses on empirical evidence, where it is available, or seek it out where it is not but nonetheless obtainable.

I now propose to elucidate this weakness and its effects by analysing the experience of the auditing branch of the accounting profession in Commonwealth jurisdictions generally and in Canada

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22 Robert C. Ellickson, 'Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics' (1989) 65 Chicago-Kent L. Rev. 23; Cass Sunstein, ed., *Behavioural Law and Economics* (Cambridge, MA: Cambridge University Press, 2000); and Hamish Stewart, 'Economic Analysis of Law: Which Way Ahead?' (2003) 53 U. T.L.J 425.

specifically.

Ⅳ. Auditors' Liability

Since the pronouncement of the House of Lords in *Hedley Byrne & Co. v. Heller and Partners Ltd.*,[23] the accounting profession in Commonwealth jurisdictions has experienced a vastly-increased scope of lawsuits against its members, principally from their work as auditors.[24] This has particularly been the case in Canada[25] where, nearly 30 years ago, the Supreme Court of Canada in *Haig v. Bamford*[26] found a defendant auditor liable to an investor who had relied on certain financial statements. There, a sole proprietor of a business had sought a $20,000 loan from a provincial government agency. In order to meet one of the loan's conditions (that the sole proprietor obtain $20,000 equity capital from another source), the sole proprietor hired the defendants to prepare a financial statement, which they negligently drew. In reliance on that statement, the plaintiff invested $20,000 (and a further amount which the court held was not induced by the financial statement), which he ultimately lost.

The Court specifically found that the plaintiff investor was a member of a class of potential users of such financial statements

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23 [1964] A.C. 465, [1963] 2 All E.R. 575 (H.L.).

24 See Carl Pacini, Mary Jill Martin and Lynda Hamilton, 'At the Interface of Law and Accounting: An Examination of a Trend toward a Reduction in the Scope of Auditor Liability to Third Parties in the Common Law Countries' (2000) Am. Bus. L.T. 171.

25 Scott Haggett, 'Fears Raised over Liability Issue: Trend is to Sue the Accountant When Firms Go Under' *Financial Post* (June 25, 1993) 17. By 1990, Canadian accountants faced over 100 current lawsuits. (See 'Auditors Must Deal with an Increasing Number of Lawsuits Charging Negligence' *Financial Post* (March 20, 1990) 18.

26 {1976}, [1977] 1 S.C.R. 466, 72 D.L.R. (3d) 68.

about which the auditor would have or ought to have known. In so ruling, the Court abandoned a 150 year-long insistence on shielding auditors from liability to anyone who was not in contractual privity with them. That is, auditors had previously been liable only to the party who had contracted for the financial statement - in this case, the sole proprietor - and not to investors who read and relied upon it. Now, however, auditors were to be liable to an anticipated class of readers.

Yet, just twenty years later, in ***Hercules Management v. Ernst & Young,***[27] the Court would revert to a more restrictive approach to auditors' liability. There, the defendant accountants were hired by two corporations to perform annual audits of their financial statements and to provide audit reports to the shareholders. The plaintiffs, shareholders in both corporations, lent and invested money to and in them. After both corporations were placed in receivership, the plaintiffs sued, alleging that the audit reports were negligently prepared and that, in reliance on these reports, they suffered financial losses.

Although it did not retreat entirely to the traditional 'bright-line' exclusionary rule, the Court held that it would not allow recovery in these circumstances - a result that would appear to be inconsistent with *Haig v. Bamford*. In doing so, however, it imposed an important twofold condition for liability in claims of this nature. Specifically, it required (1) that the plaintiff demonstrate the defendant's prior or contemporaneous knowledge of the identity of either the plaintiff or the class of plaintiffs who would reasonably rely on the financial statement, *and* (2) that the reliance losses claimed by the plaintiff stem from the particular transaction in respect of which the statement at issue was made.

At first glance the differences between *Haig v. Bamford* and ***Hercules***

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27 [1997] 2 S.C.R./165, 146 D.L.R. (4th) 577 [*Hercules* cited to S.C.R.].

are insubstantial: both tests clearly require an ascertained or at least ascertainable class of potential plaintiffs. *Hercules*, however, was *not* a case of an accountant being retained for a particular transaction, such as the defendant in *Haig v. Bamford*, but rather for general assistance of all shareholders as a collective, and not as individuals. In the result, while Canadian law now allows recovery for audits designed to facilitate particular transactions, it appears that audit reports to shareholders will not attract tort liability.

What prompted this partial retreat from *Haig v. Bamford*, a mere two decades after the court abandoned 150 years of common law to impose broad-ranging liability on auditors? It was not obvious, *ex ante*, that *Hercules* would have been determined any differently than *Haig*. Both cases were decided under the test for duty of care in tort law prescribed in 1977 by the House of Lords in *Anns v. Merton Borough Council*[28] which, as I have already described, provides that the proximity between the plaintiff's loss and the defendant's conduct engenders a '*prima facie* duty', which can be 'negatived' by 'policy considerations.' Yet, a different result *was* reached as between the cases: in *Hercules*, while the Court (as it did in *Haig v. Bamford*) recognized a *prima facie* duty of care, the purpose of the audit report, being to report to shareholders *collectively* (and not as individual investors in a particular transaction), amounted to a policy consideration that negated that *prima facie* duty of care.

The explanation for this apparent judicial caprice may lie in part in the influence of the ongoing debate between formalists and Law & Economics scholars. Several commentators have discerned in the past decade the beginnings of a shift at the Court towards more orthodox conceptions of duty of care,[29] based less on concerns of

28 *Supra*, note 13. This test has since been refined by the Supreme Court of Canada. See *Cooper v. Hobart* (2001), 206 D.L.R. (4th) 193, [2002] 1W. W.R. 221, 2001 S.C.C. 79, and Brown, 'Still Crazy', *supra note* 12.

29 Lewis Klar, 'Foreseeability, Proximity and Policy' (2002) 25 The Advocates' Q. 360; and Brown, 'Still Crazy', *supra note* 12.

proximity, and more on *stare decisis*. Or, the explanation may also lie in part in the accumulation, through the 1990s, of empirical data on the effects of increased liability for auditors in Canada, the United Kingdom and the United States.

Thus two nascent developments, being a somewhat doctrinaire, formalist shift away from instrumental determinants of liability (such as economics), and the emergence of empirical data illustrating the impact of liability, may be operating cumulatively in order to influence the law in this area. The first factor is reflective of the ongoing debates between those who reject instrumental considerations and those who embrace them, and is probably an inevitable result of the two competing and emergent trends which I have identified in contemporary Anglo-Americal tort law. The second, however - the emergence of empirical data - is significant, and ought to be carefully considered by Law & Economics scholars. It allows them, and us, to take advantage of the consequences post-*Haig v. Bamford* liability in order to review the largely theoretical and hypothetical structure of the debate thus far and to consider the principal economic arguments for and against auditors' liability.

Given the time constraints of a seminar format, it is possible only to briefly canvass and summarize those arguments as well as the empirical data available, and to reach some basic conclusions. Consequently, I will approach the subject by grouping the different economic arguments as well as the empirical findings into generalized categories. Among those categories - which are (1) 'Loss Spreading', (2) 'Information as a Product', (3) 'Quality of Product' and (4) 'Social Cost' - the first ('Loss Spreading') is the most pervasively-employed in the caselaw and consequently I intend to subject it to particular scrutiny.

a. Loss Spreading

In 1992, the Supreme Court of California in *Bily v. Arthur Young & Co.*[30] identified 'efficient' spreading of the risk' as a rationale against

auditors' liability, the majority stating:

> In light of the relationships between the auditor, client and third party, and the relative sophistication of the third parties who lend and invest based on audit reports, it might also be doubted whether auditors are the most efficient absorbers of the losses from inaccuracies in financial information. Investors and creditors can limit the impact of losses by diversifying investment and loan portfolios. They effectively constitute 'a broad social base upon which the costs of accounting errors can be spread.'... In the audit liability context, no reason appears to favor the alleged tortfeasor over the alleged victim as an effective distributor of loss.[31]

Conversely, ten years earlier the Supreme Court of New Jersey, in *H. Rosenblum Inc. v. Adler*,[32] emphasized loss-spreading as *justifying* liability. Here, the loss-spreading was achieved through accountants' liability insurance, the cost of which would have been ultimately borne by the client company's shareholders. For the court, Schreiber J. said:

> The objection to imposing a duty on accountants to third persons to whom the statements have been given by the company for proper business purposes is the spectre of financial catastrophe. It is feared that the unknown costs will be so severe that accounting firms will not be able to absorb the losses that will be visited upon them, particularly because in all likelihood the audited clients will be judgment proof or unable to satisfy their share of the indebtedness due. The reasonableness of this concern is questionable.
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> ...
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> Independent auditors have apparently been able to obtain liability insurance covering those risks or otherwise to satisfy their financial

30 834 P. 2d 745 (Cal. Sup. Ct. 1992). The facts were atypical: common stock investors sued the auditor of the corporation's books prior to public offering.

31 *Ibid*. at 766.

32 461 A. 2d 138 (N.J. Sup. Ct. 1983) [*Rosenblum*]. The facts, for the purposes of considering the general issue of auditors' liability for negligence, were in all material respects identical to those of *Bily*.

> obligations. We have no reason to believe that they may not purchase malpractice insurance that cover their negligent acts leading to misstatements relied upon by persons who receive the audit from the company pursuant to a proper business purpose.
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> ...
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> Much of the additional costs incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers.
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> ...
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> Why should an innocent reliant party be forced to carry on the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, who can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public?[33]

Curiously, then, risk spreading has been used to justify both liability and immunity. Both applications cannot be correct. Which one is wrong? I suggest that, at both a practical and a theoretical level, the result in *Rosenblum* does not reflect an effective allocation of risk. First, based as it is on an assumption that part of the loss absorption will occur through liability insurance and on the 'apparent' ability of auditors to obtain it, it fails to consider the prospective impact on insurance availability in New Jersey as a result of the Court's decision. That is, the Court has, in order to support a shift from non-liability to liability, relied on the subsistence of a state of affairs without considering the impact upon that *status quo* of the Court having changed that law.

At a more theoretical level, the reasoning is also unsatisfying. It is one thing to shift the loss from the investor. It is quite another to shift it *to* a particular person or class of persons. For example, (and by way of the series of rhetorical questions which I have cited), the Court in *Rosenblum* justifies shifting the loss from the investor to the auditor's customers, but it does not attempt to justify the

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33 *Ibid*. at 151-53.

accompanying suggestion that the loss ought to be borne by the stockholders. This would seem to be a relevant inquiry, since it amounts to a requirement that existing stockholders subsidize potential stockholders or, for that matter, creditors (although, in the latter case, stockholders will probably have to pay in any event). These concerns notwithstanding, the perception of the auditor (or his or her insurer) as an insurer if an investment or credit loss occurs is a powerful and recurring theme in the judiciary's 'loss-spreading' argument. This auditor-as-insurer view has also received implicit endorsement by the United States Supreme Court in *United States v. Arthur Young*.[34]

The accountant, then, at least in respect of investors, is viewed as a 'deep pocket.' Again, two assumptions, both of which were identified by the Supreme Court of New Jersey in *Rosenblum*, are at work here. First, the auditor is the only solvent defendant. Secondly, and more to the point, auditors usually carry malpractice insurance. Here, empiricism intrudes. Empirical data has been accumulated over the past two decades which suggest that the insurance consideration - that is, the view of investors as relying on the fact that the auditor has an insurer lurking in the background - has become a self-fulfilling prophesy, as courts in different U.S. and Commonwealth

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34 465 U.S. 805 (1984) [*Arthur Young*]. The endorsement is only 'implicit' because *Arthur Young* did not directly involve auditors' negligence. The issue before the Court, rather, was whether, in the context of an Internal Revenue Service criminal investigation of a corporation's tax returns, audited financial statements fell within the terms of a summons for 'any books, papers, records or other data which may be relevant or material.' For a unanimous Court, Chief Justice Burger ordered disclosure. In doing so, however, he added (at 817-18):

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any ... relationship with the client. The independent public accountant performing this public function owes ultimate allegiance to the corporation's creditors and stockholders, *as well as* to the investing public.

jurisdictions broaden the exposure of auditors to tort liability. That is, accounting research has amassed evidence that investors place value - often a specific value - on the legal entitlement to sue auditors to recover such losses. Indeed, the evidence is that this value can be quantified and represents a component (albeit a small one) of the share price for publicly-traded firms.[35]

Empiricism aside, let us consider loss-shifting as a rationale for auditors' liability in its own economic terms. I suggest that the auditor - as - insurer is difficult to justify economically. It is a gratuitous guarantee, given to investors and creditors who are often sophisticated and capable of taking precautions against risk.[36] There are more cost-effective ways than relying on auditors for investors to protect themselves from bad transactions, especially in the case of a large share acquisition or takeover, where an investor can pay his own financial expert to evaluate the corporation whose shares are being acquired. Even in less significant transactions, potential investors can scrutinize unaudited information which the corporation has disclosed. Finally, they can diversify their portfolios to cushion the risk of loss by reason of inaccurate financial information.

As to investors' sophistication, under a broad liability rule investors and creditors (who must have previously used risk-assessment techniques before deciding whether to invest or lend) would come to rely exclusively, or at least more heavily, on the accuracy of audited financial statements. The impracticality of such reliance was recognized by the Supreme Court of Canada in *Hercules* :

> Creditors and investors on the other hand are likely to be in a better position than auditors to know the likely extent of their losses. ...

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35 K. Memon and David Williams, 'The Insurance Hypothesis and Market Price' (1994) 55 Acct. Rev. 327; William Baber et al., 'Client Security Price Reactions to the Laventhol and Horwath Bankruptcy' (1996) 33 J. Acct. Res. 385 at 386-87.

36 The Supreme Court of Canada in *Hercules* made this very point about investors' sophistication, at *supra* note 27 at 182.

> Unlike most plaintiffs in negligence cases, these investors and creditors can take steps to protect themselves against loss. Some creditors and investors will have the staff or means to investigate and verify that part of the audited person's financial affairs that is relevant to the loan or investment. ... Investors can spread their risk by diversifying their investments.[37]

Now, back to empiricism. Does insurance serve as this socially efficient loss-spreading vehicle? In fact, the empirical data suggests that the hypothetical loss-spreading through the vehicle of insurance has not materialized. Specifically, auditors have been unable to spread or socialize risk through professional liability insurance. In the U.S., large accounting firms are now able to purchase only a portion of the coverage they had been able to acquire prior to 1985, and even then at a considerably higher premium. At the same time, nearly all mid-size firms are (substantially) underinsured, and 50% of small firms carry no insurance at all.[38]

In view of such an 'insurance gap', then, the loss-spreading argument for liability is not empirically tenable. Judicial assumptions have created a substantial crisis in the accounting industry, and in fact we now see in Canada the phenomenon not only of accounting firms becoming fewer and larger, but accounting firms want to acquire a size that their profession itself cannot sustain, and for that reason they look to join forces with large law firms. And, to close my consideration of loss-spreading by again engaging it in the economic terms which spawned it: it has had the effect of increasing the direct cost of auditing services (presumably in part to

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37 *Ibid*. at 182-87.

38 Dan Goldwasser and M.T. Arnold, *Accountant's Liability* (1998, Unpublished, provided through Vedder, Price, Kaufman and Kammholz, Attornies, New York). See also Graham Ward, 'Auditors' Liability in the U.K.: The Case for Reform' (1999) 10 Critical Persp. Acct. 387 at 389, where he notes that, in Canada and Australia, auditors are finding it increasingly difficult to obtain insurance and that, where available, it is prohibitively expensive.

account for higher insurance premiums), and also the indirect cost of auditing services (as smaller firms close and customers incur higher transaction costs - such as travel and long-distance communication). And, there has been a third consequence - reduced access to auditors in certain sectors - which I will comment on shortly. Such are the consequences of a judicially-imposed gratuitous guarantee.

b. Unique Nature of Information as a Product

The 'gratuitous' aspect of the guarantee afforded to investors and creditors by imposing liability on auditors beyond their contractual obligations can be carried further by considering another general category of argument employed by legal economists, in this case, *against* imposing liability on auditors. I have, admittedly arbitrarily, entitled this category 'Unique Nature of Information as a Product.'

The proposition is that information as a product, is unique. Its singularity arises because, in cases of physical damage, the provision of information gives rise to a particular indeterminacy derived from the rebroadcasting of the information. Contrast this with products liability cases. Where a product has been consumed and causes injury, usually only one person, or at least a determinate class of persons, will have participated in the consumption, and thus the defendant manufacturer's liability will be correspondingly determinate. In contrast to products liability cases, however, in the case of an audited prospectus, an indeterminate class of persons may be 'consuming' the product. This engages the notion of subsequent consumption - that is, consumption of the information beyond the client who originally paid for the information, the value of which subsequent consumption the original producer cannot capture. Very little can impede this successive use, as the transfer costs are typically small and indeed the seller has an incentive: by selling the information, he or she can appropriate the value of the original producer's efforts.

While a no-liability rule in these circumstances would obviously have,

at some point, a deleterious effect on the quality of the information supplied, one would expect that it would also ultimately have a corresponding impact on demand, which would decrease as the information became less reliable.[39] The no-liability rule is thus seen as increasing information availability, based on a view that social gains of increased information outweigh losses derived from decreased quality, while also engendering a mitigating factor because of decreased demand.

In fact, however, as I will discuss below under the third category of argument - which I have entitled 'Quality of Product' - auditors' liability has had virtually no impact on the quality of information provided. Not surprisingly, however, given the above-noted insurance-related difficulties, auditors' liability has resulted in less access in certain sectors to auditing services.

c. Quality of Product

The third category of argument, 'Quality of Product', embodies, at least on one side of the debate, the classic economic argument *against* a duty of care. Specifically, it is suggested that the imposition of a duty of care is unnecessary because a reputation for imprudent audits would impel the auditor to decrease his or her audit fee. This

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39 This is the argument of W. Bishop, 'Negligent Misrepresentation through Economists' Eyes' (1980) 96 Law Q. Rev. 360. Note, however, Bruce Chapman, 'Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law' (1992) 20 Can. Bus. L.J. 180 [Chapman, 'Limited Auditors' Liability'] where, at 192, he argues that it does not necessarily follow that the original producer of information cannot privately capture the benefit of such reasonably foreseeable uses. Chapman's argument is that the purpose of an audit is, in most cases, to induce investment by potential investors. Therefore, the corporation will benefit, and the auditor can harness that benefit in his or her fee. That is, he or she can charge a higher fee to reflect the product's value to the company in attracting subsequent users of the auditor's product.

tends to assume that subsequent investors would be less likely to invest based upon his or her product and that the auditor's corporation would receive less benefit. The countervailing suggestion, however, is that the imposition of liability on auditors will promote more diligent accounting by creating an incentive to take reasonable care. Here, Bruce Chapman has featured prominently in the debate.[40] He defends the common law duty of care to the 'alternate' market as a superior control of reputation. For Chapman, then, the risk of reputational loss alone is an inadequate substitute for a duty of care. In economic terms, it does not present a sufficient incentive for prudence.

At an hypothetical level, however, it would seem likely that, at some point, numerous favourable market performances by companies audited by a particular auditor would require us to allow for some sort of statistical attribution to careful accounting. Moreover, at the early stages of an auditor's professional activity, the development of a reputation requires the delivery of a high quality product.[41] So, for example, the initial delivery of a high-quality product will generally be at a decreased price. 'Decreased', in this sense, would mean that it is reduced comparative to longer-term high-quality producers. This shortfall is later recaptured by the premium charged once an accomplished and meticulous auditor has acquired a corresponding reputation for achievement, accuracy and, therefore, reliability.

Of course, that is only at the early stages of the auditor's professional activity. The difficulty is, however, that auditors continue to make up for the shortfall in other ways. Principally, they might, (once their reputation is established) deliver average or low-quality product at a high-quality price - that is, by trading on his or her reputation. Here, only the imposition of a duty of care would provide

40 Chapman, 'Limited Auditors' Liability', *ibid.*

41 Here I am agreeing with Reinier Kraakman, in 'Gatekeepers: The Anatomy of a Third Party Enforcement Strategy' (1986) 2 J. L. Econ. & Org. 53 at 96-97.

the incentive structure.

Moreover, when the debate over 'Quality of Product' is considered from the investors' perspective, Chapman's argument (about the inadequacy of risk of reputational loss as an incentive to take care) begins to carry some force. Investors' conclusions about an auditor's reputation are just as likely *not* to be based upon the care that the auditor takes, as investors would be unlikely to know anything about the auditor's degree of prudence. Rather, investors will judge an auditor, and mould his or her reputation, by the performance of investments induced by the audit, which performance, of course, may be impacted by numerous factors over which the auditor has no control. More to the point, because tort liability engages the care taken and the quality delivered, it will associate an auditor's reputation more closely with quality delivered.

All this, of course, is hypothetical and, to a degree, theoretical speculation. What can past empirical research tell us? In fact, the evidence suggests that exposing auditors to liability has not fostered more careful auditing, but rather - as I have already suggested - has resulted in auditors withdrawing audit services from high-risk forms, such as financial services, computers and electronics, real estate and emerging technologies.[42] Consequently, because audited financial statements are requirements to enter capital markets, this decreased availability is a barrier to firm growth and economic activity generally inasmuch as it impedes their ability to "go public."

This phenomenon, whereby a decrease in quantity of service prevails over an increase in *quality* of service, can be explained by

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42 Ivan F. Ivankovich, 'Accountants and Third-Party Liability: Back to the Future' (1991) 23 Ottawa L. Rev. 505 at 520-21. See also Zoe-Vonna Palmrose, 'An Analysis of Auditor Litigation and Audit Service Quality' (1988) 58 Acct. Rev. 55 at 70, and Frederick Jones and K. Raghunandan, 'Client Risk and Recent Changes in the Market for Audit Services' (1988) J. Acct. & Pub. Pol'y 169 at 171-72.

understanding the nature of a deterrent as being effective only insofar as the probability of incurring liability when performance is substandard is greater than when the performance is adequate. Assuming a duty of care owed to non-contracting parties such as investors, then, a rational auditor can be understood as responding to increased liability by reducing his or her services, especially to emerging industries, on the basis that, if they fail, the auditor will be a likely target of disgruntled investors.

d. Social Cost

Auditors' liability forms part of a body of damage known in Anglo-American tort law as 'pure economic loss.' Its name derives from the purely economic nature of the loss, which involves no damage to one's property or bodily integrity. Traditionally, Law & Economics adherents who oppose liability in cases of pure economic loss have argued that such cases do not give rise to social costs.[43] As a consequence, the argument goes, it is inefficient to have auditors take care to avoid such losses, and the law ought not to create incentives to do so by imposing liability.

This argument is not entirely satisfactory, as there may in fact be social costs involved in cases of negligent auditing. For example, if shares are purchased at an inflated price in the context of a takeover, there may well be a social cost. Indeed, this was the case in the House of Lords decision of *Caparo Industries plc v. Dickman and Others*.[44] Takeovers are, of course, typically followed by a change in management and investment behaviour, giving it an impact that transcends a mere transfer between shareholders. Here again,

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43 W. Bishop, 'Economic Loss in Tort' (1982) 2 Oxford J. Legal Stud. 1. Note that his analysis made a dubious assumption of oversupply and did not apply at all to 'information' as a product. Indeed, it was heavily criticized on this basis by Mario J. Rizzo in 'A Theory of Economic Loss in the Law of Torts' (1982) 11 J. Legal Stud. 291.

44 [1990] 2 A.C. 605, [1990] 1 All E.R. 568 (H.L.).

empirical research debunks Law & Economics theory, showing in this case that consequent management change and investment behaviour in the context of takeovers entail real social gains and losses and not mere transfers.[45] Takeovers aside, the pricing of a corporation's shares among investors also has an impact on the corporation's share offerings: if a negligently-performed audit inflates the price of shares in the secondary market, it would also inflate prices in the primary share offerings, which results in a social cost. All this would tend to support liability for auditors.

The stronger argument, homever, that those Law & Economics adherents who oppose auditors' liability might want to advance is *not* that it entails no social cost. It clearly does. Rather, they might want to consider that any social cost is more than offset by the social cost of imposing a duty of care upon auditors. They would not, at least at their familiar hypothetical level of discourse, be without supporting arguments. For example, auditors would spend more time and resources trying to protect themselves from liability. Lawsuits would be more common, as would the associated expenses, which would not just include direct costs (such as defence lawyers' fees and increased insurance premiums) but also indirect opportunity costs (foregone revenue-generating activity because of time spent preparing for pre-trial procedures and for the trial itself).[46] Transactional costs would increase, as auditors (or their insurers) would try to rely more on exclusion clauses. And, as we have already seen, insurance premiums would rise since auditors could anticipate more claims. Indeed, the scope of insurance coverage could itself become an issue of dispute, thereby multiplying the social costs incurred as a result of litigation. Concomitantly, the supply of

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45 John Coffee, Louis Lowenstein, Susan Rose-Ackerman, eds., *Knights, Raiders and Targets: The Impact of Hostile Takeover* (New York: Oxford University Press, 1988) at 314.

46 Here I am agreeing generally with Brian Cheffins, 'Auditors' Liability in the House of Lords: A Signal Canadian Courts should Follow' (1991) 18 Can. Bus. L.J. 118.

accounting services would be reduced, both by reason of accountants withdrawing services from marginal sectors (which, as I have already noted, has demonstrably occurred), and by reason of marginal accounting firms having to withdraw from the market altogether, leaving their clients to assume the increased costs of shifting to the remaining firms.

Litigation costs are a significant concern in this debate. To the extent that litigation represents a social cost, increased auditors' liability imposes that cost.[47] Moreover, not only has litigation increased, but it has also become increasingly complex and time-consuming. These types of negligence trials tend to be complicated and inordinately lengthy, occasionally taking, in the Canadian context, more than a month of trial time, and sometimes even longer. Indeed, one 1990 case leading to the decision of the British Columbia Supreme Court in *Surrey Credit Union v. Wilson* consumed over 2½ months of trial time.[48] The reasons are typical of time-consuming characteristics of all such cases: the court has to inquire not only into a complex set of facts, but also the client's operations, the auditor's performance, and the plaintiff's conduct *in detail*.

V. Conclusion

So, what can we learn from the empirical contribution to the debate? A common theme discernible in almost all the empirical research into the impact of exposing auditors to liability to non-contracting parties such as investors and of the associated increased litigation is that of differential expectations (as between auditors and the public) about the auditor's role. That is, allegations about negligently-performed audits are related directly to a difference between auditors' understanding of their function, and investors' and

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48 The magnitude of that cost is evident in *supra* note 25.
49 (1990), 73 D.L.R. (4th) 207 (B.C.S.C.).

others' expectations of the auditor's function.[49]

The empirical research demonstrates that this 'expectation gap' relates principally to three areas: detecting and reporting fraud, detecting and reporting other illegal client acts, and reporting when there is uncertainty about the ability of an entity to continue as a going concern.[50] Indeed, research specific to Canadian and U.S. non-client users of audited information suggests that nearly all of them believe, notwithstanding the lack of a contractual relationship between auditors and the public generally, that auditors have an absolute responsibility to them for detecting and reporting fraud and financial mismanagement, and that this responsibility is not generally being adequately discharged.[51] Research out of the U.K. and Australia has revealed broadly consistent results.[52]

One could posit several different possible explanations for these differential expectations - that is, for the public's view of general social obligations owed by auditors, as opposed to the narrower view that auditors owe obligations only to contracting parties. One obvious possibility is that investors expect too much of an audit, out of an ignorance of its nature, purpose and capacity. Conversely, however, one could argue that the legitimacy of the duties and standards adopted by any self-regulating profession cannot be isolated from the

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49 Christopher Humphrey et al., 'The Audit Expectations Gap in Britain: An Empirical Investigation' (1993) 23 Acct. & Bus. Res. 395. See also Brenda Porter, 'An Empirical Study of the Audit Expectation-Performance Gap' (1993) 24 Acct. & Bus. Res. 49 [Porter, 'Expectation-Performance Gap'].

50 Porter, 'Expectation-Performance Gap', *ibid*. at 53-59.

51 Christian Bellavance, 'Liability and the "Expectation Gap"' (1998) 13 C. A. Mag. 11, and the Canadian Institute of Chartered Accountants (CICA) *Report of the Commission to Study the Public's Expectations of Audits* (1988).

52 David Godsell, 'Auditors' Legal Liability and the Expectation Gap' (1991) 61 Aust. Acct. 22.

expectations of those who pay for and rely upon its services[53] or, for that matter, of the public who through its legislators have conferred the privilege of self-governance.

This is, of course, a digression from the rigourously empirical methodology I am urging upon legal economists. And, in respect of such empiricism, it is worth emphasizing that this research was conducted prior to the scandals surrounding Arthur Andersen's delinquence in Enron. It would be interesting to know whether the public continues to hold these expectations. That is, have the associated revelations affirmed the perceived importance of the auditors' role (thus preserving the expectations gap) or has it diminished the trust that obviously underlay those expectations (thus bringing expectations into conformance with reality)?

Enron's impact may in fact go further. Recall that, in my introduction, I situated the emerging trend away from auditors' liability in the context of recent Canadian judicial pronouncements, and highlighted an emerging and increasingly doctrinal approach. In the post-Enron investment climate, however, it is intriguing, at least for Canadian academic lawyers, to consider whether a reassessment of the obligations assumed by auditors would be taken up by the Supreme Court of Canada. This is particularly important in view of the severity of the commercial repercussions of the obstruction of justice charges against certain of Arthur Andersen's representatives, whereby thousands of other companies that have since left Andersen have had to retain new auditors to review past financial statements. These new auditors have, not surprisingly, restated earnings and as a result sparked multiple class action lawsuits against Arthur Andersen, brought both by disgruntled investors and by former clients.

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53 David Godsell makes this point, in 'Auditors' Legal Liability and the Expectation Gap', *ibid.* at 25.

This is a necessarily brief 'thumbnail sketch' of a multifaceted subject. It does, however, demonstrate that, as a practical matter, any judicial reassessment of auditors' liability will have to address the arguments against its reimposition or expansion, some of which emphasize genuine problems arising from, for example, the costs of protracted, complex litigation. In particular, it will have to account for, if not resolve entirely, the now-evident insurance gap.