

## *Deloitte & Touche v. Livent Inc. (Receiver of)* : a Reformulation of the Test for a Duty of Care in *Hercules Managements Ltd. v. Ernst & Young*

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In *Deloitte & Touche v Livent Inc (Receiver of)*,<sup>1</sup> Justices Gascon and Brown for a 4:3 majority of the Supreme Court of Canada (the “Court”) affirmed its earlier decision *Hercules Managements Ltd. v. Ernst & Young*<sup>2</sup> which held that an auditor will owe a duty of care to a plaintiff if a proximate relationship exists and there are no policy concerns which serve to negate a relationship of proximity. However, the Court in *Livent* updated and refined the duty of care analysis as it applies to cases of negligent misrepresentation or performance of a service.

The essence of the case advanced by Live Entertainment Corporation of Canada Inc. (“Livent”) was that it detrimentally relied on the services and representations of Deloitte & Touche (“Deloitte”) to artificially manufacture and extend a picture of solvency and delay filing for bankruptcy. This loss was characterised as Livent’s “liquidation deficit”, being the increase in the deficit in its liabilities and assets between the date Deloitte should have resigned and Livent’s eventual CCAA filing.<sup>3</sup>

The Court found Deloitte liable for approximately \$40 million in losses suffered by the shareholders of Livent, halving the total damages awarded by the Ontario Court of Appeal.<sup>4</sup> The Court held that these losses were recoverable because they were a result of the audit work performed by Deloitte that impeded the shareholders in their oversight of Livent’s management.

However, the Court allowed Deloitte’s appeal on the balance of the damages claim based on audit work performed by Deloitte on a press release and comfort letter used by Livent to solicit investment. Deviating from the decisions of the courts below, the majority held that these losses were not recoverable because they resulted from reliance on the representations to solicit investment, and not from the shareholders’ reliance on the representations to oversee management.

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<sup>1</sup> *Deloitte & Touche v Livent Inc (Receiver of)*, 2017 SCC 63 [“Livent”].

<sup>2</sup> *Hercules Management Ltd v Ernst & Young*, [1997] 2 S.C.R. 165.

<sup>3</sup> *Livent Inc (Receiver of) v Deloitte & Touche*, 2016 ONCA 11, at para 61.

<sup>4</sup> *Deloitte & Touche v Livent Inc (Receiver of)*, 2017 SCC 63, at para 113.

At its core, the findings of the Court have clarified that a duty of care will only be imposed where:

1. The defendant undertakes responsibility to provide non-negligent representations or services to be used for a particular purpose; and
2. The plaintiff relies on the representation or service for that particular purpose.

## Background

Throughout the 1990's, Garth Drabinsky and Myron Gottlieb built Livent as a live entertainment empire which developed, produced and staged high profile stage performances such as *The Phantom of the Opera*, *Show Boat*, and *Sunset Boulevard*.<sup>5</sup> Each show was a heavily capital-intensive undertaking with unpredictable risk and reward.

Drabinsky and Gottlieb were committed to raising funds on the public market at all costs. With the help of a few key employees, Drabinsky and Gottlieb began to spin a complex web of fraudulent financial reporting to hide losses.

Deloitte & Touche ("Deloitte") was Livent's auditor from 1989 through 1998. Deloitte had issued clean audit opinions throughout its dealings with Livent.<sup>6</sup> Deloitte had also prepared non-audit work during this time, including drafting comfort letters and reviewing press releases for public offerings.

At the trial level it was held that Deloitte's negligence could be divided into two separate events: (1) Deloitte's approval of a press release in September 1997 (the "Press Release") and the provision of a comfort letter in October 1997 (the "Comfort Letter") both used by Livent to solicit investment; and (2) Deloitte's preparation and approval of a clean audit opinion for the 1997 financial year which was ultimately issued in April 1998 (the "1997 Audit").

In August and September 1997, during the course of the work performed by Deloitte in the lead up to Livent issuing the Comfort Letter, Deloitte identified irregularities in the accounting for the reporting of profit. Livent and Deloitte disagreed about the irregularities, leaving Deloitte with a choice between resigning and remaining as the company's auditor. Deloitte negligently chose to remain and to issue the Press Release, Comfort Letter, and 1997 Audit.

The "web began to unravel" in 1996 when Livent suffered a set of simultaneous financial setbacks.<sup>7</sup> New management took over in 1998 and a new audit revealed massive accounting irregularities. The next day, Drabinsky and Gottlieb were fired and Livent declared bankruptcy.<sup>8</sup>

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<sup>5</sup> *Livent Inc (Receiver of) v Deloitte & Touche*, 2016 ONCA 11, at para 61, at para 9.

<sup>6</sup> *Ibid*, at para 4.

<sup>7</sup> *Ibid*, at para 14.

<sup>8</sup> *Ibid*, at paras 45-46.

Livent, through its special receiver, sued Deloitte for damages in contract and negligence. At trial, Gans J. found Deloitte liable for damages arising from the audit and non-audit engagements.<sup>9</sup> The Ontario Court of Appeal dismissed Deloitte's appeal and upheld the full damages award.

### The Supreme Court's Decision

In *Livent*, the Court affirmed the seminal *Anns/Kamloops* test, but updated and refined it in order to take into account developments in our law relating to the duty of care in cases of pure economic loss. In particular, the Court updated the test to take into account revisions to the framework by which a duty of care is imposed in *Cooper v. Hobart*.<sup>10</sup> In *Cooper*, the Court revised the *Anns/Kamloops* test by distinguishing more clearly between foreseeability and proximity in the first stage of the test and by recognizing that policy considerations play an important role in both stages of the test. The Court in *Cooper* recognised that policy considerations such as whether a duty of care would give rise to indeterminate liability as between the parties are considered in determining a relationship of proximity. Residual policy considerations fall to be considered in the second stage of the test. These are not concerned with the relationship between the parties, but with the effect of recognizing a duty of care on other legal obligations, the legal system and society more generally.

In *Livent* the majority updated Justice LaForest's analysis in *Hercules* to achieve a measure of consistency with the law relating to a common law duty of care since *Cooper*. Justices Gascon and Brown outlined the general legal framework for finding a duty of care, adding clarifying remarks specific to cases of pure economic loss:

1. **The Basic *Anns/Cooper* framework applies:** the court considers first whether there is proximity and foreseeability and, if so, whether residual policy considerations exist which should negate a finding of a *prima facie* duty of care.<sup>11</sup>
2. **Proximity should be assessed before foreseeability:** what the defendant reasonably foresees as flowing from his or her negligence depends on the characteristics of his or her relationship with the plaintiff.<sup>12</sup>
3. **In considering proximity, the factors are "diverse and depend on the circumstances of each case":** where a proximate relationship has not previously been established, the court must examine all relevant factors arising from the relationship between the plaintiff and defendant.<sup>13</sup> By assessing all relevant factors arising from the relationship between the parties, the proximity analysis

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<sup>9</sup> *Livent Inc. (Receiver of) v Deloitte & Touche*, 2014 ONSC 2176, at para 369.

<sup>10</sup> *Cooper v. Hobart*, 2001 SCC 79.

<sup>11</sup> *Deloitte & Touche v Livent Inc (Receiver of)*, 2017 SCC 63, at para 22.

<sup>12</sup> *Ibid*, at para 24.

<sup>13</sup> *Ibid*, at para 29.

determines both the *existence* of a relationship of proximity and delineates the *scope* of the duty that flows from that relationship.<sup>14</sup>

**4. The correlation between the purpose of the defendant's undertaking and the plaintiff's reliance is determinative in the proximity analysis:**

- (a) the defendant's undertaking of responsibility relates to the *purpose* for which the representations was made or the services undertaken;
- (b) the plaintiff's reliance must correlate with the defendant's undertaking in the sense that the plaintiff must rely on the representation or service for the very same purpose for which it was undertaken.<sup>15</sup>

**5. Indeterminate liability is liability of a specific *character*, not of a specific *amount*:** Certain undertakings - like auditing a large corporation - give rise to significant liability, but such liability arises from the nature of the defendant's undertaking and the severe but reasonably foreseeable loss that can result when such undertakings are negligently performed. Liability will only be truly indeterminate where "the scope of such liability is impossible to ascertain"<sup>16</sup> By addressing questions relevant to the relationship between the parties such as whether there is determinacy of amount, time and class, the proximity enquiry will address concerns of indeterminate liability.<sup>17</sup>

**6. Indeterminate liability is a policy *consideration*, not a policy *veto*:** the Court made the *obiter* comment that while indeterminacy may militate against liability in some cases, it will not do so in all cases. Other policy considerations - such as the extent to which "high risk" actors voluntarily assume the risk of indeterminate liability in order to acquire the opportunity to make immense profit - may ultimately justify maintaining liability despite indeterminacy.<sup>18</sup>

### Applying the Reformulated Analysis

Justices Gascon and Brown held that Deloitte stood in a relationship of proximity to Livent in respect of the Press Release and Comfort Letter as well as the 1997 Audit. However, only the losses resulting from reliance upon the 1997 Audit were reasonably foreseeable.

#### *The 1997 Press Release and Comfort Letter*

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<sup>14</sup> *Ibid*, at para 31.

<sup>15</sup> *Ibid*, at paras 30-31.

<sup>16</sup> *Ibid*, at para 43.

<sup>17</sup> *Ibid*, at paras 43-44.

<sup>18</sup> *Ibid*, at para 45.

The Court embarked on a full proximity analysis relating to the 1997 Press Release and Comfort Letter, as a relationship of proximity between an auditor and its client for the purpose of soliciting investment had not previously been recognised.

The Court found that the purpose for which Deloitte undertook its work on the 1997 Press Release and Comfort Letter was to assist Livent in soliciting investment.<sup>19</sup> However, the losses ultimately suffered by Livent related to its book value (rather than, say, its share price) which was not a reasonably foreseeable consequence of Deloitte's negligent assistance in soliciting investment.<sup>20</sup>

The Court found that work provided for the purpose of helping Livent solicit investment was relied upon for an entirely different purpose - to oversee management.<sup>21</sup> Had Livent's losses been attributed to a drop in share price due to Livent's inability to attract investment, such a loss would have been a reasonably foreseeable consequence of negligent preparation of the 1997 Press Release and Comfort Letter.<sup>22</sup> Livent's reliance on Deloitte's work to extend the life of the corporation was a matter of the oversight of the corporation rather than being tied to the solicitation of investment. Justice Gascon and Brown agreed with Chief Justice McLachlin (as then was) in dissent in finding that loss that may have resulted from Livent's inability to attract investment could be recoverable.

### *The 1997 Clean Audit Opinion*

As a relationship of proximity between a company and an auditor carrying out a statutory audit had previously been recognised by the Court in *Hercules*, the Court only needed to consider whether the facts underlying the recognition of that duty were distinguishable from the present case.<sup>23</sup> A relationship of proximity existed because the purpose of a statutory audit is to permit the shareholders to oversee management, which is exactly what Deloitte undertook to do in its work on the 1997 Audit. The increase in Livent's liquidation deficit was reasonably foreseeable because the risk of injury flowing from a corporation's inability to properly oversee management to uncover management's fraud is precisely the type of injury statutory audits seek to avoid.<sup>24</sup>

### **Livent's Potential Ramifications**

The Court in *Livent* confirmed that accountants engaged in the audit of a company for the purposes of satisfying statutory audit requirements will only be held liable to third party

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<sup>19</sup> *Ibid*, at para 53.

<sup>20</sup> *Ibid*, at paras 54-55.

<sup>21</sup> *Ibid*, at para 55.

<sup>22</sup> *Ibid*, at para 53.

<sup>23</sup> *Ibid*, at para 58. See also para 28 where the Court stated:

"It follows that, where a party seeks to base a finding of proximity upon a previously established or analogous category, a court should be attentive to the particular factors which justified recognizing that prior category in order to determine whether the relationship at issue is, in fact, truly the same as or analogous to that which was previously recognized."

<sup>24</sup> *Ibid*, at para 65.

investors in the most exceptional circumstances. While the Court in *Livent* provided a clear and consistent framework for when such an attribution of liability will be justified, this statement of principle is not inconsistent with the law long entrenched since *Hercules*. It is therefore anticipated that *Livent* is unlikely to have any significant effect on either lending practice or investment due diligence. However, we should expect auditors to take steps during the course of their audits to objectively and unambiguously restrict the purpose of their audit work, through more restrictive engagement letters and by limiting their involvement and contact with lenders and investors.