

For Competitiveness. For Fairness. For Ontario:

The Need for Legal Liability Reform



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Welcome to an automated presentation explaining the need for legal liability reform in Ontario, presented by the Institute of Chartered Accountants of Ontario.

The Current Environment

- Globalized business = globalized risk
- Threat of catastrophic exposure to liability
- More litigious business climate
- Intense competition for top professional talent and investment capital



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In order to understand this issue, it's important to first understand the environment that Chartered Accountants operate in today. That environment is characterized by the increasing globalization of business. This raises the threat of catastrophic exposure to legal liability for auditors in an increasingly litigious business climate.

As an example, legal claims against the top five accounting firms in Canada have increased more than 300 per cent since 1988. With the North America-wide increase in litigation, that upward trend seems destined to continue.

So it's clear that legislative change is needed. But what kind of change?

Reforms Needed

- Move to Full Shield Limited Liability Partnerships (LLPs) from Partial Shield LLPs
- Move to Proportionate Liability for financial loss from Joint and Several Liability



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Specifically, change is needed on two fronts related to professional liability. Ontario audit firm partners need full shield limited liability partnerships, or LLPs, in place of the current partial shield LLP regime, and Ontario audit firms need a system of proportionate liability for financial loss, instead of the current system, known as joint and several liability.

Part One

The Case for Full Shield LLPs



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Let's start with the case for full shield limited liability partnerships.

Definitions

Limited Liability Partnership (LLP):

- Business structure for limiting liability for certain obligations
- Provides protection for personal assets of individual partners
- Assets of firm remain available to satisfy judgments
- Scope of LLP protection varies by jurisdiction



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First, what is an LLP? A limited liability partnership is a way to structure a professional services firm so that liability for the partners in that firm is limited to certain partnership obligations. It's different from a general partnership in one important respect: Unlike a general partnership, in which partners are liable for the partnership's debts and obligations, an LLP provides each of its individual partners with protection for their personal assets. The assets of the firm itself, however, remain available to satisfy judgments. LLPs are common in most western countries. However, the scope of the protection they provide differs depending on the jurisdiction, with some offering so-called "full shield" protection, and others lagging behind, with only "partial-shield" protection. Ontario currently only offers partial shield protection for LLP partnerships.

Definitions

Partial Shield LLP:

- All partners are personally liable for partnership's obligations merely because they *are* partners
- Managing partners may be found responsible for acts of negligence, wrongful acts or omissions of another partner or employee they knew nothing about - simply because of their position in the firm



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Under partial shield LLPs, all partners are liable for a partnership's obligations merely because of the fact that they are partners. That's the "partial" in partial shield. If you're a managing partner – even one with no direct supervisory role over an individual, such as another partner or employee who committed a negligent or wrongful act or omission and, therefore, no knowledge of it and no way to prevent it - you are still held fully liable.

Definitions

Full Shield LLP:

- Would reduce liability on an individual partner to those matters he/she had some responsibility for
- A partner would still be fully responsible for acts he/she committed or was responsible for overseeing



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Under full shield LLPs, a partner would still be liable for acts he or she had some responsibility for – that is, when the partner committed the act or had knowledge of the act, and failed to take reasonable steps to prevent it. However, a partner would no longer be held responsible for acts that partner had no involvement in or control over - which is only fair.

Consequences: Partial Shield

- Creates a climate of unfairness
- Inhibits talent recruitment and retention
- Undermines economic competitiveness



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There are three major problems with partial shield LLPs:

First, they are inherently unfair because partners are held responsible for acts they didn't commit or, in some cases, have knowledge of, or oversight responsibility for.

Second, the threat of catastrophic personal liability for partners hurts Ontario's audit industry's ability to recruit and retain the best professional talent.

And third, the high level of personal risk makes auditors less likely to take on assignments with even moderate risk - this prevents deals from occurring, jobs being created and inhibits Ontario's ability to maintain its competitiveness with jurisdictions that have full shield LLPs.

Benefits: Full Shield

- Restores fairness - partners only responsible for errors they committed or knew about
- Improves recruitment and retention of top talent
- Ensures continued access for Ontario businesses to quality audit services



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By contrast, full shield LLPs would bring fairness back into the equation, by making partners responsible only for those wrongful acts they themselves committed, or knew about and failed to stop.

They would help safeguard Ontario's competitive edge, by creating a climate that attracts and retains top professional talent, at a time when competition for that talent has become fierce not only here in Canada, but around the world.

Most importantly, full shield LLPs would allow Ontario's auditors to focus less on personal risk and potential consequences, and more on ensuring continued access for businesses to quality audit services.

Part Two

The Case for Proportionate Liability



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Now, let's take a look at the case for moving to a system of proportionate liability.

Definitions

Joint and Several Liability:

- If a person has suffered a financial loss, each person who contributed - no matter how minimally - may be fully liable for that loss
- Means plaintiffs can go after “the deepest pockets”
- Means the auditor, who may be only 1% responsible, could be required to pay 100% of the loss



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Right now, Ontario uses a system called joint and several liability. Under this regime, if a person has suffered a financial loss, each person who contributed to that loss – however minimally – may be fully liable for it. In other words, the wronged person may recover the full amount of the loss or damages from any of the persons responsible. This often enables plaintiffs to go after the defendant with the deepest pockets, which, in the case of a business failure, is often the audit firm involved. Remember, public companies are required by law to have auditors. In many business failure cases, other responsible parties can no longer pay for their responsibilities due to bankruptcy or other causes. All this means that a company’s audit firm could be made to pay 100 per cent of the loss, even though it may only have been one per cent responsible.

Definitions

Proportionate Liability:

- Responsibility for financial loss is apportioned according to the extent of responsibility



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By contrast, under a system of proportionate liability, each defendant is individually liable only for its proportionate share of the plaintiff's financial loss. Put another way, the person who has suffered a loss can only recover against persons who caused the loss to the extent that each is responsible for that loss.

Consequences: Joint and Several

- Audit firms turning down assignments - transactions involving healthy businesses aren't happening
- Audit quality and efficiency being put at risk
- Insurance companies being forced from the audit market - can't quantify the risk
- Higher insurance costs levied by remaining insurers being passed to clients
- Ontario less attractive to top quality professional talent and investment



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As it stands in Ontario today, joint and several liability is forcing many audit firms to turn down audit assignments **or stop audit work completely** because of the disproportionate risk. In just one measure of this trend, there were 400 public company audit firms in Canada in 2001. Today, there are only 230.

The risk to personal assets inherent in joint and several liability also puts audit quality and efficiency at risk, as it discourages the best and brightest professionals from entering or remaining in audit practices. As well, insurance companies are exiting the audit market because it's increasingly difficult for them to quantify the risks of audit assignments. As a result, higher insurance costs, levied by those insurance companies that remain in the market, are being passed on to audit clients in the form of higher fees.

Overall, this makes Ontario a less attractive place for top professionals, set against the growing number of competing jurisdictions that have either scrapped joint and several liability or have heavily amended it.

Real Business, Real Impacts #1

“A company involved in leasing fixed large assets for many years had maxed out its finances and had used securitization to pool assets and come up with needed funding. It was still a decent company but it was highly leveraged, although not to the point of breaching its debt covenant. Normally we would have accepted an engagement to work with the management and help them turn the company around. The company required an audit which we wouldn’t accept because the risk of failure might expose the firm to litigation even if the audit wasn’t negligent. They were denied access to the audit they needed to help obtain required financing.”



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These aren't hypothetical impacts. Here are just three accounts of transactions that could not proceed because of the risk of the audit assignments involved. These case studies were provided to the Institute by audit firms. For business confidentiality reasons, all references to the actual companies in question have been removed.

[VOICE-OVER, SLIDE 14]

Real Business, Real Impacts #2

“We were approached by a relatively new company in the audio networks business. They were proposing to enter a new field and wanted to set up a system to charge people for uploading and downloading music from a website. To do so, they’d need to go public to raise funding. They were honest and capable people and the business looked viable. But, in today’s environment for assessing risk, this business still looked too new and unproven. Emerging industries are always vulnerable, whether it is to changes in technology or other unknown factors. We wouldn’t take their business or help with their IPO.”



[VOICE-OVER, SLIDE 15]

Real Business, Real Impacts #3

“An established business selling household soft goods wanted to hire our firm as auditors. We looked and found that, while they were well capitalized, they had engaged in some inventory financing. Their market was increasingly competitive and, in Canada, a mature one, which necessitated the product having to be sourced off shore. We felt that the commoditization of the product was resulting in declining profit margins and that, at some future point, this company could face financial difficulties. If that occurred, and a lender had to realize on the inventory, the lender could sustain significant losses. That could in turn result in the lender coming back and look at the audit, with the intention of tagging the auditors to recoup some of their losses. The risk in that scenario was too high, so we declined the audit work, even though the company was not currently in any trouble.”

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[VOICE-OVER, SLIDE 16]

Main Street *and* Bay Street

- Not just an issue for big firms
- Recent CA Institute survey of 1,700 small and mid-sized firms and sole practitioners:
 - 73% report moderate-to-significant insurance cost increases
 - 64% are turning down some audit engagements
 - 58% say the liability crisis is impeding access to quality audit services



This is not an issue that is important only to the big audit firms and their large public company clients.

Last year, the Institute conducted a survey of just over 1,700 small to medium-sized firms and sole practitioners, most of whom provide audit services for smaller, non-public companies. Among the findings: 73 per cent of respondents said that they have faced a moderate-to-significant increase in liability insurance costs over the last five years. 64 per cent of respondents said they are being deterred from taking on assurance engagements. And 58 per cent said the liability crisis is creating difficulty for clients to access assurance services.

Their message is clear: The liability crisis is an issue as much for Main Street as it is for Bay Street. Across Ontario today, businesses are running out of places to go for quality audit services.

Benefits: Proportionate Liability

- **Fairness:** Audit firms would be fully responsible for their share of the loss - but no more
- **Competitiveness:** Business would retain access to necessary audit services
- **Modernization:** Ontario would be back in step with U.S., U.K., Australia, etc.



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Here is the case for change. Proportionate liability would return the principle of fairness to the system. Audit firms would be fully responsible for their share of a financial loss – as they should be – but no more than that. More importantly, businesses would retain access to quality audit services that they need to grow, innovate, remain competitive and create jobs. A proportionate system would also modernize Ontario laws to keep us in step with our major trading partners and competitors. For example, in the United States 39 states have either eliminated or significantly changed their liability regimes in favour of proportionate liability. A move to proportionate liability is also underway in the UK and Australia, and being considered in the European Union.

Another Perspective

Mindy Paskell-Mede

Partner, Nicholl Paskell-Mede

Law firm specializing in insurance law and civil liability defence work

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The need for change is widely acknowledged by third party experts. Following are the views of just two such authorities, one from the legal field, the other from the insurance industry. First, Mindy Paskell-Mede, a partner with the law firm Nicholl Paskell-Mede, which specializes in insurance law and civil liability defence work.

[MINDY VOICE-OVER, SLIDE 19]

Another Perspective

Richard Hardingham

Underwriter, Brit Syndicate at Lloyd's of London

Global Insurance Company



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Next, the insurance industry point of view, and an international perspective, from Richard Hardingham, a veteran underwriter with Brit Syndicate at Lloyd's of London.

[RICHARD VOICE-OVER, SLIDE 21]

Another Perspective

Joel Cohen, CA
Partner, RSM Richter
Mid-tier public accounting firm



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Let's round out these perspectives now with the inside view from the audit profession itself at the partnership level. Here is Joel Cohen, a partner with the mid-sized Ontario audit firm RSM Richter.

[JOEL VOICE-OVER, SLIDE 20]

On the Media Radar

**Liability
chill a
worry:
Report**

Full disclosure
may be suffering
Firms fear new law
raises risk of suits

LIABILITY

CAs lobbying to change
Ontario negligence law

Share the liability,
spare the accountant,
says institute chair

Overexposure –
CAs say legal liability
reforms needed

**Outdated liability laws
harming economy: ICAO**

LIABILITY LIMITS:

Does Harper offer new hope?

Accountants call for reform in liability laws

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It's important to note that interest in this issue is not confined just to immediate stakeholders. Increasingly, the business and financial media are also focusing on Ontario's auditor liability problem.

[NEWS CLIPPING MONTAGE]

In Conclusion

- **Our businesses** need continued access to audit services to create jobs, grow and compete
- **Our economy** needs an environment that attracts and retains top professional talent and investment
- **Our province** needs to keep pace with more progressive jurisdictions



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In conclusion, the case for legal liability reform in Ontario is founded on three basic goals. Our businesses need continued access to high quality audit services that are essential when it comes to businesses creating jobs, products and services. Our economy needs to retain its reputation as a good place for top professional talent to call home. Ontario needs to safeguard its reputation as a secure place to invest in. And, at a time of unprecedented globalization and competition, our province needs to keep pace with rival jurisdictions when it comes to modern and efficient public policy.

Full shield LLPs and proportionate liability for Ontario audit professionals will help us **accomplish these vital goals.**

Thank you.

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Thank you.