Duty of care owed by auditors to third parties: a case comment on *Whitehouse v BDO Canada LLP*, 2020 ONSC 144

Action by investors against auditors

The Plaintiffs were individual unitholders in the mutual funds of Crystal Wealth Management System Ltd. They lost their life savings and blamed BDO Canada LLP, which audited Crystal Wealth's financial statements and issued clean audit opinions in the years 2009 to 2016. The Plaintiffs alleged that, unbeknownst to them, the management of Crystal Wealth was misappropriating assets and that BDO did not detect the fraud. Rather, the fraud was discovered only when the Ontario Securities Commission appointed a Receiver after Crystal Wealth failed to deliver its audited financial statements for 2016. However, by that time, the unitholders had already suffered losses of over $100 million. In 2017, the Plaintiffs brought an action under the Ontario *Class Proceedings Act*, *1992*, alleging the negligent provision of auditing services and that had BDO done proper audits, the fraud would have been detected earlier and they would not have suffered the losses they did.

In May, 2018, the CEO of Crystal Wealth admitted to having misappropriated millions of dollars of investors' money and to having misled both BDO and the OSC. Ultimately, the court found that the plaintiffs had no claim against BDO because it did not owe them a duty of care.

The statutory regime and discovery of fraud

Crystal Wealth was a discretionary portfolio management firm that specialized in creating and managing alternative investment strategies that were outside traditional stock and bond portfolios. It was registered with the OSC as an Exempt Market Dealer, Investment Fund Manager, Portfolio Manager, and Commodity Trading Manager. Pursuant to the Ontario *Securities Act,* Crystal Wealth was required to file annual audited financial statements with the OSC and send them to every unitholder or face suspension.

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BDO provided clean audit opinions for the 10 Crystal Wealth mutual funds that were in existence in 2015. Crystal Wealth created 5 more mutual funds in 2016. BDO did not audit the financial statements of these mutual funds. As a result of the failure of Crystal Wealth's CEO to provide information and documents requested by BDO, Crystal Wealth did not file or deliver December 31, 2016, audited financial statements to the OSC within the March 31, 2017, deadline. Therefore, on April 7, 2017, the OSC issued a temporary cease trade order.

On April 26, 2017, the OSC applied to have Grant Thornton LLP appointed as Receiver over all of the assets of Crystal Wealth. The Receiver reported to the court that Crystal Wealth had manipulated the Net Asset Values of the mutual funds, causing them to be materially overstated, and that inter-fund investments gave a false sense of liquidity to meet investor distributions and/or redemptions. The value of all units in the funds was thereby impaired.

The investors' class action

On June 20, 2017, the Plaintiffs commenced a class proceeding against BDO for negligence with respect to the clean audit reports. **The Statement of Claim seeks a declaration that BDO had a duty of care to the Class Members, which it breached in negligently performing professional services, thereby causing damages of over $150 million**. "Class Members" were investors in Crystal Wealth mutual funds in the period April 12, 2007, to April 7, 2017.

On April 3, 2018, the Receiver also brought an action against BDO alleging negligence, negligent misrepresentation, breach of contract, and gross negligence with respect to the audit of the 2014 and 2015 financial statements of two of the mutual funds.

The duty of care issue on the certification motion

On June 15, 2018, the Plaintiffs brought a motion to certify the class action. The motion was dismissed and the the motion judge declined to certify the action as a class proceeding on the basis that the Plaintiffs could not meet the first element of the five-part test in s.5 of the Ontario *Class Proceedings Act, 1992*; **the Statement of Claim did not disclose a cause of action because BDO did not owe the Class Members/ unitholders a duty of care in negligence.**

The motion judge noted that the **Statement of Claim did not plead any direct relationship, undertaking, or representation by BDO to the unitholders. Also, there was no contract between BDO and the unitholders**. Rather, the relationship between the unitholders and BDO was said to arise out of the statutory regime set out in the Ontario *Securities Act*:

> … Thus the Plaintiffs submit that BDO had a duty of care to investors because the OSC permitted Crystal Wealth to continue offering its mutual funds and the OSC did so because it relied on receiving properly audited financial statements from BDO.

> Reliance and legal responsibility and what the parties knew or ought to have known or what the parties could rely on is based upon the statutory provisions of the *Securities Act*. Thus, for example, the Plaintiffs plead….that “accordingly” BDO conducted its audits for two purposes associated with the *Securities Act*.
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> The Plaintiffs do not plead that the two purposes of BDO’s audits arise from any directly proximate relationship between the unitholders and BDO. The only direct relationship in the immediate case is between BDO and Crystal Wealth. The relationship between BDO and the unitholders is a conceit of the *Securities Act* and involves the interposition of the OSC.
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> As pleaded in the Amended Statement of Claim, the two purposes of BDO’s statutory audits are: (a) to assist the investors in making investment decisions; and (b) to ensure that Crystal Wealth was compliant with Ontario securities laws. In the Amended Statement of Claim, the Plaintiffs plead that BDO breached the duty of care it owed the unitholders based on the duty of care that is grounded on these two purposes of the statutory audits.

The motion judge considered this case to be within the category of economic loss cases dealing with the negligent performance of a service. **He found that the motion could be decided by a consideration of the current three leading cases in Ontario on the duty of care owed by auditors to third parties: *Hercules Managements Ltd. v Ernst & Young*, [1997] 2 S.C.R. 165; *Deloitte & Touche v Livent Inc. (Receiver of), 2017 SCC 63 ; and Lavender v Miller Bernstein LLP*, 2018 ONCA 729, leave refused, [2018] S.C.C.A. 48**.

(a) No duty of care to assist the investors in making investment decisions

In *Hercules Managements*, the Supreme Court of Canada held that an auditor performing a statutory audit does not owe a duty of care to shareholders in relation to their personal investment decisions. The duty of care is owed to the auditor’s client with which it has a contract, the corporation. Under *Hercules Managements*, the court recognized that there were lots of third parties who would reasonably and foreseeably rely upon an audit report and to whom the auditors would owe a prima facie duty of care. However, the duty of care analysis allowed for a consideration of public policy factors, primarily the risk of indeterminate liability, to negate the duty of care by auditors to third parties in many circumstances.

Twenty years later, in *Livent*, the Supreme Court of Canada refined the duty of care test. It focussed on the proximity of the relationship between the plaintiff and the auditor to determine whether a duty of care existed (specifically, the scope of the defendant’s undertaking of responsibility and the plaintiff’s reasonable reliance). This approach generally includes considerations of the risk of indeterminacy. *Livent* was a claim by a corporation (via its Receiver) against the corporation’s auditor, so the auditor’s duty of care was clear.

In *Lavender,* the plaintiffs invested in the securities of Buckingham Securities. Under the Ontario *Securities Act*, Buckingham was required to segregate investors’ assets and maintain a minimum level of net free capital. The OSC terminated Buckingham’s licence and put it into receivership for non-compliance with these regulatory requirements, as result of which the investors lost the value of their investments.

They brought a class action against Buckingham Securities' auditor Miller Bernstein LLP. They alleged that the auditors had negligently audited Buckingham's annual registration renewal form (the Form 9 Report). Buckingham's Form 9 Reports in 1988, 1999, and 2000 had falsely stated that Buckingham was in compliance with the regulatory segregation and minimum capital requirements of the *Securities Act*. The Ontario Court of Appeal held that the auditors did not owe a duty of care to the investors. There was not a sufficient relationship of proximity because: (1) The purpose of the Form 9 Reports was to allow the OSC to regulate securities dealers and protect investors, but did not create a relationship of proximity between Miller Bernstein and the class members. **Therefore, in *Lavender*, the relationship was too remote because the auditors did not offer to help the investors make investment decisions and made no representations to the class members**, who were not given copies of the Form 9 Reports and who did not even know of Miller Bernstein's involvement in the audits; (2) The class members did not see or rely upon the Form 9 Reports, which were submitted to the OSC confidentially. The Form 9 Reports therefore were submitted purely for regulatory purposes and not for informing or inducing class members to make decisions; (3) The auditors did not even know the identities of the investors; (4) The statutory scheme required Buckingham to segregate assets, maintain net free capital, and file a Form 9 to confirm that it had met the reglulatory requirements. None of those facts created a relationship of proximity to the class for the purpose of assisting them in making their individual investment decisions; and (5) according to the Supreme Court of Canada, recognition of a duty of care in a claim for pure economic loss requires more scrutiny than other negligence claims.

The motion judge in *Whitehouse v BDO* found that the duty of care analysis was the same as in the *Lavender* case, and he was bound by it. Although the investors were provided with copies of BDO's reports to the OSC, BDO gave no undertaking to the investors to assist them with their investment decisions or to safeguard them from Crystal Wealth's non-compliance with OSC requirements. Therefore, the relationship between the investors and BDO was too remote. It was not relevant that the auditor knew the identities of the investors.

Therefore, for want of proximity, it was plain and obvious that the Plaintiffs did not have a legally viable cause of action against BDO for auditor's negligence in performing a statutory audit based on an alleged duty of care to unitholders with respect to their investment decisions.

(b) No duty of care to ensure that Crystal Wealth was compliant with Ontario securities laws

The motion judge determined that the statutory scheme could not be seen as the basis for a duty of care to ensure that Crystal Wealth complied with Ontario's securities laws such that the OSC would permit it to continue to offer and redeem units in the mutual funds. This theory of a duty of care did not depend upon the unitholders relying on, or even seeing, the audited financial statements. The only possible reliance would be in the unitholders expecting that the OSC would police Crystal Wealth's compliance with securities laws.

According to *Lavender*, these circumstances do to not give rise to a duty of care. Under the *Livent* analysis there is not sufficient proximity between the unitholders and BDO to found a duty of care on the basis of the statutory scheme.

Analysis

One significant difference between the *Whitehouse* and the *Lavender* cases is the stage at which the court decided the duty of care issue. In *Lavender*, the issue was decided on a summary judgment motion, as a result of which the court had a full evidentiary record. By way of contrast, *Whitehouse* was decided on a certification motion, based solely upon the allegations made in the Amended Statement of Claim. Those allegations included assumed "facts" that were not present in the *Lavender* case that would seem to be significant – the BDO audit reports were addressed directly to the unitholders; BDO knew the identities of all the unitholders and the unitholders relied upon the audited financial reports. Nonetheless, the motion judge found that certain elements of the Amended Statement of Claim were fatal to a finding of a duty of care. There was no pleading of any direct relationship, undertaking, or representation by BDO to the investors and no allegation of any direct contact between BDO and the investors.

As both the *Whitehouse* and *Lavender* decisions demonstrate, the Supreme Court of Canada's *Livent* decision has brought greater rigour to the legal analysis of whether there is a relationship of sufficient proximity to ground a duty of care in cases in which auditors are sued by third parties. In many cases, those third parties are the investors or shareholders of the corporation, who had no contractual relationship with the auditors to provide audit services.

The *Whitehouse* and the *Lavender* cases are instructive in that they make it clear that:

- No general duty of care has been recognized between an auditor and the company's investors for the purpose of auditing financial reports that are required to be filed pursuant to a statutory securities regime;
- This means that in each case, the court must undertake a full *Livent* proximity analysis of the relationship between the auditor and the investors to determine whether there is a sufficiently close and direct relationship to ground a duty of care;
- The proximity analysis requires the court to embark upon a fact-specific inquiry to identify all relevant factors that arise from the relationship between the parties;
- The relevant factors vary from case to case and may include reliance, expectations, representations, property or other interests, and statutory obligations;
- In cases of pure economic loss arising from negligent misrepresentation or negligent performance of a service, the auditor's undertaking and the investors' reliance are determinative;
- The plaintiff investors must establish that the relationship between the parties was such that the auditor may be said to be under an obligation to be mindful of the investors' legitimate interests;
- The following factors militate against a finding of proximity:
  - The auditor has made no undertaking to assist the investors in making investment decisions;
  - The auditor has made no representations to the investors;
  - There is no direct connection between the auditor and the investors (such as when there is an interposition of a securities regulator and the corporation between the auditor and the investors); and
  - There is no reliance upon the audited financial reports by the investors.

The *Livent* analysis, in the context of actions brought against auditors by third parties, has introduced a more principled approach to the determination of whether a duty of care exists, and also greater predictability as to outcome. Arguably, the effect has been to narrow the categories in which auditors have been held to owe duty of care to third parties and bring the case law into conformity with both the principles that were articulated in *Hercules Managements* and also the professional standards to which auditors must adhere. Those professional standards require auditors use appropriate accounting procedures to obtain "reasonable assurance" that the financial statements, as a whole, are free from material misstatement, whether caused by error or fraud. **Those standards do not make auditors guarantors of the accuracy of the financial statements or liable to investors who suffer a loss caused by a fraud of management which is not detected by the auditors.**

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