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AN EDUCATED VIEW

ONTARIO NEEDS A LEGAL LIABILITY FRAMEWORK THAT CONTRIBUTES TO PROSPERITY

In recent years, Canadians have become increasingly aware of the importance of productivity as the driving force behind increases in real wages that allow Canadians to enjoy, among other benefits, publicly financed health care and, more generally, increases in the standard of living.

In an era of a much higher standard of living than our parents' generation, we also have much higher expectations. Realistic and credible expectations are good for they drive us higher – or in the words of the Olympic motto, “Citiūs, Altius, Fortius” – swifter, higher, stronger.

However, there are risks associated with ever-higher expectations, especially when they become unrealistic and demand a risk-free world. Indeed, such expectations can threaten our standard of living if they influence public policy and laws that negatively affect economic performance.

In Canada, our commerce, business and economics are governed by a legal system known as joint and several legal liability. What this means is that a party that is judged by the court to be only one per cent responsible for a financial loss can be held 100 per cent liable for the claim. This imposes a very high cost on organizations that do business in Canada as it very substantially increases the risk to these organizations, thereby dramatically increasing liability insurance costs.

Equally importantly – to a country that prides itself on fairness and justice – this system is most unfair and wrong. In an increasingly litigious era, driven by ever-higher and sometimes more unrealistic expectations, the amounts demanded have skyrocketed.

This risk and danger is especially relevant to the auditing profession. By law, publicly traded companies must provide audited financial statements annually. This also affects important organizations in the non-profit sector that as normal practice require audited financial statements so they can continue to provide needed services to a wide range of disadvantaged groups.

As a consequence of the joint and several legal norm that emerged several hundred years ago, huge increases in liability insurance costs are driving the cost of annual audits through the ceiling.

As the Institute of Chartered Accountants of Ontario recently noted, the impact of auditor liability in Ontario has meant:

- It is harder for audit firms to attract and retain the top talent needed to keep Canada competitive;
- Firms, both large and small, are being driven out of the audit and assurance services market because of skyrocketing insurance costs and exposure to disproportionate liability;
- Access to vital audit and assurance services for enterprises of all sizes is becoming more expensive or unavailable; and
- As a result, companies cannot access investment capital needed to grow and create jobs.

Even worse, many of the largest customers of Canadian firms are located in the U.S., where the issue of disproportionate liability has been addressed. For example, New York, Illinois, Pennsylvania, Michigan, Wisconsin, Minnesota, Ohio and Indiana have radically restricted or effectively abolished joint and several liability while California, Connecticut, Florida, New Jersey, Texas and Washington are in the midst of significant liability reform. Moreover, the U.K., E.U. and Australia are in the midst of major reforms that will eliminate or substantially restrict open-ended liability. Canada is at the very back end of the reform process.

In an ever more globalized and thus competitive world, Canada's high standard of living and prosperity are not guaranteed. They must be earned. In order to maintain our high standard of living, we must ensure that we have a legal framework that contributes to productivity and prosperity – not one that subtracts from and harms the ability of our firms to succeed, create jobs and generate a high standard of living.

Our leaders must step up to the plate and resolve the problem of disproportionate liability to ensure our continued competitiveness and prosperity. □

casforchange.ca

The Toronto Financial Services Alliance is one of the city's leading advocates for boosting the competitiveness of our financial sector. Creating the right environment for the right people is part of making that happen. The issues raised by Ontario's “CAs for Change” campaign will be important in accomplishing this task.

- Janet Ecker, President, The Toronto Financial Services Alliance

RESEARCH FINDINGS

DISPROPORTIONATE LIABILITY BAD FOR BUSINESS

The negative impacts of joint and several liability are more than just a matter of opinion. According to Dan Thornton, who holds the Chartered Accountants of Ontario Professorship at Queen's University, it's a fact proven by rigorous research that also linked a decrease in litigiousness in the U.S. to the introduction of a law that addressed joint and several liability issues in that country.

The study, conducted by Prof. Thornton and doctoral candidate Zhefeng Frank Liu, concluded that the burden of joint and several liability causes accounting firms to be overly conservative, resulting in information asymmetry, a distortion of information transmitted to capital markets. Further, the study noted that addressing joint and several liability issues reduces litigiousness.

Under joint and several liability, each defendant in a lawsuit is liable for the entire amount of damages regardless of fault. For example, a successful plaintiff can recover all damages against a single defendant, such as an auditor, even if other defendants are held to be more at fault.

“Our research looked at the sensitivity of conservatism to information asymmetry. The evidence we have, which is supported by other recent research as well, indicates that when accountants are worried about getting sued they become overly conservative to protect themselves from being sued and from judgments,” says Prof. Thornton.

The resulting conservatism amplifies information asymmetry, which can have material implications for a company.

“People are looking at distorted accounting information and allocating resources based on overly conservative estimates,” says Prof. Thornton, who

adds, “As litigiousness increases, the sensitivity of earnings relative to stock market returns becomes stunningly higher for losses than gains.”

Joint and several liability has other direct impacts on the accounting profession and its ability to serve businesses of every size. “Breathtaking lawsuits discourage the best and brightest would-be practitioners who are unwilling to bear the degree of litigation risk.”

Facing an increasingly zealous litigious environment some 13 years ago, U.S. lawmakers addressed these rising impacts of joint and several liability by passing the Private Securities Litigation Reform Act of 1995.

Prof. Thornton and Liu's study notes, “The Act significantly reduces litigiousness by virtually eliminating joint and several liability associated with investor class-action lawsuits, by decreasing the expected benefits of filing such lawsuits, and by increasing the transaction costs of filing such lawsuits.” Further, the study states the change reduced litigiousness because it reduced investors' expected awards for damages if their suits were successful.

The results? “Sensitivity of conservatism with respect to information asymmetry went down. The general level of conservatism decreased. And the race to the courthouse slowed,” says Prof. Thornton.

To bolster their findings, Prof. Thornton and Liu compared the sensitivity of conservatism in the U.S. and the U.K. before and after the Act. “Before the Act was introduced, the U.S. accountants were more conservative than their U.K. counterparts. The gap closed around the time of the Act.

“The only thing that changed in the U.S. at that time was that monumental legislation,” says Prof. Thornton. □