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An Assessment of Auditors' Civil Liability towards Shareholders in Comparative Perspective with Special Reference to Islamic and Conventional Insurance Principles and Practices

Sultan Abdulsalam

UCD Number: 13201369

The thesis is submitted to University College Dublin in fulfilment of the requirements for the degree of Research Doctor of Philosophy in Law

Sutherland School of Law

University College Dublin

Dean: Professor Imelda Maher

Primary Supervisor: Associate Professor Brian Hutchinson

Secondary Supervisor: Professor James Devenney

Professor Joseph McMahon (DSP Member)

Assistant Professor Noel McGrath (DSP Member)

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Abstract

This thesis explores auditor civil liability towards the company and third parties in Saudi Arabia and selected common law countries. In Chapter One, the researcher outlines the methodology adopted to conduct this study using descriptive analysis as well as both doctrinal and comparative approaches. Chapter Two will present the nature of auditor civil liability towards companies and third parties in Saudi Arabia based on Islamic law of tort and modern legislation. Chapter Two also argues that as of 2020 the Saudi judiciary has struggled to cope with issues raised in common law countries due to the complexity of existing Shariah principles and regulation, the lack of understanding among judges and legal practitioners of shareholders' right to be indemnified that may lead to a weak litigation culture. However, the Chapter identifies a few legal provisions and established Islamic principles that would entitle shareholders to be indemnified on behalf of their corporation through personal and class actions if the company refuses to file the suit for their benefit. Despite the fact that there is no specific article showing how a court can determine the proper damages suffered by shareholders, the researcher has designed mathematical formulae to assist Saudi judges in this respect considering Saudi legal regulations and Islamic principles. A better understanding on how Islamic principles and legal provisions operate, will hopefully assist and benefit judges, practitioners and litigants.

This thesis argues in Chapters Three and Four that common law principles with respect to auditors' civil liability to third parties, and more particularly to shareholders, are not satisfactory from the Saudi perspective. Chapter Three is focused on theories of auditor liability towards third parties, with a focus on the United States of America (US), perhaps the first country with a clear precedent in this respect. Chapter Four then looks at England where two contrasting cases with respect to the liability of the auditor, and some other related cases, are examined. Chapter Four also investigates auditors' civil liability towards third parties in other common law jurisdictions that follow the approaches adopted in the US or in England either completely or partially.

Since, in practice, the availability or non-availability of insurance to indemnify auditors against liability to shareholders and others has a significant impact on the topic under review in this thesis, Chapter Five then goes on to discuss the nature of Takaful - "an Islamic form of

insurance" - and compares it to from conventional (western) insurance, and as well as the challenges that the Islamic model faces in Muslim majority and Muslim minority jurisdictions. Chapter Six develops that discussion by examining conventional liability products and exposing their limitations in providing appropriate protection and indemnification for those insured.

Chapter Seven, draws together the key arguments, reasons and principles developed by common-law judges in the context of auditor liability, and explores a recent case from Saudi Arabia. The chapter also develops the discussion of the potential for insurance to extend to auditor liability by comparing and contrasting actual and existing applications of Takaful and conventional insurance in the area of professional liability.

Chapter Eight addresses the research questions posed in Chapter One and concludes with final remarks and observations on the implications of the research.

Statement of Original Authorship: "I hereby certify that the submitted work is my own work, was completed while registered as a candidate for the degree stated on the Title Page, and I have not obtained a degree elsewhere on the basis of the research presented in this submitted work".

Chapter 1

1.1 Introduction

The auditing industry aims to prepare trustworthy financial statements for public and private entities that allow those in receipt of them to take better financial decisions. Scientific methods and technical standards are used to verify annual financial statements. Quarterly financial statements are prepared by the administration of such entities. The auditor is required to critically examine the validity of the financial statements and to ensure that the management of the entity has followed the required standards. This complex preparation process may naturally yield errors or inaccuracies in the financial statements - either from administration or the auditor, or both. Some have complained that misleading financial statements seem to have become acceptable, and that they are the product of an emphasis on enrichment of audit firms.[1] Indeed, contrary to the claims of the audit profession, the nature of this discourse, as it is played out in practice, supports the view that the auditor's job is to ensure that the needs of the enterprises are met, rather than to protect ordinary investors.[2] The sternest critics complain that audited financial statements provide as much support to investors "as a leaky umbrella from a thunderstorm".[3]

Since the beginning of the twentieth century, scholarly debates in the literature have followed common law cases and have discussed to what extent the auditor is civilly liable. Theories of criminal and civil liability were shaped based on case law or regulations in common law countries. The law of contract has been used by common-law courts to assert the privity rule between the client and the auditor, and the privity rule has influenced to some degree the law of tort in the dilemma whether to justify third parties being given the right to be indemnified, particularly if they are identified in the financial statements.

Alongside the law, the insurance industry plays a vital role in civil societies by protecting insured persons from liabilities that may arise due to a variety of reasons. It is used to compensate injured persons to a specific limit agreed between the insurer and the insured person. In the context of auditor liability, the question of whether and how insurance can assist

[1] M Lokanan, 'Auditors' liability and investors' protection in Canada: The 'leaky umbrella''(2018) Journal of Accounting and Auditing: Research & Practice, 16.
[2] P Sikka, 'The corrosive effects of neoliberalism on the UK financial crises and auditing practices: A dead-end for reforms' (2015) Accounting Forum, 39(1), 1-18.
[3] A Rosen, and Rosen, M. (2010) Swindlers: Cons & Cheats and How to Protect Your Investments from Them. Toronto, ON: Madison Press Limited. 15.

in protecting investors from auditor error in the financial statements is of immense practical significance.

This thesis focuses on the liability of auditors to shareholders for error in the audited financial statements, with particular focus on the position in Saudi Arabia having regard to general Islamic principles of tort and specific Saudi legislation, and it explores whether common law principles in this area can be of assistance or indeed may contain any warnings that should be heeded. The thesis further focuses on the question posited above as to whether Islamic or conventional insurance can meet the needs of protecting auditors and, indirectly, shareholders, in this area.

1.2 Main Thesis Question and Sub-Questions

This study seeks to answer the following questions:

- Can Common Law principles regarding auditor civil liability towards shareholders assist in the development of the regulation of auditor civil liability towards shareholders in Saudi Arabia?

In order to answer this main question satisfactorily, the researcher focuses on specific sub-questions as follows:

1. Since auditor civil liability differs from one country to another, while Saudi Arabia does not yet have developed principles of auditor civil liability towards shareholders, in what way can Saudi Arabia benefit from other countries' experiences and practices to enhance its legal system?

2. What is the extent and state of the law in this area in Islamic and non-Islamic jurisdictions?

3. Should third parties, particularly shareholders who suffer economic loss, be indemnified if an auditor is found civilly liable for errors in the audited financial statements in Saudi Arabia?

4. Do existing conventional professional liability insurance products play effective role in indemnifying third parties against auditor error in primary and secondary markets?

5. In what ways can Islamic professional liability insurance products provide an effective alternative to current conventional practices in the sphere of auditor civil liability for error in the audit of financial statements?

1.3 Main Hypothesis "Scenario"-1

Fahad works as a partner at one of the 'Big Four' Auditing Firms in Saudi Arabia. He has certified the Annual Financial Statements of listed Company X in Saudi Arabia. After a short period of time, he has discovered that he made a mistake or an omission in the financial statements. He contacted his legal advisors Noel, a partner in one of the British Law Firms that works in Saudi Arabia with a Saudi affiliate and Brian who similarly is also a partner of one of the US Law Firms that works in Saudi Arabia with a Saudi affiliate. He discloses to them the negligence that has occurred.

Noel and Brian advise Fahad to contact the CEO and, or, the audit committee of Company X and to explain the situation. Based on this information, the company restates its financial statements and disclose the revision to the Saudi stock exchange. Some shareholders of the company noticed the addendum announcement and then appointed Sultan (a partner at one of the Saudi Law firms), who in turn filed a lawsuit on behalf of his clients for damages occurred to their "former/current" stocks as a result of a decrease in the value of the share price, as some of them already sold their shares. Some shareholders kept their shares based on the original financial statements and some bought after the announcement and sold before the revision. Fahad contacted Noel and Brian again to seek advice on how to escape liability. Both of them informed him of the various articles of Saudi legislation which imply in broad terms the eligibility of shareholders to be indemnified in such instances. However, the complicating issue is that there appears to be no Saudi precedent applying the Saudi legislation, so they turn to arguments taken from common law countries, particularly the non-privity rule. Acting for the shareholders, Sultan was ready to present the other side of the argument that under Saudi Arabian laws and Shariah, nobody could escape liability. He points to supporting Shariah principles and legal articles in favour of shareholders being compensated through the auditors' personal money or their insurance.

Sultan also presented two mathematical equilibriums to measure the loss of his clients as follows: 1- Economic Loss = Actual Share Price on the Date of Release of the FS – The Sold Price Before the release of the restated FS or 2- Economic Loss = Actual Share Price on the Date of Release of the FS – The Current Price of the share after the release of the restated FS.

1.3.1 Sub-Hypothesis "Scenario"-2

The regulators (the Capital Market Authority "CMA" for all listed companies, and the Saudi Arabian Monetary Authority "SAMA" in the case of listed companies that work in banking and insurance sectors) discover the auditor's error.

1.3.2 Sub-Hypothesis "Scenario"-3

Other professionals, e.g. financial analysts, journalists, or stakeholders, including shareholders or the Association for Retail Investors' Protection,[4] discover the auditors' error.

1.4 Methodology

1.4.1 Introduction

Despite the fact that Saudi Arabia adopts a general Islamic law of tort which could be used and implemented in modern professions, such Islamic principles and regulations have never been tested when it comes to auditor liability. Hence, the doctrinal and comparative legal analysis method must be used, whilst acknowledging the limitations of the comparative method.

In the US, by contrast, there are as many as four auditor liability theories that judges have developed. In England, the law is developed principally in two cases. Other common-law countries refer to the US cases and the English cases.

[4] The Retail Investors' Protection Association has been established in October 2019. This society aims to protect investors through escalating their awareness on their rights and supporting them in related issues. It also aims to analyse and assess investor-related regulations, submit recommendations, cooperate with the regulatory agencies on monitoring any potential or occurring suspicious practices, and report any violations against the investors. This association will also provide legal advice and assistance to its members and individual investors.

As regards insurance in the context of auditor liability, in Saudi Arabia and many Islamic (and some non-Islamic countries) the Takaful structure is used either alone or with conventional western insurance for general professional cover though not particularly auditor cover, yet. Insurance products for auditor liability have however been discussed extensively in the western literature.

This research explores how a financial statement product could be modified to work under Takaful so that compensation could be given to shareholders. Hence, a comparative approach will be used.

Finally, the descriptive analysis method is employed to show that current regulations, principles and scholars' views in relation to auditor civil liability towards third parties, along with connected discussion of insurance, are still far from converging on common ground.

1.4.2 Brief Elaboration on the Proposed Qualitative Methodology

The researcher would like to elaborate in brief on the proposed qualitative methodology as follows:

a) Some legal systems in this study - especially the US and England - have extensive literature and precedents in the areas of civil liability and insurance. This literature forms part of the primary data that is explored and compared to the Saudi Arabian legal framework where very little in the way of literature or precedent exists on the topic.

b) Extent and limitations of the comparative method in this study:

Kamba contends that "comparative law still lacks a clearly formulated and widely accepted theoretical framework within which specific comparative legal studies and research may be undertaken in a meaningful and effective manner".[5] Örücü further argues that "the basic problems have remained the same. There is no one definition of what comparative law and comparative method".[6] Researchers in comparative law have to set parameters of research within the theoretical framework, provided in the comparative law literature as well as to justify the direction he chooses to give as regards his methodological choices.[7]

[5] Walter Kamba, 'Comparative Law: A Theoretical Framework' (1974) 23 International and Comparative Law Quarterly 485.
[6] Esin Örücü, 'Developing Comparative Law' in Esin Örücü and David Nelken (eds), *Comparative Law: A Handbook* (Hart 2007) 43.
[7] Marie-Luce Paris, 'The Comparative Method in Legal Research: The Art of Justifying Choices' in Laura Cahillane and Jennifer Schweppe (eds), Legal Research Methods: Principles and Practicalities (Clarus Press 2016) 4.

It is important to note here that the comparative legal research methodology applied in the current research does not intend to promote the legal transplant. The researcher is of the opinion that common law countries' approaches to civil liability of auditors towards third parties and related insurance products have to be considered in the context of Saudi legal culture, in particular, Shariah law. However, the situation with regard to Companies Law (now 2015, formerly 1965) in Saudi Arabia is also complex, given that its general structure was originally promulgated through French and Egyptian Law.[8]

A primary aspect of a comparative study is that it identifies weaknesses in the laws of one country and so can serve as a basis for considering practicable legal solutions. To illustrate, a comparatist might go beyond the mere description and analysis of differences and similarities between jurisdictions and evaluates the potential of learning from foreign laws and applying that learning to solve legal problems at home.[9] This part of comparative law concerns the study of legal transplant and the reception of foreign rules, which often explains the process in terms of the 'fit' between transplanted law and local conditions.[10] It is necessary for legislators to identify the potential opportunities that the adoption of a legal element can offer.[11]

In addition, realising the nature of law and knowing the ways and the sources of legal development are the major features of comparative law.[12] This provides a precious opportunity to get a fuller insight into the set of facts that shape the legal rules along with improving academic and practical fields in this context, which can be very useful in legal reform.[13] As Valderrama gives the main qualities that qualify laws for legal transplant: "(i) authority, (ii) prestige and imposition, (iii) chance and necessity, (iv) expected efficacy of the law, and (v) political, economic and reputational incentives from the countries and third parties." [14]

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[8] Maren Hanson, 'The Influence of French Law on the Legal Development of Saudi Arabia' (1987) Arab Law Quarterly 272-291. Hanson gives an example of the French influence over the regulation of companies by pointing out that the types of company mentioned in the CL 1965 directly match their French counterparts set forth in the pre-1966 Code of French Companies. 290. It has become common to describe Saudi law, at least in relation to its commercial law, as a French-based legal system. See, for instance, J L Brand, 'Aspects of Saudi Arabian Law and Practice' (1986) 9 B C Int'l & Comp L Rev 1, 25 and 26; N Foster, 'Islamic Perspectives on the Law of Business Organizations: Part 1: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-style Law' (2010) 11 European Business Organization Law Review 3, 34.

[9] K Zweigert and H Kotz, An Introduction to Comparative Law (T Weir tr, 3rd edn , Clarendon Press 1998) 15–17.

[10] M Siems, Comparative Law (Cambridge, Cambridge University Press 2014) 198-199.

[11] Allan Watson, 'From Legal Transplants to Legal Formats' (1995) 43(3) Am J Comp L 469-470.

[12] Khalid Alamri and David Milman and Philip Lawton, 'The board of directors in listed companies under the corporate governance system in Saudi law as compared to English law and global standards' (PhD thesis, Lancaster University 2018) 19.

[13] A Watson, *Legal transplants: An Approach to Comparative Law* (1st ed., Edinburgh: Scottish Academic Press 1974) 16,17.

[14] I Valderrama, 'Legal Transplants and Comparative Law' (2004) International Law Journal, 1(2), at 265. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2017940, accessed on 15/08/2019.

Paris outlines five practical steps inspired by De Cruz's method of comparison.[15] The following steps mentioned by Paris are: the identification of the problem, the choice of comparators, the strategy to get access to the most relevant authoritative and up-to-date primary and secondary sources about the foreign jurisdiction(s) and the analytical comparison and the production of findings.[16] Van Hoecke identifies six different methods for comparative research. They are: the functional method, the structural method, the analytical method, the law-in-context method, the historical method and the common-core method.[17] The above methods are not suitable to be compared with Saudi Arabia due to the different nature of sources used in this thesis, and it would be only used along with general comparative methodology to benefit from different forums and researches occurred in common law countries.

1.4.3 Particular Aspects of the Comparative Approach in the Context of this Research:

i- Islamic Law of Tort versus Western Law of Tort: Islamic Law of Tort in the context of auditor liability has never been discussed; so, before a straight transplant of common law principles could be considered one must first establish the Islamic general principles and from them deduce the Islamic law of tort's position on auditor liability.

ii- Auditor liability in Saudi regulations: There are a number of specific Saudi regulations which explicitly provide, on the face of them, for auditor liability and compensation of shareholders. There is, however, a lack of literature or precedent on these regulations or on how they are to be interpreted. It is important to recognise that universal Islamic principles have a significant influence on how these regulations ought to be interpreted, and that these principles may produce a result which contrasts radically with the common law approach to auditor liability.

iii- Though auditor liability in common-law jurisdictions is the subject of rich literature and discussion, there is not in fact a single, harmonised, approach. It is important therefore to discuss, criticise and extract related concepts from the various jurisdictions to assess their suitability to the Saudi situation.

[15] Paris (n7) 15-18. See also, Peter De Cruz, *Comparative Law in A Changing World* (2nd edn, Cavendish 1999) 235-39.
[16] Paris (n7).
[17] Mark Van Hoecke, Epistemology and Methodology of Comparative Law (Bloomsbury Publishing 2004) 9-21.

iv- Shareholders' rights in Islam and Saudi Regulations (with a focus on the right to litigate) and insurance: There exists some literature on this topic but it is not comprehensive. Most of the literature has to date focused on suing Directors and Officers ("D&O's") without extending the discussion to how shareholders or their company would be able to get compensation. In contrast, there is comprehensive literature on this from a western perspective, and some useful principles can be devined; but care must be taken not to assume that the principles which found the derivative action (the rule in Foss v, Harbottle etc.) exist or are available in Saudi Arabia.

v- Takaful Corporate Structure and Practices: No need for extensive comparison but only to show that there are some differences from conventional insurance. Moreover, there are still some debates among Muslim scholars within the field.

vi- Professional and other liability insurance products based on Takaful and Conventional insurance: The available products and current practices are almost the same in non-life insurance products. There is a lack of literature about Takaful professional liability products in the area of auditing unlike the conventional ones.

1.5 Concluding Summary:

In this introductory chapter the research hypothesis is identified and the method of testing the hypothesis is developed to justify whether the findings of the research will be plausible and logical. The main question and sub-questions were presented to define the narrow focus of the thesis. The next chapter will now set the scene in closer detail by elaborating on the civil liability of auditors and their connections with shareholders rights in Saudi Arabia.

Chapter 2: The Civil Liability of Auditors and its Relationship with Shareholders' Rights in Saudi Arabia

2.1 Introduction

This chapter identifies the main principles of the Islamic Law of Tort and their implications for auditor liability towards shareholders, and then explores the current Saudi regulations with respect to auditor civil liability towards shareholders.

Shariah principles and Saudi regulations combine to form the basis of auditor civil liability towards shareholders in the Saudi Arabian legal system. Primary and secondary sources and different legal schools of thought scholars are reviewed in this chapter to provide additional insights. Those principles are reviewed alongside regulatory codes governing modern professions in Saudi Arabia.

This chapter identifies some conceptual similarities between Islamic and conventional, or Western, laws of tort, while highlighting some differences as to how liability of professionals is determined and allocated: e.g. in cases of direct or indirect cause of wrongdoing, as well as in identification of who qualifies as injured persons. Differences between Saudi legislation and other countries' laws are clearly noticeable when Saudi legislative articles governing auditor liability towards shareholders are examined, since no comparable regulations are found in comparative jurisdictions where the principles are largely based on case law.

The main contributions of this chapter are thus: to establish and evaluate whether the arguments based on general Islamic principles and Saudi statutes are valid and plausible in measuring professional liability cases with respect to an auditor of a listed company, and to explore the possibility of indemnifying the shareholders or the company itself in case of financial statement error in from Islamic and legal perspectives.

2.2 The Islamic Principles of Tort and Liability and Their Influence in Shaping the Saudi Tort and Liability Law

2.2.1 Principles of Shariah in the Area of Tort

Despite the fact that tort law has developed internationally, it is applied internationally according to the laws and practices of the country. Each state bases its tort law on its "common law", modifying and qualifying it as is required.[18] In the Muslim world, the Shariah is the "common law" of the land, and hence, must be considered in all matters.[19] However, several Muslim-majority countries adopt Shariah differently. Some consider it as the primary source of legislation, whether it is stated in its constitution, such as in Saudi Arabia or in a country that does not have an official constitution but is mentioned in its basic law, such as Oman. Other nations incorporate Shariah into their legal systems to varying degrees. The United Arab Emirates, Sudan, Yemen, Syria, Egypt, Kuwait, Iraq, Pakistan, Iran and Qatar regard Shariah as the primary source of law. In other countries, such as Malaysia, Indonesia, Libya, Algeria and Morocco, Shariah law is highly influential and remains a source of legislation. In the modern legal system, Shariah law acts as: (i) an immutable source of constitutional law; (ii) a precedential source of common actions and defences; and (iii) a source of treatise for the interpretation of civil codes. [20]

Although there may not exist a distinct Islamic code of tort laws, this should not be construed to mean that the Shariah contains no laws regulating torts and wrongs.[21] Some articles from the

[18] Abdul Basir Bin Mohamad, 'Islamic Law of Tort' (PhD thesis, University of Edinburgh 1997) 1. Abdul Basir bin Mohamad, *Islamic tort law In Comparative Tort Law: Global Perspectives* (Cheltenham, UK: Edward Elgar Publishing, 2015). This article is considered as a synopsis of his thesis with minor changes.

[19] Mohamad (n18) 1.

[20] Julio Colon, 'Choice of Law and Islamic Finance' (2011) 46(2) Texas International Law Journal <https://ssrn.com/abstract1⁄41856351> accessed 1 September 2018 8-9; see also, Sultan Abdulsalam, 'A Brief Analysis of the Expected and Non-expected Outcomes from the Application of the Rome I Regulation in the European Zone in Light of Islamic Cross-Border Transactions'. In Efendić V., Hadžić F., Izhar H. (eds), *Critical Issues and Challenges in Islamic Economics and Finance Development* (Palgrave Macmillan, Cham 2017).

[21] Mohamad (n18); see also, Mohammed Mosmar, 'Civil Liability in the Jordanian Civil Code: A Comparative Study with the Shari'a' (PhD thesis, University of London 1998); see also, Rashed Shabib, 'Tortious Liability in the Sharia and Modern Middle East Law with Particular Reference to UAE Law' (Unpublished PhD. Thesis , University of London School of Oriental and African Studies 2004); see also, Abdulrahman Aldweish, 'Delictual Liability of the State Under Saudi law' (PhD thesis, University of Glasgow 2011) 1. There are two reasons why delict/tort as a general concept is not found in a single legal treatise or dealt with as a distinct issue in classical texts. According to Mosmar, the principles of liability for civil wrongs are scattered among and derivable from the jurisprudence of criminal law on punishment (hadd); quasi-criminal proceedings of fixed compensation for personal injury (dhiyyah and Irsh) and destruction of (other's) property (itlaf) among others. Second, it is the nature of the Shariah as a legal form that it "did not progress methodologically on the basis of general rules and principles made up into theories" Shabib 1.

Majallat al-Ahkam al Adliyyah (the Book of Rules on Justice), purportedly the first code of tort in general, and the Majallah or Mejelle of the Ottoman Civil Code, which was enacted between 1867 and 1877, are an important source for Islamic civil code.[22] The Majallah sets out the Maxims of Islamic Jurisprudence,[23] and has been described as "Islamic in content but European in form".[24] Nyrop indicates that in 1976 only two countries (Jordan and Kuwait) were still using the Majallah for their country's Civil law.[25]

The Majallah is, in fact, based on doctrines from the Hanafi School of thought (among other main Sunni schools of thought such as Maliki, Shafie, and Hanbali which are also recognized in Saudi Arabia).[26] In addition, the code of Islamic law of tort never appears by itself in the manuscripts, but rather is found in conjunction with the scholarly writings and treatises.[27]

Some modern writers believe that there is no general rule in Islamic law which requires that every damaging act shall render the tortfeasor liable to compensate a loss.[28] This suggestion, however, cannot be supported, either in theory or in practice in Islamic Jurisprudence. The author of Badai al-Sanai outlined the general principle of tort in Islam by stating that every aggression or injury that causes harm, whether direct or consequential, renders the perpetrator liable.[29] One plausible explanation for the confusion that led the jurists to say that Shariah law lacks a general theory of tort is that the field of tort is not compiled in one chapter or under one general theory.[30] Another explanation may be that the Majallah, in its treatment of civil wrongs, has failed to include a general clause of liability in tort.[31]

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[22] Charls Tyser, *The Ottoman Islamic Civil Code of 1876 Drafted by a Team of Ulama* (The Mejelle, Lahore: The Punjab Educational Press 1967); also see, Charls Hooper, *The Civil Law of Palestine and Trans-Jordan* (The Azriel Printing Works, Juresalem 1933).

[23] Bashayer Al Majed, *The History and Development of Contract Law in With a Particular Emphasis on the Role and Precepts of Islamic Law in its Formulation and Implementation*, (Phd Thesis, the University of Leeds, 2018).

[24] Enid Hill, 'Al-Sanhuri and Islamic Law: The Place and Significance of Islamic Law in the Life and Work of ʿAbd Al-Razzaq Aḥmad Al-Sanhuri', Egyptian Jurist and Scholar, 1895-197110 (1), Cairo Papers in Social Science (Buhūth al-Qāhira fī 'Al-'Ulūm Al-Igtimā'īya), (American University in Cairo Press 1987), 132 (papers later published as book) (citing the following: S.S. Onar, 'The Majalla' in Law in the Middle East, ed. M. Khadduri & H.J. Liebesny, Washington 1955, this Edn 1963; Majiid Khadduri, Political Trends in the Arab World: The Role of Ideas and Ideals in Politics (Johns Hopkins Press, 1970) 243; Herbert Liebesny, The Law of the Near and Middle East: Readings, Cases & Materials, (State University of New York, Albany 1975) 65-80, passim; F.J. Ziadeh Lawyers, the Rule of Law and Liberalism in Modern Egypt (Hoover Institute, Stanford, California 1968) 135).

[25] Richard F. Nyrop et al, *Area Handbook for the Persian Gulf States* (Foreign Areas Studies of the American University, Washington D.C. 2008) 177.

[26] It has usually been thought that the codification of the provisions of Shari'ah was carried out by the Ottomans, who were commonly known as Majallah, in 1876. See Heba A. Sewilam, *The Jurisprudential Problems of the Early Codification Movement in the Middle East*, (PhD thesis at the University of California, 2011) p1.

[27] Mohamad (n18); see also, Aldweish (n21).

[28] Abd Al-Razzaq Al-Sanhuri, *Masadir AI-haqq fi Al-fiqh Al-islami* Vol. 6 (Manshurat Al-Halabi Al-Huquqiyah, Beirut 1998).

[29] Alaudeen Alkasani , *Badai Al-Sanai fi Tareeb Al-Sharaii* (Darul Nashr 1986).

[30] Mohamad (n18).

[31] Mosmar (n21).

Finally, some countries have extracted Islamic principles and drafted them in modern legal terms. For example, the Jordanian Civil Code "JCC" has a general principle covering tortious liability derived exclusively from the practical examples dispersed in the classical texts on tort and property. It can be said that the JCC is the first Arab legislation to contain a general rule of tortious liability originating from Islamic jurisprudence.[32] Article 256 of the JCC lays down: "Every injurious act shall render the person who commits it liable for damages even if he is a non-discerning person." [33]

2.2.2 Tort in the Qur'an and Hadith

The Shariah insists that no person should interfere with the personal liberty of another (without any legal right) or deal with another person's properties without his or her permission, and thus a person should neither take another's property without legal cause, nor wrongfully destroy or misappropriate another's properties.[34]

The rights of human beings, from an Islamic perspective, from the following verses of Qur'an:

"The recompense for an injury is an injury equal thereto" [35]
"Do not consume one another's property unjustly" [36]
The Prophet Mohammed in this well-known Hadith said:
"There should be neither harming nor reciprocating harm".[37]
This dictum furnishes the foundation of the law of tort in Islam. The generality of this hadith makes it applicable not only to tortious, but also to contractual situations.[38] There have been

[32] Ibid.
[33] Identical to Article 282 of the UAE Article 264 of the UACC contains a similar provision and stipulates "Every person, who by his aggressive act has caused harm to another person, shall be liable in damages regardless of whether he acted wilfully or lacked prudence."
[34] Mohamad (n18); see also, Mosmar (n21); see also Shabib (n21).
[35] Holly Quran (42:40).
[36] Ibid (4:29).
[37] Ahmad Hanbal, *Al-Musnad,* vol 1(Dar Al-Marifah, Cairo 1956) 313; see also, B Malik & A Anas, *Muwatta Imam Malik (*Muhammad Rahimuddin (trn) New Delhi, Kitab Bhavan 1989) 529; see also, Muhammad Ibn Majah, *Sunan Ibn Majah, vol 2* (Alkhattab N. (trn) Maktaba Dar-us-Salam 1953) 784; see also, Zain Alabideen Ibn Nujaym, *Al-Ashbah wa al-Nazair* (Muassasat Al-Halabi wa Shurakah, Cairo 1986) 94; see also, Ibn Hajar, *Bulugh Al-Maram min Adillat Al-Ahkam* (Muhieddin al-Selek (trn) Dar al-Fikr, Beirut 1993) 396 ; see also, Jalaluddin Al-Suyuti, *Al-Ashbah wa Al-Nazaair fi Qawaid wa Furu Fiqh Al-Shafi'e* (Beirut, Dar al-Kutub al-Ilmiyyah 1983) 83.
[38] Mohamad (n18) 182.

numerous interpretations of this hadith.[39] One common interpretation is that there shall be no harming of an individual while benefiting yourself personally at the same time.

This statement of the Prophet stated above has been interpreted as having two principles. The first is that no one shall inflict any damage on the person or property of another. The second principle is that there ought to be no retaliatory damage, and that the aggrieved person should not take the law into his own hands by inflicting a similar injury.[40] This hadith also contains a very important maxim of fiqh among the five major maxims of fiqh.[41] The Shariah has also regulations which ensure that harm cannot be carried out. One of these regulations is:

"If you harm an individual due to recklessness whilst benefitting yourself, then you are liable to pay compensation, even if your intention was not to harm the individual"

Many legal maxims have branched from this dictum, which were compiled by Ibn Nujaym in al-Ashbah wa al-Nazair, and Al-Khadimi in al-Majami and have been copied by the Majallah.[42]

Amongst the most important maxims is the one that provides that: "The damage shall be eliminated (al-darar yuzal)".[43] Accordingly, if a person causes an injury to another this damage can be put right by restoring the status quo ante which can be done by binding the wrongdoer to make good the resulting loss in kind or in value.[44] This maxim specifically is vital for indemnifying shareholders from wrongdoers such as auditors, as will be explained in detail in a subsequent chapter.

Other precepts are found in the Islamic maxims related to liability in general that preface the Majallah: An injury cannot be removed with an injury (Article 25); Repelling an evil is

[39] See https://hadithcommentary.wordpress.com/nawawi/hadith32/, accessed August 1, 2019.
[40] Ibn Nujaym (n37) 94; see also, Sulyman Murqus, *Alwafi fi sharh Alqanun Almadani - Al-Fil Al-dar (* Cairo, Dar Alnashr lil Aljamiaat Almasriah 1956) 229-303; see also, Mustafah Al-Zarqa, *Al-Fil al-dar wa Al-daman fih* (Damascus, Aldar Alshamiyah li Altibaah wa Alnasher wa Altawzee 1988); see also, Abdul-Qadir Zubair, *An Outline of Islamic Law of Tort* (Lagos, I.I.C. Publications 1990), see also, Sulyman Ahmad, Daman al-mutlifat fi al-fiqh al-Islami, Cairo, 1975.
[41] Al Majed (n23) There are five major maxims of fiqh that the Shariah is based upon. These are:
1.Actions are accepted or approved by their intentions
2.Difficulty ought to bring about ease
3.Certainty is not removed by doubt
4.Harm is to be removed
5.Customs are deemed part of legislation
[42] Ibn Nujaym (n37); see also, Faydallah M, *Nazariyyt Al-daman fi Al-fiqh Alislami Alaam* (Kuwait, Maktabat Alturath Alislami 1983).
[43] Ibn Nujaym (n37) 94.
[44] Mosmar (n21) 181-182.

preferable to securing a benefit (Article 30); Injury is removed as far as possible (Article 31); Disadvantage is an obligation accompanying enjoyment (Article 87); If the person who commits the act and the person who causes it are present, responsibility shall be attached to the former (Article 90); a person who executes an act, even if not deliberately, is accountable to make good any loss caused thereby (Article 92); the actor of consequential injury is not liable except with an intention (Article 93).[45] In brief, Article 30 could be understood as an obligation for a professional to disclose his/her wrongdoing even if he/she is going to secure a loss in his or her reputation and fees.

Article 31 is also important for example for this study where an auditor has discovered unintentional mistakes or omissions in the annual financial statement, then such injuries ought to be removed through a restatement to current investors and then indemnity will be limited to specific investors who were injured during the press release and restatement periods of the financial statement. Moreover, Article 92 could be vital for shareholders to seek compensation from the auditor and others. Articles 90 and 93 are further elaborated on in the strict and vicarious liability sections.[46]

2.3 Tort in Islam and Common law: Definitions and Understandings

2.3.1 Western Definitions of Tort

The term "tort" and "wrong" are originally synonymous. Tort is derived from the Latin word "tortum" while "wrong" is in its origin identical with "wrung", both the English and the Latin terms mean primarily "conduct which is crooked or twisted, as opposed to that which is straight or right (rectum)".[47]

[45] Mosmar (n21) 182.

[46] Raed El-Saadouni, 'The Liability of Groups of Companies in Islamic Law: A Comparative Study with Common Law' (PhD thesis, University of Stirling 2013) 253, has explained that the Shariah Maxims are a set of principles and their subordinate legal maxims, which Muslim jurists have derived from the Quran and the Sunnah to determine a ruling or verdict on any act, institution or policy. They provide general holistic guidelines which may be applicable in different social situations. Shariah Maxims form an important part of Islamic Jurisprudence, encapsulating concepts and precepts that can assist one to understand the details of law. More importantly, they are capable of helping in arriving at the appropriate ruling where no explicit law exists.

[47] R.F.V. Heuston R.A. and Buckley, *Salmond & Heuston on the Law of Torts* (London: Sweet & Maxwell LTD. 1992) 14.

The Black's Law Dictionary has defined the tort as "a civil wrong, other than a breach of contract, for which a remedy may be obtained, usu. in the form of damages."[48] According to Rogers: "Tortious liability arises from the breach of duty primarily fixed by the law, such duty is towards persons generally and its breach is redressable by an action for unliquidated damages."[49] While Horsey and Rackley defines it as a civil wrong for which the law provides a remedy. Furthermore, tort law is the name given to a diverse collection of legal wrongs.[50] Many definitions exist regarding what constitutes a tort. However, Peel and Goudkamp think that these definitions have 'varying degrees of lack of success' and no single definition can fully capture the nature of what a tort is.[51] Therefore, understanding what forms a tort is best approached by examining the nature of liability imposed and the aims of the law of torts. As there are various types of tort, it is more convenient to refer to the law of torts, as opposed to the law of tort. For example, it has been estimated that there may be as many as forty torts in the English legal system.[52]

There are four classes of wrongs which stand outside the scope of tort:[53]

1. Wrongs absolutely criminal;
2. Civil wrongs which make no right of action for unliquidated damages, but offers growth to some other forms of civil remedy;
3. Civil wrongs which are completely breaches of contract;
4. Civil wrongs which are exclusively breaches of trust or of some other purely reasonable obligation.

Roach has distinguished the law of torts from other types of wrongs outside the scope of tort as follows in brief:[54]

1. The law of torts relates only to civil wrongs. However, certain acts can result in both criminal and civil liability. For example, battery is a crime and a tort.

[48] Bryan A. Garner, *Black's Law Dictionary* (10th ed. 2014), Thomson West.
[49] Rogers W, *Winfield and Jolowicz on Tort* (London, Sweet & Maxwell 1984) 11.
[50] Kirsty Horsey and Erika Rackley, *Tort Law* (6th ed, 2019), Oxford University Press, 1.
[51] Peel, WE and Goudkamp, J, *Winfield & Jolowicz on Tort* (19th edn, Sweet & Maxwell 2014) 2.
[52] Roach, Lee**,** *Card & James' Business Law* (4th edn, 2016), Ch 13. An introduction to the law of torts, Oxford University Press, 337.
[53] Heuston & Buckley (n47) 9.
[54] Roach (n52) 338.

2. Although torts can bring in civil liability, it does not follow that all civil liability results from torts. Tort is just one type of civil liability, with other notable instances of civil liability being breach of contract and unjust enrichment.
3. The law of torts protects only specific interests. Particular acts caused by another will be regarded as compensatable, whilst other acts may not.
4. The mere fact that a party has harmed another is enough per se to result in the payment of compensation. A tortious remedy will solely exist if the party causing the harm owed the victim a legal duty not to cause that harm and was in breach of this duty.

2.3.2 Islamic Definition of Tort

The root meaning of the word corresponding to "tort" literally is madarrah, darar, aldhiyyah and khasarah. Tortious is multawin, tortiously is bi al-tiwa and tortiousness is iltiwa.[55] According to al-Mughni al-Akhbar Arabic dictionary, "tort" is fil darar.[56] The law dictionaries also lay down that the meaning of tort is fil al-darr.[57]

In Shariah, the Arabic word for tort generally is jinayah and it is mostly applied to physical injuries illegally inflicted on a person whether such injuries have caused death, grievous harm or other harm of a lesser degree.[58] This can give rise to liability for qisas or diyah (compensation).[59] However, some fuqaha prefer to use the word al-jirah instead of al-jinayah.[60] Some of them used both of these terms in their works.[61]

Some jurists like Ibn Juzayy used the term al-taaddi conveying the meaning of tort in general. Al-taaddi connotes "transgression" or "trespass" which leads to any injury to property, life,

[55] George Badger, *An English-Arabic Lexicon: in which the Equivalents for English Words and Idiomatic Sentences are Rendered into Litrary and Colloquial Arabic* (London: C. Kegan Paul & Co., 1881).
[56] Hasan Karmi, *Al-Mughni Al-Akhbar (English-Arabic)* (Lubnan, Librairie du Liban 1988) l487.
[57] Harith Faruqi, *Faruqi's Law Dictionary: Arabic-English* (Beirut, Librairie du Liban 1983) 259; see also, Ibrahim I Al-Wahab, *Law Dictionary: English-Arabic* (Beirut: Librairie du Liban 1972) 256.
[58] Abdur Rahim, *The Principles of Muhammadan Jurisprudence According to the Hanafi, Maliki* (Shafi and Hanbali Schools, Madras: S.P.C.K. Depository 1911) 352.
[59] Alahaji Ajijola, *Introduction to Islamic Law* (New Delhi, International Islamic Publishers 1989) 125.
[60] A Al-Ansari, *Matn Al-Minhaj, printed with Minhaj Al-Talibin wa Umdat Al-Muftin fi al-Fiqh* (Maktabat al-Thaqafah n.d) 269.
[61] Muhmmad Ibn Rushd, *Bidayat Al-Mujtahid wa Nihayat Al-Muqtasid*, 2 vol (Beirut: Dar al-Fikr, 595H/1198M n.d) 296.

body and so on.[62] Some jurists used the term alsiyal in a particular chapter which may be related to the term "tort". Alsiyal denotes "attack" or "assail" or "assault" to physical injury or property.[63]

In the next section, the concept of liability is discussed from an Islamic legal perspective.

2.4 The Concept of Daman (Liability) in the Islamic Law of Tort

Daman generally means liability that arises from the causing of damage or harm to others "Taadi" or for not performing a contract.[64] Billah et al think that Daman is one of the tools conformed with Shariah to preserve society by protecting people's property.[65]

Allah (swt) says in the Qur'an: "Allah (swt) doth command you to render back your trusts to those to whom they are due."[66]

The term Daman literally means responsibility, answerability, accountability, amenability, suretyship, guaranteeship, security, warranty and the like, and it is synonymous with kafalah, but it is more commonly used and it is wider (in signification) than kafalah.[67] Sometimes, it signifies what is not Kafalah (suretyship) but referred to as indemnification or restoration of the like, or the value of a thing that has perished.[68] Daman mal or ghurm signifies responsibility for property or for a debt, owed by another person.[69]

Daman also means iltizam (obligation) and it is used in a wider sense, which is synonymous with the term Arabic term al-haqq al-shakhsi, which means personal right.[70] Thus, the term

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[62] Al-Zarqa (n40) 78.
[63] Shihab Al-Naqib, *Umdat Al-Salik wa Uddat Al-Nasik, Printed with Anwar Al Masalik* (Cairo, Shirkah Maktabah wa Matbaah Mustafa al-Babi al-Halabi wa Awladuh n.d) 358; see also, Ibrahim Al-Bajuri, *Hashiyat Al-Shaykh Ibraim Al-Bayjuri ala Sharh Al-Allamah ibn Al-Qasim Al-Ghazzi ala Matn Al-Shaykh Abi Shuja* (Beirut, Dar al-Kutub allamiyyah 1994) 463; see also, A Ruslan, *Matn Al-Zubad fi Ilm Al-Fiqh ala Madhhab Al-lmam Al-Shifi* (Beirut, Muassasat al-Kutub al-Thaqafiyyah 1986) 66; see also, Muhammad Al-Mufti Al-Hubayshi, *Fath Al-Mannan Sharh Zubad ibn Ruslan* (Beirut: Muassasat al-Kutub al-Thaqafiyyah 1988) 421.
[64] Bearman P., Bianquis Th., Bosworth C.E., Donzel E. van and Heinrichs W.P. Encyclopedia of Islam (2ed), Brill Online, 105.
[65] Billah, M. M., GhlamAllah, E., & Alexakis, C. (2019). 'Understanding the pillars of Takaful'. In Encyclopedia of Islamic Insurance, Takaful and Retakaful. Cheltenham, UK: Edward Elgar Publishing, 32.
[66] Al-Qur'an, 4:58, Abdullah Yusuf Ali (trans.) The Meaning of The Holy Qur'an (10 ed, 2001), Amana Publications.
[67] Mohamad (n18) 37.
[68] Ibid 38.
[69] E Lane, *An Arabic-English Lexicon. England* (England: The Islamic Texts Society Trust 1984); see also, Faruqi (n 57).
[70] S Amin, 'Al-Masuliyyah Al-Taqsiriyyah an Fiel Al-Ghayr fi Al-Fiqh Al-Islami Al-Muqaran' (Unpublished Phd. Thesis, The University of Cairo 1968); see also, Mohammad Al-Khatib, *Mughni Al-Muhtaj ila Marifat Maani Alfaz Al-Minhaj Sharh ala Matn Al-Minhaj* (Cairo, Shirkah Maktabah wa Matbaah Mustafa al-Bab al-Halabi wa Awladuh 1958) 198; see also, W Al-

tadmin which is the verbal noun of daman implies an act of holding someone responsible or answerable (masul) for a certain thing or act.[71]

Additionally, the concept of daman is also associated with gharamah which refers also to compensation, reparation, amends or even penalty and fine. However, in classical Arabic it was mainly used in connection with the duty to pay compensation for wrongs done to others. However, daman can also mean kafalah (guarantee). Thus, damin is similar in meaning to kafil i.e. guarantor or surety.[72] It is mentioned in Lisan al-Arab, Damina al-shay wa-bi-hi damnan wa-damanan i. e kafala bih meaning he stand as a guarantor for the thing as a result of which it was guaranteed. The guarantor is called damin or kafil while the thing so guaranteed madmun.[73]

The application of the term Daman by Islamic scholars could be divided into two aspects:[74]

i- Suretyship (kafalah).
ii- Compensation (gharamah).

However, some scholars have put forth other ways in which daman can be applicable or understood in relation to tort:

1- Daman is an obligation to replace destroyed property, if it is similar or fungible, or to pay the value thereof, if it is a thing which could be grouped in dissimilar or infungible.[75]
2- A duty to pay a pecuniary reward against an injury incurred upon tortfeasor.[76]
3- Daman is compensation for destruction.[77]
4- Daman is liability to pay compensation due to injury to another.[78]

Zuhayli, *Nazariyyat al-Daman wa Ahkam Al-Masuliyyah Al-Madaniyyah wa Al-Jinaiyyah fi Al-Fiqh Al-Islami: Dirasah Muqaranah* (Dar al-Fikr, Damascus 1982) 198.
[71] Z Abd Rahman, 'The Concept of Daman and Compensation in the Islamic Law of Jinaiah' (PhD thesis, University of Birmingham 1997) 107.
[72] Mohamad (n18) 38.
[73] Jamal Ibn Manzur, *Lisin Al-Lisan: Tahdhib Lisan Al-Arab*, 2 vol (Beirut: Dar al-Kutub al-Illmiyyah, 1993) 126.
[74] Mohamad (n18) 38.
[75] Tyser (n21).
[76] Amin (n70) 69.
[77] M Al-Shawkani, *Nayl Al-Awtar min Ahadith Sayyid Al-Akhyar Sharh Muntaqa Al-Akhbar* (Beirut, Dar al-Jil 1973) 210.
[78] Al-Zarqa (n40) 1032; see also, Al-Zuhayli (n70) 15.

The cases mentioned in paragraphs 2 and 4 are relevant for this study and will be explained further later. The yardstick to measure the tortious liability is an infringement or transgression of the rule of rights. The rule of rights which is related to Daman is understood as follows:[79]

1- The right of God means the right of the public and is linked with no specific person. It involves benefit to the community at large and not merely to a particular individual.
2- The right of mankind is a right that pertains to an individual's interest and is called a "private right", such as a right to the enforcement of contracts, and protection of property. Enforcement of such a right is entirely at the option of the individual whose right is infringed. This right, contrariwise to the right of God, accommodates emendation and remission. The injured person affected by the infringement of a private right, may either sue for compensation or pardon the tortfeasor.
3- When the rights of two natures are combined, of God and of mankind, the former is preponderant in some cases while the latter in others.[80]

From the classification of the rights above, the liability can be classified in two kinds:
1- Specific punishment.
2- Unspecific punishment.

When the punishment is unspecific, the judge is empowered to adjudicate in such cases. These cases could be put in the class of "civil wrong". The liability of this kind warrants that the tortfeasor is liable to indemnify the wrongful act against another's person, land or chattels as

[79] A Ibn Taymiyyah, *Al-Siyasah Al-Shariyyah fi Islah Al-Rai wa Al-Raiyyah* (Iskandariyyah, Dar al-Iman n.d) 87; see also Ibn Qayyim Al-Jawziyyah, *Shams Al-Din, Ilam al-Muwaqqiin an Rabb al-Alamin*, 4 vol (Cairo: Dar al-Kutub al-Hadithah, 1969) 108-109; see also, A Khalaf, *Ilm Usul Al-Fiqh, Kuwait* (Kuwait, Dar al-Qalam 1978) 128.

[80] Albrahim, M 2016, 'The enforcement of directors' duties in the context of shareholders' rights: a comparative study between UK and Saudi law', PhD thesis, Lancaster University, 102-103. As a way of comparison in regards to directors' duties and court discretionary power to relieve from liability, section 1157 of the UK CA 2006 describes actions by directors that are fair, honest and reasonable that give power to courts to relieve liability from directors, when liability was caused by negligence or default. However, liability relieve claimed in many courts under section 1157 is often unsympathetically dismissed. It has been argued when applying Shariah principles, directors are always required to act in good faith and honestly, but if directors are found to have committed aggressive or negligent actions, then they cannot claim this as an excuse. Hence, section 1157 of the UK CA 2006 that could apply the power of the courts for forgiveness is not supported by Shariah law for two main reasons: directors can be found to be relieved from liability to God (Allah) but cannot be discharged from liability to people; and the terms of negligence and of reasonableness are seen to be contradicting, due to the fact that, if a director acted reasonably, he could not be found to be negligent. The Saudi CL 2015 includes article 78 that defines joint liability of directors for compensation by third parties, shareholders or companies if, as a result of their violation, abuse or misconduct of the company's constitution or company law, damage has been caused. Therefore, the Saudi law is also not in favour of the power of forgiveness of the UK CA 2006. Concerning the auditor civil liability towards shareholders, it has been argued within this thesis that shareholders as economic ownerships have the right to forgive the auditor if they wish within the general assembly, otherwise, they could claim their damages from the auditor misconduct in the annual financial statement.

regulated in the rule of right. However, there are cases of civil wrong where punishments have been specified like in the case of qisas and diyyah.[81]

Billah et al. provided specific cases of al-Dhaman such as: Bearing Liability of Uncertainty and Bearing Liability but Not Binding; Bailment; Binding Promise in the School of Maliki; and Surety for Hazards on the Highway.[82]

The main argument the researcher would like to emphasise is that there is a specific value that could be measured between the start of such an incident until its discovery either through an official disclosure by a company, an investigation by a regulator or a claim by injured parties, so that if there is a devaluation or "depreciation" of the share price due to a particular incident justifying claim for compensation.

Lastly, daman, or remuneration is the sum adjudged to be paid for the damage inflicted on property. Islamic scholars have also employed the expression to denote the legal obligation to provide indemnity and reparation. It is within this concept the discussion on tortious liability in Islamic law will be focused on.[83]

Generally, a civil wrong is divided into two types, namely:

1- Contract.
2- Tort. [84]

Due to the specific scope of this thesis, the area of Tort will be the main focus, with less emphasis on contractual civil liability.

[81] Mohamad (n18) 48; see also, Shabib (n21).
[82] Billah et al. (n65) 33-35.
[83] Mosmar (n21).
[84] According to Shabib (n21) 42, the jurists distinguished between tortious liability and contractual liability in what is indemnified. The former liability is set forth in the provisions to be indemnified in kind which is different from the latter liability, on the ground that the purpose of a contract is in achieving profit and benefit. S Al-Sharakhsi, *Kitab Al-Mabsut,* vol XXVII (Beirut, Dar Almarifah Publisher 1993) 80; explains the ground of such distinction that: "the contractual liability is not established on liability in kind. The purpose of the contract is to receive profit. The question is only the lawfulness of the contract. Liability should be provided on the ground of whether the agreement in the contract is invalid or is considered permissible. Contrary to this is the liability for events, which cannot be expected. Therefore, this damage is indemnified in kind as stipulated in the provision and the increase in the amount of the damaged thing due to the damage is not permissible."

2.5 Elements of Tort Law in Shariah

To better understand tort theory in Shariah, it is necessary to identify three elements of tort that would apply for all tort cases, regardless of the type of the tort case or its time. These elements are wrongdoing, harm, and causation.[85]

a. An Act as an Element of Torts

Most Islamic jurist prefer to describe wrongdoing as an act or an utterance in order to make it generally applicable to any offence.[86] They define the act broadly in order to include any possible action that may cause harm. Therefore, they define the act related to wrongdoing as any act that would cause damage to another

Within the Shariah tort system, an act should comprise of a trespass, which in this context means any wrongful or unusual conduct that causes harm to another. In the Shariah tort system, there is no classification of assault or battery, as is found in the U.S. tort system. However, it would be defined along the lines of an act of harm done to another individual (or group of individuals).[87] Under Shariah, such an act can be considered wrongdoing, even without a trespass, if it meets one of the following criteria: the act itself is religiously forbidden, the act will largely cause harm to another, or if the act itself is permissible, but the intent is to harm another. Further, if the act is permissible, but is performed negligently or carelessly the tortfeasor is still held liable.[88] In the Shariah tort system, even if the act was unintentional, but harm was caused to another person or property, the tortfeasor will be considered liable regardless of their age or any other extenuating factors.[89]

Based on the above discussion from secondary sources in addition to the already highlighted principles of tort found in primary sources related to strict liability in Islamic law of tort,[90] it could be argued that either an error or an omission done by an auditor which caused a harm to a shareholder would make the former liable to the latter. The assumption of the wrong act done by an auditor is built on being a direct tortfeasor who caused damages to specific persons.

[85] Othman Talbi, 'Tort Reform in Saudi Arabia: Obstacles and Solutions' (SJD dissertation, Indian University 2015) 21.
[86] Ibid 23.
[87] Ibid 22-23.
[88] Ibid 24.
[89] Shabib (n21); see also, Abd Rahman (n71); see also, Talbi (n8585) 24.
[90] See subsections 2.2.1, 2.2.2, and section 2.6.

Moreover, as Shariah law does not provide a higher threshold for liability in its primary sources and neither do the legal Islamic schools of thought, the researcher extends his discussion to relevant Saudi Certified Public Accountants Regulations 1992 (and the proposal of the Auditing and Accounting Act in Chapter Seven), where it stated that the liability of an auditor will be on a partner level as a skilled professional. This level of professionality is an important addition from the Saudi regulator perspective to ensure that an auditor at partner level ought to be liable for his mistakes that have repercussions for others.[91]

b. Harm as an Element of Torts

Shariah principles state that for harm to be covered by a tortfeasor, the harm should be the result of a direct or indirect act, which can range from loss of money or property, bodily injury, or emotional damages.[92] Material damage has to prejudice a right or financial interest of the victim and it has to be certain. Therefore, damage is material if there is prejudice to the victim's rights, such as: causing the victim to suffer financial loss by hindering his ability to earn his living.[93]

With regards to the condition of certainty, it should be noted that damage is indemnified if it is certain which may be immediate or in the future. Immediate damage is damage that has actually occurred. As such, compensation is payable if the other elements of liability are present. Future

[91] For further discussion, see subsection 2.9.2.
[92] Ali Al-Khafif, '*Compensation Compilation 154'*(Dar al-Fiqr al-Arabi 2000) 38.
[93] Abd Rahman (n71); see also, Aldweish (n21).

damage which is certain to occur should also be indemnified.[94] If the damage is unstable, the judge has to assess it as it is at the time of the judgment not as it was when it occurred.[95]

Islamic Jurisprudence narrows the scope of the actionable harm.[96] This is manifested in the conditions laid down by the jurists on the right to claim damages.[97] The first requirement is that the thing must be a property (mal). Mal is defined by the Hanafi scholars as that which can be hoarded or secured for use and enjoyment purposes at a time of need.[98] It follows that, only corporeal and tangible objects can be the subject of a property and, consequently, enjoy the protection of the law. This removes from the category of property usufruct, future produce and services as they cannot be physically possessed. Moreover, the property must be a commodity (mal mutaqawim). This term refers to what may be lawfully possessed for utilisation. The term mal mutaqawim also refers to acquired property.[99]

To sum up, the basic principle in Shariah law is that there must be an exact equivalence between the injury and pecuniary compensation. The basis of reparation in Shariah law is built on the principle of removing the injury. This can only be done by replacing the destroyed property with a similar item if it can be found in the market, or paying its value if similar property cannot

[94] Abd Rahman (n71) 261 has discussed the future losses by saying that compensation for financial loss is looked upon objectively in the Shariah in the sense that compensation is paid to cover the actual loss or damage suffered; no more or no less. Accordingly, the general rule is that unless in the form of actual damage already suffered or inflicted, it will not give rise to any liability. The ground for this is that, in theory, compensation is supposed to quash, eradicate or wash away the effect of the darar that has been inflicted on the plaintiff (izalat al-darar) to return the plaintiff to the position he was in before the damage. Thus, if the damage has resulted in the plaintiff losing certain amount of money, then he is entitled to recover the same amount from the defendant as compensation. If however the wrongful act of the defendant has caused destruction to the plaintiffs' property, then the compensation is the return of a similar property, or if an identical property cannot be found in the market for the purpose, its full value must be paid as the compensation. In this regard, no other compensation for consequential loss needs, in normal circumstances, to be paid to the plaintiff, because Daman is the return of the same property or its full value.
The rule is that compensation can neither be used to enrich the position of the plaintiff nor to undercompensate the defendant. In this connection, it has been held that by the majority of the jurists that future loss or darar (including what is generally known as loss of future earning, future expenses, loss of expectation of life, loss of prospective income and a few others) cannot, as a general rule, be the basis for awarding compensation.
There are a number of arguments put forward in favour of this opinion:
1. The whole basis for awarding compensation rests upon the existence of a certain and identifiable darar which itself is the sine que non for the liability in the first place. Since future darar or loss is not in existence at the material time, then how could it be compensated? Should the defendant is made liable under this situation, then he is thus forced to pay for something which he did not cause because the darar that he is supposed to make good has yet to exist. In other words, future loss or damage is not a good illah (cause) at all.
2. Future loss or damage is difficult to assess and estimate in addition to the fact that there is a possibility that it may not even occur in the future. The rule here is that uncertainty cannot be the basis for the creation of a legal burden or liability. The general rule is that a person is free from any liability unless proven to be liable with certainty; al-asl baraat al-dhimmah. There are however opinions to the effect that if it is highly likely (mutahaqqiq alwuquu) that a certain loss or damage will result in the future and provided its nature is clearly predicted with near certainty, then compensation can be paid in relation thereto.
[95] Ibid; see also, Shabib (n21) 213.
[96] M Ghauth, *Torts due to Negligence: a Comparative Study of the Islamic and English Laws,* (Islamic Culture, XXXII 1958) 153-163.
[97] Mosmar (n21) 191.
[98] Hashiyat Ibn Abidin, *Hashiat Radd Almuhtar ala Al-durar Al-mukhtar Sharh Tanwir Al-absar,* Vol IV (Dar Al-Kotob Al-Ilmiyah, Beirut 1992) 501.
[99] Ibid 205-206.

be found in the market.[100] This means that the total damages awarded should not exceed the actual loss incurred.[101]

The researcher thinks that the commodities under this study from an Islamic perspective are only ordinary shares of a listed company as they represent full ownership therefore they are entitled as owners to have rights and obligations to the company or to others at general meetings. Due to share value depreciation, shareholders suffer from the wrongs done by professionals. A judge might be able to measure the future unstable damages at the time of judgement not on the occurrence of such incident and with reference to the mathematical equation I propose at section 2.11, which is in conformity with Islamic principles. Put it simply, how can a judge measure the harm done by an auditor of a listed company in a fair manner? Also, what kind of damages occurred to the company except to its reputation or through bankruptcy. If this is the case, then shareholders will also be damaged as well as in the latter case where no funds may be obtained and shareholders are the last on the list to receive their rights by law.

This conclusion presents a stark contrast with examined common law countries' positions as will be discussed in Chapters Three and Four where the damaged commodities are not presented. Finally, the thesis will elaborate on this issue in further detail in Chapter Seven contending that the civil liability regulation in primary and secondary market should be similar in terms of identifying the tortfeasor, damaged persons and commodities.

c. Causation as an Element of Torts.

It is necessary to establish the causal connection between the act of the defendant and the harm suffered by the plaintiff for the existence of the right to claim damages. To satisfy this requirement, the Islamic jurists have introduced a generally accepted test, based on classifying injuries suffered by the victim into two categories: direct and indirect injuries. Shariah also defines two categories of causation: direct and indirect cause.[102]

[100] Ibid 184-185.
[101] Mosmar (n21) 210.
[102] Mosmar (n21) 194-195; also see Abd Rahman (n71) 139 who commented on this point and state that before reaching a conclusion that a particular darar was in fact caused by a mubasharah (direct) on the part of the defendant, the law will rather consider whether it is not but a direct result of his act. The act will be considered direct if there has been no sentient intermediary agent that separated the defendant's act from the darar or damage making it possible to implicate the defendant as the creator of the darar. If that is the case, then the court will not look at the defendant's state of mind and its role in causing the darar, because the law considers the damage itself as the illah (legal basis) for fixing the liability on the defendant given the directness

According to this formula, the jurists hold the opinion that the defendant is unconditionally liable for all injuries directly resulting from this act. Conversely, if damage is indirect, the doer is held liable only if he was at fault. To complete the elements of causative link, the jurists have added a supplementary rule to the effect that when the injury is a combined result of two causes, liability is attached to the person whose act is the direct or effective cause of the injury.[103]

Considering direct cause, the Shariah states that the tortfeasor will be held liable in all situations, regardless of the type of trespass. Furthermore, it makes no distinction regarding age or capacity.[104] Direct damage is frequently defined by the jurists as harm caused by an act without the intervention of any extraneous cause between the act and the result.[105] In relation to indirect causes, the Shariah requires the existence of a trespass to establish liability. The concept of indirect destruction denotes the conduct which contributes to the damage without being the direct cause; the qualifying principle is that without that act, the harm would not have occurred.[106]

The Majalla offers a definition for indirect destruction, as elaborated by AlKasani.[107] Thus, article 888 states: "Indirect destruction consists of being the cause of the destruction of a thing. That is to say, to do an act which causes the destruction of another thing in the normal course of events."[108]

Muslim jurists require the fulfilment of specific conditions before the defendant can be held liable in cases of indirect destruction. This is based on the grounds that the direct act is an independent cause sufficient in itself to inflict damage because of its attachment to the specific place of destruction; whereas in the case of indirect injuries, the relationship between the act and the result is not obvious.[109] While Muslim jurists agree on strengthening the causative link for the remote injuries to become actionable, they disagree on the conditions that must be satisfied. It has been asserted by Baghdadi that the actual doer of an injury is bound to make good the loss occasioned thereby, even if he does not trespass; the causer, on the other hand, is

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of his act vis-a-vis the damage.
[103] Mosmar (n21) 195.
[104] Talbi (n85) 26.
[105] Alkasani (n29) Vol. VII, 165.; Article 887 of the Majalla defines direct destruction as follows "Direct destruction consists of the destruction of a thing by a person himself. The person destroying the thing is called the actual doer of the act."
[106] Shihab Al-din Al-Qarafi, *Kitab AI-Furuq Fi Usul Al-Fiqh,* Vol IV (Cairo 1927) 27.
[107] Alkasani (n29) Vol VII, 165.
[108] Tyser (n21).
[109] Ali Al-Khafif, *Al-Daman Fi Al-fiqh Al-Islami,* Vol I (Cairo 1970) 83.

held liable for the damage, only if he trespasses.[110] However, this rule is elaborated in al-Ashbah wa al-Nazair as follows: "The actual doer of an injury is liable for damage even if he does not intend it; the causer on the other hand, is held liable, only if his act is associated with intention." The Majalla copied the rule, as stated by Ibn Nujaym.[111]

In contrast, al-Qari's Majallat in Article 1431 lays down as a general rule that trespass as the condition that must be met to bind the causer to pay reparation i.e. compensation is conditional on the presence of taadi. This misunderstanding led some contemporary jurists to find the formulation of the rule unsound, which is expounded in al-Ashbah and in the Majalla that a person is liable to make good the loss resulting from his indirect behaviour only when he acts intentionally.[112] They found support from Al-Sarakhsi's statement, that "The person who is the indirect cause of damage is not liable unless he trespasses."[113] Another argument put forward by the Muslim scholars who support this view is that the concept of intent (taamud) is foreign to Islamic Jurisprudence, which determines tortious liability on the basic principle of faultless liability. They conclude that, in cases of indirect damage, the requirement of trespass, and not that of intent, must be fulfilled to make the offender liable.[114]

When the action is not lawful then the tortfeasor is presumptively at fault. This concept is illustrated by one of the major principles of Shariah regarding torts, which states that, "permissible acts are restricted by safety" meaning that an individual can do whatever he or she wants, as long as the act causes no harm to another.[115] Concerning the issue of an act committed by multiple people, Shariah makes a distinction between joint and several liability. In cases of joint liability, for instance, a group of people committing the same act, Shariah considers the direct and indirect cause of harm. In this case, the individual most directly responsible for causing harm would be held liable. Furthermore, in cases involving several

[110] Abu Mohammad Baghdadi, *Majma Al-Damanat fi Madhhab Al-Imam Al-Azam Abi Hanifah Al-Numan* (Dar al-Salam 1890) 146.
[111] Ibn Nujaym (n37) 340.
[112] Mosmar (n21) 198.
[113] Abu Bakr Al-Sarakhsi, *Kitab Al-Mabsut* Vol XXVII (Beirut, Dar Almarifah Publisher 1993) 22.
[114] Mosmar (n21) 198.
[115] Talbi (n85) 26.

liability, Shariah takes into account whether or not the individual actions were direct or indirectly responsible for harm.[116] Shariah assigns priority to the direct act.[117]

The next section will explain how the Saudi regulator has endorsed the joint and several liability concept in several laws relating to this study.

In the context of this thesis, it is necessary to establish the causal connection between the act of the auditor and the harm suffered by the shareholder for the existence of the right to claim damages. Moreover, an assessment of the auditor action to determine if it is the direct or indirect cause of action ought to be done. The quantum of damages might then be measured based on parties' involvement in the defective annual financial statement other than auditor such as directors and officers of a listed company.[118]

2.6 The Concept of Strict Liability in the Islamic Law of Tort

The Shariah has confirmed that the rule of Strict Liability (al-Masuliyyah al-Shakhsiyyah) exists in the Islamic law of tort.[119] Therefore, it mentioned the notion of individual liability where every person is liable for his own action or omission and not that of another person. It can be elucidated by referring to the verses of the Qur'an, the Traditions of Muhammad and Muslim jurists' opinions.[120]

The Qur'an propounds the strict liability of tortfeasor in committing wrong by emphasizing: where it states that "no bearer of burden can bear the burden of another."[121] From the above verse Mawdudi says that every person is accountable for his actions and no one is accountable

[116] According to Ibn Qudamah, *Al-Mughni fi Fiqh Al-Imam Ahmad ibn Hanbal*, Vol. 8 (Dar al-Fiker, Beirut 1984) 287 in arriving at a proper conclusion on the direct cause of a particular loss or injury, the court will consider every aspect of the means by which the loss or injury has been inflicted. Once it is established that the injury was a direct result (darar mubashir) of a particular act of the defendant, then for the purpose of compensation, no question as to the defendant's state of mind while causing the darar is to be raised as the answer sought here is not whether the defendant had intended the act or its result but rather whether the damage or loss or injury is directly caused by him.
[117] Talbi (n85) 165; see also, Ibn Qudamah (n116) part 7 at 430.
[118] For example, constant mistakes might happen from D&Os in preparing quarterly financial statements and these mistakes might not be detected in the collected sample investigated for a specific item in the annual financial statement verified by the auditor. This is discussed more in Chapter Seven, particularly about errors covered under professional liability products to support some findings in Chapters Two to Four related to errors and omissions in the IFRS and GAAP auditing standards.
[119] Wahbah Al-Zuhayli, *Al-Fiqh Al-Islami wa Adillatuh* (Dar al-Fikr, Damascus 1989) 251; see also, Faydallah (n42) 158; see also, Mohamad (n18) 50. The term does not appear in the classical books of fiqh, but the emergence of the rule in those books may be construed from the explanations and examples in them. There is another term usually used in the modern books of fiqh or Islamic law such as daman al-fil al-shakhsi which renders the same meaning.
[120] Mohamad (n18) 50.
[121] Holly Quran (35:18).

for the deeds of others and therefore no man can deny the liability after the intention is established.[122] A saying attributed to the Prophet Muhammad mentions that "You should not do harm to others nor others on to you"[123]

All Muslim jurists approve that a person is not liable for what is lost or destroyed except if there has been negligence (tafrit) or transgression on his part.[124] There is an exception to the general rule, however. There are cases where a defendant is held strictly liable for accidental harm, independently of the existence of either wrongful intention or negligence.[125]

This statement can also be associated to the Islamic maxim: "Injury is to be removed."[126] This maxim means that a direct consequence of the prohibition on causing damage is the obligation to make redress, and this is the cornerstone of Islamic civil liability.[127] Moreover, there are many maxims which can be connected to the rule. The maxims are:

1- Injury should be avoided as much as possible.[128]
2- Private injury should be borne to avoid public injury.[129]

In addition, the Majallah gives two more maxims which could be related to the rule of Strict Liability.[130] One of them is: "The responsibility for an act falls upon the person who does it, it does not fall upon the person who gives the order, as long as he does not compel the commission of the act."[131] And, another maxim states that: "A person who does an act, even though not intentionally, is liable."[132]

Ibn Qudamah records:

[122] Sayyid Mawdudi, *The Islamic Law and Constitution* (Islamic Publications Ltd, Lahore 1980) 299.
[123] Ibn Majah (n36) Vol. 2, 890. It means that in tort action what is committed by a person, he who acts is liable for what he has done, not another.
[124] Al-Zarqa (n40) 78-79; see also, Baghdadi (n110110) 146; see also, Mohamad (n18) 52.
[125] Tyser (n21); see examples in Majallah article 912, 913 and 914.
[126] Al-Zarqa (n40) 179-183; see also, Ali Al-Nadwi, *Al-Qawaid Al-Fiqhiyyah* (Dar al-Qalam, Damascus 1994) 287-293; Tyser (n22) article 20.
[127] Talbi (n85).
[128] Tyser (n21) article 31; see also, Al-Zarqa (n40) Vol. 2, 981-982, no.587.
[129] Tyser (n21) article 26; see also, Al-Zarqa (n40) 197-198.
[130] Mohamad (n18) 55.
[131] Tyser (n21) article 89.
[132] Ibid article 92.

"The Ajir Mushtarak (independent contractor) is liable for damage caused by his act, the porter is liable for the load that falls from his head. The camel driver is liable for loss caused by the way he leads or drives the camel or by the breaking of the ropes which secure the load."[133]

With regard to the discussion of Strict Liability, the rule of mubasharah (direct cause) and the rule of tasabbub (indirect cause) cannot be disregarded. Even, the element of al-taaddi (trespass or transgression) is an important matter." [134]

Mubasharah means to create the cause of destruction by oneself; such as murdering some person. Tasabbub means to create conditions leading to the destruction of something. That is to say, to do an act which in the normal course of events causes the destruction of another thing. An example of mubasharah is if a person digs a well at a certain place where it is not lawful to do so and an animal belonging to some other person happens to fall into the well and die.[135] The word al-taaddi connotes "action against another person's right or against his ownership which is inviolable."[136]

For the tort action by a mubashir (tortfeasor by direct cause), the element of al-taaddi is not considered. The mubashir will be held liable in all tort actions whether the element of Al-taddi existed or not. This is understood from the statement of Baghdadi: "A mubashir is liable even though he does not trespass."[137]

Likewise, the Majallah states that a "mubashir [is a person] who does an act, even though not intentionally, is liable."[138] The words "even though not intentionally" can be replaced by the words "even though he does not trespass".[139] Briefly speaking, the element of al-taaddi is not an important condition in the actions of the mubashir. So, the rule of Strict Liability would be applied to him when the mubasharah tort action is brought.[140] In cases of tort action by mutasabbib (tortfeasor by indirect cause), the element of al-taaddi is considered as a condition

[133] Muwaffaq Ibn Qudamah, *Al-Mughni wa al-Sharh al-Kabir* (10 vols., Beirut: Dar al- Kutub al-AIlmiyyah, n.d., vol.5) p.479.
[134] Mohamad (n18) 57.
[135] Ibid.
[136] Al-Zarqa (n40) 78.
[137] Baghdadi (n110) 146, 165.
[138] Tyser (n21) article 92.
[139] Al-Zuhayli (n70) 196.
[140] Mohamad (n18) 59.

for liability.[141] The Majallah records that a "mutasabbib is not liable to any loss caused unless intentionally."[142]

The words "unless intentionally" could be replaced by the words "unless with trespass". Al-taaddi is a condition for liability in tortfeasor by indirect cause whether the element of intention (qasd) existed or not.[143]

But, there are opinions which consider that the conditions of liability for the mutasabbib are:

i- Al-Mutaammid (al-taammud).
ii- Al-Mutaadi (Altaadi).

Most of the Muslim jurists prefer to use al-mutaaddi (al-taaddi) as the condition, because the element of al-mutaammid (al-taammud) is included in al-mutaaddi (al-taaddi). Indeed, if the element of al-taaddi does not exist as an element of tort action by the mutasabbib, the liability (Daman) is not adjudged upon him.[144] Hence, the word al-taammud in the maxim above is construed as al-taaddi. It is in conformity with a few statements by the Muslim jurists. Al-Sarakhsi stated that "the liability is not upon a mutasabbib when the element of mutaaddin (al-taaddi) did not exist in his tort action".[145] Baghdadi held the view that the "Mutasabbib is not liable unless he is al-mutdaaddi", whereas Ibn Abidin indicated the opposite when the person is mutaaddin.[146]

What is crucial in the context of this thesis is that the tortfeasor by direct cause will be held liable in all tort actions whether the element of transgression existed or not. As stated in the examples of Ibn Qudamah of Ajir Mushtarak above, one may contend that the auditor is responsible about verifying the annual financial statement and then be deemed liable for a misstatement in it and caused by a neglected act, if the person is the direct tortfeasor by not applying the prevailing accounting standards properly (IFRS in Saudi). The Saudi judge will also evaluate who is considered the direct or indirect tortfeasors or if both the auditor and the board of directors contributed to the negligence act and should be dealt with on a case by case

[141] Ibid.
[142] Tyser (n22) article 93.
[143] Tyser (n22) article 924; see also, Al-Zuhayli (n70) 198.
[144] Al-Zuhayli (n70) Vol. 5, 749.
[145] Al-Sharakhsi (n74) Vol. 27, 22.
[146] Baghdadi (n110) 146 and 165; see also, Ibn Abidin (n88) Vol. 6, 596.

basis before respected courts.[147] It is still unclear yet in the West for example how an auditor and others could be liable in the secondary market civil cases as will be discussed in subsequent chapters.

2.7 The Concept of Vicarious Liability in the Islamic Law of Tort

In the Islamic law of tort, the term "Vicarious Liability" specifically did not emerge in these particular terms in the classical books of fiqh or Islamic jurisprudence. Also, the early scholars did not mention clearly an equivalent term.[148] However, some mentioned the features and criteria regarding vicarious liability through practical examples which could be understood explicitly or implicitly.[149] The term for "vicarious liability" is quite clear when it is used by contemporary Muslim scholars, whether in the discussions related to tort or criminal law.

Islamic vicarious liability may be described as the liability enforced on one person for the tortious act or omission of another which produces loss to a third person.[150]

In the Islamic law of tort, vicarious liability arises in the following acts:

1- Liability of guardian (wali) for the act of his ward.[151]
2- Liability of employer (principal) for the act of his employee (ajir).

According to Islamic civil law, the fuqahaa have divided ajir (servant or employee) into two categories:

i- Ajir Khass (Private Agent or Exclusive Employee).[152]
ii- Ajir Mushtarak (Independent Contractor or General Agent).[153]

[147] Previous discussion about the negligence of an auditor and when he is considered as a direct tortfeasor at section 2.5 related to: An Act as an Element of Torts, Causation as an Element of Torts supports the primary and secondary sources findings in this section.
[148] Mohamad (n18) 63.
[149] Ibid 64.
[150] Mosmar (n21) 244; see also, Mohamad (n18) 65; see also, Aldweish (n21) 101.
[151] Ibid 65-74.
[152] Al-Khatib (n70) Vo1.2, 352; see also, Al- Zuhayli (n119) Vol. 4, 766.
[153] Al- Zuhayli (n119) Vol. 4, 766.

Ajir Khass means a person working for another for a definite time and for specific work, or a person taken on to work for the hirer alone, not for another.[154] This means that the wages are due if the person is ready to work during the period for which the services were hired for.[155] In contrast, Ajir Mushtarak means a person who is hired, and is not restricted by the condition that he [sic] is not to work for anyone other than the hirer, and that the wages are paid when the work is done.[156]

Ajir Khaas is entitled to wages by attending for work during the period for which the person's services were hired even though that person might not have performed them.[157] However, the person cannot decline to do the work. If this is the case, then the person is not entitled to his wages.[158] The fact that the person committed and available for the job which was for the benefit of the employer means that the person is not to be held liable for any damage which occurred without the person's own fault in the course of duty because the person is Amin (trustee), and working with the permission of the owner of the property.[159]

Therefore, the employer will be liable when:

1- There is a warrant in the contract providing that the employee is to give his service for the benefit of the employer. However, if the commanded act concerns another person's property, the command will be null and void if the property owner had not given his consent, because the Shariah does not allow a person to exercise any action on another's property without his consent.[160]

2- An injury to a third party has occurred whilst the employee was acting in the course of his employment within its range of activities.[161]

[154] Mohamad (n18) 75; Tyser (n22) article 422.
[155] Tyser (n22) article 425.
[156] Fakhr Al-Din Al-Zaylai, *Tabyin Al-Haqaiq Sharh Kanz Al-Daqaiq*, Vol. 5 (Dar al-Kitab al-Islami, Cairo n.d) l33; see also, Al-Khatib (n70) Vol. 2, 352; see also, Mohammad Al-Haskafi, *Al-Durr Al-Mukhtar: Sharh Tanwir Al-Absar fi Fiqh Madhhab Al-Imam Abi Hanifah Al-Numan,* Vol. 2 (Dar al-Fikr, Beirut 1992); see also, Al- Zuhayli (n119) 768; see also, Tyser (n21) article 424.
[157] Mohamad (n18) 76.
[158] Tyser (n22) article 425.
[159] Faydallah (n42) 174; see also, Mohamad (n18) 76.
[160] Mohamad (n18) 76-77.
[161] Ibid.

If the above conditions are not achieved, the employer is not vicariously liable for any act or omission.[162] The reason for the liability of the employer for an injury which is caused by the employee is that the employee is an authorised representative where "liability is an obligation accompanying gain".[163] However; this does not mean that an employee is always exonerated from liability: if transgression or negligence on the part of the employee could be proved by the employer as causing the particularly injury or harm to the third party or the property, then the employee should not be free from liability.[164]

Wahbah Al-Zuhayli briefly mentions the views of the Hanafi jurists on the subject of vicarious liability by stating that: "When the matbu (employer) asks his tabi (employee) for any work, and between them there existed a contract of employment (aqd ijarah), and injury (darar) happens on account of the employee in the course of his work; and the equipment, the place and the method of the work is in accordance with normal practice, or the employer ordered it explicitly or implicitly: if these two stipulations are not confirmed, the employer is not liable."[165]

In sum, one may argue that an understanding of vicarious liability finds resonance within Islamic law. For the purpose of this study, it is contended that senior officers and board members with executive roles are considered Ajir Kaass, while board members with non-executive roles and experts such as auditors are Ajir Mushtarak. What would be important to highlight here is that if there is a transgression or negligence from senior officers and board members with executive roles, then they could be liable for their wrong actions and that is in conformity with existing Islamic principles and Saudi legislations. However, the application of professional liability insurance products from an Islamic perspective is still not clear except for medical professional insurance where specific punishments and compensation exists.[166] Hence,

[162] Faydallah (n42) 390.
[163] Tyser (n22) article 87.
[164] For general discussion see Shabib (n21); see also, Aldweish (n21).
[165] Al- Zuhayli (n119) 257.
[166] Additional justification about the role of professional insurance products from an Islamic perspective at Chapter Seven explains the vital role of the Insurance industry is expected to play in terms of indemnification if applicable Shariah principles and legal rules are clearer. In general, there are insurance products rely on occurrence base while others rely on claim base, and this difference needs to be rectified in relation to auditor liability insurance current practise to suit the Takaful nature. Moreover, some insurance products rely on first party claim while others rely on third party claims. Moreover, there is a clarity about the quantum of damage occurred to a patient from malpractice of medical professional in Shariah. Furthermore, other professions such as investment advisor and brokers in Saudi have additional statutory rules and they are liable to their clients who are limited and could be identified through the law of contract in principle and the law of tort is a secondary source for compensation, hence, it could be argued that no need to look at the Islamic tort of law in detail unlike the cases of auditor and D&Os. In contrast, the quantum of damages and assessment of compensation related to D&Os as well as Auditors need to be examined in detail to identify their liabilities first and then to see how the Takaful industry can interact. Finally, addressing

the researcher intends to simplify liability roles of concerned professionals[167] so that professional insurance products may play a better role in terms of compensation.

2.8 Negligence in the Islamic Law of Tort

Tort regarding careless conduct or neglect of some care which people are bound to exercise towards others is known as "tort of negligence". In Arabic, the term for negligence may be rendered as "al-tafrit", "al-taqsir", "adam al-Tabassur", or "qillat al-Taharruz".[168] They both literally mean "negligence" or "recklessness" or "carelessness" where a person failed to do what he ought to do. The word "al-tafrit" is mentioned in the Qur'an: "Lest the soul should (then) say: Ah! woe is me!, in that I neglected ((farrattu) (my duty) towards God, and was but among those who mocked."[169]

It has also been highlighted in a Hadith: "There is no negligence (tafrit) (of one's duty) in sleeping, the negligence of one's duty is not awaking until the time of the other (prayer) commences."[170]

In legal terminology, the term al-tafrit may be signified as the omission to do something which a prudent and reasonable man would do, or the doing of something which a prudent and reasonable man would not do. There is, however, no specific definition for this term. Occasionally, the term of "al-khata" (mistake or misadventure) has been used by the classical and contemporary Islamic scholars who render its significance as the same as al-tafrit. Further, there is no systematic theory of negligence in Islamic law of tort.[171] Most of the discussion found in the manual texts are instances written by the scholars on certain topics, mainly in the

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the professional liability of medical practitioner in this text is only to show that Shariah has elaborated in this area so later scholar could further build their arguments based on a solid ground of Shariah principles.

[167] Abd.Rahman (n71) 206, believes that the same rules applicable to the case of medical profession can be extended to many other cases involving other professionals possessing special skill and knowledge who render services to the general public like lawyers, architects, engineers, teachers, professors and many others. The jurists have even discussed the position of a mufti or a qadi who issued wrong fatwa or decision and whether that was the result of a mistake, negligence or of purely a matter of Ijtihad.

[168] Lane (n69) Vol. 2, 2376 and 2533; see also, Abd.Rahman (n71) 176, It is worth noting that tafrit is the opposite of ifrat meaning exaggeration and excessiveness i.e. to exceed what ought not to be exceeded or crossed. The middle concept between the two is al-mutawasit or al-wasat or wasuta meaning the middle path, prudent, balanced, moderate and medium that is not to be too reserved or too reckless. The word al-taqsir means to fall short of what is expected from the word al-qasr and al-qasir meaning shortening and short respectively, and the verb qassara, to cut short or to shorten. While the term adam al-Tabassur connotes the failure to exercise or employ a clear-sightedness about a certain thing. While qillat al-taharruz means lack of care or caution from the root verb haraza: a meaning to keep, guard, protect, preserve or take care.

[169] Holly Quran (39:56).

[170] Lane (n69) Vol. 2, 2376.

[171] Mohamad (n18) 349.

chapter of al-jinayah or al-diyat or al-siyal.[172] When these texts are looked at, it will be seen that the word tafrit is not based on any theory as in the discussions in Western law.[173] It is particularly tough to formulate any general rule from the few instances given by the Islamic manual texts.[174] The word "al-ihmal" is also occasionally used by the scholars such as Ibn Farhun and Muhammad al-Sharbini al-Khatib in their texts to convey the same meaning as al-tafrit and al-taqsir.[175] Negligence in the Islamic Law of Tort has been studied in a few sub-topics related to duty of care, duty of persons in transportation, cases of collision, duty of carriers of passengers or goods, duty of bailees of goods and duty of care of persons in charge of children.[176]

Finally, the researcher would like to emphasise that there are detailed principles discussed in by scholars.[177] Moreover, what has been extracted is not also comprehensive but only to show that some principles can be used for other modern professions.[178]

At the present, it could be decided that Shariah principles extracted from different sources and then supported by Shariah legal maxims developed by Islamic scholars can be applied to the auditing industry in case an auditor found negligent in a defective annual financial statement. Moreover, the relationship between the auditor's negligence and the injury caused to a shareholder is justified due to the economic loss encountered to his or her shares as they are considered a damage in his or her own properties. The causation link is also clear in the Islamic law of tort as shareholders are the only one among other third parties who have direct links with the company's economic ownership. In next section, Saudi statutory rules, with respect to civil liability of auditors towards shareholders, are discussed.

[172] Ibid 350.
[173] According to Mohamad (n18) 350, there is, however, a contemporary Islamic treatise such as: al-Fiqh al-Manhaji ala Madhhab al-Imam al-Shaffie by Mustafa al-Khin, Ali al-Sharbaji and Mustafa al-Bugha which provides a small chapter to discuss the cases of negligence. That chapter is named as "al-Masuliyyah al-taqsiriyyah" other than that, Subhi Mahmasani and Muhammad Ahmad Siraj have also bluntly analysed cases which can be related to negligence in their books - Al-Nazariyyah Al-Ammah li Al-Mujabat wa Al-Uqud and Daman Al-Udwan fi Al-Fiqh Al-Islami.
[174] Mohamad (n18) 350.
[175] Ibid 351.
[176] Ibid 351-396.
[177] However, they are out of the scope of this thesis due to their relations to topics mentioned above and their irrelevancy to the liability of professionals.
[178] Auditing is considered as a new type of profession so there are no primary sources related to their civil liability in comparison with medical practise. In addition, Islamic scholars during the history of Islam did not address the auditor liability, and it could be argued that Shariah and legal scholars should implement basic principles to suit modern profession.

2.9 Auditor Civil Liability Towards Shareholders in Saudi Legislation

2.9.1 Saudi Companies Law 2015

On November 9, 2015, Saudi Arabia issued the new Companies Law, called Saudi Companies Law 2015, which superseded the old Companies Law of 1965. It came into force on 2 May 2016. Despite the fact the Companies Law "CL" 2015 has a new character; many articles and provisions remain unchanged.

In the context of this study, Article 136 of the Saudi Companies Law 2015 states that: "1- The auditor may not disclose to shareholders in other than the general assembly or to others the confidential information that he becomes privy to in the course of performing his duty. Otherwise, he shall be discharged and be liable for compensation. 2- The auditor shall be liable for damages sustained by the company, the shareholders or third parties due to faults attributed to the auditor's performance of his duties. If such faults are the responsibility of multiple auditors, said auditors shall be jointly liable." [179]

The said article confirms the Saudi regulator's intention towards the civil liability of auditors and their accountability to others for injury caused through their auditing work. It also confirms the joint and several liabilities of auditors as in the case with Insurance and Banking industries (as required by SAMA to have two auditing firms to conduct the audit) in Saudi Arabia. The researcher would like to highlight that the said Article covers criminal, civil and administrative liabilities of auditors. This Article is supported by other provisions stating the criminal liability of an auditor towards the company, shareholders and others.[180] For example, Article 211 (a, d)

[179] This article is general in relation to auditor liability for his errors in auditing and non-auditing services, and there is no implementing regulation in the old Saudi Company Law 1965 nor the new Saudi Companies Law 2015 yet. This text creates great confusion to legal scholars and practitioners and this research identifies their concerns and tries to provide plausible answers. For example, the Article states that the auditor is liable to the company, however, in the case of civil liability with respect to annual financial statement, it is impossible to measure damages of the company. What is also important to argue in this thesis is to show that common-law literature and precedents erred in treating both creditors and shareholders as third parties with no specific indemnification measures, while the Saudi CL 2015 did not address specific situations on how an auditor becomes civilly liable to the company and others. Alamri et al. (n12) 205 has compared in brief the liability of auditor in the English and Saudi Companies Law 2015, when he indicated that under *Caparo Industries plc. v. Dickman*, there is no liability for the company auditor that would emerge in relation to any negligent misstatement as long as there is no special relationship or assumption of responsibility. Therefore, there is no duty of care from the auditor that would be due to potential investors with regards to their investment decisions since the necessary degree of proximity between the parties is absent. In contrast, the Saudi Companies Law 2015 states that the external auditor "shall be liable to compensate the Company, the shareholders or third parties for the damages resulting from errors it commits in the course of its engagement." The same rule in regards to the liability of an auditor has also been stipulated in article 82/3 of the Corporate Governance Regulations 2017.

[180] The discussion of auditor criminal liability is out of the scope of this thesis, which may lead to discuss certain aspects of public and private deterrence. The focus of this thesis is to assume auditor liability to compensate shareholders regardless of

and Article 212 (a) state the sanctions that should be imposed on auditors and they range from financial penalties to imprisonment sentences or both. With respect to administrative liability, Article 213 (h) imposes administrative penalties on those who accept auditing tasks or continue in their work despite their knowing of reasons preventing them to do such tasks, in accordance, with the companies' regulations.[181]

The civil liability most relevant to this thesis is related to the financial statement of a listed corporation. Article 135 of the CL 2015 stipulates in relation to an annual financial statement that an auditor has to submit to the annual general assembly meeting a report in accordance with the prevailing auditing standards. Such report has to state the following: the position of the corporate in giving him or her requested data and notes; if there are breaches of the companies' law or the corporate bylaws and his or her judgement on the fairness of the financial statement.

Both, this Article and Article 136 specifically contemplate the shareholders among others so that in case there is a default in the financial statement caused by the auditor then the shareholders, independently of the company or through the company's legal action, would appear to be able to seek compensation as explained in section 2.10 as there is no other plausible way to quantum the damage.

2.9.2 Certified Public Accountants Regulations 1992

The Saudi Certified Public Accountants' Regulation has been issued under the Royal Decree No. M/12 dated 13.05.1412H (1992 G). Article 15 of the Certified Public Accountants Regulations stipulates that a "Certified Public Accountant shall be liable for damages sustained by clients or other parties as a result of professional errors in the performance of his work. Partners in an accounting firm shall be held jointly and severally liable."

This Article is not supported by additional criteria or texts in the executive regulation of the Certified Public Accountants Regulation 1992, and the Saudi regulator has left it to the main Article 15 for explanation, while few other articles were clearly explained in in the executive

the type of the case category as a criminal or civil so that it enables the researcher to provide clarity on measuring the damages occurs to them.

[181] For a detailed discussion in regards to auditor role as stipulated in the Saudi Companies Law 2015, see Alamri et al (n12) 202-204.

regulation. It has to be noted that this regulation has been enacted after the Companies Act 1965 so it confirms the Saudi regulator intention with respect to auditor's liability towards shareholders.[182]

2.9.3 Corporate Governance Rules 2017

The Corporate Governance Rules "The CGR" was issued by the board of the Capital Market Authority (CMA) pursuant to resolution number (8-16-2017) dated 16/5/1438H corresponding to 13/2/2017G and based on the Companies Law issued by Royal Decree No. M/3 dated 28/1/1437H, which superseded the previous regulation issued in 2006.

In Article 82 of the CGR 2017, it highlighted the main duties of the External Auditor. One of these provisions stated that should be a: "…3) request [to] the Board to call for a General Assembly meeting if the Board has not facilitated their mission; that they shall be liable to compensate the Company, the shareholders or third parties for the damages resulted from errors it commits in the course of its engagement. If an error is attributable to more than one external auditor, they shall be jointly responsible therefore."

It is worth noting that the CGR 2017 has been prepared by the CMA and Ministry of Trade and Investment officials to reflect changes made in the Saudi Companies Law 2015, and these rules will be applicable completely or partially (depending on their listing market "Main or Parallel-Nomu" to listed companies in the Saudi Stock Exchange. This Article affirms the liability of an auditor towards shareholders by compensating them which is also in conformity with the Saudi CL 2015.

Lastly, the CGR 2017 has stated the general rights of shareholders, however, the regulator does not intend to limit their rights as stated in Article 5. In addition, the regulator gives shareholders at the Ordinary General Assembly "OGA" to look into the violations and errors made by the external auditors of the company as outlined in Article 12. Both articles support the right of shareholders to be indemnified through personal, class or company actions.[183]

[182] Additional discussion in Chapter Seven with respect to the proposal of Accounting and Auditing Law is provided to confirm the Saudi regulator intent to make it in conformity with the Saudi Companies Act 2015.

[183] The CGR (2017) in part 2 titled "Rights of Shareholders" stated in Chapter one general rights of shareholders. In article 5, the law stated: "All rights related to shares shall be guaranteed to the shareholder, and particularly the following: …7) to hold Board members accountable, to file liability lawsuits against them and appeal for nullification of the resolutions of the General and Special Shareholders Assemblies in accordance with the conditions and restrictions provided in the Companies Law and the bylaws of the Company…"

2.9.4 The Capital Market Law (2003)

In the CML 2003, auditors' civil liability in the secondary market has not been identified. However, this liability is discussed clearly in the primary market when a default occurs in such a prospectus. This might show that the CML 2003 might be changed at a later stage to reflect new articles with respect to auditor civil liability as seen in the CGR 2017, however, the CML cannot be taken into consideration without referring to the Saudi CL 2015. Furthermore, the CGR 2017 has been prepared in conjunction with the capital market authority officials and Ministry of Commerce and Investment officials to reflect the nature of liability imposed to auditors of listed companies as discussed above.

The CML 2003 mentioned in Article 55 that: (a) If a prospectus, when approved by the Authority, contains incorrect statements of material matters or omits material facts required to be stated in the prospectus, the person purchasing the security subject of such prospectus shall be entitled to compensation for the damage incurred by him as a result thereof… (b) The following persons shall be liable under paragraph (a) of this Article: 2. Senior officers … 3. Members of the Board of Directors …5. The accountant…"

This Article is similar to other provisions identified in all compared jurisdictions with respect to auditor's civil liability in a prospectus (or a registration statement in some jurisdictions).[184] The importance of discussing this Article here is just to show that auditor civil liability in this

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The CGR (2017) in Chapter 2 titled "Rights Related to the Meeting of the General Assembly" in Article 12 with respect to Competencies of the Ordinary General Assembly has stated the following "...10) looking into the violations and errors committed by the external auditors of the Company when performing their duties and any difficulties, reported by the Company's external auditors, regarding their empowerment by the Company's Board or Management to review the books, records and other documents, statements and clarifications required to perform their duties, and respond to that as it deems appropriate in this regard;…"

From the above texts, it could be understood that part 2 contains general rights of shareholders so that it has to be understood from a broader perspective and such understanding would reflect the regulator intent. For example, art 5 addresses the rights related to shares are not limited to specific rights as the legal text states "and particularly the following…"

To support our view, Article 12 gives the ordinary general assembly to look into civil and criminal acts done by the auditor. The researcher could build from the above texts that the right of shareholders to get indemnified is solid regardless of such a legal action has been taken by the company itself or if not, a shareholder or a group of shareholders will then be able to get indemnified by suing the auditor through personal or class actions. This analysis will eliminate the confusion with respect to the nature of the corporate legal entity and its right to litigate, so if damages are done to the corporate then they should be measured as stated at section 2.10.

[184] See for example: Section 11 of the U.S Securities Act of 1933, Securities Act 1990 (Ontario) s.130 (1)(d) - Canada, s.84 of the Financial Services and Markets Act 2000-UK, s.90 (1) of the Financial Services and Markets Act 2000-UK.

law is also built on general Islamic principles as their liabilities may occur in the primary market as well as in the secondary market.[185] It is also significant to develop mathematical equilibriums to be used in defective annual financial statements not included in prospectuses which are released to all shareholders and not to specific categories of shareholders.

2.10 Can Shareholders be Indemnified from a Legal Perspective?

As we have seen in the discussed acts and regulation, the auditor liability towards shareholders are supported in principle by relevant legal texts in Saudi Arabia. Even though there are various Articles that address the duties and obligations of a certified external auditor who audits a Saudi listed company, they are generally similar to provisions in comparable jurisdictions. There is still a lack of clarity despite of existing regulations, which may not be clear enough to professional lawyers and judges with respect to auditor liability towards shareholders in case of an error or an omission found in the annual financial statement from the one hand. On the other hand, no cases heard yet before competent court/quasi-judicial committees to test concerned regulation and Shariah principles. The researcher would like to note that quarterly financial statements are prepared by a company's officials and an auditor does not give an opinion on them so that any liability for errors in such statements would be on the directors and officers, where there is a restatement in annual financial statement. The annual financial statement is verified by the external auditor with an opinion after implementing the prevailing auditing standards in Saudi Arabia, which are based on the IFRS on all listed companies in the secondary market starting from January 2017, and standards will be applicable on stages, which will also impact the outcomes of prospective cases as the areas of interpretation or discussion can be clarified by the standards-setting board, and provide fewer exceptions than a rules-based system. Hence, judges may need experts' views to deliver better judgments with plausible justifications.

From the researcher perspective, even though there are not any legal texts which supply principles that can be used to calculate the damages incurred by shareholders in case of a default in the annual financial statement, a Saudi judge could make such calculations to compensate shareholders by applying Islamic principles as follows:

[185] In the context of this thesis, purchasers of shares from existing shareholders are considered as dealings/trading in the secondary market rather than the original allottees of the shares purchasing directly from the company as the case in the prospectus dealing case regardless of being before a company's decision to float or at later stages such as decreasing or increasing the capital.

1- Economic Loss = Actual Share Price on the Date of Release of the FS – The Sale Price Before the Release of the Restated FS; or

2- Economic Loss = Actual Share Price on the Date of Release of the FS – The Current Price of the Share after the Release of the Restated FS.

The calculation formulas that have been used in this thesis are very broad and do not react to other events intervened to affect the share price. The CRSD or other competent courts may develop other formulas driven from the suggested ones or may interpret them with other formulas as it is unclear yet what methods can be used to calculate the damage of affected shareholders in case of an error occurring in the annual financial statement.

Naifar and Al-Suhabaibani have suggested new econometric methods that are widely used in the west that may fit the Saudi legal environment to estimate the damage in securities fraud cases. Their econometric methods were compared with current methods used by the CRSD in fraud cases. Further, their paper opens the door for future research on the economic analysis of Saudi laws and the role of econometrics in court rulings.[186]

This article has also identified the absence of information in relation to the facts and methods of estimating the confiscated ill-gain in fraud cases concerning directors, officers and auditors, as some of the cases were decided lately such as Al-mojil and Mobily.[187]

[186] Nader Naifar and Mohammed Al-Suhaibani, 'Estimating Damages in Securities Fraud Cases in Saudi Capital Market: The Fiqh, Legal Basis and Econometric Methods' (2017) 30 Journal of King Abdulaziz University: Islamic Economics 47-82.
[187] Ibid 48.

They also have commented on Article Fifty-Five[188] of the CML 2003, and concluded that issues may come when applying the law on actual cases.[189] It is worthy to note that paragraph (a) is in relation to violation that occur in a prospectus.

In their article, they provide a general overview about the major U.S cases to show the development of dealing with compensation cases before courts, mainly *Basic Inc. v. Levinson*,[190] *Dura Pharmaceuticals, Inc. v. Broudo*,[191] and *Halliburton Co. v. Erica P. John Fund, Inc*.[192] They noted that most of cases are settled before upholding judgements based on common econometric methods of calculating damages.[193]

From an economical perspective, they have stated the econometric methods that are used to calculate damages in connection with fraud. In general, in order to calculate the total damage,

[188] It reads in part of it "...e. Damages may be obtained through a claim brought on the basis of paragraph (a) of this Article, which damages shall represent the difference between the price actually paid for purchasing the Security (not to exceed the price at which it was offered to the public) and the value thereof as of the date of bringing the legal action or the price which such Security could have been disposed of on the Exchange prior to filing the complaint with the Committee, provided that if the defendant proves that any portion in the decline in value of the Security is due to causes which are not related to the omission or the incorrect statement which is the substance of the suit, such portion shall be excluded from the damages for which the defendant is responsible. The defendants are individually, jointly and severally liable for damages for which they are responsible under this Article. The amount of indemnification shall be subject to the provisions of the contract or agreement entered into between the parties identified in paragraph (b) of this Article or as the Committee believes is equitable and does not harm the interest of investors or otherwise contravene the spirit of this Law."
The CML 2003 has been officially amended and published on the official magazine on the 4th of October 2019. More importantly, an addition to this article is subparagraph (e), which has considered what it is stated in paragraph d of Article 59 of the said law. Paragraph d of Article 59 has also considered sub-paragraph (4) of paragraph a of this Article (59). Furthermore, it gives the Capital Market Authority the right to organise procedures in relation to indemnifying damaged persons caused by accused violations. For instance, the CMA could create special compensation funds sourced from ill-gains received to the CMA account. The compensation of damaged persons will be pursuant to distribution plans that will be ratified by the committee (CRSD). Those funds are subjected to rules and procedures put by the CMA that reinforce the work of such funds and may limit connected legal and financial risks. Lastly, sub-paragraph 4 of paragraph a of Article 59 gives the CMA the authority to legally sue a violator before the CRSD and ask to enforce appropriate punishments/penalties that include others to pay an amount that does not exceed three times the achieved gains or three times the avoided loss resulting from violating the CMA account, or compensating damaged persons as a result of the accused violation. These new referred articles, added to the CML, are significant to crimes occurring in the stock market. More importantly, paragraph a of Article 55 is focused on fraud that occurs in a prospectus. Moreover, such compensation funds are sourced from ill-gains, so the collected money comes from criminal cases. In contrast, the scope of this thesis focuses on civil liability cases based on tort and contract laws. Therefore, gathered money must come from either those involved in negligence directly or from their insurers. This thesis suggests to add other articles that cover civil liability cases in the secondary market. For further clarification and discussion see discussion in text and related footnote 202 that respond to respected scholars' opinions.
[189] Naifar and Al-Suhaibani (n186) 51-52.
[190] *Basic Inc. v. Levinson* 485 US 224 (1988), was a case in which the Supreme Court of the United States voiced the "fraud-on-the-market theory" as giving rise to a rebuttable presumption of reliance in securities fraud cases.
[191] *Dura Pharmaceuticals, Inc. v. Broudo* 544 US 336 (2005), is a securities fraud decision by the Supreme Court of the United States, considering that an inflated purchase price will not by itself endure or immediately cause the relevant economic loss needed to claim and prove "loss causation."
[192] *Halliburton Co. v. Erica P. John Fund, Inc.* 134 S. Ct. 2398 (2014). The Supreme Court considered whether to "overrule or substantially modify" the Basic presumption - the linchpin of modern private securities litigation. The Court declined to overturn Basic, but held that defendants can defeat the presumption at the class certification stage by introducing evidence that the alleged misrepresentation did not affect the stock price. See also Naifar and Al-Suhaibani (n186) 52-53.
[193] Ibid 54.

first, there is a need to calculate the value and return (damage on every share). In order to do so, there are two main western methods: Value Line and Event Study.[194]

Second, to calculate the total damage on all shares, some of the used models are: Proportional Trading Model, Accelerating Trading Model, Multiple Trader Model, Theoretically grounded Microstructure Trading Model.[195] They argue that these methods developed in the west are based on specific assumption that do not rely on any firmly-fixed scientific ground, however, they become acceptable means in practice to calculate the damaged shares.[196] These methods were developed in the U.S which has multiple markets, where some of stocks are unregistered with the real owner name "street name", hence, parties may need to calculate the number of damaged shares. In comparison, this not the case in Saudi where there is one central market so it is easier to find information in relation to all previous transactions and shareholders accounts during the fraud period.[197]

It is worth noting that these models are used in the U.S as a condition for class action cases to estimate the total damage in securities cases.[198] From their knowledge of the Saudi Stock Market, they think that these econometric models cannot be used due to the availability of detailed trades of all investors, and in light of this, the damage can be calculated on an individual basis, hence, there is no need to know the total damaged shares.[199]

This paper has also tested the Value Line and Event Study methods on three cases. One of the cases (Sahara Petrochemical Co.) was compared with a final judgment the CRSD held with a simple formula based on out of pocket damage that occurred to the plaintiff. The second case was about Integrated Telecom Company (ITC), which has been liquidated in 2013, and the third compared case is Mobily (Etihad Etisalat).[200]

This paper has addressed important recommendations. One of them is to facilitate the rise of compensation lawsuit from damaged investors. One of the suggested recommendations in this respect is to create a balance in the litigation arena, in order to facilitate the prove of causation link and damage from the plaintiff perspective even if this step requires a change to the law or

[194] Ibid 56-58.
[195] Ibid 59.
[196] Ibid.
[197] Ibid 59.
[198] Ibid 60.
[199] Ibid 59.
[200] Ibid 60-74.

uphold new precedents that could be relied on. They have referred to the ACRSD decision, which is a step in this direction as decided by it to redirect the cases back to the Committee for the Resolution of Securities Disputes for additional examination according to the reasoning in the decisions of the Appeal Committee. In reaching its decisions, the Appeal Committee distinguished that reviewing the cases involves investigating the responsibility of the company and the people involved in its management in consideration of the relevant articles of the Capital Market Law and its implementing regulations.[201]

The second recommendation is in connection to putting compensation rules. First rule that should be in place is allocating damaged investors in each fraud violation. The second rule is related to the allocation of the total damage due to a violation so that the total compensation could be estimated, and taking into consideration the details of the transactions belonging to the damaged investors during the fraud period. The method of splitting the confiscated ill-gain upon the damaged person might be distributed on a pro-rata base if the total amount of damage is bigger.[202]

The article of those two prominent authors in Saudi Arabia has addressed the need for further studies in this area. As of May 2020, the Mobily case is not decided yet. The reason that I did not include this in the analysis of the thesis is due to the fact that misstatements in the quarterly and annual financial statements (2013-2014) occurred due to the recognition of revenues based on the Saudi accounting standards applicable before the transition to the IFRS, where the company has applied the IFRS standard in the concerned issue.

In relation to Al-mojil case, the judgment is not published yet,[203] however, it would be beneficial to examine how the CRSD and ACRSD would decide if an issue occurs in a prospectus even if it belongs to a criminal case. It was planned earlier in this research to include other case studies but it was very hard to discuss them in the context of this thesis. Moreover, the researcher is in the opinion that other western methods do not interact fairly with Islamic principles to acquire more reasonable compensation to all damaged shareholders. The Saudi regulator could amend the Companies Law 2015, the Capital Market Law 2003 and the Accounting Act 1992 (or the proposal) to add additional criteria or add relevant articles in the implementing/executive regulations of these acts. The current articles (55-57) at the CML 2003

[201] Ibid 77.
[202] Ibid.
[203] For more discussion about the main principles in this case, see Chapter Seven footnote 1645.

with respect to estimating the damages are concerning insider trading, market manipulation, and violations in a prospectus. Thus, they are connected to criminal acts, which is beyond the scope of this thesis. The CMA is working on initiatives to develop compensation measures as mentioned below. In relation to western methods of calculating damages that were discussed in the literature through out of court settlements and not decided by courts, these measures are connected to other criminal violations and not to accounting fraud at minimum. Therefore, it is a controversial move to connect the discussion to a civil matter as the thesis argues with the western literature in detail, which that may not lead to solving the raised matter in connection with auditor liability to shareholders. The thesis is also connected to only ordinary shareholders and excludes other third parties, so that class action in the west especially in the U.S may include part of the damaged shareholders. Thus, in one hand it is and that is why it is not fair for other damaged people to not rely on the final judgment or out of court settlement if they wish to raise another lawsuit. While in the other hand, in the U.K, a derivative action might be beneficial for other third parties such as the creditors of a corporate as the case would be raised for a corporate benefit. Hence, as the situation in Saudi is different as argued through having personal action for the benefit of shareholders, then the same would apply to the company action as the compensation would come to them as the end aim of a lawsuit as it is much easier to allocate each shareholder damages in a centralized market.

One may argue that there are other events intervened that affects the share price. In the case of fraud that has been discovered between the announcement of the annual financial statement and the restatement of it, the court should take into account the fraud case and examine to what extent it has affected the share price at that time so that it may develop an additional formula or apply the existing formula specified in the stated regulation. In relation to a material action taken by a regulator or a material dispute or contract that exceed 5% of the corporate capital, for example, then, the court should also take that into consideration to estimate the damage that occurred to each individual shareholder. The same case would apply to a merger and acquisition talk even before it is announced in the stock market, and whether insider dealings or market manipulations are happening during that time. Hence, a Saudi judge/member of committee may use economic methods to narrow down the impact of each event in order to reach a fair judgment. This thesis builds in its essence a plausible application of liability rules in a specific area, and it is almost impossible to develop a calculation formula with no clear guidelines in Saudi or in the west without the involvement of financial specialists. It could also be understood that judges/panel members would rely on expert’s opinion, either internal

consultants as in the case with the CRSD and ACRSD, or external experts in courts to reach a judgment/decision. Hence, presenting a broad calculation formula is thought to be acceptable at this level in the area of law, and of the recommendation in Chapter Eight that illustrates the need to test them from an economic and financial perspective.

Another issue to be discussed here is in relation to the corporate legal personality and its influence on shareholders' right to be indemnified for their own benefits. According to the Saudi CL 2015, a corporate is considered a legal personality starting from the date it was created in the approach proposed under Companies Law as per article 14 (1). There are still contrary views among judges, legal scholars and practitioners with respect to which court/quasi-judicial committee has a jurisdiction of civil liability cases related to a listed company in the Saudi Stock Exchange. To illustrate, Saudi Commercial Courts "Under the Umbrella of General Courts" over two years ago have started to look at some commercial cases and under the Law of Judiciary 2007, it exempted for a specific period, cases related to listed companies which have securities traded in the Saudi Stock Exchange to be heard before the Committee for the Resolution of Securities Disputes (CRSD) formed under the kingdom's Capital Market Law 2003.

Conflicts of jurisdictions among Saudi courts arise in the case of default in quarterly and annual financial statement for several reasons. First, given that the board has wide-ranging powers, the board acts on behalf of the company in any lawsuit such as initiating the case against the auditor. In fact, there is no article in the Saudi system that refers to this but we can understand, in light of Article 75 of the CL 2015, that "1- With due regard to the prerogative vested in the general meeting, the board of directors shall enjoy full powers in the administration of the company. It shall entitle, within the scope of its competence, to delegate one or more of its members or others to perform an act or certain acts". Hence, the company has the right to start the claim against the auditor by its board or by shareholders in the GM. This is called company action.

Second, shareholders of a listed company could file a lawsuit for board of directors' maladministration in accordance with Article 80 (the company has the same right if board of directors' defaults created damages of shareholders collectively as addressed in article 79), based on damages caused to the shareholder, either because they violated the law or the

company's articles. This article stipulates that the shareholder has the right to file a suit under the following conditions, namely:

1. The shareholder is entitled to raise his claim if the directors caused harm to his personal interests.
2. The shareholder cannot initiate the lawsuit unless the company has the right to litigation.
3. The shareholder must inform the company of its intention to raise the lawsuit.
4. The compensation shall be for the petitioner shareholder.

The Saudi Council of Ministers has recently added a new provision (80 duplicate) on April 9, 2018 based on its decision number 403 stating that it might be permissible for the company to pay the legal expenses that a shareholder has paid to initiate a case regardless of its outcomes conditioning that:

1. He initiated the case based on good faith.
2. If he has told the company about the reason for initiating the case and does not get an answer within thirty days.
3. If there is an interest from the company to initiate the case based on article 79.
4. The case should be based on a correct (legal) ground.

Based on this article, it could be clear that a shareholder is able to sue the board of directors for their misstatements in the quarterly financial statements. However, it is not clear yet if a shareholder is able to file a civil liability suit against an auditor before concerned court for his/her personal benefit. The researcher thinks that a shareholder has this right despite the fact it is not stated in the CL 2015 with the same conditions stated above.

To support my view, commenting on Article 78 of the old Saudi Companies Law 1965 (Similar to Article 80 of the CL 2015), Alzahrani contends that there are a number of criticisms, ambiguities and uncertainties in this Article, and there is considerable confusion between

shareholder personal suits and derivative action.[204] Furthermore, Article (78) does not clarify which type of lawsuits it addresses; is it an individual/personal or a derivative action? Consequently, it could be argued that Article 78 designates the right of shareholders to sue the directors of the board on behalf of the company. However, it could be said that, in light of the wording of Article 78, this refers to the claim on behalf of the company, but in fact the Saudi Legislature did not intend to establish derivative action as it exists in other countries.[205] Furthermore, the problem with this Article is that it could lead to the risk of multiple actions and vexatious actions, and it is unreasonable for the law to give all shareholders the right to claim on behalf of the company at one time; such legal process should be regulated in detail. Moreover, it was not possible to find any article regarding derivative action in Saudi academic literature. In addition, many lawyers and legal lecturers at Saudi universities agree that there is no derivative action under SCL 1965.[206] The situation stays with no change under CL 2015.[207] Aleshaikh has suggested to reform the CL 2015 to include the derivative action applied in the U.K with some modifications to eliminate the ambiguity of shareholders' personal action.[208] Albrahim has suggested when considering the introduction of the derivative claim in Saudi, there is a need to balance the prevention of unreasonable claims by minority shareholders, which can damage the company, by imposing some limitations and filters on such actions, with the guarantee that the claim is available to minority shareholders, as it can redress the equilibrium between shareholders and directors and protect shareholders' rights.[209]

Nevertheless, the lawsuit indicated in Article 78 aims to recover the damages done to the shareholder alone; furthermore, this Article mentions that the compensation adjudged is for the petitioner shareholder, whereas the compensation in derivative action is for the company. However, the purpose of the legal suit in this Article, and the indemnity of the damages are absolutely contrary to the objectives and purpose of the derivative suit.[210] He believes that the Saudi legislature was unsuccessful in the formulation of Article 77 and 78 of SCL 1965, where the personal suit and the derivative action were combined; each lawsuit requires a separate legal provision, in order to avoid confusion between each suit, as well as to remove any

[204] Youseif Al-Zahrani, *Rights of Shareholders under Saudi Company Law 1965*, (PhD Thesis, Brunel University 2013) 195.
[205] Ibid.
[206] Ibid.
[207] Albrahim (n80) 194.
[208] Mohammed Aleshaikh, *Towards legal reform of Saudi law of directors' duties and of enforcement by derivative action* (PhD thesis, University of Glasgow 2018).
[209] Albrahim (n80) 200.
[210] Al-Zahrani (n204) 195.

ambiguity in the article, as this may be the cause of harm to shareholders or can lead to a loss of their interests because of a lack of clarity in the legal provision.[211]

Aleshaikh has recently elaborated on issues and concerns that come with the Shareholders' use of article 80 of the Companies Law 2015. In short, first, if the remedy sought under an article 80 claim will flow to a shareholder claimant, the implication is that the company, including shareholders other than the shareholder claimant, will not benefit from any remedy granted by the court. Second, the permission for an individual shareholder to obtain personal relief for a wrong done to the company is likely to 'lead to a multiplicity of proceedings' in connection with the one wrongful act. Third, to be successful under article 80 claim, it appears that shareholders would not only bear the burden to prove the breach of directors' duties, but also that the relevant misconduct on the part of a director(s) would have caused them personal prejudice, which could be difficult to establish.[212]

The most important benefits of this discussion are to distinguish between Saudi Arabia and other common law countries such as England in terms of shareholders financial interest in case of a default in the annual financial statement as well as their rights to litigate through different legal channels.

The researcher understands that in England for example an auditor is liable to the company itself or to the collective shareholders of the company as discussed in *Caparo* case.[213] Moreover, in England, shareholders have litigation right called derivative action. It has emerged from common law and refers to the well-known and old principle that is commonly known as, "*the rule of Foss v Harbottle*" (1843) 2 Hare 461.[214] The principle states that the individual shareholder or minority shareholders are not allowed to litigate or make a complaint for alleged damages. Consequently, the correct plaintiff to sue is the company itself, to enforce its rights. Based on this brief discussion, we could conclude that there is no derivative action in Saudi Arabia unlike England and it is crucial at this stage of analysis to say that compensation from auditors' default in the annual financial statement goes to shareholders' pockets which cannot be achieved through the derivative action.

[211] Ibid.
[212] Aleshaikh (n208) 194.
[213] For more discussion, see Chapter Four.
[214] For further discussion, see Albrahim (n80) 175-176.

Third, the Saudi Capital Market Authority has approved a recent way of litigation right for shareholders in 2017 in its implementing regulation titled (The Resolutions of Securities Disputes Proceedings Regulations). In this regulation, article 1(13) defined the class action suit as: "a suit filed by a group of plaintiffs against one or more defendants, where the group of plaintiffs' suit share the same legal bases, merits and the subject matter of the requests. Any decision made on the case shall affect all of its parties." Moreover, Article 48 stated that this type of action shall be applicable on civil suits related to securities disputes.

It could be understood that shareholders of a listed company might be able to file a civil liability suit based on a default in a prospectus. Also, there are some types of civil cases related to maladministration of board of directors as the cases of merger and acquisition of listed companies so that the CRSD has an authority to hear these lawsuits. In contrast, it is not clear yet in the cases of default in the quarterly or annual financial statement initiated in the secondary market if the commercial court has an authority or the CRSD to hear the case. To clarify, if an auditor has done a mistake in a prospectus, the case will then be referred to the CRSD and the quantum of compensation will be based on the difference between the premium price and the sale price or as determined by the CRSD. On the other hand, if the mistake has been done in the annual financial statement by the auditor alone or through contributory negligence by the D&Os, then the question is if cases would be heard before different courts? In the researcher's opinion, the nature of these cases is related to a listed company's auditor or D&Os so they should be referred to the CRSD regardless if it has been considered a personal, class, or company action until the jurisdiction transfers to the commercial court by law at later stage. Finally, in order for the court to measure damages between the negligence act on the annual financial statement and the restatement, it needs to compensate all shareholders as stated in the mathematical equilibriums I proposed. Hence, neither the individuals or the group or the company will be compensated alone on their favour but for all as they could be discovered in the stock exchange trading system.

Fourth, it is not clear yet if shareholders would be able to seek recovery from an insurer if an auditor has a liability professional insurance or the company itself has bought financial statement insurance or if the mistake were contributed with D&Os.[215] However, if the

[215] More discussion is provided in Chapter Seven. A recent article about the first-Class Action in Saudi Arabia could be found in this article: Saud Alsaab and Robert James 'The conclusion of Saudi Arabia's first ever class action - just the beginning?'

researcher's opinion is supported through a final judgment, then, there would be no issue for the Committees for the Resolution of Insurance Disputes and Violations to have a final decision.

To conclude, Sharia principles and legal texts presented in Chapter Two support the researcher's opinion despite the fact that:

1. Current Legal Actions are against the board of directors for their malpractice/mal-administration only.

2. No legal articles with respect to shareholders' right to sue the auditor directly but that does not hamper respected Saudi judges to hear the case from the company directly or through shareholders directly, if the company refuses to initiate the case and all compensation would be allocated for the shareholders interest.

3. Such Shariah principles and Saudi legal rules mentioned in Chapter Two will never be activated unless there are better understandings of why such principles and rules are formed.

4. The studied common-law precedents (in Chapters Three and Four) never succeeded to compensate the company, shareholders nor others such as creditors fairly due to the lack of understanding between the company and its shareholders from different perspectives. Hence, shareholders cannot be treated as third parties by any means due to their economic ownership or "special relationship". In contrast, the company has its own legal entity and it has a liability towards others/third parties "other than shareholders" such as creditors who could secure their positions through security interest, pledges, promissory notes and so on, in addition to seek a verification from an auditor himself if they wish to rely on a specific financial statement prepared for a listed company. Thus, shareholders cannot be treated as other third parties

May 11, 2020. Available at: https://www.clydeco.com/insight/article/the-conclusion-of-saudi-arabias-first-ever-class-action-just-the-beginning. See also earlier articles: Alsaab, Saud. and Al-Hudaithy, Sara., 'KSA: the first ever Class Action Suit filed against the Board of Directors of Al-Mojil Group', March 5, 2019, available at: https://www.clydeco.com/insight/article/ksa-the-first-ever-class-action-suit-filed-against-the-board-of-directors-o. Beswetherick, Mark., Karim, Shabnam. and Alsaab, Saud., A new class action regime comes into force in the Kingdom of Saudi Arabia, May 25, 2020, available at: https://www.clydeco.com/insight/article/a-new-class-action-regime-comes-into-force-in-the-kingdom-of-saudi-arabia. In the last article, the authors have suggested the following "Management individuals and insurers of stakeholders (such as auditors and management individuals) should, however, take note of this change which may signify the expectation of increased regulatory activity and consequent litigation in KSA in the coming years." The thesis attempts to solve raised maters through available actions should be taken by shareholders in civil liability cases. Hence, the discussion under criminal conduct may present confusing views through connecting professional liability and related insurance products to similar discussion found in common law cases and literature.

because financial statements must be disclosed to them by law in addition to their economic ownership which will be addressed in Chapter Seven in more detail.

5. The Saudi Consultative (Shoura) Council in his session dated May 1, 2018 requested the Saudi Capital Market Authority to develop mechanisms in relation to indemnify damaged shareholders from breaches of the Capital Market Law 2003 and its implementing regulations. The CMA in its Financial Initiative Program 2020[216] in its seventh strategic goal titled the enhancement of the structural environment of the capital market through initiative number 3.7.4. stated the same goal. Indeed, the CMA is already making progress in this respect; however, it may take some time to find plausible solutions for shareholders' indemnification occurring from auditor's negligence. Hence, such improvements are in their early stages and this thesis provides one way of improvement.

Fatimah Aldubais, has recently outlined in two separate articles[217] the willingness of some members at the Saudi Shura council "council" to present in the near future a proposal to the council in relation to a draft of the Compensation Law.[218] The proposal of the Compensation Law will provide general rules that apply to the law of tort and the law of contract in addition to specific rules to these areas. Due to the importance of this proposed law to this thesis, the researcher was able to get a draft of this act with its explanatory note from one of the Shura Council's members.[219]

The explanatory note of this proposal has comprised several aims to achieve from this Law such as: 1- putting clear and transparent standards for compensation. This move would

[216] CMA Financial Initiative Program 2020, available at:https://cma.org.sa/AboutCMA/Documents/Stategy2020_ar.pdf.

[217] Fatimah Aldubais, 'Shoura is going to discuss the Compensation Law' *Okaz Newspaper* (16 October, 2018). Available at: http://cdn.okaz.com.sa/article/1678868; see also: Fatimah Aldubais, 'Okaz obtains the details of the proposed Compensation Law at Shoura council' *Okaz Newspaper* (22 October), available at: https://www.okaz.com.sa/article/1680231.

[218] According to the Shoura Council Law 1992, article 23 stipulates: "The Shura Council shall have the jurisdiction to propose a draft of a new law or an amendment of an enacted law and study them within the Shura Council. Speaker shall submit the shura council' resolution of the new or amended law to the king.", available at: https://www.shura.gov.sa/wps/wcm/connect/ShuraEn/internet/Laws+and+Regulations/The+Shura+Council+and+the+rules+and+regulations+job/Shura+Council+Law/.

[219] A special thanks to Dr. Faisal Alfadhel (https://www.shura.gov.sa/wps/wcm/connect/ShuraEn/internet/CV/Faisal+bin+mansour+bin+ali+al-fadhel/), who provided this important information before it is discussed officially to support the outcomes of this research and to enable the researcher to provide comments on the proposed act, which may take some time to be approved. He was also one of the main supporters of doing this thesis when he was working as the Chairman of the Appeals Committee for the Settlement of Disputes and Insurance Violations in 2014. However, other obstacles to contain semi structured interviews with quasi-judicial committees' members could not be overcome due to unexpected delays in obtaining approvals from competent authorities. It should be noted that early questions not included in this thesis reflect complicated issues that are not addressed yet before competent courts and quasi-judicial committees. Moreover, due to the reason mentioned above, the researcher and his principal supervisor agreed to move on and address most of them generally to envisage how courts and committees should uphold judgments in the research area after considering Shariah and Saudi regulations with the use of common law precedents.

contribute to the judiciary rating globally; 2- improving the sufficiency of the judicial role through having codified law; 3- increasing the level of transparency and clarity in regards to available legal mechanisms that comply with Shariah, must be used for compensation from the harmful act to achieve justice especially in medical and commercial arenas; 4- configuring a suitable environment to achieve its development and maintain its sustainability that attracts investment; and 5- reducing lawsuits before courts through empowering the preventive role that protects the rights, restrict from doing illegal acts, and the procrastination of rights' fulfilment.

The explanatory note has stated several principles and reasons "among many others" to bring this act into life. First, it discussed the Saudi government action to unify the court system through transferring quasi-judicial committees to the commercial court, which is under the orbit of general court through several stages. This action must be taken after considering the amendment of existing laws, and develop them if they have legislative deficiencies. Hence it will increase judicial independence. Second, various researches and articles about the judicial role in compensation cases have indicated the differing standards that Saudi judges apply with the lack of clarity and transparency so that subjective standards are needed. Third, this proposal is similar to other laws and international treaties in connection with the law of compensation and has benefited more specifically from the Jordanian, Bahraini and Egyptian laws as well as the guided unified civil law for GCC. Fourth, this act would be a helpful tool with the royal order issued in 2014 in regards to compiling precedents in Shariah matters, that would be codified as legal provisions. These judgements would then be helpful references for judges during their judicial work. Fifth, there is a need to implement this law as a public policy, and some Shariah scholars have stated the importance of specific texts not in the subjects mentioned, as principles included may have significant impacts on other judgments. Sixth, there were several complaints from different categories that the judicial system is not clear for scholars, and gave two examples about the compensation cases of the lost opportunity and moral damages that need to be re-considered.

The proposal of the Compensation Act includes 32 articles. Article 3 stipulates that articles in this law would be valid to all matters in connection with compensation in its content or its meaning, and if there is no applicable article, then the court would uphold its judgment based on Shariah principles.

Chapter two of the proposal in its first part is related to the law of tort: personal "strict" liability on the wrongful act. Article 6 states that "Every harmful act that caused harm to another person, then the person whom he made it shall be liable." There are some exemptions to this rule as stated in article 4 with respect of force major circumstances or in the case of self-defence as indicated in article 5. Article 8 has explained the joint liability of the multiple tortfeasor about their harmful act to compensate in equal, unless the competent court has decided their quotas individually. The proposal in article 9 explains how the damage occurred from the harmful act would be allocated through the achieved loss for the damaged person in addition to the achieved lost gained. Moreover, the absolute loss or the lost gain are considered natural result for the harmful act if it could not be prevented "avoided" with reasonable effort from a normal person in his/her circumstance. Article 12 discusses the contribution of harmful act between the wrongdoer and the person who suffered the damage, then the wrongdoer is going to be liable in portion. Article 13 has stated the invalidity of any prior agreement in connection to avoiding liability about the harmful act, which may exclude the liability in total or in partial. The second part is largely linked to the vicarious liability, which has been discussed in detail in section 2.7 with a special reference to the liability of the board of directors.

Chapter three of the proposal is related to the contractual liability. Article 20 states that the liability based on contract arise in case of not fulfilling the obligation as agreed, or even in partial, or after the specified time, or as not requested in the contract. The wrong from the debtor side is the base for the contractual liability as indicated in article 22. Article 23 states that the compensation resulting from the harm in the contractual liability is specified in the contract, and if not, then the court will determinate it. In addition, the compensation should be monetary, however, the damaged person may depend on the case ask to return the situation as before or perform something else. If there are several people who are responsible, then the contractual liability will be divided among them equally by the court, or to the extent that is suitable with respect to the case's status as articulated in article 24. Article 25 sheds the light on the permissibility of exempting/discharging from the contractual liability, or amending the rules upon as long as it is stated in the contract itself, unless the liability has been created due to fraud or gross negligence.

Chapter four of the proposal is titled final provisions. Article 27 stipulates the power of the competent court to determine the extent of compensation on damages occurring to the damaged person after considering the relevant circumstances. If the court was not able to determine the

definitive amount of compensation at the time of judgment, then the damaged person has the right to demand within a specific period for a reassessment. Article 28 in its first part gives the competent court the authority to specify the compensation method according to the circumstances. Moreover, the compensation could be in instalments or as fixed income, and in both cases, the court could oblige the debtor to provide an insurance. The second part of the same article states that the compensation method should be in cash, however, the court according to the circumstances and with the request from the damaged person may return back the situation to its prior status, or to uphold to perform a specific act in connection with the illegal work as a way of compensation. Article 30 provides that the compensation case will not be heard in all cases after three years from the time of knowing by the damaged person in regard of the damage, or ten years from the date of the occurrence of the harmful act, or which period is nearer. However, if the liability case from the harmful act occurred due to a crime, then it does not refrain from hearing the case as long as the criminal case still exists, even if stated dates in this article have elapsed.

This law is in conformity with the discussion about the Shariah principles examined in Chapter Two of this thesis in regards to the law of tort as well as general principles that could apply too in the law of contract. Article 2 is general and has been discussed extensively in this Chapter. Article 3 might be used with other legal provisions stated in the Companies Law 2015, the Certified Public Accountants' Regulation 1992 "or the proposed Accounting and Auditing Act", the Corporate Governance Rules 2017, and general Islamic principles to indicate how the compensation should be estimated. Article 8 confirms the researcher's analysis in connection with determining the exact amount of compensation that tortfeasors (in the case of having multiple tortfeasors) should pay to damaged persons. More specifically, the court may examine if an error or omission found in the financial statements has been made from the company's board of directors and officers with the auditor through not applying relevant accounting standards, then, a proportionate liability might be determined. Article 9 also is in consistence with the researcher's finding in respect of allocation of damages to shareholders from an auditor negligence through their achieved loss within the release of the financial statements and the restatement periods as a natural result from the harmful act. In the case that shareholders are considered as a third party, whom also have economic ownership in their listed company, then it could be argued that they have a special relationship with the auditor to make him liable to them directly or indirectly.

Moving the discussion to the contractual liability, article 20 states the liability of an auditor may arise for example by not fulfilling his duty of care for not following the prevailed accounting standards, when he has conducted the annual financial statements. Article 23 has given the competent court the right to determine the amount of compensation if not specified in the contract. This means that an approval must be made from the general assembly by shareholders to conclude the auditing contract, otherwise, the court might determine it based on other rules. It could be argued that the only way the court would be able to estimate the damage occurred to the company is via the number of damaged shareholders as discussed in this Chapter and Chapter Seven.

Article 25 is also important to this thesis to demonstrate the unfeasibility of auditor's disclaimer in the annual financial statements due to the fact it has not been identified in the auditing contract. Moreover, the liability of an auditor occur from negligence might be treated as gross negligence, therefore, he cannot be exempted from his liability. The court also gives the right for a shareholder for instance to ask for a reassessment within a specific period if the court is not able to determine the exact amount of compensation as expressed in article 27. This way would allow the shareholder to argue how the court should be able to estimate the damage as explained in this Chapter and Chapter Eight. Lastly, one may argue that the contractual liability is between the auditor and the company, then it could be contended that there is no difference between the liability of contract and the liability of tort to the extent of negligence creation. In addition, how the company is then able to seek a specific amount of compensation, as the evaluation of damages must be in line with specific commodities "shares" as stated in Shariah.

Given the expected role from this proposed law in addition to other existing Shariah principles, Saudi laws and regulations in connection with this thesis, it could be argued that shareholders have the right to be economically indemnified from the auditor him/herself or with those who are involved in the wrongdoing that occurred in the annual financial statements. Besides, this law would be a valuable judicial tool to activate existing legal provisions stated in this thesis. However, the law may not involve specific cases in relation to this thesis, hence, it is suggested to include additional legal provisions in concerned regulations to support the existing ones. Finally, this thesis has provided general equilibriums to be used elastically after considering all relevant circumstances and be more Shariah compliant in deciding the fair amount of compensation.

In summary, based on legal articles discussed above, it appears that Saudi laws have stated clear guidance that shareholders should be indemnified by D&Os and auditors. In comparison, while other comparable countries have made specific legal provisions for their liabilities in prospectuses, they leave the liabilities of such persons in the secondary market, if any, for the courts to decide. This difference is very crucial to compare: it will be important to learn from western liability theories, both in the literature and precedents, whether the apparently wider Islamic liability can and should be taken at face value or should be interpreted differently to preserve an important policy or principle.

2.11 Conclusion

In sum, this chapter aimed at exploring both general Islamic principles and Saudi statutes to measure professional liability cases with respect to an auditor of a listed company, and to explore the possibility of indemnifying the shareholders or the company itself in case of an error in a financial statement from Islamic and legal perspectives. Examined existing Islamic principles and Saudi statutes coupled with proposed legislations bring further clarity to applying relevant rules to auditor civil liability towards shareholders. Moreover, the new direction that might be taken from the Saudi regulator in regards to the proposed Compensation Act may enable the regulator to enact a law that is found in other civil law countries. However, issues found in the area of research are not appropriately addressed in civil law countries' literature, acts and court precedents. It is believed that Saudi may overcome existing issues found in both civil and common law jurisdictions due to having Islamic principles and legal provisions that cover this area very well, conditioning learning from other countries' experiences to take a different position.

Chapter 3: The Civil Liability of Auditors in the United States of America

3.1 Introduction

This chapter examines auditor civil liability towards third parties in the US. In the last century, the 1929 stock market crash and the Great Depression resulted in the largest financial crisis of the twentieth century. After that, American courts tried to impose certain limitations on auditor liability so that third parties were and still are unable to be indemnified for their economic losses in many circumstances. The American courts developed four main legal rules or criteria for determining which third parties are due a duty of care by the auditor with a care task, whereby they can sue the auditor for loss arising from the inaccuracy of financial statements resulting from the auditor's negligence. These rules were developed by Supreme Courts in both New York and New Jersey, and by the American Bar Association. [220]

The four legal approaches are: a. the privity rule; b. the primary beneficiaries' rule (near privity rule); c. the foreseen user rule; and d. the reasonable foreseeability rule.[221] These rules form the basis in this Chapter for discussion, analysis and critique based on the literature. Then the theories will be critically examined in the context of their applicability in the Saudi Arabian courts.[222]

3.2 The Privity Rule

3.2.1 Privity – A General Overview

The common law requirement that privity exists between two parties before liability can be found was first realised in the English case of *Winterbottom v. Wright*.[223] In this case, a passenger was injured while riding on a mail coach. The passenger sued the mail coach

[220] Soud Matar, 'The Impact of Legal Responsibility of External Auditors on Auditing Quality and Investment Level' (PhD Thesis, Brunel University, 2012) 22.
[221] Ibid.
[222] For further discussion about the suitability of American precedents into the Saudi context, see Chapter Seven.
[223] *Winterbottom v. Wright* 10 M & W 109 152 Eng. Rep. 402 (1842).

company for negligently manufacturing a wheel, which broke and caused the accident. The court held that the passenger did not have a cause of action because of the lack of privity between the passenger and the mail coach company. The court reasoned that allowing the plaintiff, a third party, to file a lawsuit for negligence would extend liability to be found in almost any circumstance. The court stated that "unless we confine the operation of such contracts, ... to the parties who entered into them, the most absurd and outrageous consequences, to which I see no limit, would ensue."[224]

Historically, privity has been recognised as a necessary element in maintaining a suit in contract law.[225] Prior to the extension of tort law, accounting suits were brought under the theory of contract law because of the existing contract between the auditor and the client.[226] As courts began to expand auditors' liability to outside third parties other than the client, the privity rule had to be replaced with a more flexible and subjective rule.[227] Although *Winterbottom* set out the privity requirement in a contract action, courts have interpreted the holding to mean that an action in tort was also precluded from being brought by a third party.[228]

Later, the doctrine of privity was expanded in *Lawrence v. Fox*[229] so that it, as applied in contract law, included persons who were clearly designated as beneficiaries of a promise.[230] The New York Court of Appeals affirmed that a third party can maintain an action to enforce a contract not entered by him directly. Since this decision the courts in the U.S. have normally acknowledged third party's right to enforce a contractual obligation made for his benefit.[231]

In 1922, the New York Court of Appeals decided in *Glanzer v. Shepard* that liability extended to a seller who mis-weighed beans and certified the weight to a buyer.[232] In that case Judge Cardozo had reasoned: "The plaintiffs' use of the certificates was not an indirect or collateral

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[224] 152 Eng. Rep. 402 (Ex. 1842) at 405.
[225] Julie Faussie, 'Limiting liability in public accounting suits: a desperate appeal from a beleaguered profession' (1994) 28 (3) 'Valparaiso University Law Review' 1075.
[226] E.g., *East Grand Forks v. Steele* 141 NW 181 (Minn. 1913).
[227] Faussie (n225) 1075.
[228] Ibid; Third-party liability involves a third-party to an action, which alleges injury from the defendant's intentional or unintentional conduct. For a discussion of the broad theory behind third party liability in a negligence action, see Page Keeton & William Prosser, *Proseer & Keeton on the Law of Torts* (5th edn, West Publishing Company 1984) 668. One of the first cases to deal with third-party liability in negligence cases was *Palsgraf v. Long Island* R.R. Co 162 N.E. 99 (N.Y. 1928).
[229] *Lawrence v. Fox* 20 N.Y 268 (1859), cited in *Ultramares Corp. v. Touche* 174 N.E. 441,445 (N.Y. 1931).
[230] Faussie (n225)1075.
[231] Sulaiman Abdussamad, *Auditor Liability to Third Parties in Spain and the United States: A Comparative Study* (PhD Thesis Pablo Olavide University 2015) available at: https://rio.upo.es/xmlui/bitstream/handle/10433/2262/abdussamad-sulaiman-tesis15.pdf?sequence=1&isAllowed=y., 114.
[232] *Glanzer v. Shepard* 135 N.E. 275 (N.Y. 1922); see also; R Gromley, 'The Foreseen, the Foreseeable, and Beyond – Accountants' Liability to Nonclients' (1984) 14(3) Seton Hall Law Review 528.

consequence of the action of the weighers. It was a consequence which, to the weighers' knowledge, was the end and aim of the transaction."[233]

In this case, the seller of beans contracted a weigher to certify the weight of the beans. The wiegher's certificate, which forms the basis of the contract between buyer and seller, was overstated. The buyer instituted this action asserting negligence on the part of the weigher. Even though the court recognized that the plaintiff was not a party to the contract, it reasoned that the plaintiff was the primary beneficiary of the contract hence the weigher owed a duty of care to him. Cardozo J. went on to explain the concept of 'primary benefit' as follows:

"[T]he plaintiff's use of the certificates was not an indirect or collateral consequence of the action of the weighers.... It was... the end and aim of the transaction.... The defendants held themselves out to the public as skilled and careful in their calling.... In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed."[234]

Under this analysis, although there was no contract between the weigher and the buyer because the "end and aim" of the transaction was to offer a service to the buyer, the weigher was held liable. The fact that the contract was not between the plaintiff-buyer and the defendant-weigher was of no importance, if the relationship between the plaintiff and the contracting parties is as close as in this case. The buyer, therefore, can maintain an action against the weigher either for negligent performance of service or as a third-party beneficiary of the weigher's contract with the seller. Here, recovery is revolved on the relationship between the plaintiff and the parties in contract, a clear achievement of practical substance over legal form: "equity looks to the substance rather than to the form", as the maxim goes.[235]

3.2.2 The Privity Rule Applied to Auditor Liability

With respect to auditor liability towards third parties, the case of *Landell vs. Lybrand* considered the auditor's overall responsibility towards the third party, the Pennsylvania Supreme Court holding that the auditor had no responsibility toward a buyer of normal stocks

[233] Ibid 238-39, 135 N.E. 275 (emphasis added).
[234] *Glanzer v. Shepard* 135 N.E. 275 (N.Y. 1922) at 275-276.
[235] Abdussamad (n231) 169.

of the employer's indemnifying company.[236] These stocks were bought in direct reliance on the report issued by the auditor concerning the financial situation of the company. This report was later demonstrated not to have been accurate and/or honest. In its rejection of liability, the court relied on the non-existence of a contractual relationship between the plaintiff and the defendant auditor. In addition, the plaintiff could not provide evidence that the auditor had issued the report with intent to cause damage to the plaintiff.[237] The court found for the accountants, stating the following:

"There was no contractual relationship between the plaintiff and defendants, and if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report, but the plaintiff was a stranger to them and to it, and, as no duly rested upon them to him, they cannot be guilty of any negligence of which he can complain."[238]

Under this strict approach, the only party with the right to sue an auditor for negligence is the client having privty of contract. The rule required the existence of a contractual relationship or direct connection with the auditor. This expression of the privity rule is the strictest rule regulating auditors' responsibility from the point of view of the third party; but it operates only in Virginia and Pennsylvania.[239]

3.3 The Known User Approach

3.3.1 The Known User Approach to the Privity Rule

Ultramares Corp. v. Touche [240] has consolidated and refined the privity rule.[241] It expanded the rule by extending the zone of the auditor's responsibility for negligence to include parties other

[236] *Landell vs. Lybrand* 107 A. 783 (Pa. 1919); see also, Willis Hagen, 'Accountants' Common Law Negligence Liability to Third Parties' (1988) 1988(1) Columbia Business Law Review 183.
[237] Carl Pacini & David Sinason, 'Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends' (1998) 103(1) Commercial Law Journal 21-22.
[238] *Landell vs. Lybrand* (1919) 264 PA 406.
[239] Gromley (n222) 543; According to Pacini & Sinason (n237) 22, In Pennsylvania, the Landell ruling continues to be the prevailing rule of law. *Guy v. Liederbach* 459 A.2d 744 (Pa. 1983). In Virginia, privity became the applicable legal standard in 1993. *Ward v. Ernst & Young* 435 S.E.2d 628 (Va. 1993).
[240] *Ultramares Corp. v. Touche* 174 N.E. 441 (N.Y. 1931).
[241] Ray Whittington & Kurt Pany, *Principles of Auditing and Other Assurance Services* (18th edn, Irwin/McGraw-Hill, Boston 2012); see also, Faussie (n225) 1072.

than the client, but limited that class to persons having a sufficiently proximate relationship.[242]

The plaintiff (the Ultramares company) provided financial loans to the Fred Stern company, relying on the auditor's (Touche and Niven Com) report which presented an unqualified opinion on the financial statements of the Fred Stern company.[243] Subsequently, the plaintiff incurred large financial loss when it was found that the financial statements were misleading and failed to reveal its actual financial situation: though the financial statements revealed that the net assets of the company were US$1,070,000, the liabilities of the company were greater than its assets by US$200,000. Moreover, it was demonstrated that the assets as mentioned in the balance sheet implied fallacious debts, the value of which were US$950,000. Furthermore, the balance sheet did not reveal some of its obligations. The auditor presented 32 copies of this report to the client, including the balance sheet of the company, which he approved, knowing that various different creditors and stockholders would review such reports. When, later, the company declared bankruptcy, the plaintiff sued the auditor for negligence.[244]

The trial judge found that while the auditor was negligent he was not liable to a third party who did not enjoy privity. An intermediate appellate court reversed the finding, holding that the auditor was liable and that the plaintiff enjoyed privity. The New York Court of Appeals, Cardozo J presiding, held that, in spite of the auditor's negligence, he was not liable to compensate for the loss incurred by the plaintiff, as he did not know that the financial statements of the company would be presented to exactly that plaintiff; the only recourse was for the Ultramares Company to sue the auditors. Only if the client had informed the auditor, upon appointment, of the identity of another party as a particular user of the financial statements could the third party be considered a primary beneficiary of the audit.[245]

The court thus established that to identify a primary beneficiary as a person considered to be the main receiver of the auditor reports, the auditors were required to know the name of this beneficiary prior to the audit.[246] On the evidence presented to the court in this case, even though it was demonstrated to the court that the audit was originally performed for the sake of the client, since the plaintiff was not identified and named as the user of the auditor's report he

[242] Matar (n210) 23.
[243] Faussie (n225) 1076.
[244] Pacini & Sinason (n237) 22.
[245] Ibid 23.
[246] J Tucker & J Zurich, 'Auditors' Liability to Third Parties Under Common Law: Traditional Approaches and Recent Trends' (1993) 52(4) The Ohio CPA Journal 25.

could not be considered to be a beneficiary of the audit. The plaintiff failed thus to prove negligence and claim was rejected.[247]

The New York Court of Appeals' judgment had decided the case on the foundation of the rule of the primary beneficiary of the auditor's work. This rule implies that the auditor is responsible for normal negligence towards a third party, other than a client known in advance, when those parties depend on the auditor's work in terms of making certain decisions. Since such parties would benefit directly from the auditor's work, they must benefit similarly to the clients in spite of the non-existence of a direct contractual relation linking them with the auditor. This rule is still been used as of 2020 in several American and common-law courts when identifying the third party with the right to sue the auditor for negligence.[248]

During consideration of the *Ultramares Corp.* case, it was evident that, if the auditing procedures were tarnished with serious negligence by calling the court to believe that the auditor was not persuaded by the sufficiency of these procedures, or was otherwise considered to be careless or intended to turn a blind eye to the essential occurrences, or did not investigate the situations that must raise doubts, negligence in these cases is considered to be serious negligence.[249]

This makes the auditor responsible to the other party in this case even if the other party was not identified. Cardozo J indicates, in the same case, that the auditor's responsibility towards the client was represented by the law in terms of compiling the report without fraud, and so he was therefore obliged in virtue of the auditing contract to prepare the report with a degree of care required from a person in such a situation, but also with regard to the creditors and investors to whom the client presented the auditing report. In this regard, the auditor's obligation toward them was to compile the report without any fraud, as the auditor knew from the surrounding conditions that the client did not have the intention to keep the report for himself. From this, it was demonstrated that the court tends to restrict the auditor's responsibility in regard to the other party concerning fraud or serious professional negligence

[247] Ray Whittington & Kurt Pany, *Auditing* (2nd edn, Irwin/McGraw-Hill, New York, NY 1997).
[248] Matar (n220) 24.
[249] Ibid.

committed by him.[250] Therefore, the expansion of liability in the *Glanzer* court's holding was short lived because in 1931 the holding in *Ultramares Corp. v. Touche*[251] curbed this expansion of liability.[252]

The *Ultramares* New York Court of Appeals held that "ensuing liability for negligence is to be enforced between the parties by whom the contract has been made".[253] The *Ultramares* court distinguished *Glanzer* by reasoning that the defendant's service in *Glanzer* was primarily for the information of a third person, an indirect party to the contract, and was only incidentally for the benefit of the formal promisee.[254] In the *Ultramares* case, however, the court reasoned that the service was performed primarily for the benefit of the Stem Corporation, and was only incidentally for the use of those whom Stem might later involve.[255] The *Ultramares* court reasoned that the extension of liability to third parties would expand the field of liability for negligent speech so that it would be nearly the same as liability for fraud.[256] The court also considered the possible effects of an expanded liability theory to other similarly situated professions such as title companies and lawyers.[257] The *Ultramares* court further emphasised the fact that a reasonable businessperson receiving a certificate without paying for it, and receiving it as one of many possible investors, would look for more outside assurance than the audit.[258]

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[250] Pacini & Sinason (n237) 22; see also, Carl Pacini, Mary Martin & 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) 37 American Business Law Journal 171-236.

[251] *Ultramares Corp. v. Touche* 174 N.E. 441 (N.Y. 1931).

[252] The *Glanzer* court's holding has since been cited by various courts (see, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.C.R.I. 1968); *Security Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080, 1087 (N.Y. 1992) (claiming, by the dissent, that the majority applied *Glanzer*) who wish to depart from the later decision in *Ultramares*, which reinstates the requirement of privity in extending third-party liability. *Glanzer* and *Ultramares* are conflicting decisions that Judge Cardozo decided. However, the unusualness of these cases is minimised because *Ultramares*, the latter of the two cases, does not overrule *Glanzer*, but rather, distinguishes it on technical factual grounds. Although a valid distinction could be drawn from the two cases, it appears as though Judge Cardozo may have had a difficult time admitting that *Glanzer* may have been wrongly decided; see also, Faussie (n225) 1075.

[253] *Ultramares Corp. v. Touche* 174 N.E. 441 (N.Y. 1931) 448.

[254] Ibid.

[255] Ibid. The court went on to consider *Glanzer v. Shepard* and distinguish it from *Ultramares* as follows:
"[in *Glanzer*, there] was something more than the rendition of a service in expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where there transmission of the certificate to another was not merely one possibility among many, but the "end and aim of the transaction ...." In a word, the service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the Stern Company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter. Foresight of these possibilities may change with liability for fraud. The conclusion does not follow that it will change with liability for negligence." at p. 176.

[256] Ibid.

[257] Ibid 441.

[258] Ibid 448; see also, Faussie (n225) 1075.

Giudici thinks that the audit can create a spill-over effect, as information originally addressed to the shareholders can go to the benefit of creditors as well.[259] This means that the company can seek to use the audit to reassure creditors and get funds, as is commonly observed in commercial practice. Is the auditor to be held liable if a creditor relies on his audit to finance the company? Judge Cardozo decided that the auditor was not liable for negligence towards *Ultramares*, whereas he would have been liable if fraudulent intent had been proven.[260] According to Goldberg, Cardozo was too lenient on this point.[261] Therefore, the auditor was not in privity with *Ultramares*, as the latter had not employed the former.[262] Judge Cardozo warned that:

"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."[263]

Accordingly, a negligence claim would be equivalent to a fraud claim. As Judge Cardozo points out that "the extension, if made, will so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud."[264]

The *Ultramares* decision has influenced all the subsequent history of Anglo-American law on the issue and therefore the law and economics thinking about the subject.[265] The US state courts or state legislation have developed and in many cases reshaped the concepts analysed by Judge Cardozo, adopting concepts like 'near privity', 'reasonable foreseeability' etc.[266] In England, the House of Lords explicitly followed the *Ultramares* principles in *Caparo*.[267] It decided that the auditor owes a duty to the company and not to creditors or to any single shareholder who "as a purchaser of additional shares in reliance on the auditor's report, … stands in no different position from any other investing member of the public to whom the auditor owes no duty."

[259] Paolo Giudici, 'Auditors' Multi-Layered Liability Regime' (2012) 13 European Business Organization Law (4) 531.
[260] Ibid.
[261] Victor Goldberg, 'Accountable Accountants: Is Third-Party Liability Necessary?' (1988) 17(2) The Journal of Legal Studies 296.
[262] Giudici (n259) 531.
[263] *Ultramares Corp. v. Touche* N.E. 441 (N.Y. 1931) 179-180.
[264] Ibid 185.
[265] Giudici (n259) 532.
[266] Ibid.
[267] Ibid.

This statement takes into account that the accounts and the audit become public at the Register, but do not entail any responsibility of auditors to the public at large.[268]

Lastly, in a recent Canadian case *Livent Inc. v. Deloitte & Touche*, the impact of the *Ultramares* case was discussed.[269] In paragraph 175 of the Court of Appeals judgment, Deloitte, however argues that, in effect, the trial judge extended an auditor's duty of care to its client to comprise economic responsibility for losses faced by those standing behind it. In doing so, it raises the "spectre of indeterminate liability" – an issue that has been the subject of discussion in a number of cases.[270]

3.3.2 The Near Privity Approach

Approximately 50 years following the *Ultramares* case, the Court of Appeals of New York consolidated the primary beneficiary rule in *Credit Alliance vs. Arthur Anderson and Co*.[271] For several years, the financial services company Credit Alliance provided financing for a company called Smith. In 1978, the creditor company asked Smith to provide its financial statements, after subjecting them to auditing by an external auditor, as a condition for any additional financial credit in the future. Smith provided its financial statements to the creditor company accompanied by the auditor's report, which contained an unqualified opinion with regard to these financial statements for the years 1976 to 1979. In 1980, the Smith company declared bankruptcy, and the creditor company sued the auditor for negligence.[272]

The Court in *Credit Alliance v. Arthur Andersen & Co.* clarified the 'near privity' standard.[273] Chung et al. and Hagen identify three prerequisites which according the *Credit Alliance* must be satisfied before auditors can be detained liable for negligent misrepresentation to non-contractual third parties: (1) the auditor must have known that financial reports were to be used for a particular purpose; (2) the known party or parties were proposed to be able to depend on

[268] Ibid; Detailed review about the *Caparo* case is addressed further in Chapter Four.
[269] Other Canadian cases mentioned will also be discussed in Chapter Four.
[270] See e.g. *Ultramares Corp. v. Touche* 174 N.E. 441 (N.Y.C.A. 1932), per Cardozo C.J., 444; *Caparo Industries plc v. Dickman* (1990) 1 All E.R. 568 (H.L.) 576-77; *Haig v. Bamford* (1977) 1 S.C.R. 466, 484; and *Hercules Managements v. Ernst & Young* (1997) 2 S.C.R. 165 at paras. 31-41.
[271] *CreditAlliance Corp. v. ArthurAnderson & Co.* 65 N.Y.2D 536, 483 N.Y.S.2D 435 (N.Y. App. Div. 1985).
[272] Matar (n220) 25.
[273] *Ultramares Corp. v. Touche* 174 N.E. 441 (N.Y. 1931); see also, *Credit Alliance v. Arthur Andersen & Co.* 483 N.E.2d 110 (N.Y. 1985).

those reports; and (3) there must have been some conduct linking the auditor to the relying party.[274]

Although *Credit Alliance* expanded the *Ultramares* requirement of strict privity, the *Ultramares* privity requirement is still basically intact after the *Credit Alliance* modification.[275] According to Faussie, the modification of the privity requirement in *Credit Alliance* was instrumental in reversing an earlier case which is *Westpac Banking Corp. v. Deschamps*.[276] The court in *Credit Alliance* distinguished the facts of *Ultramares* and *Glanzer* primarily in terms of the specificity of the intended purpose and users of the information. Although the public accountant's report in *Ultramares* was exhibited to various third parties depending upon the particular circumstances, the accountants in *Ultramares* were unaware of the actual persons to whom the report would be shown or the number of transactions for which the report would be used.[277]

Conversely, in *Glanzer*, the public weigher, pursuant to the instructions of his employer, furnished a copy of the weight certificate directly to the buyer. As the *Credit Alliance* court observed, the facts of *Glanzer* "bespoke an affirmative assumption of a duty of care to a specific party, for a specific purpose." [278]

According to Pacini et al., a near-privity approach is followed, either by statute or court decision by 12 States: Arkansas, Idaho, Illinois, Kansas, Louisiana, Michigan, Montana, Nebraska, New Jersey, New York, Utah and Wyoming.[279] For example, one New York case, *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*,[280] reaffirmed the New York courts' application of the near privity rule. The court rejected a broader standard that would hold accountants liable to third parties who merely alleged that they relied on the accountants' prepared financial statements.[281] This ruling impacts all States following the New

[274] Janne Chung and others 'Auditor Liability to Third parties After Sarbanes-Oxley: An International Comparison of Regulatory and Legal Reforms' (2010) 19 Journal of International Accounting, Auditing and Taxation 67; see also, Hagen (n236) 193.
[275] Faussie (n225)1077; The modification of the privity requirement in Credit Alliance was instrumental in reversing an earlier case. See *Westpac Banking Corp. v. Deschamps* 484 N.E.2d 1351 (N.Y. 1985).
[276] Faussie (n225) 1077; *Westpac Banking Corp. v. Deschamps* 484 N.E.2d 1351 (N. Y.1985).
[277] Hagen (n236)192-193.
[278] Hagen (n236) 193; see also, *Glanzer v. Shepard* (n219) 441.
[279] Pacini et al. (n250) 402.
[280] 597 N.E.2d 1080 (N.Y. 1992)
[281] Ibid 1085-87.

York courts' application of the near privity rule, and will have a persuasive effect on those courts that still permit unlimited accountant liability.[282]

In *Security Pacific*, an institutional lender, *Security Pacific Business Credit, Inc*. (SPBC), sued the defendant, Peat Marwick Main & Co., for allegedly negligently performing an audit for Top Brass Enterprises, Inc. (Top Brass).[283] SPBC allegedly relied on Peat Marwick's unqualified audit opinion and financial statements when deciding to loan Top Brass forty million dollars on a fifty million dollar line of credit.[284] SPBC allegedly relied on the opinion based on a ten-minute telephone call that it made to Peat Marwick's audit partner in order to discuss Top Brass's audit report.[285]

The *Security Pacific* court affirmed the Court of Appeals of New York's near privity rule by reaffirming *Credit Alliance* and the requirement for an existing relationship between the accountant and the third party that "sufficiently approaches privity".[286] The *Security Pacific* court held that SPBC did not establish a relationship between itself and Peat Marwick that sufficiently approached privity.[287] The *Security Pacific* court reasoned that SPBC's reliance on a ten minute telephone call did not establish a sufficient privity relationship because SPBC's inquiries during the call were "limited to generalities that nothing untoward had been uncovered in the course of the audit and that an unqualified opinion would issue, certifying the tentative draft which plaintiff had received from Top Brass itself".[288] The court further stated that a non-client cannot impose negligence liability on an accountant by alleging reliance on the audit report.[289]

The *Security Pacific* court also recognised an absence of sufficient conduct to establish a relationship between SPBC and Peat Marwick.[290] In addition, the court stressed the observations made by the *Credit Alliance* court that "if a lender can secure a possible loan recourse against a borrower's auditor by the simple act of calling the auditor before advancing a loan and announcing reliance on the auditor's opinion, then every lender's due diligence list

[282] Faussie (n225) 1093.
[283] *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.* 597 N.E.2d 1080. Security Pacific claimed that Peat Marwick's unqualified opinion overstated Top Brass's accounts receivables and merchandise inventory.
[284] *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.* 597 N.E.2d 1080 (N.Y.1992).
[285] Ibid 1082.
[286] Ibid 1083.
[287] Ibid 1083.
[288] *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.* 597 N.E.2d 1080, 1085 (N.Y. 1992).
[289] Ibid.
[290] Ibid.

will in the future mandate such a telephone call".[291] Moreover, the Security Pacific court recognised the absence of any evidence showing that Peat Marwick performed the audit opinion for a specific purpose, other than the SEC's requirement for publicly held companies to file audits.[292]

The New York court's holding in *Security Pacific* was a reaffirmation of its reliance on the near privity rule and its reluctance to extend accountants' liability in suits that fall short of the privity requirements. This case also demonstrates the New York court's careful consideration of policy considerations when applying a narrow definition of duty to non-contractual parties.[293]

3.4 The Restatement of Torts/Foreseen User Approach

The restatement rule broadens the class of persons to whom the auditor owes a duty. Intended identifiable and unidentifiable beneficiaries are included in the class. However, if an auditor has no reason to believe the information would be made available to a third party, or if the information's use changes so as to increase audit risk materially, the auditor is not liable to this class. The major difference between the restatement rule and the near-privity rule is that the restatement rule does not necessitate that the identity of certain third parties be identified by the auditor, just that they be members of a limited group known to the auditor.[294]

Gossman stated that: "The Restatement limits the persons to whom he owes a duty to his client, to intended identifiable beneficiaries and to any unidentified member of the intended classes of beneficiaries. The only extension in the Restatement beyond *Ultramares* and *Glanzer* appears to be that the auditor need not know the identity of the beneficiaries if they belong to an identifiable group for whom the information was intended to be furnished."[295] The Restatement's standard is not problematic; rather, however, the courts' interpretation and

[291] Ibid 1085-86.
[292] *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.* 597 N.E.2d 1080, 1085-96 (N.Y. 1992).
[293] Faussie (n225) 1093.
[294] Chung et al. (n274) 67.
[295] Thomas Gossman, 'The Fallacy of Expanding Accountants' Liability' (1988) Colum. Bus. L. Rev 218.

application has led to a range of conflicting decisions that has tended to expand the auditor's liability.[296]

The main case in this regard is *Rusch Factors, Inc. v. Levin*.[297] According to Gossman, when *Rusch Factors* was decided in 1968, excluding *Biakanja v. Irving*,[298] most courts had adhered to the *Ultramares* rule regarding the requirement for limited privity. Since the *Rusch Factors* decision, however, a vast number of states have applied the Restatement standard.[299]

In *Rusch Factors*, a Rhode Island corporation sought financing from Rusch Factors, a commercial banking and factoring corporation. To determine the financial status of the borrower, Rusch Factors requested certified financial statements. The defendant, a certified public accountant, prepared financial statements showing the corporation to be solvent and in sound financial condition. In reliance upon the financial statements, Rusch Factors loaned the Rhode Island corporation over $337,000. The corporation, which was actually insolvent, subsequently went into receivership.[300]

In arriving at its decision in *Rusch Factors,* the US District Court for the District of Rhode Island considered and then distinguished *Ultramares* on its facts.[301] The *Rusch Factors* court identified the plaintiff as a "member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable".[302] The *Rusch Factors* court identified with the holding in the *Glanzer* case and the tentatively proposed Restatement (Second) of Torts § 552 and held that the plaintiff could not recover against the defendant-accountants.[303] An interesting aspect of the *Rusch Factors* case is that the court appeared to

[296] E.g., *Bily v. Arthur Young & Co.* 834 P.2d 745 (Cal. 1992). For a court's different application of the Restatement, see *Bethlehem Steel Corp. v. Ernst & Whinney* 822 S.W.2d 592 (Tenn. 1991).
[297] *Rusch Factors, Inc. v. Levin* 284 F. Supp. 85 (D.C.R.I. 1968).
[298] *Biakanja v. Irving* 320 P.2d 16 (Cal. 1958).
[299] Gossman (n295) 219.
[300] *Rusch Factors, Inc. v. Levin* 284 F. Supp. 85 (D.C.R.I. 1968**)** 86-87.
[301] The court then concluded that "[t]he defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential [creditors] of the ... corporation.", Id at p. 93. The court went on to question the wisdom of the *Ultramares* decision, as pronounced below: "[t]he wisdom on the decision in *Ultramares* has been doubted ... and this court shares the doubt. Why should an innocent reliable party be forced to carry 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, which can pass the cost of insuring against the risk onto its customers who can in turn pass the cost onto the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this Court the decision in *Ultramares* constitutes an unwarranted inroad upon the principle that the risk reasonably to be perceived defines the duty to be obeyed." Id at p. 90.
[302] Ibid 91.
[303] *Rusch Factors, Inc. v. Levin* 284 F. Supp. 85**,** 91, 92 (D.C.R.I. 1968).

have left open the possibility of applying full limits of foreseeability to accountants for negligent misrepresentation.[304]

Biakanja v. Irving[305] decided by the California Supreme Court in 1958, was the first case to break away from the *Ultramares* decision. *Biakanja* considerably expanded third-party liability in negligence actions. Although the *Biakanja* court held that a balancing test is required when deciding the existence of third-party liability, other authorities have classified this case as one applying the Restatement (Second) of Torts § 552.[306] This case did not involve an action against an auditor or public accountant, however the rule of law set forth in the case was later applied in public accounting cases.[307]

The *Biakanja* court held that when determining whether a defendant will be held liable to a third party who does not enjoy privity, a question of policy arises and involves several factors.[308] These were: 'the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm'.[309] The court reconciled its holding with *Glanzer* by stating that the "end and aim" of the transaction was to offer the service to the plaintiff,[310] so the *Biakanja* court applied a balancing test that approached the foreseeability standard.[311]

While qualitatively distinguishing *Ultramares*, the *Rusch Factors* court differentiated third parties which are actually foreseen from those which are reasonably foreseeable. Since the plaintiff in *Ultramares* was a member of an undefined class of remote lenders, the plaintiff was not actually foreseen, but rather merely foreseeable. In contrast, the plaintiff in *Rusch Factors* was a "single party whose reliance was actually foreseen."[312] As in *Glanzer*, the plaintiff in *Rusch Factors* was actually known to be relying on the defendant's representations. In addition,

[304] Ibid 93.
[305] *Biakanja v. Irving* 320 P.2d 16 (Cal. 1958).
[306] Faussie (n225) 1079.
[307] *International Mortgage Co. v. John P. Butler Accountancy Corp*. 223 Cal. Rptr. 218 (Cal. App. 4 Dist. 1986), overruled by *Bily v. Arthur Young & Co.* 834 P.2d 745 (Cal. 1992).
[308] *Biakanja v. Irving* 320 P.2d 16, 19 (Cal. 1958).
[309] Ibid 19.
[310] Ibid.
[311] Ibid. For an application of the Biakanja balancing standard, see *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.* 493 S.W.2d 378 (Mo. Ct. App. 1973).
[312] *Rusch Factors, Inc. v. Levin* 284 F. Supp. 85 (D.R.I. 1968) at 86-87.

as with the weight certificate in *Glanzer*, the balance sheet in *Rusch Factors* was prepared for the purpose of influencing the third party's conduct. Noting that the *Glanzer* principle was incorporated into Section 552 of the Restatement, the *Rusch Factors* court held that an accountant would be liable for negligent financial misrepresentations which were relied upon by actually foreseen and limited classes of persons.[313]

Under Section 552 of the Restatement,[314] a person practising a profession who supplies false information for the guidance of others, which is justifiably relied upon, is subject to liability for the failure to exercise reasonable care. Liability under Section 552 extends to any person, or member of a limited group of persons, for whose benefit the information was intended to be supplied. However, in order for Section 552 to apply, the certified public accountant "CPA" must be actually informed that a recognised third party or class of third parties will be exercising the financial statements even though the CPA knows that the financial statements are used in a wide range of financial transactions by the corporation and that they could be relied upon by various stakeholders. Many States have since followed the *Rusch Factors* court's or the *Biakanja*[315] court's lead and have applied the Restatement standard when determining whether third party liability can be extended to public accountants.[316]

3.4.1 Problems with the Restatement Standard

According to Faussie, one problem with the Restatement standard is that the courts are given a large amount of discretion to place more weight on some factors than on others.[317] This discretion creates an inconsistency in judgments due to the subjectivity of the application of

[313] Ibid 93.
[314] Restatment (Second) of Torts § 552 (1977) states: Information Negligently Supplied for the Guidance of Others. (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a financial interest, brings wrong information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information. (2) ... The liability stated in subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) though reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.
[315] *Biakanja v. Irving* 320 P.2d 16 (Cal. 1958).
[316] Faussie (n225) 1080.
[317] E.g., *First Nat'l Bank of Commerce v. Monco Agency, Inc.* 911 F.2d 1053, 1062 (5th Cir. 1990) (rejecting an attempt to broaden Louisiana's application of the Restatement and clarifying Louisiana's narrow interpretation regarding the Restatement's parameters).

the test. Some courts decided that the Restatement standard did not provide sufficient protection for the plaintiff and instead applied the foreseeability standard.[318]

Shortly after *Rusch Factors* was decided, the Iowa Supreme Court applied the Restatement in *Ryan v. Kanne*[319] where an accountant had prepared, but not audited, a financial statement. In *Ryan*, the accountant was engaged to prepare a balance sheet of Kanne's lumber business for purposes of incorporation. While the balance sheet showed a net worth of $44,424.82, the company's actual net worth was a deficit of $5,443.34. In addition, there was a discrepancy of $33,689.22 in trade accounts payable, an account which Kanne specifically requested the accountant to review. The accountant contended that he should be relieved of liability because the financial statement was not certified, and it affirmatively stated that the accountant did not express an opinion.[320] In fact, the financial statement itself was marked "Unaudited Statement" when it was submitted by the plaintiff.

In rejecting the accountant's argument, the court asserted that the liability of an accountant is dependent upon the undertaking, rather than upon the rejection of dependability in the accountant's report. Accordingly, the court decided that an accountant would not be absolved of liability by the presence of a disclaimer or the lack of a certification on the financial statements.[321]

The Restatement standard enlarges the class of persons to whom the accountant owes a duty to include intended identifiable beneficiaries and to any unidentified members of the intended class of beneficiaries. However, liability does not attach if the auditor had no reason to believe the information would be made available to the third party or if the information's use changes so as to increase audit risk materially.[322] In other words, the Restatement approach does not require direct supplying of data by the auditor to the user, does not mention "linking conduct" or "shaping," and allows a plaintiff carrying out a "substantially similar transaction" as one contemplated by the auditor to bring suit. However, it is more restrictive than a pure

[318] Faussie (n225) 1080.
[319] *Ryan v. Kanne* 170 N.W.2d 395 (Iowa 1969).
[320] *Ryan v. Kanne* 170 N.W.2d 395 (Iowa 1969) 404. In fact, the financial statement itself was marked "Unaudited Statement" when it was submitted by the plaintiff. Ibid 398.
[321] Ibid 404.
[322] Pacini et al. (n250) 402.

foreseeability standard, limiting suits to members of a limited class the auditor intended to benefit carrying out particular types of transactions.[323]

3.5 The Foreseeable User Approach

Expanding the class of third parties to whom the auditor owes a duty of care, in *Rosenblum Inc. vs. Adler*,[324] the Supreme Court of New Jersey, in 1983, established a new concept considered to be the widest: the Foreseeable User Approach. This approach is very liberal and broad in terms of scope, unlike the privity approach. The approach holds an auditor liable to all third parties that rely on financial statements.[325]

According to this approach, the auditor is responsible for normal professional negligence, and not toward primary beneficiaries and foreseen users only, but towards all persons the auditor predicts, to a reasonable degree, will use and depend on the financial statements. Importantly, the auditor's report should consider unforeseen users, including all creditors and stock holders, which exposes the auditor to legal responsibility towards an unlimited class of persons.[326]

The auditor in this case issued an unqualified report on the financial statements of the Giant stores company. Relying on these statements, *Rosenblum* sold its undertaking to the Giant Company in exchange for a share of its stock. After a short time, the Giant Company declared bankruptcy, at which point the stocks became worthless. *Rosenblum* sued the auditor, claiming normal negligence, and it was demonstrated that the client's management had manipulated records to conceal that assets were not possessed by, or otherwise omitted the creditor's accounts from these records.[327]

The plaintiffs *Rosenblum* claimed that Touche Ross had negligently audited Giant's fiscal years 1971 and 1972 financial statements. The 1972 audit report[328] rendered by Touche Ross, which was virtually identical to their 1971 audit report, stated that:

[323] Gromley (n232) 529; see also, Ivan Ivankovich, 'Accountants and Third-Party-Liability - Back to the Future' (1991) 23(3) Ottawa Law Review 505.
[324] *Rosenblum v. Adler* 461 A.2d 138 (N.J. 1983).
[325] Whittington & Pany (n241).
[326] Tucker & Zurich (n246) 25.
[327] Pacini & Sinason (n237) 29.
[328] Giant Stores Corporations, Annual Report 19 (1972).

"We have examined the accompanying consolidated balance sheet of Giant Stores Corp. and wholly-owned subsidiaries as of January 29, 1972 and January 30, 1971, and the related statements of earnings, stockholders' equity and changes in financial position for the years (52 weeks) then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The consolidated financial statements referred to above fairly the financial position of Giant Stores Corp. and wholly-owned subsidiaries at January 29, 1972 and January 30, 1971, the results of their operations and changes in the financial position for the years (52 weeks) is in conformity with generally accepted accounting principles applied on a consistent basis."

The court of first instance refused to condemn the auditor, finding the auditor had no responsibility for normal negligence towards a non-identified third party. However, the Supreme Court of New Jersey reversed the judgment, and refused to apply the restrictive rules of primary beneficiaries and foreseen user, holding instead that the auditor was responsible for normal negligence towards any third party the auditor can reasonably foresee as receiving and depending on the financial statements audited by him.[329]

Nevertheless, the court identified the zone of application of this rule to include normally only the users of the financial statements who received such statements from the auditing firm *directly* so as to achieve a specific goal related with its works. Consequently, the auditor was deemed normally to have no responsibility towards persons receiving these financial statements from annual reports existing in libraries and specialised governmental bodies.[330]

Given the plaintiffs' reliance on the audit, the *Rosenblum* court held, however, that when an independent auditor gives an opinion without a limitation regarding to whom the client may disseminate the financial statements, the auditor has a duty to all who should reasonably be foreseeable as recipients of the information from the client, provided that the recipients rely on the information pursuant to the business purposes of the opinion.[331]

[329] Whittington & Pany (n247); see also, Matar (n220) 29.
[330] 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) 37(2) American Business Law Journal 171-236 at 179.
[331] 93 N.J. at 339, 461 A.2d at 153; see also, Hagen (n236) 183.

The *Rosenblum* court reasoned that because Touche's audit did not contain any limitation as to dissemination, it was reasonably foreseeable that Giant would distribute the audit to further its business and that Touche had placed the audit into the economic stream.[332] Therefore, Touche was responsible for its careless misrepresentations, and owed a duty to those parties who justifiably relied on the audit.[333]

Although the court's holding was far-reaching, the court's dicta indicated that the classification of recipients would be limited and would not include stockholders who purchased stock after the audit's preparation, or institutional investors or portfolio managers who did not obtain the financial statements from the client.[334] However, in justifying imposing the broad doctrine of foreseeability, the *Rosenblum* court stated that the defendant's ignorance as to the financial statements' precise use would not eliminate the auditor's obligation.[335]

The *Rosenblum* court observed that while the position advanced by the plaintiffs was directed to the service performed by the accountants, their claim could be viewed as based on a negligent misrepresentation.[336] As such, a basis for recovery exists where damages result from a justifiable reliance upon a false statement. The misrepresentation, however, need not be of a factual nature; it may be the expression of an expert opinion.[337]

Since negligent misrepresentations referring to products have been the basis of liability irrespective of privity, the *Rosenblum* court felt that non-contractual parties should, in some situations, be allowed recovery for losses due to careless misstatements made by one furnishing a service. The court asserted that the determination of whether an accountant should be held negligently liable to non-contracting parties involves a balancing of the relationship of the parties, the nature of the injury and the public interest in the projected solution.[338]

After evaluating these factors, the court quoted a Securities and Exchange Commission decision rendered twenty-five years earlier, stating that "the responsibility of a public

[332] Ibid 154-55.
[333] *Rosenblum v. Adler* 461 A.2d 138, 155 (N.J. 1983).
[334] Ibid 153; see also, Hagen (n236)189.
[335] Ibid 155; see also, Hagen (n236)189.
[336] 93 N.J. 324 at 328, 461 A.2d 138 at 142. (1983); see also, Hagen (n236)189.
[337] Hagen (n236)189.
[338] Ibid 333, 461 A.2d at 147; see also, Hagen (n236) 190.

accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies."[339]

While noting that accountants have been able to adequately protect themselves from civil liability under the federal securities laws through malpractice insurance, the court in *Rosenblum* believed that accountants could similarly insure themselves against awards to reasonably foreseeable third parties due to negligence. Under Section 11 of the Securities Act of 1933, a plaintiff need not prove scienter or negligence; rather, the burden of proof rests on the accountants to show "due diligence."[340] Section 18 of the Securities Exchange Act of 1934 allows accountants to avoid civil liability if they act in good faith and have no knowledge that the financial statements are misleading.[341] Neither of these statutes require privity and, thus, accountants are exposed to substantial liability to third parties.[342]

The court examined farther securities statutes and reasoned that the accountant is "a kind of arbiter" among the competing interests of his client, third parties who may rely on his work, and of course his own professional responsibility.[343] The court continued further that it is untenable to restrict economic loss recovery in negligent misrepresentation cases when same is allowed in product defects cases. The court in removing any liability concern, decided that contrary to the view expressed in *Ultramares,*[344] imposition of liability through negligent misrepresentation will not have deleterious consequences but rather it will provide an incentive for accountants to exercise due care.[345] The court then went on to weigh the risk involved in this decision against the public interest it would serve, and stated:

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[339] Ibid 335, 461 A.2d at 149 (Citing In *re Touche, Niven, Bailey, & Smart* 37 S.E.C. 629, 670 (1957)); see also Hagen (n236)189.

[340] Cf. 15 U.S.C. §§ 77k, 771, 77o. See generally *Herman & MacLean v. Huddleston* 459 U.S. 375 (1983). The "due diligence" defense allows an accountant to avoid liability by showing a belief, after reasonable investigation, that when the registration statement became effective, the assertions therein were true *D. Causey, Duties and Liabilities of the CPA* 206 (rev. ed. 1976). Because negligence is the failure to exercise reasonable care, the "due diligence" defense is essentially a negligence standard. Ibid 207.

[341] 15 U.S.C. § 78r (a) (1982). The apparent effect of relieving an accountant of liability if he acted in good faith and without knowledge of a false or misleading statement is to make gross negligence the test of liability under Section 18 of the Securities Exchange Act of 1934. *D. Causey, Duties and Liabilities of the CPA* 206 (rev. ed. 1976).

[342] See for example, *Escott v. BarChris Constr. Corp.* 283 F. Supp. 643 (S.D.N.Y. 1968) (liability of accountant under Section 11 of the Securities Act of 1933); *Fischer v. Kletz* 266 F. Supp. 180 (S.D.N.Y. 1967) (liability of accountant under Section 18 of the Securities Exchange Act of 1934).

[343] (1983), 93 N.J. 324 at p. 336.

[344] 174 N.E. 441 (N.Y. 1931).

[345] *Rosenblum v. Adler* 461 A.2d 138, 155 (N.J. 1983) at p. 349.

"[T]he burden [that the suggested duty] would put on defendant's activity; the extent to which the risk is one normally incident to that activity; the risk and the burden to [the] plaintiff; the respective availability and cost of insurance to the two parties; the prevalence of insurance in fact; the desirability and effectiveness of putting the pressure to insure on one rather than the other, and the like." [346]

As accounting firms have been able to obtain liability insurance covering these risks, the *Rosenblum* court reasoned that accounting firms should be able to purchase malpractice insurance covering common law negligence liability to foreseeable third parties. Accordingly, the *Rosenblum* court held that an accountant's duty of care for ordinary negligence extends to foreseeable users of audited financial statements which are received from a company pursuant to a proper business purpose. In summary, a misrepresentation of the financial condition of the company was due to the accountant's negligence.[347]

Many courts have adopted the application of the reasonably foreseeability rule; of these courts, the Supreme Court of Wisconsin has expanded the zone of the auditor's legal responsibility to include all parties who predicted that they would depend on the auditor's work, and who add that there were reasons for applying such rules as compensation for the injured party, risk-spreading and deterrence, which are essential goals for any civil legal responsibility system.[348] Shortly after the *Rosenblum* decision was handed down, the Wisconsin Supreme Court decided *Citizens State Bank v., Timm, Schmidt & Co*.[349] In *Timm*, the court held that an accountant may be liable to a third party not in privity for negligently preparing an audit report. The accountant's liability extends to the foreseeable injuries resulting from the negligent preparation of the audit unless the court decides, based on the specific facts of a case, that as a matter of public policy, recovery should be denied.[350]

Wisconsin was the second State to judicially apply the foreseeability standard to extend accountants' liability to third parties.[351] The *Timm* court reasoned that Wisconsin's fundamental principle of negligence law "is that a tortfeasor is fully liable for all foreseeable

[346] Id.
[337] 93 N.J. at 339, 461 A.2d at 153; see also, Hagen (n236) 191.
[348] Matar (n220).
[349] 113 Wis. 2d 376, 335 N.W.2d 361 (1983).
[350] Hagen (n236) 191.
[351] Gromley (n232) 557.

consequences of his act except as those consequences are limited by policy factors."[352] After examining the *Ultramares* privity standard and the Restatement standard, the court stated that the Restatement's effect of limiting liability to certain third parties was too restrictive in its policy factors,[353] and that the accountants' liability to third parties would be determined according to the accepted principles of Wisconsin's negligence law.[354]

In *Touche Ross & Co. v. Commercial Union Insurance Co.*, the court discussed the three standards that courts have used when determining an accountant's liability to a third party: the *Ultramares* privity requirement, the Restatement standard, and the foreseeability standard.[355] The *Commercial Union* court dismissed the possibility of using the *Ultramares* test because requiring privity is forbidden under Mississippi law.[356] Similarly, the *Commercial Union* court dismissed the Restatement approach, stating that the Restatement approach is like the privity requirement because it also draws an arbitrary limit on the potential class of plaintiffs.[357]

The *Commercial Union* court ultimately held that "an independent auditor is liable to reasonably foreseeable users of the audit, who request and receive a financial statement from the audited entity for a proper business purpose, and who then detrimentally rely on the financial statement, suffering loss, proximately caused by the auditor's negligence."[358] The *Commercial Union* court reasoned that this approach would simultaneously protect third parties, who request and rely on the financial statements, and the auditor from an unlimited number of potential users who may read a published financial statement.[359] The *Commercial Union* court further recognised the auditor's right to limit the dissemination of the opinion in a separate agreement with the client.[360]

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[352] *Citizens State Bank v. Timm, Schmidt & Co.* 335 N.W.2d 361, 366 (Wis. 1983).
[353] The court recognized that some public policy factors might justify limiting the accountant's duty. These justifications are that: "(1) [t]he injury is too remote from the negligence; or (2) the injury is too wholly out of proportion to the culpability of the [defendant]; or (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm; or (4) because allowance of recovery would place too unreasonable a burden on the [defendant]; or (5) because allowance of recovery would be too likely to open the way for fraudulent claims; or (6) allowance of recovery would enter a field that has no sensible or just stopping point.", 335 N.W. 2d 361 (Wis. 1983) at p. 366.
[354] Ibid 386, 335 N.W.2d at 366.
[355] *Touche Ross & Co. v. Commercial Union Ins. Co.* 514 So. 2d 315,322-23 (Miss. 1987).
[356] Ibid 321.
[357] Ibid.
[358] Ibid 322.
[359] *Touche Ross & Co. v. Commercial Union Ins. Co.* 514 So. 2d 315, 320-23 (Miss. 1987).
[360] Ibid 323.

It means noting that there are diverse opinions with respect to the scope of duty of care as in the case of *Palsgraf v. Long Island Railroad Co.*[361] Under the duty-risk analysis, the scope of the duty of care is generally considered to be a question of law and public policy. The foreseeability of particular risks does not determine the extent of the duty. Rather, foreseeability is employed in determining if the conduct was negligent.[362] Accordingly, whether the risk that injured the plaintiff was foreseeable is relevant to the issue of negligence, which is decided by the trier of fact. On the other hand, the court determines as a matter of law whether the risk that was increased by the defendant's act was within the scope of the defendant's duty.[363]

Employing this line of reasoning, the *Rosenblum* court stated that "within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty."[364] Because the source of the duty is the law, the court in *Rosenblum* looked to prior cases, legislation, official pronouncements of the accounting profession, and policies of the law in declaring the presence of a duty to foreseeable users of audited financial statements.[365] By uniquely restricting the circumstances giving rise to an accountant's negligence liability to third parties. However, the *Rosenblum* court significantly narrowed the scope of an accountant's duty of care considering the reasonable foreseeability of the particular risk. Under *Rosenblum*, the plaintiff must prove that he received the audited financial statements from the company in accordance with a proper business purpose.[366]

This requirement precludes some third parties with a foreseeable risk of injury, such as institutional investors and portfolio managers, from recovery because they did not obtain the financial statements from the company.[367] The court in *Rosenblum* also asserted that in some instances an accounting firm may, in their audit opinion, particularly restrict the persons or class of persons who would be permitted to rely upon the financial statements.[368] Since

[361] 248 N.Y. 339, 162 N.E. 99 (1928).
[362] Leon Green, 'The Duty Problem in Negligence Cases' (1928) 28(8) Columbia Law Review 1014-1045, 1045.
[363] Leon Green, 'Duties, Risks, Causation Doctrines' (1962) 41(1) Texas Law Review 42, 1045.
[364] 93 N.J. at 339, 461 A.2d at 145.
[365] Ibid; see also, Hagen (n236) 202.
[366] Ibid 350, 461 A.2d at 152; see also, Hagen (n236) 203.
[367] Ibid.
[368] The presence of a disclaimer may prevent a reasonable reliance upon the financial statements. See Stanton & Dugdale, Recent Developments in Professional Negligence - II: Accountant's Liability to Third Parties 132 NEW L.J. 5 (1982); Compare *Stephens Indus. v. Haskins & Sells* 438 F.2d 357 (10th Cir. 1971) (a qualified audit opinion absolved the accountant of liability) and *MacNacland v. Barnes* 129 Ga. App. 367, 199 S.E.2d 564 (Ct. App. 1973) (accountant relieved of negligence liability in preparing financial statements containing an express disclaimer) with Rhode Island Hosp. *Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs* 455 F.2d 847 (4th Cir. 1972) (disclaimer accompanied by misleading explanatory

Rosenblum allows an accounting firm to restrict the users of financial statements, *RosenbIum* has markedly departed from the traditional duty-risk analysis by transferring the determination of the foreseeability of a particular risk from the trier of fact to the defendant.[369]

3.6 Concluding Overview of the Development of Auditor Liability Principles in the US

Hagen provides a useful overview of the development of auditor liability principles in the US courts stating as follows:

"Over the years, courts have traditionally followed the *Ultramares Glanzer* requirement of a "contractual relationship or its equivalent" before an accountant will be held liable for a misrepresentation in the financial statements. Although some jurisdictions have adopted Section 552 of the Restatement (Second) of Torts whereby an accountant may be liable to persons who are actually foreseen or members of a limited class of persons for whose benefit and guidance the information was intended, the Restatement position is, at most, a slight variation of basic contract law principles that allow an intended beneficiary to recover. Alternatively, three recent decisions, *Rosenblum*, *International Mortgage*, and *Citizens State Bank*, have disregarded privity of contract and implemented basic tort law principles where an accountant has failed to exercise ordinary care. Basically, the decisions in *Rosenblum* and *International Mortgage* represent an application of the Cardozo view, while the decision in *Citizens State Bank* demonstrates an application of the Andrews view to an accountant's liability for negligence. While *Rosenblum* has essentially applied the Cardozo philosophy by extending an accountant's duty of care to reasonably foreseeable third parties, the court's limitation that the plaintiffs have received the financial statements from the company pursuant to an appropriate business purpose significantly restricts the scope of the accountant's duty. Additionally, in permitting an accountant to restrict expressly the persons who would be entitled to rely on the financial statements, the *Rosenblum* court improperly transferred the determination of the foreseeability of the risk from the trier of fact to the defendant. *International Mortgage*, on the other hand, is a more traditional application of the Cardozo view. Under *International Mortgage*, the duty of care of an accountant extends to any reasonably foreseeable plaintiff who relies on the financial statements. Alternatively, *Citizens*

paragraph was inadequate to prevent accountant from being negligently liable) and *Ryan v. Kanne* 170 N.W.2d 395 (Iowa 1969).

[369] Hagen (n236) 203.

State Bank used the Andrews philosophy by basing the extent of an accountant's duty on the foreseeability of the effects of the negligent act; but by including additional public policy factors in the proximate causation analysis, the court decreased the possibility of an accountant's liability. Moreover, by employing the procedural aspects of the Cardozo view, *Citizens State Bank* inappropriately transferred the evaluation of foreseeability from the trier of fact to the court. A certified public accountant purports to render an independent, expert opinion on the reliability of a company's financial statements. Where the accountant's failure to exercise ordinary care is the actual and proximate cause of a misrepresentation, the accountant should be held negligently liable to an innocent victim. The concepts of privity of contract, intended third party beneficiary and actual foreseeability, which arose out of contract law, should not serve as insulation from tort liability. Furthermore, because the law should strive to achieve fairness and justice, courts should rigorously apply the Andrews philosophy without any modification and allow the jury to determine whether an investor or creditor who has suffered a foreseeable pecuniary loss can recover against a careless accountant. If the consequences of an accountant's negligent actions are reasonably foreseeable, the accountant should be held accountable."[370]

The next section of this Chapter addresses the U.S legislators' attitude towards auditor liability.

3.7 Reactions of American Legislators

Audit failure occurs when an auditor incorrectly issues an opinion that financial statements fairly present an issuer's financial condition and results in conformity with generally accepted accounting principles (GAAP).[371] Under federal law, a limited risk of auditor liability for negligence exists in connection with initial securities offerings, although most federal law actions involve secondary market trading and require a showing of scienter for private actions.[372] Principal federal laws are section 11 of the Securities Act ("SA") of 1933, 15 U.S.C. § 77k (2000), and section 10(b) of the Securities Exchange Act ("SEA") of 1934, 15 U.S.C. § 78j (2000). The latter applies to secondary trading in securities and exposes auditors to liability under fraud theories if *scienter* is shown. The former applies to registered public offerings of

[370] Hagen (n236) 210.
[371] Lawrence Cunningham, 'Securitizing Audit Failure Risk: An Alternative to Caps on Damages' (2007) 49(3) William and Mary Law Review 717.
[372] Ibid.

securities and exposes auditors to nominally strict liability, which becomes essentially a negligence standard because auditors can defeat liability by showing reasonable investigation and belief. Section 11 liability also depends on the investor's ability to prove tracing. Other relevant federal laws include section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (2000), which imposes on auditors the duties of inquiry and disclosure, and section 18(a) of the Securities Exchange Act, 15 U.S.C. § 78r (2000), which creates private rights of action against persons, including accountants, who "make or cause to be made" significantly misinforming statements in reports or other documents filed with the SEC.[373]

Both the 1933 SA and the 1934 SEA expanded auditors' liability to third parties beyond the boundary of common law.[374] The plaintiff will not need to prove reliance, but instead the defendant will have to demonstrate that the former is aware that the disputed section of the reported document is false as in s. 11 1933 SEA, which does away with the common law requirement of scienter and perpetrators are held strictly liable for any misrepresentations in the registration statement. Section 10(b) of the 1934 SEA and Rule 10b-5 are also wide enough to create an implied liability for auditors, but unlikely to attract strict liability due to the Supreme Court ruling in the case of *Ernst & Ernst v Hochfelder* that negligence is not adequate to violate Rule 10b-5 as there must be scienter.[375]

Federal law imposes further jurisdictional limitations on what kinds of securities-related claims may be brought in state, rather than federal court. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.) restricts securities fraud class actions to federal court, although it does not cover individual actions or derivative litigation in state courts.

While the majority of auditors tend to settle their claims out of court, the few cases that are heard in court focus on the scope of audit and causation and not on issues of auditor's negligence.[376] In most instances, professional service firms prefer to settle out of court because of the adverse impact on office morale and business ties.[377]

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[373] Ibid 717-718.
[374] D Guy, C Alderman & A Winters, 'Auditing' (1999) The Dryden Press: Fort Worth.
[375] Scienter is the "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder* 425 U.S. 185, 185 (1976).
[376] D Gwilliam, 'Changes in the Legal Environment' in M Sherer & S Turley (eds), *Current Issues in Auditing* (3rd Edition, Paul Chapman Publishing, London 1997).
[377] Peter Yeoh, 'The Legal Implications of Off Balance Sheet Financing: A Comparative Analysis of UK and US Positions' (PhD Thesis, University of Wolverhampton, 2007) available at: http://hdl.handle.net/2436/17614.

In the United States, of course, common law is state dependent. This means that courts in a particular State are not obliged to follow the precedents in others, yet they may borrow principles from them where they do not have pertinent precedents of their own. In contrast, courts are obliged to follow statutes enacted by the federal or local state legislatures unless these conflict with the federal or state constitutions. Courts will resort to their own interpretations where provisions of the statutes concerned are not explicit enough. In respect of audit statements and other related services, auditors may be liable for ordinary negligence, gross negligence, or fraud. To establish these, the victims have to prove that they relied upon and suffered damages arising from misstatements in the audited financial statements; and that adequate employment of Generally Acceptable Accounting Practices (GAAP) should have spotted such misstatements.[378] The courts have reaffirmed the GAAP as the appropriate framework for evaluating fairness.[379]

Ordinary negligence occurs when auditors fail to exercise reasonable care in their work. Gross negligence occurs when auditors fail to exercise minimum care. Fraud occurs when auditors issue opinions on financial statements or audit reports, which they know to be untrue. It differs from gross negligence in that the auditors, not only lack reasonable foundation for their beliefs but also, are aware of the falsity and intention to deceive. There is therefore a continuum of misrepresentation extending from innocent (belief with sufficient basis) to fraudulent (with awareness of falsity).[380] However, where there is collusion and senior management override of internal control systems and procedures, it is unlikely that auditors will be caught with gross negligence.[381] Nonetheless, gross negligence can occur where there is recklessness, and where adequate implementation of GAAP should have uncovered the errors or fraud (the *Ultramares* principle).[382] The case for fraud against auditors is founded on intentional deceit and auditor complicity.[383]

[378] Yeoh (n377) 186.
[379] *U.S. v Simon et al.* 425 F. 2d 796 (2nd Cir. 1969).
[380] L Konrath, *Auditing: A Risk Analysis Approach* (South Western Publication: Cincinnati, 2002); see also, Yeoh (n377) 186.
[381] Konrath, supra note 182 citing the case of *Cenco Inc. v Seidman & Seidman* 686 F. 2d 449 (CA 7 1982); see also Yeoh (n377) 187.
[382] Ibid, citing the case of *Ultramares v Touche* 225 N. Y. 170, 174 N. E. 441 (N. Y. Ct. App. 1931); see also, Yeoh (n377) 186.
[383] Ibid.

3.8 Conclusion

This Chapter has explored the development of the civil liability of auditors towards third parties in the US courts and the legislative response. The US courts have developed a variety of opinions and approaches and the law has developed at different paces, spanning the spectrum of contract privity through to foreseeability in negligence.

The US cases universally indicate, however, that it is unlikely for a corporation or its shareholders to be indemnified specifically in the secondary market for improper annual financial statements audited by an auditor, at least according to the case law, unless specific legislation so provides. This research emphasises that the approach of the US courts remains incomplete as an effective indemnification system and not compliant with Shariah law which is applicable in Saudi Arabia.

The next chapter will discuss the civil liability of auditor towards third parties in England.

Chapter 4: The Civil Liability of Auditors in the UK and Other Countries

4.1 Introduction- Overview of Auditors' Civil Liability Towards Third Parties in the UK and Other Countries

This chapter first explores the development of the law of auditor civil liability towards third parties in the English courts, which have had a profound on the development of the law in other common law countries.[384]

The literature on auditor liability in England identifies an assumed liability in relation to contractual parties, with the principle of privity of contract limiting liability to the corporate body being audited.[385] But the 1970s and 1980s saw a substantial extension of liability to the point where it could be asserted that virtually any party who could reasonably be considered to have relied on an audit opinion could claim damages against auditors arising from negligent misstatement.[386] This was considered to be an appropriate mode for disciplining auditors and also for responding to public calls for fairer treatment of "innocent" third parties such as potential investors, creditors, employees and other stakeholders.[387] In subsequent years, however, these arrangements were reconsidered. In England, for example, the landmark decision by the House of Lords (now the Supreme Court of the UK) in the *Caparo* case signified a move back to a narrower understanding of the notion of stewardship. It returned the focus to the company as a corporate body rather than a collection of interests of individual shareholders and laid down stricter conditions under which a duty of care could be said to be owed by auditors.[388] That being said, it has been argued that this period of relative calm was followed by gradual expansions of the notion of privity by the British courts.[389] Before addressing the main modern cases of this chapter, some older cases are considered to evaluate

[384] See Chapters Three and Four for other common-law cases relied on the U.K precedents.
[385] Brenda Porter, Jon Simon and David Hatherly, *Principles of External Auditing* (3th edn, John Wiley& Sons Ltd, Chichester, 2008); see also, Anna Samsonova-Taddei and Christopher Humphrey, 'Risk and the Construction of a European Audit Policy Agenda: The Case of Auditor Liability' (2015) 41 Accounting, Organizations and Society 55-72. 56.
[386] Porter (n385); see also, Taddei and Humphrey (n385) 57.
[387] D Gwilliam, 'Auditor Liability: Law and Myth' (2004) 20(3) Professional Negligence 172; see also, John Siliciano, 'Trends in Independent Auditor Liability: The Emergence of a Sane Consensus?' (1997) 16(4) Journal of Accounting and Public Policy 339-353. 341; see also, Taddei and Humphrey (n385) 56.
[388] Taddei and Humphrey (n385) 57.
[389] Christopher Napier, 'Intersections of Law and Accountancy: Unlimited Auditor Liability in the United Kingdom' (1998) 23(1) Accounting, Organizations and Society 105-106; see also, Taddei and Humphrey (n385) 57.

their impact and to better understand how and perhaps why the English courts have changed their attitudes of auditor liability towards third parties.

Harlow identifies several general criteria that must be satisfied in order for someone to be liable towards another in tort for negligence. He asserts that in order for someone to be found liable for negligence, a defendant (a) must owe a plaintiff a duty of care, (b) have failed to take reasonable care, and (c) the defendant's acts or omissions must have caused damage to the plaintiff that it was reasonable to expect the defendant to foresee would result from the acts or omissions.[390]

Napier observes that Harlow's schematic statement of liability brings many crucial questions.[391] For example, to whom is a duty of care owed? Under what circumstances is a duty of care owed? What acts or omissions matter? What damage matters? What level of care is reasonable? What constitutes reasonable foresight? According to Napier, there were different answers given by British law at different times, which are reflected in attitudes towards auditor liability.[392] The first important notion considered by the courts was that of privity. During the nineteenth century, judges were reluctant to find that a duty of care was owed at all to third parties. The parties to a contract were considered to owe duties of care to each other, and failure to perform explicit or implied contract terms was actionable if damage ensued. But those not involved in the contract had only restricted rights.[393]

Until the beginning of the twentieth century, the third party had no right to sue the auditor for negligence even if the financial statements on which they depended were the direct reason for the damages incurred.[394] In other words, there was a difficulty in suing the auditor outside of the frame of contractual relations where either the contract lagged or the contracted relation was non-existent. This meant that the auditor had no responsibility to third parties, unless he committed fraud. This was confirmed in *Candler vs. Crane Christmas & Co.*,[395] where the necessity to prove the existence of a contractual relation between the auditor and plaintiff was emphasised, Moreover, the third party had no right to litigate the auditor for a mere mistaken statement.[396]

[390] Carol Harlow, *Understanding Tort Law* (Fontana Press: London 1987) 42-43.
[391] Napier (n389) 110.
[392] Ibid.
[393] Ibid.
[394] Ibid 111.
[395] *Candler v Crane, Christmas & Co.* (1951) 2 KB 164.
[396] Napier (n389) 111; see also, Pacini et al. (n250); see also, Matar (n220) 41.

The categories of negligence can never close, for "the criterion of judgment must adjust and adapt itself to the changing circumstances of life" said Lord Macmillan in *Donoghue v. Stevenson*.[397] There, the House of Lords famously held that a person who has no contractual relationship with the wrongdoer, may nonetheless sue the wrongdoer if first, the wrongdoer owed a duty of care to him; secondly, the wrongdoer breached his duty; and thirdly, the person has suffered damage as a result of the wrongdoer's breach of duty.[398]

Yet, according to Fleming, it was also almost impossible to hold accountants and other gatekeepers liable for negligent misstatements in disclosure documents until 1964.[399] In that year the House of Lords held in *Hedley Byrne & Co v Heller & Partners*[400] that investors who relied on the negligent misstatement of an accountant and ended up incurring loss in their investment were entitled to sue the accountants regardless of the non-existence of privity of contract.[401] The House of Lords held that all persons who provide a statement owe a duty to any third person with whom a special relationship exists.[402] Their lordships approved a dissenting opinion of Lord Denning given in 1951 in *Candler v Crane Christmas & Co*[403] that accountants owe a duty "to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts".[404]

Although the phrase "special relationship" was not defined, the House of Lords held that special relationship existed in the case before it owing to the fact that the defendant voluntarily assumed the responsibility of making accurate disclosures to the public.[405]

The English judiciary started applying this ruling broadly, [406] and gradually the scope and meaning of the phrase "special relationship" changed from the concept of "voluntary

[397] *Donoghue v Stevenson* (1932) AC 562 618-19.
[398] Chan Meng, Ng Thye and Lee Leong, 'Professional Indemnity Insurance Policy: A Need to Reform in Malaysia' (2007) 5(1) Competition Forum 131-132; see also, Napier (n389) 111.
[399] J Fleming, 'The Negligent Auditor and Shareholders' (1990) 106 Law Quarterly Review 349.
[400] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1964) A.C. 465 (H.L.).
[401] Napier (n389) 111.
[402] Bruce Chapman, 'Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law' (1992) 20 Canadian Business Law Journal 184.
[403] *Candler v. Crane Christmas& Co.* (1951) 1 All E. R. 426 (C.A .).
[404] *Hedley Byrne & Co. Ltd v. Heller & Partners Ltd* (1964) A.C. 465 (H.L.) 368-369; see also, Chapman (n402) 189.
[405] G Morris, 'The Liability of Professional Advisers: Caparo and After' (1991) Journal of Business Law 36; see also Joseph Abugu, Re-examining the basis of auditors' liability in Nigeria and the United Kingdom (2014) 11(3) International Journal of Disclosure and Governance 240.
[406] R. Mullender, 'Negligent Misstatement, Threats and the Scope of the Hedley Byrne Principle' (1999) 62(3) The Modern Law Review 425-434, 429.

assumption of responsibility" by gatekeepers to "reasonable reliance" of a third party, and then to "foreseeability" which was first introduced in 1978 in the case *Anns v Merton LBC*.[407]

The crucial factors, namely "causation" and "reliance", were often found to be extremely difficult to prove against the defendants.[408] Thus, it has been argued that the judicial decisions in effect narrowed down the scope of 'gatekeeper' liability for negligent misstatements.[409] Under these principles, in the United Kingdom, an auditor as a gatekeeper could be held liable for misstatements only if it could be proved that he or she knew that the audited work would be communicated to non-client third parties and that those non-clients would rely on the work in relation to a financial transaction.[410]

The case of *Caparo Industries*[411] is an important refinement of the law of negligent misstatement insofar as it concerns auditors' liability to third parties. At the backbone of this decision rests the requisite that the auditor must have anticipated personal responsibility to the third party as to the correctness of the report or account to create the duty of care-the breach of which could offer upsurge to a claim in tort.[412] The overall rule is that auditors owe their duties to the corporate body.[413] Instead, they owe a duty to outsiders simply when they anticipated personal responsibility to third parties.[414] The claim in *Caparo Industries* thus failed since the third party, who depended on the accounts and underwent losses, did not support the test of assumption of responsibility and resulting proximity,[415] resulting in the auditors escaping liability.[416]

This chapter then aims to introduce the auditor civil liability towards third parties within selected common law countries that may have followed the English or US approaches. One of the main aims of this chapter is to show how the approach of the leading common law countries

[407] *Anns v Merton LBC* (1978) A.C. 728.
[408] S Gunz and J McCutcheon, 'A New Perspective on the Role of the Audit' (1996) 2 Journal of Law and Business 10; see also, Carl Pacini, Andrew Greinke and Sally Gunz, 'Accountant Liability to Nonclients for Negligence in the United Kingdom, Canada, Australia, and New Zealand' (2001) 25(1) Suffolk Transnational Law Review 27.
[409] Pacini et al. (n408) 27.
[410] Pacini et al. (n408) 70.
[411] *Caparo Indus. v. Dickman* (1990) 2 A.C. 605 (H.L.).
[412] Ibid 619, 621, 627.
[413] See Caparo 619. ("In advising the client who employs him the professional man owes a duty to exercise that standard of skill and care appropriate to his professional status and will be liable both in contract and in tort for all losses which his client may suffer by reason of any breach of that duty. But the possibility of any duty of care being owed to third parties with whom the professional man was in no contractual relationship was for long denied…"); see also Ibid 659.
[414] Ibid 620–21.
[415] Ibid 642–43.
[416] Ibid 654, 663; see also, Adolfo Paolini, 'Auditors' Liability and Corporate Fraud in the UK: Does Corporate Size and Structure Matter' (2015) 10 J. Bus. & Tech. L. 249.

has been followed, either completely or with minor deviation, in other countries, suggesting that there is a convergence of opinion at least within the common law world on the liability of auditors towards shareholders in the secondary market. The secondary aim of this chapter is to examine recent developments in regulation in the same area.

According to Khoury, a comparative analysis of legal systems provides a useful method to critically examine both the strengths and weaknesses of one's own legal system.[417] Briefly, Chung et al., who investigated auditor liability to third parties in different common and civil law jurisdictions based on their regulatory and legal reforms, found France and Germany to be leaders in the area having had the highest levels of auditor liability to third parties, as these two countries have the least restrictive levels of auditor third party legal liability.[418] However, the same study did not identify specific precedents to illustrate how civil law countries apply these principles. Consequently, it is not surprising that the post-Sarbanes Oxley ("SOX") changes to auditors' liability have been minimal in these two countries as compared to other five countries, which will be part of this study. The rules regarding auditors' legal liability in Germany and France are based upon tortious-only principles that are consistent with a civil law approach, whereas in the US., Canada, UK., Australia, and New Zealand, they are based largely upon contractual obligation, where it can be difficult to establish a case in tort. [419]

France and Germany in both the pre-SOX era and post-SOX era had the highest standard of auditor liability, as reasonable foreseeability means that auditors in these countries are liable to any party that would reasonably be foreseen to rely on their audited financial statements.[420] In contrast, U.S. common law is not limited to just one of four legal standards; Canadian common law follows the near-privity standard; UK common law follows the strict privity standard; and Australian and New Zealand case law most closely follows the restatement standard.[421]

[417] Lara Khoury, 'The Liability of Auditors Beyond their Clients: A Comparative Study' (2001) 46(2) McGill Law Journal 413 at 414.
[418] Chung et al. (n274) 73-74.
[419] Chung et al. (n274) 75.
[420] Ibid.
[421] The High Court of Australia has for example ratified only one case relating to auditor liability to third parties – the *Esanda Finance* case – which is the only one of the three Australian cases cited that clearly follows the restatement standard. The other cases have been classified as following the restatement standard, although they adhere to more of a near-privity standard, because their outcomes are inferior to the *Esanda Finance* outcome in that the High Court of Australia did not preside over them. For more discussion about the four legal standards of auditor liability towards third parties standard; see also, Chung et al. (n274) 75-76.

It also means that among some British Commonwealth countries, there is a lack of convergence, despite mutual origin in British common law. Although common law in the United States is also rooted in British common law, auditor liability to third parties is state-specific and spans the gambit of all four levels of privity. In comparison, it shows that France and Germany have the highest level of auditors' liability to third parties by virtue of France having case law that requires reasonable foreseeability, and Germany requiring contract with protective effect and implicit contract for information, both of which require reasonable foreseeability.[422]

We now turn to a more comprehensive examination, the two main cases dealing with auditor liability in tort in English law, and review their impact on subsequent cases.

4.2 *Hedley Byrne & Co v Heller & Partners*[423]

Following the House of Lords decision in 1964 in *Hedley Byrne & Co Ltd. vs. Heller & Partners Ltd* there began an interest in the nature of the auditor's responsibility towards third parties for negligent misstatement. In *Hedley Byrne,* the House of Lords held that liability for loss emanating from negligent misstatement could arise in certain circumstances.[424] The facts in this case were that the defendant's firm (Heller & Partners Ltd), a commercial bank, presented financial data concerned with the credit-worthiness of Easipower Ltd. in response to the demand of another bank (National Provincial Bank) charged with this task for the sake of one of its clients. The defendant knew that these financial data would be transferred to another unknown party (Hedley Byrne), which depended on these data to decide whether to extend credit to Easipower. Shortly afterwards, Easipower was declared insolvent, and it was subsequently demonstrated that the data on which it relied were untrue and misleading.[425]

The House of Lords established a new legal principle that a person who has special skills, and gives advice and information and knows that the information will be depended on must exert

[422] Civil law jurisdictions are beyond the scope of this thesis; however, the researcher will refer briefly in Chapter Six, which is related to professional liability insurance to their importance and assess how Saudi Arabia would be able to benefit from both civil and common law jurisdictions in Chapter Seven.
[423] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* [1964] A.C. 465 (H.L.).
[424] Ibid.
[425] Pacini et al. (n408) 22.

due diligence towards the person who will depend on such, and will be responsible for any negligence or breach of duty in this task and liable to compensate those relying on the information for any loss incurred. The significance of the case for auditors is obvious: applying similar logic, an auditor will be held responsible for negligence towards persons other than the client as well as to the client itself.[426]

Lord Devlin alleged that the classes of special relationships which could offer an increase to a duty of care in words as well as in deed are not limited to contractual relationships or to relationships of fiduciary duty, 'but include also relationships which in the words of Lord Shaw in *Nocton v Lord Ashburton*[427] are "equivalent to contract" that is, where there is a notion of responsibility in conditions in which, but for the lack of consideration, there would be a contract'.[428] He then continued:

"I have had the advantage of reading all the opinions prepared by your Lordships and of studying the terms which your Lordships have framed by way of definition of the sort of relationship which gives rise to a responsibility towards those who act upon information or advice and so creates a duty of care towards them. I do not understand any of your Lordships to hold that it is a responsibility imposed by law upon certain types of persons or in certain sorts of situations. It is a responsibility that is voluntarily accepted or undertaken, either generally where a general relationship, such as that of solicitor and client or banker and customer, is created, or specifically in relation to a particular transaction."[429]

Much of Lord Devlin's concern was to avoid the risk that people would be held liable for remarks made in a social or other informal context. Hence, the emphasis on liability arises because the defendant himself assumes responsibility for what he says.[430]

Hedley Byrne raised an important question as to how a person can recover damages for loss suffered by negligent misrepresentation. It was acknowledged that there exists a myriad of circumstances that show that irrespective of any contractual or fiduciary relationship and irrespective of any direct dealing a duty may be owed by one person to another. Independent

[426] Napier (n389) 111.
[427] *Nocton v Lord Ashburton* (1914) AC 932.
[428] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1964) A.C. 465 (H.L.) 528; see also, Abugu (n405) 240.
[429] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1964) A.C. 465 (H.L.) 529.
[430] See such subsequent cases such as *Spring v. Guardian Assurance plc* (1995) 2 AC 296.

of contract, there may be circumstances where information is given or where advice is sought, which establish a relationship creating a duty not only to be honest but also to be diligent.[431] It was held that:

"it should now be regarded as settled that if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies on such skill, a duty of care will arise. The fact that the service is to be given by means of, or by the instrumentality of, words can make no difference. Furthermore if, in a sphere in which a person is so placed that others could reasonably rely on his judgment or his skill or on his ability to make careful inquiry, a person takes it on himself to give information or advice to, or allows his information or advice to be passed on to another person who, as he knows or should know, will place reliance on it, then a duty of care will arise."[432]

Since *Hedley Byrne*, the British courts have moved through a cycle of extending and then curtailing the contexts in which a duty of care is deemed to arise.[433] Moreover, for many years, accountants and other professionals believed, with justification, that, whilst they clearly owed a duty of care to the parties to whom their reports were addressed (usually the shareholders of a company), no duty of care to any other party arose other than in very specific and restricted circumstances, such as fraud or through the existence of some other clearly defined contractual or fiduciary duty.[434] In Ireland, *Hedley Byrne* effectively became Irish law through the judgment of Davitt P. in *Securities Trust Ltd v. Hugh Moore and Alexander Ltd*.[435]

These decisions had the effect of extending the duty of care beyond actual contractual relationships to where there was a 'special relationship' equivalent to a contract between the parties.[436] In *Securities Trust,* Davitt P summarised the extended duty of care as follows:

"The proposition that circumstances may create a relationship between two parties in which, if one seeks information from the other and is given it, that other is under a duty to take reasonable care to ensure that the information given is correct, has been accepted and applied in the case

[431] Abugu (n405) 240.
[432] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1964) A.C. 465 at 502-503 per Lord Morris.
[433] A Jaffey, *The Duty of Care* (Aldershot: Dartmouth Publishing 1992); see also, J Stapleton, 'Duty of Care and Economic Loss: A Wider Agenda (1991) 107(2) Law Quarterly Review 249, 5.
[434] Niamh Brennan and John Hennessy, 'Accountants' Liability for Negligence' (2001) 33(5) Chartered Accountants Ireland 21-23, 23.
[435] *Securities Trust Ltd v. Hugh Moore and Alexander Ltd* [1964] I.R. 417.
[436] Brennan and Hennessy (n434) 22.

of *Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.*, recently decided by the House of Lords."[437]

The decision in *Hedley Byrne* has since been considered in a number of cases in the UK and Ireland as the Courts have attempted to interpret the general principle and apply it to specific circumstances. These attempts appeared to restrict the accountant's potential responsibility.[438] Yeoh[439] thinks that the case of *Caparo*[440] seems to have shown the reluctance of the House of Lords to extend the proximity test found in *Hedley Byrne.*[441]

This contrasting view holds that what is important in practice, "… is the holding out, by self-styled financial advisers and others, of knowledge and expertise in the provision of financial advice and information. That holding out is sufficient to attract the imposition of legal obligations and any corresponding legal entitlements of the customers who rely upon such information or advice, should it prove defective".[442] On this basis, it may be appropriate to include investment banks, brokerage firms, and accounting firms involved in the provision of financial advisory services either as ancillary services or through separate legal entities created for this expressed purpose.[443]

The latter approach is derived mainly from the landmark decision in *Hedley Byrne*.[444] The critical element of the *Hedley Byrne* decision is the assumption of responsibility principle. This can be explained as follows; "That a person should be bound by legal duty of care to avoid causing economic loss to another in circumstances where a reasonable man in the position of the defendant would foresee that kind of loss and would assume responsibility for it."[445]

From this perspective, tort is the equivalent of the assumption of legal responsibility to another through a contractual or near to contractual relationship by a professional to undertake a service

[437] *Securities Trust Ltd v. Hugh Moore and Alexander Ltd* [1964] I.R. (1964) I.R. 417 at 421.
[438] Brennan and Hennessy (n434) 23.
[439] Yeoh (n377) 162.
[440] *Caparo Industries Plc v Dickman & Others* (1990) 1 All ER 568.
[441] *Hedley Byrne & Co Ltd v Hedley & Partners* (1963) 2 All ER 575
[442] Gerard McMeel and John Virgo, *Financial Advice and Financial Products: Law and Liability* (Oxford University Press: Oxford 2001) 37; see also, C Hollander and S Salzedo, *Conflicts of Interest & Chinese Walls* (Sweet & Maxwell: London 2004) 1-7.
[443] Yeoh (n377) 162.
[444] Yeoh (n377) 162; see also Norman Katter, 'The Liability of Professionals to Third Parties for Negligent Misstatement Under Consumer Protection Legislation: Outflanking the Neighbourhood Principle' (2007) 15 Tort Law Review 31.
[445] Christopher Harvey, 'Economic Losses and Negligence; The Search for a Just Solution' (1972) 50 Canadian Bar Review 580, 620.

with care and competence to achieve an objective without negligence. If not, as a result of reliance, a claim can be filed for liability for direct economic loss.[446] In other words, outsiders find it more difficult to make claims against auditors who do not owe them the alleged duty of care.[447] For a claim of this kind to work, the third party has the onus of proving that the situation is different in the sense that the auditor has assumed certain responsibility to the person in question, as to the accuracy of the reports and/or accounts care.[448] *Hedley Byrne* is authority for pure economic loss claims in tort, based on negligent misrepresentations. Nevertheless, it will not be sufficient for the outside party to verify that an auditor negligently organised the report or accounts on which he or she relied and caused losses, if the outsider fails to support also that the auditor owed the person a duty of care.[449]

Depending on the case of *Hedley Byrne*, the Institute of Chartered Accountants in England and Wales issued its bulletin concerning the auditor's responsibility towards the other (third party), demonstrating that the third party-who notably has the right to litigate for compensation-is limited to who incurred the damage due to the auditor's negligence in preparing his report.[450] The bulletin of the Institute of Chartered Accountants included various practical applications in the light of the previous judgment, where it indicated to *Hedley Byrne & Co. Ltd. vs. Heller & Partners Ltd*.[451]

With respect to stockholders, in the next *Hedley Byrne* case, there appeared a direction towards expanding the zone of parties having the right to litigate the auditor for negligence; this was ascertained by the judgment pronounced in the case of *JEB Fasteners Ltd. vs. Marks Bloom & Co.*.[452] In this case, the concept of foreseeability was applied. Occurrences of this case are summarised as the plaintiff buying all the stocks of a company depending on the auditor's report, which implies an unqualified opinion concerning the validity of the financial statements. Subsequently, it was demonstrated that such financial statements contained a huge amount of errors resulting from stocks possessed by the plaintiff where they were evaluated as being worth more than their real value. Although the auditor did not know when contracting with the client about auditing that there was a third party who wanted to possess stocks of the company,

[446] Yeoh (n377) 162.
[447] Paul Davies and Sarah Worthington, *Gower and Davies' Principles of Modern Company Law* (9th ed, Sweet and Maxwell 2012) 847.
[448] Ibid 248; see also, Paolini (n416) 248.
[449] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1964) 1 A.C. 465 at 483, 496, 504; see also, Paolini (n416) 248-249.
[450] Matar (n220) 42.
[451] Ibid.
[452] *JEB Fasteners Ltd v. Marks Bloom &Co.* (1981) 3 All E.R. 289, affirmed (1983) 1 All E.R. 583 (C.A.).

the auditor later became aware of such a purchasing process, and there were communications between the buyer (plaintiff) and the auditor throughout the purchasing process. [453]

The court held that "the accountants owed a duty of care to the plaintiffs. They knew that they would rely upon the accounts. However, in this case, the plaintiffs would have proceeded in any event, and so the negligence did not cause any of the damage actually suffered as long as the misrepresentation plays a real and substantial part, though not by itself as decisive part, in inducing the plaintiff to act, it is a cause of his loss and he relies on it, no matter how strong or how many are the other matters which play their part in inducing him to act"[454]

Liability may also be predicated on a combination of both a breach of duty and negligent misstatement.[455] Negligent misstatement was the basis of the issues in *Owen Investments Ltd. v. Bennett, Nash, Wolf & Co.*,[456] and the decision in the leading case *of J.E.B. Fasteners Ltd. v. Marks, Bloom & Co.*,[457] reliance of course being the concept at the heart of the liability for negligent misstatements created by *Hedley Byrne* case.[458]

Abugu asserts the case had several far-reaching consequences for future potential plaintiffs who may forward a *Hedley Byrne*- like claim against auditors.[459] At the heart of the "special relationship" concept lies the idea of reliance by the plaintiff on the words of wisdom (or otherwise) being uttered by the professional man. The "reliance" idea can be further split into two separate but related questions, namely: (i) Was the reliance by the plaintiff reasonable in the circumstances and (ii) Was the reliance by the plaintiff known to the defendant? An affirmative response is needed to both these questions before any claim can succeed.[460]

[453] Pacini et al. (n250); see also, Gwilliam (n376) 27; see also, J Holyoak, 'Accountancy and Negligence' (1986) Journal of Business Law 121; see also, Abugu (n405) 241.
[454] *JEB Fasteners Ltd v. Marks Bloom &Co.* (1981) 3 All E.R. 289, affirmed (1983) 1 All E.R. 583 (C.A.), Stephenson LJ., at 588.
[455] J Holyoak, 'Accountancy and Negligence' (1986) Journal of Business Law 121.
[456] *Owen Investments Ltd. v. Bennett, Nash, Wolf & Co.* (1984) 134 N.L.J. 887.
[457] *J.E.B. Fasteners Ltd. v. Marks, Bloom & Co.* (1981) 3 All E.R. 289, affirmed (1983) 1 All E.R. 583.
[458] Holyoak (n453) 121; see also: Abugu (n405) 240.
[459] Abugu (n405) 241.
[460] An instructive case tracing the history of professional liability for negligent misstatements is the *English House of Lords decision in Commissioners of Customs and Excise v. Barclays Bank Plc* (2006) UKHL 28.

4.3 *Caparo Industries Plc (Caparo) v Dickman*[461]

Matar comments that there was the need to control the zone of the auditor's responsibility towards third parties in the UK during the 1980s by the time of the judgment in *Caparo Industries PLC vs. Dickman*.[462] The case laid to rest the vexed question is: "To whom do auditors owe these duties?"[463]

It is clear from *Caparo* that company auditors, in principle, owe their duties to the corporate body and not to outsiders.[464] Hence, it is up to the company to claim against the auditors as a result of negligently prepared, misleading, or inaccurate accounts and that the action itself will be based on breach of contract or in negligent misstatement leading to a claim in tort.[465]

In *Caparo,* the plaintiffs, a public limited company, which had accomplished the takeover of F. Plc., brought an action against its directors alleging fraud, and in contradiction of its auditors claiming that they were negligent in performing the audit and creating their report, which they were obligated to do within the terms of Sections 236 and 237 of the Companies Act 1985. In the statement of claim, the plaintiffs claimed that they had begun purchasing shares in F. Plc. in June 1984 a few days before the accounts, which had been certified by the auditors in April and May, had been published to the shareholders; that in support of those accounts they completed more purchases of shares, and that by October they owned or had received acceptances for all the issued shares of F. Plc. They also claimed that the auditors owed investors or potential investors a duty of care in respect of the certification of the accounts. As they should have known that F. Plc.'s profits were not as high as projected, its share price had fallen significantly and it required financial assistance such that it was susceptible to a takeover bid and that dependence on the precision of the accounts would be positioned by any prospective bidder such as the plaintiffs. On the trial of a primary issue against the auditors, on the facts as claimed, the judge determined that the auditors did not owe the plaintiffs a duty of care at common law either as a shareholder of F. Plc. or as a prospective investor. As a general principle, the court in examining the statutory framework for accounts and audit under the 1985

[461] *Caparo Industries Plc v Dickman & Others* (1990) 1 All ER 568.
[462] Matar (n220) 45.
[463] Pacini et al. (n408); see also: Ingrid De Poorter, 'Auditor's Liability Towards Third Parties within the EU: A Comparative Study Between the United Kingdom, the Netherlands, Germany and Belgium' (2008) 3 Journal of International Commercial Law & Technology 68.
[464] Paolini (n416) 248.
[465] Davies and Worthington (n447) 835.

Companies Act decided that the purpose of statutory accounts is *not* to inform shareholders' investment decisions, and *nor* is it to inform the investment decisions of the wider public. In the ordinary course of events, therefore, the directors in preparing the accounts and the auditors in auditing the accounts owe no duties of care to potential investors or to the public at large to ensure that the accounts are accurate.

The House of Lords decided unanimously in favour of the auditor. The House of Lords acknowledged the absence of identified conditions, stating that the auditors in public shareholding companies were not responsible for negligence towards foreseen investors or current investors buying new stocks of the company relying on the statutory audit.[466] Their Lordships established the conditions for the auditor's responsibility towards a third party – namely, the auditor must foresee the dependence of the third party on the auditor's work, and a proximity state must exist in the relationship between the auditor and the third party.[467] Their Lordships emphasised that:

1. The auditor must know and understand that the results of the auditing process would be conducted to a third party known to him or belonging to a limited and identified class of persons.
2. The third party must experience financial damages due to its reliance on the auditor's work.
3. The reliance of the third party on the auditor's work must be the identified purpose of the auditing process.[468]

As mentioned above earlier, the general rule is that auditors owe their duties to the corporate body. Thus "In advising the client who employs him the professional man owes a duty to exercise that standard of skill and care appropriate to his professional status and will be liable both in contract and in tort for all losses which his client may suffer by reason of any breach of that duty. But the possibility of any duty of care being owed to third parties with whom the professional man was in no contractual relationship was for long denied..."[469]

[466] Pacini et al. (n330) 3.
[467] Pacini et al. (n330) 3.
[468] Ibid.
[469] *Caparo Industries plc v Dickman* (1990) 1 All ER 568, per Lord Bridge at 576.

The claim in *Caparo* failed as the third party, who count on the accounts and experienced losses, did not support the test of assumption of responsibility and subsequent proximity, resulting in the auditors escaping liability.[470] The House of Lords in *Caparo* Industries observed that if the test were otherwise, a duty of care would be established between the auditors and third party investors/claimants with respect to a potential negligence claim against the auditors for the preparation of the company's accounts, even though the auditors have no privity of contract with the investors because the auditors were hired by the company and its board (not the investors) to conduct the audit.[471]

Pacini et al. observe that in the eyes of the *Caparo* court, the purpose of audited statements is to fulfil the auditor's statutory duty to the shareholders collectively to enable them to monitor management, and no more.[472] No duty is owed to stockholders as individual shareholders or third parties as regards the audited financial statements. Under the Companies Act in England, the auditor reports to the members of the company, but contracts with the firm as a corporate entity.[473] Such a narrow purpose was ascribed to the statutory audit to avoid, in the famous words of US Justice Cardozo, "indeterminate liability to an indeterminate class for an indeterminate time".[474]

Notably, the House of Lords explicitly followed the *Ultramares* principles in *Caparo*.[475] It decided that the auditor owes a duty to the company and not to creditors or to any single shareholder who "as a purchaser of additional shares in reliance on the auditor's report, he stands in no different position from any other investing member of the public to whom the auditor owes no duty."[476] This assertion takes into consideration the fact that the accounts and the audit become public at the Register, but do not entail any responsibility of auditors to the public at large.[477] Davies, editor of the celebrated *Gowers' Principles of Company Law,* was surprised at this new development of a more transparency focused approach required in

[470] Matar (n220) 45.
[471] Alexander Kern, 'Tort Liability for Ratings of Structured Securities Under English Law' (2015) University of Oslo Faculty of Law Research Paper No. 2015-06, 14, Available at SSRN:http://ssrn.com/abstract=2547517. 7
[472] Pacini et al. (n250); see also, Pacini et al. (n330) 3.
[473] Pacini et al. (n330) 3.
[474] Ibid.
[475] Giudici (n259) 532.
[476] Giudici (n259) 532.
[477] Giudici (n259) 532.

disclosing the financial details beyond the stakeholders of the company than just their circulation to members and other current investors in the company." [478]

The shareholders' watchdog role of the auditor is central in English law. The auditor is appointed by shareholders, who set his remuneration.[479] The auditor's role is to act antagonistically in regard to the directors, even though auditors are paid by the company.[480] This shareholders' watchdog role is evidenced in and central to the decision in *Caparo*, in which the House of Lords decisively re-affirms that the auditor is an agent of the shareholders, not as investors, but as persons who have delegated the day-to-day management of the company to the directors and who face a collective action problem in monitoring them, and they thus charge the auditor to be a check upon the directors.[481]

In England, the shareholders' watchdog role is still considered the only role that auditors have, though in other legal environments the understanding is that the auditor serves the company, the investors and the general public.[482] However, in all legal environments it is clear that the auditor is contractually bound to the company for the benefit of its shareholders and, liable to the company.[483]

Abugu discussed the concept of "True and Fair View"[484] which the auditor is required to take, when he criticised the *Caparo* decision. He thinks that the True and Fair View is obscure, ill-

[478] Paul Davies, 'Gower's Principles of Modern Company', in L Davies D Prentice and L Gower (1997) *Gower's Principles of Modern Company Law* (6th edn, Sweet & Maxwell, London 1997) 554.
[479] The traditional English auditor's role of a watchdog chosen by the shareholders was trailed by a range of legislation in England that, after the 'railroad mania', began to instruct the audit. The lineage of companies acts started with the Joint Stock Companies Act of 1844 and led to the Companies Act of 1929, which required an auditor's report on the profits of the company of the last three years to be part of any prospectus used to sell shares, thereby introducing, for the first time, the prospectus audit into the history of securities regulation. Under the complex stream of companies' law statutes, the auditor was always considered exclusively as an agent of the shareholders collectively. The shareholders' watchdog role stayed relatively intact by the manifestation of the prospectus audit, which established a direct relationship between directors and auditors. The prospectus audit was covered by the Directors Liability Act 1890, which permitted directors to defend themselves against investor suits concerning prospectuses on the grounds that they, the directors, had in good faith relied on the expert reports of others. As to the role of prospectus liability in disordering the auditor's role; see also, Giudici (n259) 523.
[480] In *Caparo Industries plc v. Dickman and others* (1990) 2 AC 605, Judge Bridge quotes the passage where Judge Vaughan Williams wrote in *Re Kingston Cotton Mill Co* (1896) 1 Ch 6 at 11: "No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them."; see also, Giudici (n259) 523.
[481] Lord Bridge of Harwich, quoting *Judge Bingham in Bingham LJ in the Court of Appeal* (1989) 1 All ER 798 at 804. The shareholders of the company "have a collective interest in the company's proper management … indistinguishable from the interest of the company itself and any loss suffered by the shareholders … will be recouped by a claim against the auditor in the name of the company"; see also, Giudici (n259) 523.
[482] Sean M O'Connor, 'Be Careful what you Wish for: How Accountants and Congress Created the Problem of Auditor Independence' (2004) 45(4) Boston College Law Review 741, has utterly explored the history of auditors in the US between 1880 and 1934, contrasting it with the English experience. He noted that from the multiple roles assumed by the accountant ('the self-proclaimed "authorized agents of publicity" at 790 an imbroglio resulted, where external auditors were hired to perform a service on behalf of the client company, "with a host of implied duties to creditors, directors, and the "investing public", not to mention a duty to shareholders and possibly even employees" at 824; see also, Giudici (n259) 524.
[483] Ibid.
[484] Abugu (n405) 236-237; see also, Section 335(1); See also UK Companies Act (2006) Section 393.

defined, dated and impracticable in terms of contemporary corporate markets. Accountants have failed to understand the True and Fair View as a concept of law and the cases show the failure or unwillingness on the part of lawyers to understand the complexities arising from its application to accounting. The professional accounting perspective must give way to the legal perspective that conceives the function of auditors as experts of sort, gatekeepers whose reports are intended to be relied upon by several corporate players as representing a seal of verification and accurateness of accounts as audited. A review of the decision in *Caparo* shows the English court striving to apply the accounting perspective in an issue that is purely legal. This testifies the influence that the accounting profession wields in setting financial statement standards.[485]

The decision in *Caparo* is a great disincentive to the investing public in relying on financial statements and auditing reports. The loss will, however, be suffered by others, for example, by shareholders who sell shares at an undervalued price or buy them at an inflated one. In reality, the annual report containing the financial statements of a company's performance forms the foundation of informed investment decisions by current shareholders and prospective investors. For existing shareholders, it offers an analytical basis for the evaluation of the company and therefore influences the decision to sell or hold or even to make further purchases of the company's stock. For investment analysts, advisers and investors, it includes the most readily accessible certified performance record of the company.[486]

Furthermore, the auditor's duty of care is inherent in the statutory duty to report to shareholders, which would otherwise be valueless and indeed deceptive. It is further submitted that recognition of a duty owed to shareholders does not involve allowing shareholders to enforce the company's cause of action and does not constitute an exception to the rule that, in general, in action to remedy a wrong done to a company, the only acceptable plaintiff is the company. The duty owed to shareholders is an independent and direct duty, and so should not be denied on this ground. If the need is to protect auditors, this can be better served by insurance indemnities or similar devices available for mitigating potential liabilities.[487]

[485]Abugu (n405) 244-245.
[486] Abugu (n405) 245.
[487] Abugu (n405) 245.

4.4 Reaction to *Caparo* in other Jurisdictions

Rajapakse and Gardner made a comparative study between Singapore and the UK.[488] A number of Singaporean cases cited the English case of *Caparo Industries plc v Dickman & Ors*,[489] where the House of Lords severely limited the situations were auditors can be held liable to parties who base investment decisions on the audited accounts.[490] This means that there is no duty of care owed, regardless of whether the auditors acted negligently. Whilst this case is regularly cited in Australian decisions on the case, it does not appear to be followed as strictly and the courts have developed a more flexible approach to third party liability.[491]

Kan however notes that in the more recent Scottish case of *Royal Bank of Scotland v Bannerman Johnstone Maclay (a Firm) and Others*,[492] the Court of Sessions created a legal precedent with "potentially explosive consequences" as they enforced a duty of care on an auditing firm notwithstanding the lack of a contractual relationship with the claimant.[493] If Singaporean courts follow this expansionist approach to third party liability, it could result in a significant widening of instances of successful suits against auditors and other financial advisors.[494] This type of approach appears to have taken ground in the United States, and Goldwasser highlights the threat that it plays to the continuity of the financial advisory services in the country.[495] The approach taken by the courts to this issue will depend on the focus of the legislature and judiciary.

If the overriding aim of the regulatory regime is to minimise actions against financial advisors and instances of litigation, countries should follow the approach taken in *Caparo Industries plc v Dickman & Ors* and retain or implement a strict approach to third party liability, such as that in Singapore. In contrast, if there does not appear to be any concern over the number of third-party financial advisor cases commenced and the aim is to allow parties who may have been financially affected by the actions of accountants and audits to have their "day in court", it may be preferable to follow the more flexible approach of *Royal Bank of Scotland v Bannerman*

[488] Pelma Rajapakse and Jodi Gardner, 'Legal Liability for Financial Advisors in Australia and Singapore: A Comparative Perspective' (2015) 6(1) Global Review of Accounting and Finance 176.
[489] *Caparo Industries plc v Dickman* (1990) 1 All ER 568.
[490] Ernestauthor Kan, *'Audit and Assurance – Principles and Practices in Singapore'* (2nd edn, CCH Asia Pte Limited, Singapore. 2010); see also, Rajapakse and Gardner (n488) 195.
[491] Rajapakse and Gardner (n488) 195.
[492] *Royal Bank of Scotland plc v Bannerman Johnstone Maclay (a Firm) and Others*: OHCS 23 Jul 2002.
[493] Kan (n490); see also, Rajapakse and Gardner (n488) 195.
[494] Rajapakse and Gardner (n488) 195.
[495] Victor Goldberg (n261) 295-312; see also, Rajapakse and Gardner (n488) 195.

Johnstone Maclay.[496] If the latter method is preferred, there should however be specific limitations in place to avoid the difficulties experienced in the US.[497]

Lastly, the Australian *Bathurst* case[498] demonstrates how another common law jurisdiction with very similar principles of negligence law can apply the traditional duty of care test as set forth in the *Caparo Industries* to show how a duty of care is created between the defendant's ratings agency and plaintiff investors. The decision in *Bathurst* would be a persuasive authority, but not legally binding precedent, for an English court. Therefore, the decision would be likely read closely by English legal practitioners and judicial authorities.[499]

Moreover, the test in *Caparo Industries* for establishing a duty of care has proved to be a significant enough hurdle to prevent any claims from proceeding. However, the recent Australian case *Bathurst* suggests a possible interpretation that could be adopted by English courts to argue that a duty of care does exist between a ratings agency and the investors to whom it disseminates its credit ratings.[500] Based on analysis of English case law and on the *Bathurst* case, Kern argues that ratings agencies in issuing ratings are aware that their ratings are relied on by current or potential investors and that the ratings are issued with a view to their ultimate dissemination to investors in the market.[501] As rating agencies are in the business of accepting compensation for issuing ratings that they know are being issued for the primary purpose of being disseminated to current or potential investors, he suggested that a duty of care arises under English tort law that is owed by the rating agencies to the class of current or potential investors to whom the ratings are disseminated.[502]

To conclude this section, the researcher would like to highlight the victim's point of view. Leek, who was the Chief Executive of *Caparo*, gave a presentation to the London Practitioner Board. He presented five proposals for reform as follows:

"Firstly: we believe auditors should be made liable for their negligence to accounts users who suffer loss. Since the House of Lords judgement so severely restricts their duty of care, it will

[496] Rajapakse and Gardner (n488) 195.
[497] Goldberg (n261); see also, Rajapakse and Gardner (n488) 195.
[498] *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) (2012) FCA 1200. For more discussion about this case, see Chapter Four.
[499] Kern (n471) 14.
[500] Ibid 16.
[501] Ibid.
[502] Kern (n471) 16.

require a legislative change… Secondly: we believe auditors should have a better form of defence against their increased liability exposure. That defence is the abolition of the present three-line "true and fair" audit report. It has become meaningless and leaves so much unsaid… Thirdly: Auditors should be encouraged to make available to shareholders, on request, a summary of their "Reports to Management". These comprise an auditor's statement of accounting and control deficiencies and its client's response to them… Fourthly: The relationship between auditors and their clients should be made less cosy. To reinforce the auditor's independence there should, for publicly quoted companies, be a limit on the number of years for which an auditor may be re-appointed, and the amount of fee income from services other than audit and taxation… Fifthly and last of all, there should be an independent review body to hear cases of auditors' negligence…. These then are the "*Caparo* Five" five proposals which if adopted would, it could be argued, make the financial world a safer place for accounts users to live in." [503]

4.5 English Decisions *Post Caparo*

Since *Caparo*, English courts have continued to limit the imposition on auditors of a duty to nonclients for negligent misstatements.[504] In *Al Saudi Banque v. Clarke Pixley*,[505] the High Court again held that auditors of company accounts are not liable in negligence to banks for the loss suffered through reliance on those accounts when deciding whether to lend or continue lending to the company in that, although it may be foreseeable that prospective lenders would take the accounts into consideration, since there is no relationship between the auditors and the banks to give rise to a duty of care.[506]

In *Al Saudi*, Millett J distinguished the facts from those in *Caparo Industries Plc v. Dickman*, holding that there was no such proximity between the auditors and potential investors who might be almost literally anyone in the world and with whom the auditors had no contact and no relationship. The auditors had not made their reports either directly to the banks or to any other person with the intention or in the knowledge that the reports would be communicated to

[503] James Leek, 'Liability of Auditors After Caparo Decision' (Presentation by the Chief Executive of Caparo Grow Ltd to the London Practitioner Board, 17th April 1991) available at: http://cadbury.cjbs.archios.info/_media/files/CAD-03110.pdf, last visit December 10, 2017.
[504] Suzanne Chua, 'More Thought on the Auditor's Lability in Negligence in Respect of the Audit Report' (1995) 16(7) The Company Lawyer 195.
[505] *Al Saudi Banque v. Clarke Pixley* (1990) Chapter 313; (1990) 2 WLR 344.
[506] Abugu (n405) 244-245.

them. Therefore, the element of proximity necessary to find a duty of care was lacking, and that, accordingly, even though it was foreseeable that if any bank wished to consider whether to continue or renew existing facilities or to grant additional facilities it might well ask the company for copies of its audited accounts, the auditors were under no duty to the banks.[507]

The English Court of Appeal adopted the same principle in its judgment in the case of *James vs. Hicks Anderson & Co.*[508] In this judgment, the court ratified the importance of not expanding the zone of the auditor's responsibility towards the third party, when it mentioned that courts in England must adopt a restricted concept towards identifying the third party.[509] Furthermore, the zone of the auditor's responsibility must be limited to a person or a class to which he belongs, and the auditor is intended to make him depend on the results of the auditing, and in the purpose for which the auditing was carried out.[510]

Thus, the Court of Appeal in *James McNaughton Papers Group Ltd v. Hicks Anderson and Co.* detailed the important scope of duty factors as follows:

(A) The purpose for which the information was prepared and communicated;

(B) The relationship among the accountant, client, and third party;

(C) The size of the class to which the third party belongs; and

(D) The extent of the third party's reliance.

The Court of Appeal in *James McNaughton* noted that in England a "restrictive approach is now adopted to any extension of the scope of the duty of care beyond the person directly intended by the maker of the statement to act on it."[511]

Another case which upholds *Caparo* is *Galoo, Ltd v. Bright Grahame Murray.*[512] In this case, the English Court of Appeal stressed that an auditor's duty of care to a third party will arise

[507] Abugu (n405) 245.
[508] *James McNaughton Papers Group Ltd. v. Hicks Anderson & Co.* (1990) All E.R. 134 (Eng. C.A.).
[509] Matar (n220) 46; see also, Pacini et al. (n250) 30.
[510] Ibid.
[511] *James McNaughton Papers Group Ltd. v. Hicks Anderson & Co.* (1990) All E.R. 134 (Eng. C.A.) 143; see also, Pacini et al. (n250) 30.
[512] *Galoo Ltd. v. Bright Grahame Murray* (1995) All E.R. 16 (Eng. C.A.).

only if the auditor is aware that a particular user will rely on the auditor's work product.[513] The auditor must also intend reliance by the known party.[514]

Her Majesty's Commissioners of Customs and Excise v Barclays Bank Plc[515] is another leading English tort law case concerning negligent misstatement and pure economic loss which sheds light on *Caparo*. The facts were that Customs and Excise needed to freeze the bank account of a Barclay's customer. By law, banks are obligated to conform with requests for freezing orders and are compensated for the service. When it got the request, a Barclays employee responded that it had frozen the bank account. This was not the case and the customer proceeded to empty all of the money from the account and Customs and Excise sued Barclays for the amount that was lost. Barclays reasoned that it had no duty of care, nor had it assumed responsibility.

In the Court of Appeal, Peter Gibson LJ, Longmore LJ, Lindsay LJ held that there was no duty and proposed that type assumption of responsibility should be subsumed into the threefold test from *Caparo*. Regarding the three tests, Lord Bingham observed the following in *Customs & Excise Commissioners v Barclays Bank*:[516]

1. [Liability could arise] where one party could accurately be said to have assumed responsibility for what was said or done to another: the paradigm situation being a relationship having all the indicia of contract save consideration.
2. An assumption of responsibility was to be regarded as an appropriate but not a needed condition of liability, a first test which, if solved confidently, might obviate the need for further inquiry; if answered negatively, further consideration was called for.
3. The assumption of responsibility test was to be applied objectively and was not answered by what the defendant thought or intended.
4. The problem here was that the further the test was distant from the actions and intentions of the real defendant, and the more notional the assumption of responsibility became, the less difference there was between that test and the threefold test.
5. The *Caparo Industries* threefold test itself provided no straightforward answer to the vexed question whether or not in a novel situation a party owed a duty of care.

[513] Ibid 40.
[514] Ibid 41-43; see also, Pacini et al. (n250) 31-32.
[515] *Commissioners of Customs and Excise v Barclays Bank plc* (2006) UKHL 28.
[516] Ibid, See *Lord Bingham, Barclays Bank* (2006) para.192.

6. The incremental test was of little value in itself and was only helpful when used in combination with a test or principle which identified the legally significant features of a situation.
7. The closer the facts of the case in relation to a case in which a duty of care had been held to exist, the readier a court would be, on the approach adopted in *Caparo Industries*, to find that there had been an assumption of responsibility or that the proximity and policy conditions of the threefold test were satisfied. The converse was also true.
8. The outcomes of the leading cases were in almost every instance sensible and just, irrespective of the test applied.

It should be noted that although Lord Bingham's observations supported a close examination of the specified conditions of the particular case and the specific relationship between the parties in the framework of their legal and factual situation in totality, it should not be interpreted as disparaging the value of and the requirement for a test of liability in tortious negligence cases.[517] Indeed, any coherent law of tort must be based on a set of consistently applied principles, if it is not to become a morass of ad hoc rulings seeking to achieve a just result.[518]

The House of Lords unanimously rejected the Court of Appeal's decision that "assumption of responsibility" was unclear and incorporated into the law of negligence. It held, however, that in this case, since the bank was obligated by law to comply with the freezing order, there could not be said to have arisen any assumption of responsibility on *Hedley Byrne* grounds. Applying then the *Caparo* test, it was held to not be fair, just and reasonable to impose liability. The bank was consequently not required to reimburse Customs and Excise for the dissipated money.[519]

The limitations placed on the parameters of auditors' civil liability have continued in *Stone & Rolls v Moore Stephens*.[520] In that case, the controlling shareholder S of a company Stone & Rolls Ltd sued the auditors Moore Stephens for failing to detect fraud in sham transactions the company had carried out ultimately causing the company to enter into liquidation. The auditors proceeded to strike out the claim and this was ultimately upheld by the House of Lords. The House reasoned that auditors would owe a duty of care to the company and the body of

[517] Kern (n471) 8-9.
[518] Ibid 9.
[519] Paul Mitchell and Charles Mitchell, 'Negligence Liability for Pure Economic Loss' (2005) 121 Law Quarterly Review 194.
[520] *Stone & Rolls v Moore Stephens* (2009) 1A.C. 1391.

shareholders as a whole. However, S was the only shareholder and controlling mind of the company and knew that fraud was being carried out. S therefore could not rely on an action against auditors to benefit from his own fraud. The auditors are entitled to the defence of ex turpi causa against S. The majority decision in the House of Lords also suggested that fraudulent acts of persons in the course of business could be imputed to the company itself, such that the company was also precluded from suing its auditors for failure to detect fraud.[521] Watts has criticised this part of the judgment as going too far as companies are an abstraction that act through natural persons, and hence, an imputation of fraud should not easily be made to undermine the separate legal personality of the company.[522] According to Chiu, this would prevent liquidators from suing for the company. However, where there may be other innocent shareholders, there is still a possibility for calling auditors to account, subject to the test of proximity above.[523] The judgment however rejected that a wider remit of care was owed to creditors.[524]

Paolini believes that when auditors' liability is established, the viability of the ex turpi causa defense remains unclear, although auditors successfully pled the defence in *Stone & Rolls Ltd. v. Moore Stephens*.[525] Generally, the answer to this point lies in two of the most important principles underpinning company law: the relationship between the directors and the company, and the rules of attribution.[526]

Matar has concluded that the legal principle in *Caparo* case resulted in restricting the zone of the auditor's responsibility towards the third party, as the auditor was not-under the absence of certain conditions-obliged to exert due diligence towards foreseen external investors or any one of the current stockholders who bought stocks of the company depending on financial statements certified by the auditor.[527] Matar also held the view that to hold the auditor responsible for negligence towards the third party, the plaintiff must put forward evidence that the auditor knew that the results of his work would be communicated to this party separately

[521] Iris Chiu, 'The Role and Liabilities of Auditors in Financial Regulation: Addressing the Expressions Gap' (2012) International Business Law Journal 545, 548.
[522] Peter Watts, 'Stone & Rolls Ltd (In Liquidation) v Moore Stephens (A Firm): Audit Contracts and Turpitude' (2010) 126 Law Quarterly Review 14.
[523] Chiu (n521) 14.
[524] Ibid 548.
[525] Paolini (n416) 251; see also, *Stone & Rolls Ltd. v. Moore Stephens* (2009) UKHL 39, (2009) 1 A.C. 1391 (H.L.) (appeal taken from Eng.).
[526] Jennifer Payne, *Corporate Attribution and the Lessons of Meridian, in The Jurisprudence of Lord Hoffmann: A Festschrift for Leonard H. Hoffmann* (forthcoming 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444732. 29.
[527] Matar, (n210) 46.

or otherwise to a member of a limited class of persons, and that this party would be dependent on the auditor's work with regard to a limited process or transaction.[528]

Abugu thinks that these cases demonstrate the difficulties of the courts in placing restrictions on the liability of auditors to third parties. With the definitions of proximity exemplified in the cases, it was foreseeable by auditors that their reports would rely upon by existing shareholders and members of the public in making investment judgement and to that extent auditors should be liable.[529] There is nothing intrinsically wrong in the courts holding that auditors in presenting audit reports voluntarily assume responsibility for their correctness to third parties that may conceivable rely on them.

Giudici believes that the collective action interest of shareholders is so well recognised, in particular by English courts, while those of creditors (e.g., *Ultramares*) or investors (e.g., *Caparo*) are not, under common law.[530] The key concept is privity, and behind privity lies one of the more catchy and more quoted phrases in modern private law: Judge Cardozo's reference to exposure to "liability in an indeterminate amount for an indeterminate time to an indeterminate class".[531] This is the floodgate argument, which dominates any scientific discussion of pure economic loss.[532] The core idea is that if the auditor is liable towards any potential lender or investor approached by the company, there is a risk being exposed to unforeseeable costs in terms of liability, as in theory there is no limit to the capital a firm can demand and obtain from creditors or the market.[533] By contrast, the auditor's potential exposure

[528] Ibid.
[529] Abugu (n405) 248.
[530] Giudici (n259) 532.
[531] *Ultramares Corp. v. Touche* (1931) 255 N.Y. 170 at 179; see also, Giudici (n259) 532.
[532] See, e.g., Mario J. Rizzo, 'A Theory of Economic Loss in the Law of Torts' (1982) 11 Journal of Legal Studies 281; William Bishop, 'Economic Loss in Tort'(1982) 2 Oxford Journal of Legal Studies 1; William Bishop, 'Economic Loss: A Reply to Professor Rizzo' (1982) 2 Oxford Journal of Legal Studies 207; Mario J. Rizzo, 'The Economic Loss Problem. A Comment on Bishop' (1982) 2 Oxford Journal of Legal Studies 197; Bruce Chapman, 'Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law' (1992) 20 Canadian Business Law Journal 180; Jan M. Van Dunné, 'Liability for Pure Economic Loss: Rule Or Exception? A Comparatist's View of the Civil Law – Common Law Split on Compensation of Non-physical Damage in Tort Law' (1999) 4 European Review of Private Law 397; Jane Stapleton, 'Comparative Economic Loss: Lessons from Case-Law-Focused "Middle Theory"' (2002) 50 UCLA Law Review 531; Mauro Bussani and others, 'Liability for Pure Financial Loss in Europe: An Economic Restatement' (2003) 51 American Journal of Comparative Law 113; Francesco Parisi, 'Liability for Pure Financial Loss: Revisiting the Economic Foundations of a Legal Doctrine' in Mario Bussani and Valentine Palmer Vernon, eds. *Pure Economic Loss in Europe* (Cambridge University 2003) 74; Gary T. Schwartz, 'American Tort Law and the (Supposed) Economic Loss Rule', in Bussani and Palmer Vernon, eds. *Pure Economic Loss in Europe* (Cambridge University 2003) 94; Fernando Gómez and Juan Antonio Ruiz, 'The Plural – and Misleading – Notion of Economic Loss in Tort: A Law and Economics Perspective' (2004) 4 Zeitshrift für Europäisches Privatrecht 908; Francesco Parisi and others, 'The Comparative Law and Economics of Pure Economic Loss' (2007) 27 International Review of Law & Economics 29; Dan B. Dobbs, 'An Introduction to Nonstatutory Economic Loss Claims' (2006) 48 Arizona Law Review 713; Helmut Koziol, 'Recovery for Economic Loss in the European Union' (2006) 48 Arizona Law Review 871; Giuseppe Dari Mattiacci and Hans-Bernd Schäfer, 'The Core of Pure Economic Loss' (2007) 27 International Review of Law and Economics 1; see also, Giudici (n259) 532.
[533] Giudici (n259) 533.

to the risk of liability towards the company is limited, as it refers -one should assume- to assets that managers can misappropriate. Accordingly, the floodgate argument is grounded in the problem of pricing the auditor's risk.[534] The auditor cannot price its service liability risk is unknown to third parties. It is very difficult for the company to credibly commit itself towards the auditor in order to sort out this problem, because once the information is provided (the audit), the company can use it freely, soliciting more and more potential investors to provide funds.[535]

Under the floodgate argument, it is up to investors to contract with auditors in order to buy protection. Needless to say, investors could face coordination problems. When these problems become significant, securities law steps in and sorts them out by fiat.[536]

Willekens contends that the auditor's expanded liability scope relates to the extent to which courts balance public policies to protect the public interest, by providing remedy with public policies protecting the audit profession's capacity to serve the public.[537] Davies describes the evolution of common law from the privity of contract doctrine towards more liberal doctrines of third-party liability as a process of implementing a "deep pocket theory" of liability placement.[538] He states that various courts' interpretations have often been influenced by individual fact findings and the degree of auditor's liability that would be socially and economically tolerable at that time.[539]

Reversal of the trend of expanding the role of the auditor in the UK by the ruling in *Caparo*, could be seen as legislation against the deep pocket theory of liability placement.[540] Also, the lobbies by the audit industry to reform liability law in the US, Australia and the UK in response to what is often called 'the litigation crisis', can be interpreted in this way.[541]

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[534] Ibid.
[535] The traditional policy basis of the floodgate argument is spelled out by the Supreme Court of Canada in Hercules [1997] 2 S.C.R. 165, quoting two law articles: Brian R. Cheffins, 'Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow' (1991) 18 Canadian Business Law Journal 118, 125-127; Ivankovich (n323) 520-521. The arguments support that liability to third parties would rise insurance and litigation costs, thus reducing the audit service supply and increasing the price paid by clients to incumbent auditing firms. These arguments are grounded on assumptions that remain very difficult to empirically prove and are, therefore, unconvincing; see also, Giudici (n259) 533.
[536] Giudici (n259) 533.
[537] Marleen Willekens, '*Economic aspects of audit regulation and auditor liability'* (PhD thesis, University of Warwick 1995) available at: http://wrap.warwick.ac.uk/36143/, 109.
[538] J Davies, 'Accountants' Third Party Liability: A History of Applied Sociological Jurisprudence' (1979) Abacus 110.
[539] Ibid.
[540] Willekens (n537) 109.
[541] Willekens (n537) 109-110.

Al-Husaini argued that analysis of the profession's campaign and its supportive research shows how the profession is rather selective and contradictory in presenting its case for limiting liability.[542] Much of the professional and academic research that supports limiting auditor's liability fails to highlight the fact that many of the legal cases are filed by audit firms (in capacity as liquidator) against other audit firms.[543] It is easier for audit firms as a liquidator to file suits against auditors than for individual shareholders or other stakeholders given the limitation of the *Caparo* decision.[544]

Stone & Rolls Ltd. v. Moore Stephens has shed light on crucial issues underpinning the company law that acquired more attention from respected common law courts.[545]

Those issues which are the relationship between the directors and the company and the rules of attribution are examined here to show the latest development in these areas. Furthermore, it is noteworthy to examine to which extent can be connected to the topic under review in this thesis.[546]

According to Howard and Kreaden, the last top-level English case directly on auditors is the 2009 case of *Moore Stephens v. Stone & Rolls Limited*. It is important to say that the preliminary issue at the House of Lords was whether the doctrine of illegality provided the auditors with a defence. By a 3 to 2 majority, it was held that in the case of a one-person private company it did. The finding was explicitly bounded to that situation and it is obvious that a contradictory result would have been reached in the case of a public or widely held company. There were five decisions rendered and subsequently courts and commentators have

[542] Walid Al-Husaini, 'The Kuwait Investment Office (KIO) Scandal: A Study of Auditing and Audit Expectations in an International Context' (PhD thesis, University of Sheffield 2000) 34.
[543] Ibid.
[544] Napier (n389) 117.
[545] In particular, according to Caylor and Kenney, the defence of illegality raises compelling issues when it is advanced by bankruptcy trustees or receivers on behalf of creditors or shareholders of a corporation whose management engaged in financial fraud that was allegedly either assisted or not discovered by the corporation's outside professional advisers, such as auditors, investment bankers, financial advisers and lawyers. England and Canada seem to be converging on a principled approach, centered on recognizing and compensating the 'true victim' of the wrongdoing. In these jurisdictions, the illegality defence has limited application in the context of third-party facilitator liability since courts view the defence as impeding the ability of the true victims of the wrongdoing from recovering their losses. In contrary, the US applies the illegality defence much more broadly in the context of facilitator liability, based on a strict interpretation of the concept of imputation of fault to a body corporate coupled with a strong focus on preventing a 'wrongdoer' from benefiting from their wrongful conduct. Caylor, L and Kenney, M, 'In Pari Delicto and Ex Turpi Causa: The Defence of Illegality – Approaches Taken in England and Wales, Canada and the US', Business Law International; London Vol. 18, Iss. 3, 2017, 259, 265-266.
[546] Further analysis on following cases are provided in chapter 7.

commented on the difficulty in reconciling them completely which led to the English Supreme Court addressing it in *Bilta* in 2015.[547]

The UK Supreme Court considered the defence of ex turpi causa within the context of a directors' liability claim in *Jetivia SA v Bilta* (UK).[548] Bilta was an English company that was compulsorily wound up in November 2009. Chopra and Nazir were the only directors of Bilta (UK) Ltd, with Chopra being the sole shareholder. Upon its winding up, Bilta had an outstanding value added tax (VAT) liability of approximately £38m. Bilta ultimately entered liquidation and its liquidators brought proceedings against the directors alleging a conspiracy to defraud Bilta and breach of fiduciary duties. It was alleged that Chopra and Nazir entered into a 'carousel fraud' of carbon credits with several other parties including Jetivia SA, a Swiss company, the effect of which was to leave Bilta insolvent and unable to pay its VAT liability. It was alleged that Bilta purchased carbon credits from Jetivia, free of VAT and then sold them back to UK companies registered for VAT at a slightly lower price, so that the UK company could make a profit through resale. The proceeds of sale (including VAT) received by Bilta were subsequently paid to other parties, including Jetivia, leaving Bilta insolvent and unable to meet its VAT liability. Jetivia and its chief executive officer were alleged to have dishonestly assisted in this fraud. The defendants sought to strike out the claims on the ground that Chopra's and Nazir's wrongdoing should be attributed to Bilta itself, and therefore Bilta should not be able to bring a claim based on its own illegal acts. The Supreme Court unanimously dismissed the defendant's application holding that where a company has been the victim of wrongdoing by its directors, the wrongdoing cannot be attributed to the company as a defence to a claim brought against the directors in the company's name by its liquidators.[549]

Lords Toulson and Hodge stated that:

"where the company pursues a claim against a director or employee for breach of duty, it would defeat the company's claim and negate the director's or employee's duty to the company if the act or the state of mind of the latter were to be attributed to the company and the company were thereby to be estopped from founding on the wrong."[550]

[547] Howard, Peter, and Aaron Kreaden. 'The Liability of Public Company Auditors in Canada After Livent', Banking & Finance Law Review, vol. 34, no. 2, 2019, 79-167, 117.
[548] *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others* [2015] UKSC 23, [2016] AC 1 (Jetivia).
[549] Ibid at para 7.
[550] [2015] UKSC 23, [2016] AC 1 [206].

Accordingly, Lord Neuberger stated that:

"Where a company has been the victim of wrong-doing by its directors, or of which its directors had notice, then the wrong-doing, or knowledge, of the directors cannot be attributed to the company as a defence to a claim brought against the directors by the company's liquidator …."[551]

In respect of *Stone & Rolls*, Day thinks that the Court could not fully agree on how that case should be regarded, but the general consensus is that the case 'now retains little precedent value'.[552] Lords Toulson and Hodge stated that, "*Stone & Rolls* should be regarded as a case which has no majority ratio decidendi. It stands as authority for the point which it decided, namely that on the facts of that case no claim lay against the auditors, but nothing more."[553] Lord Neuberger stated that *Stone & Rolls* should be "put on one side and marked "not to be looked at again".[554]

Bilta confirmed that the illegality principle considered in *Stone & Rolls* would not apply in circumstances involving public companies with innocent shareholders who took no part in or otherwise benefited from the unlawful act — an interpretation that Livent argued was already clear on the face of the judgment in *Stone & Rolls* itself.[555] The President of the Panel, Lord Neuberger, wrote a judgment for himself, Lord Clark and Lord Carnwath. Lords Toulson and Hodge wrote a joint opinion and Lord Mance and Lord Sumption each wrote a separate opinion.[556]

A final point to consider is that attributing the acts or omissions of others to the company for the purposes of raising a defence will be heavily based on the context of the case.[557] For instance, in *Singularis Holdings Ltd v Daiwa Capital Markets Europe Ltd*,[558] Sir Geoffrey Vos C observed that one justification why attribution was appropriate in *Stone & Rolls* was because the company was set up purely to perpetrate a fraud, whereas in Singularis, one reason why

[551] Ibid at para 7.
[552] Day, William, 'Attributing Illegalities' (2015) 74 CLJ 409, 411.
[553] [2015] UKSC 23, [2016] AC 1 [154].
[554] Ibid at para 30.
[555] Howard and Kreaden (n547) 121 at paras. 14-15 where Lord Neuberger describes the UK case law that results in their differences of opinion, as well as his further observation that this was not the appropriate case to decide which of the three approaches is ultimately correct. This is one of the reasons the U.K. Supreme Court returned to the subject in Patel v. Mirza. [2016] UKSC.
[556] [2015] UKSC 23, [2016] AC 1 [154].
[557] Roach, Lee, 'Company Law: Corporate capacity and liability' (2019), Oxford University Press,133.
[558] [2018] EWCA Civ 84, [2018] 1 WLR 2777.

attribution was not appropriate was because the company was set up to carry out legitimate activities.[559]

Following the confusion caused by *Stone & Rolls Ltd (in liquidation) v Moore Stephens (a firm)* [2009] 4 All ER 431, and (to a lesser extent) *Jetivia SA and another v Bilta (UK) Ltd and others* [2015] All ER (D) 149 (Apr), the Supreme Court in *Singularis v Daiwa* has reframed the analysis required. Drawing on the Privy Council decision in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 3 All ER 918, it makes clear that the answer to any question as to whether to attribute the knowledge and actions of a director to a company is always to be found in a consideration of the context and purpose for which the attribution is relevant. The ‘‘directing mind’’ analysis, and *Stone & Rolls* itself, ‘‘can finally be laid to rest’’.[560]

The UK Supreme Court on 30 October 2019 in the case of *Singularis Holdings Ltd (In Official Liquidation) (A Company Incorporated in the Cayman Islands) v Daiwa Capital Markets Europe Ltd* [2019] UKSC 50. The Supreme Court upheld the decisions of both the High Court and Court of Appeal that Daiwa, the former investment bank and broker of Singularis, had breached the *Quincecare* duty of care, which establishes that a bank owes a duty to use reasonable skill and care in executing its customer's orders.[561] As Lady Hale explained, the precise purpose of that duty is to protect the Company against a misappropriation of funds, as occurred."[562]

By the middle of 2009 it appeared that the company was running into difficulties. Between June 12 and July 27, 2009, Singularis instructed Daiwa to make eight payments, totaling approximately US$204.5M out of the money held to Singularis' account to Saad Group entities. Those instructions were given with the approval of Mr. Al Sanea who, as between Singularis and Daiwa, had authority to give instructions to make the payments. Daiwa made the payments. On August 20, 2009, Mr. Al Sanea placed Singularis in voluntary liquidation.[563]

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[559] Ibid at para 56.

[560] *Singularis Holdings Ltd (In Official Liquidation) v Daiwa Capital Markets Europe Ltd* [2019] UKSC 50 at [34].

[561] The *Quincecare* duty establishes that a financial institution will be liable in situations where it has executed a payment instruction "knowing it to be dishonestly given, or shut its eyes to the obvious fact of the dishonesty, or acted recklessly in failing to make such inquiries as an honest and reasonable man would make." *Barclays Bank plc v Quincecare Ltd and another*, [1992] 4 All ER 363 at 376.

[562] *Singularis Holdings Ltd (In Official Liquidation) v Daiwa Capital Markets Europe Ltd* [2019] UKSC 50 at at [35].

[563] Ibid at paras. 4-5.

Daiwa appealed against the finding of liability on the negligence claim, however, that appeal was dismissed by the Court of Appeal. Daiwa therefore appealed to the Supreme Court. Lady Hale, with whom the other members of the court concurred, deemed that two broad issues arose on the appeal:

a. When can the actions of a dominant personality, who owns and controls a company, be attributed to the company; and

b. If they are attributed, is the claim defeated by:

i. llegality; ii. lack of causation; or iii. an equal and countervailing claim in deceit.

The case was described by counsel for Singularis as being one ‘‘bristling with simplicity’’. De Lacey thinks that this is a bold statement to make when, as to the issue of attribution, it required analysis of decisions of the House of Lords (*Stone & Rolls*) and the Supreme Court (*Bilta*), the shorter of which Judgments runs to 86 pages. However, it is not too bold to describe Lady Hale’s judgment as simplifying the manner in which one applies the rules of attribution, such that the proper analysis at present is a consideration of the context and purpose of the rule in respect of which attribution is sought. There is no step by step guide to when it will arise—each case, as it should, will depend on its facts and on an analysis of the policy reasons behind the relevant rules. That analysis is now a little easier following this important case.[564]

4.6 British Companies Act 2006 and Limited Liability Partnerships

In the commercial environment, the economic implications of a negligent audit, i.e. “an audit report that is misleading and the inaccuracy can be traced back to lack of care, skill or diligence on the part of the auditor”,[565] for the parties involved are more severe as, among other factors, the value of transactions is higher than before. In the event of a negligent audit it is highly unlikely that an auditor will be held liable towards a third party under English law.[566] However,

[564] Joseph de Lacey, A singular analysis—attribution of illegality following Singularis v Daiwa, Trusts & Trustees, Volume 26, Issue 2, March 2020, Pages 129–137, 136-137.
[565] P Davies and S Worthington, *Principle of modern company law 835* (Sweet and Maxwell, 9th ed. 2012) p. 835.
[566] M Hemraj, ‘Taking Stock of Caparo’ (2006) 27(3) The Company Lawyer 88; see also: R Jackson and J Powell, *Jackson & Powell on professional negligence* (7th edn, Sweet & Maxwell, London 2012) p. 1221.

an auditor may be held liable by his client either in contract or in tort and this may result in serious economic problems for auditors.[567]

To deal with the extent of their civil liability towards their clients, auditors have various mechanisms available. Particularly, they can raise specific defences before the courts; they have the ability to purchase insurance against potential claims; and they can also be incorporated as a limited liability partnership (LLP).[568] However, under CA 2006 an additional mechanism of protection against their clients has been guaranteed to auditors: the contractual limitation of their liability through liability limitation agreements (LLAs).[569] The question that arises is whether the new protection layer available to auditors is disproportionately detrimental to the audit client's expectations from the audit.[570]

The client's expectation from the audit is to receive a report diligently prepared and free of misstatements, in return for the audit fees paid to the auditor. Audit quality is highly connected to liability regimes.[571] However, parties' interests with respect to liability regimes are conflicting. The auditor seeks to have, on the one hand, as limited liability as possible in order to avoid paying huge amounts of damages, whereas the client wishes, on the other hand, to have as high liability as possible so that the auditor has an incentive to provide a good quality audit.[572] Hence, the insertion of LLAs in English legislation is a mechanism serving auditors' interest.[573]

The Companies Act 2006 has removed the formerly existing restrictions on auditor liability and obliged on an agreement between the company and the auditor as addressed in Sections 534 – 536 of the Companies Act 2006.[574] Subject to sections 533 which relates to indemnity

[567] A Psaraki, 'The Protection of Auditors Against Civil Liability Towards their Clients in the United Kingdom: the Legal Regime with and Without Liability Limitation Agreements' (2014) 35(8) The Company Lawyer 227.
[568] Psaraki (n567).
[569] G Scanlan and others, *Companies Act 2006: A Guide to the New Law* (1st ed, The Law Society 2007).
[570] Psaraki (n567) 227.
[571] Ramgopal Venkataraman and others, 'Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings' 83(5) The Accounting Review 1315-1345, 1315.
[572] Psaraki (n567).
[573] Ibid. Louis et al. think that regulators and shareholders generally against any restriction on clients' rights to sue their auditors, believing that such constraints would impair reporting quality. However, the evidence proposes that the opposition to limitation of liability agreements (LLAs) between clients and auditors is likely groundless. Particularly, the evidence shows that LLAs are beneficial to clients by lowering their audit fees. More importantly, they find no evidence that they impair financial reporting quality in general. Hence, the extant contracts limiting clients' rights to sue their auditors appear to benefit auditors and their clients without any apparent detriment to the quality of financial reporting. While many managers support LLAs, U.S. regulators generally oppose any LLA clause in audit engagement letters. Extant anecdotal and empirical evidence suggests that shareholders also have a negative comprehension about restrictions on clients' rights to sue their auditors, believing such restrictions impair reporting quality. Louis, Henock, Thomas C. Pearson, Dahlia M. Robinson, et al. 'The Effects of the Extant Clauses Limiting Auditor Liability on Audit Fees and overall Reporting Quality', Journal of Empirical Legal Studies, vol. 16/no. 2, (2019), 381-410.
[574] Marianne Ojo, 'Proposals for a New Audit Liability Regime in Europe' (2009) The Accountant (6068) 4.

for costs of successfully defending proceedings and 534-536 which relate to liability limitation agreements, the auditor is not to be discharged from liability where he has been negligent, been in a breach or default of duty and other circumstances which would void his exemption from liability as delivered under section 532.[575] In this sense, the Companies Act 2006 has changed the situation, which was under Section 310 of the Companies Act 1985 whereby the liability of auditors was reduced to the companies that they audited.[576] A limit to liability, which is agreed upon by the auditor, is still subject to such as is "fair and reasonable in all conditions of the case." The reasonableness test to be used varies from that under the Unfair Contract Terms Act 1977.[577] Another variance is that in considering what is fair and reasonable, the court will consider circumstances arising after the liability limitation agreement was made.[578]

4.7 The Civil Liability of Auditors in Scotland

4.7.1 *Royal Bank of Scotland v. Bannerman Johnstone Maclay*

In *Royal Bank of Scotland v. Bannerman Johnstone Maclay*[579] the defendants, a firm of chartered accountants, audited the accounts to APC Ltd over a period of three years during which they issued audited reports without qualifications.[580] The plaintiffs were bankers to APC Ltd and during the relevant period lent substantial sums of money to APC and to its wholly owned subsidiary, APC Civils Limited.[581]

In the course of the relationship with APC, the plaintiff subsequently took and paid for shares in APC. The plaintiffs alleged *inter alia* that the defendants, as auditors of APC, owed them a duty of care, and that they suffered loss as a result of the defendants' breach of that duty in that if the audit reports had been properly done it would have been clear that APC was insolvent. It was the defendants' duty to take reasonable care in acting as the auditors of APC. It was their duty to exercise the reasonable skill and care which would be exercised by any auditor of ordinary competence. It was contended that defendants knew from the outset of the plaintiffs' involvement with APC that the plaintiffs had a choice to subscribe for an important

[575] Ibid 4.
[576] Ibid.
[577] Ibid.
[578] Ojo (n574) 4.
[579] *Royal Bank of Scotland v. Bannerman Johnstone Maclay* (2003) P.N.L.R 6; (2005) B.C.C 235.
[580] Abugu (n405) 247.
[581] Ibid.

shareholding in the company. Across their audit of the accounts of APC, the defendants knew that the plaintiffs were shareholders in APC from October 1996. They knew that the plaintiffs were substantial creditors of APC. The accounts audited by the defendants disclosed that the plaintiffs were APC's principal bankers.[582]

The defendants, relying on *Caparo*, amongst others cases, submitted that the plaintiffs had not relevantly averred the existence of a duty of care owed by the defendants to the plaintiffs in relation to the audit of the accounts of APC: and that the existence of a duty of care would depend (i) on the foreseeability of damage suffered by the plaintiffs as a consequence of reliance on the defendants' negligent misstatement, (ii) on the existence of a relationship of proximity or neighbourhood between the defendants as the providers of information and the plaintiffs as recipients of it and (iii) on its being fair, just and reasonable in the circumstances of the case that such a duty should be imposed on the defendants.[583]

On the other hand, it was contended for the defendants, that proximity was to be measured by reference to whether (i) the person providing the information was actually or imputedly aware that the information in question would be communicated to the claimant, the claimant being an individual or a member of an identifiable class; (ii) the information was so communicated by him for a particular purpose; and (iii) the person providing the information knew that the claimant would rely on it for that purpose.[584] The defendants sought reliance on another post *Caparo* case, *Galoo Ltd v. Bright Grahame Murray*.[585] In that case, Glidewell L.J. said:

"Mere foreseeability that a potential bidder may rely on the audited accounts does not impose on the auditor a duty of care to the bidder, but if the auditor is expressly made aware that a particular identified bidder will rely on the audited accounts or other statements provided by the auditor, and intends that the bidder should so rely, the auditor will be under a duty of care to the bidder for the breach of which he may be liable."[586]

The court rejected the defendants' contention that in the absence of express averment the defendants intended the plaintiffs to rely on the audited accounts. Their contractual and statutory duties as auditors were seen as inconsistent with the inference of an assumption of responsibility to the plaintiffs as lenders based on the defendants' mere knowledge that the

[582] Ibid.
[583] Ibid 248.
[584] Abugu (n405) 248.
[585] *Galoo Ltd v. Bright Grahame Murray* (1994) 1 W.L.R. 1360.
[586] Ibid at 1382.

plaintiffs were likely to rely on the audited accounts in making their lending decisions. Intention, it held, may support proximity, without elevating it to the status of a *sine qua non*. The Court pointed out that although the claim against the auditors failed in *Caparo*, the House of Lords did not hold that an auditor could never owe a duty of care to someone other than the shareholders in general meeting. For proximity is established in the act of making the information or advice available in the knowledge that it will be passed to the plaintiff for a specific purpose and is likely to be relied on by him for that purpose. While there may be other circumstances that preclude the inference of assumption of responsibility, the fact that the defendants were obliged, as auditors, to audit the accounts of APC for the limited statutory purpose does not rule out an assumption of responsibility to the plaintiffs.[587]

More specifically, the Royal Bank of Scotland (RBS), who claimed to have lost over £13m in unpaid overdraft facilities to insolvent client APC Ltd, claimed that *Bannerman* had been negligent in failing to notice a fraudulent and material misstatement in the accounts of APC. The banking facility was offered on the basis of obtaining audited financial statements every year.[588] *Bannerman*, through its audit of the banking facility letter of APC, would have been mindful of RBS's intention to use the audited accounts as a foundation for lending decisions. For this reason, it was upheld that *Bannerman* owed RBS a duty of care.[589] This result from facility letters required APC to offer audited financial statements to its principal lender, RBS, within six months of its year-end. *Bannerman* prepared audited accounts from the 30th of November 1995 to the 31st of March 1997. APC referred these accounts to RBS, following which RBS made available overdraft facilities and term loans to APC.[590] APC went into receivership and RBS lost its money. RBS tried to recover its losses from *Bannerman* saying that its preparation of the audited accounts was negligent and in breach of the duty of care it owed to RBS. *Bannerman* applied to strike out the claim on the fact that, even if the allegations were true, they did not owe RBS a duty of care.[591]

The court dismissed this application to strike out, and decided that it was sufficient for RBS to show that *Bannerman* should have been mindful that the accounts and audit report would be

[587] Abugu (n405) 248.
[588] S Finley, 'Auditor liability Limiting Exposure, Tolley's Practical Audit & Accounting: The Monthly Key To Practical Audit And Accounting Solutions' (2015) 27 PAA 2 at 14.
[589] Ibid.
[590] Christopher Arnull, 'Audit - Bannerman Disclaimer Here to Stay?' (2008) CCH in Accountancy Live 78 available at: https://www.accountancylive.com/audit-bannerman-disclaimer-here-stay.
[591] Ibid.

offered to RBS for the aim for which RBS relied on them, even though they may have been set for a different statutory aim. Vital to the court's reasoning was the lack of any third-party disclaimer in the audit report.[592] The judge in the *Bannerman* case similarly, and remarkably, decided that the non-existence of any disclaimer of liability to third parties was a major contributing factor to the duty of care owed to them.[593] The decision was appealed but prior to the appeal was heard, the case settled, so the court's ruling stands. It did not actually present any new law.[594]

Finley asserts that one of the outcomes of the *Bannerman* case was the expected exposure of auditors to litigation from third parties to whom they have not denied liability.[595] As a result, it becomes common to include a disclaimer of liability to third parties in the wording of the audit report. Furthermore, disclaimers may not entirely eliminate liability to third parties but they do reduce the scope for courts to assume liability to fall upon them. It should be noted that while this should reduce the threat of litigation in the UK, the protection may not cover abroad because the disclaimer is based on a ruling from a UK court case. It also offers no safeguard from the risk of litigation from clients under contract law.[596] There are also critics of the "*Bannerman* Paragraph", who believe that its presence devalues the audit report. They argued that the disclaimer acts as a barrier to litigation, and decreases the pressure to achieve decent quality audits in the first place.[597]

According to Yeoh, the inconsistency of the judicial tests for proximity and reasonable foreseeability and the fear of huge litigation claims have caused some audit firms like KPMG to incorporate their auditing divisions as limited corporations.[598] Others have repackaged their insurance cover to meet with this problem or are taking steps to shield themselves through limited liability partnerships. Moreover, others are waiting for the Department of Trade and Industry (which has been substituted with the formation of the Department for Business, Enterprise and Regulatory Reform and the Department for Innovation, Universities and Skills on 28 June 2007) implementation guidance on the use of limited liability agreements provided under sections 532-539 of the U.K Companies Act 2006.[599]

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[592] Ibid.
[593] Finley (n588) 14.
[594] Ibid. *Royal Bank of Scotland Plc v. Bannerman Johnstone Maclay* [2005] ScotCS CSIH39.
[595] Ibid 15.
[596] Ibid 15.
[597] Ibid 15.
[598] Yeoh (n377) 157.
[599] Ibid.

4.7.2 *MAN Nutzfahrzeuge v Freightliner Limited* [600]

The effect of *Bannerman*-style disclaimer clauses was considered by the Court of Appeal in *MAN Nutzfahrzeuge v Freightliner Limited,* finding that the auditors of a subsidiary were not liable to the parent company in respect of losses suffered by the parent as a result of a fraud in the subsidiary.[601]

However, the decision reinforced the desirability of disclaimers of responsibility to third parties.[602] The Court of Appeal's decision in *MAN/Freightliner* applied to audit liability, the duty of care analysis contained in *Excise Commissioners v Barclays Bank plc*,[603] which gave primacy to the assumption of responsibility test.[604] In the Court of Appeal's view, the main question is no longer whether, in addition to acknowledging that the recipient would rely, the auditor had to have intended such reliance, though Chadwick LJ did use the language of intention in his reasoning. Prior cases had differed on the question whether intention had to be revealed, and in a number of cases intention had been excluded as a requirement most recently in the interlocutory Scottish appeal court decision in *Royal Bank of Scotland v Bannerman, Johnstone, Maclay*. Chadwick LJ interpreted *Barclays Bank* to mean that "something more" than knowledge that the recipient can rely on the statement for a precise purpose which was needed as part of the correct application of the assumption of responsibility test, but without saying what that was exactly.[605]

The decision in *MAN Nutzfahrzeuge* appears to indicate that the auditor's statement could have been relied upon by the recipient for its specific purpose.[606] Chadwick LJ opined that "to hold that the auditors assumed responsibility for the use which a dishonest employee of the audited company might make of the accounts in the context of the parent company's negotiations for

[600] *MAN Nutzfahrzeuge v Freightliner Limited* **(**2007) EWCA Civ 910.
[601] Herbert Smith Freehills, 'Court of Appeal Rules on Audit Liability-Legal Notes' (2007) available at: https://hsfnotes.com/litigation/2007/09/17/court-appeal-rules-audit-liability/; see also, Gerald Byrne, 'Negligent Misrepresentation: Recent Developments in English and Irish Law' (2007) 2(4) Quarterly Review of Tort 22-27.
[602] Herbert Smith Freehills (n601).
[603] *Excise Commissioners v Barclays Bank plc* [2007] 1 AC 181, [2006] UKHL 28.
[604] Byrne (n601) 26.
[605] Herbert Smith Freehills (n601).
[606] Ibid.

the sale of the company would, I think, be to impose on them a liability greater than they could reasonably have thought they were undertaking."[607]

Disclaimers of responsibility to third parties had been widely used by auditors since the *Bannerman* case.[608] Based on the decision in *MAN Nutzfahrzeuge*, auditors of a subsidiary are left vulnerable, where they offer their accounts to the client's parent in situations it is known that the parent is reliant on the accuracy of the accounts for the purposes of a third-party sale.[609]

4.7.3 *Barclays Bank plc v Grant Thornton UK LLP*

In *Barclays Bank plc v Grant Thornton UK LLP*,[610] the High Court in England more recently considered again the enforceability of a disclaimer of liability within audit reports against a third party.[611]

Grant Thornton carried out audits for VEH Essen Hotels Group "VEH" in 2006 and 2007, which were relied upon by the claimant, Barclays Bank, in respect of their ongoing loan facility to VEH in the sum of £250 million. VEH following became insolvent and were incapable of repaying the loan facility to the claimant.

The claimant, looking to recover its losses, brought proceedings against the defendant for professional negligence pursuant to the defendant's assumed negligence in constructing the auditor reports. The claimant alleged that the defendant was unsuccessful to determine fraudulent statements made by VEH, which inflated VEH's financial position. The claimant alleged that this negligence initiated their loss.

The audit reports produced by the defendant included a clause comprising a disclaimer which stated that they were made for VEH's directors only and that the defendant did not accept liability to third parties for their reliance on the information covered in the reports. The claimant submitted that the terms of the disclaimer were unreasonable under the Unfair Contract Terms

[607] *MAN Nutzfahrzeuge v Freightliner Limited* **(**2007) EWCA Civ 910, para 56.
[608] Herbert Smith Freehills (n601).
[609] Ibid.
[610] *Barclays Bank plc v Grant Thornton UK LLP* (2015) EWHC 320 (Comm); (2015) 2 B.C.L.C. 537; (2015) 1 C.L.C. 180.
[611] Georgina Squire, 'Barclays Bank plc v Grant Thornton UK LLP' (2015) All ER (D) 210 available at: https://www.lexology.com/library/detail.aspx?g=d11610e8-7b2f-4c12-a6da-9df83a02be06.

Act 1977 and therefore it was inapplicable and that, as a result, they were entitled to recover their loss for reliance upon the audit reports. The defendant disputed the claimant's submissions and sought summary judgment.

The High Court found the terms of the disclaimer to be clear. [612] The Court referred to the nature of the parties involved, being two 'sophisticated commercial parties' both well experienced in the typical limitations auditors impose on their responsibilities. The High Court found that the claimant should have expected that such an exclusion clause would have been present in the audit reports.

On this analysis of the facts, the High Court found that the clause was not unreasonable and was efficient of being relied upon by the defendant. The High Court granted the defendant summary judgment and determined that the claimant had no credible prospect of success.

Cooke J said it was "hard to see what else Grant Thornton could be expected to do save for capitalising, underlining or red handing that part of the report, something which would be considered wholly unnecessary when dealing with sophisticated bankers and business people who can be expected to read documents put before them and to be familiar with notices of disclaimer in auditors' reports."[613]

According to Squire, this case shows the facts that will be taken into account by the courts when contemplating the effectiveness of a disclaimer clause.[614] Where a clause is clear on its terms and used between commercially sophisticated parties, it will typically be effective in excluding liability. In cases where a party desires to place reliance on documents covering such a clause, steps should be acquired in advance to ensure that the party may rely on the documents in question.[615]

In May 2018, the Institute of Chartered Accountants in England and Wales updated their guidance in the form of technical release 01/03AAF (Revised) The Audit Report and Auditors' Duty of Care to Third Parties.[616] This guidance has confirmed the assumption of responsibility

[612] Squire (n611).
[613] *Barclays Bank plc v Grant Thornton UK LLP* (2015) EWHC 320 (Comm); (2015) 2 B.C.L.C. 537; (2015) 1 C.L.C. 180, at 40.
[614] Squire (n611).
[615] Ibid
[616] The revised ICAEW Guidance - Technical release 01/03AAF, 'The Audit Report and Auditors' Duty of Care to Third Parties' May 2018, available at: https://www.icaew.com/-/media/corporate/files/technical/technical-releases/audit/tech01-03aaf-the-audit-report-and-auditors-duty-of-care-to-third-parties---revised.ashx.

for the audit report to the members as a body. Moreover, the *Bannerman* decision, read with earlier case law, signals that the absence of a disclaimer may enable an inference that the auditor has assumed responsibility for the audit report to a third party. The ICAEW after getting an advice from leading counsel, advises auditors who wish to manage the risk of liability to third parties to use a disclaimer. However, the wording in the disclaimer does not mean that auditors will never incur responsibilities to third parties such as lenders as in the case, for example, where both parties agree expressly the scope and nature of work that meets specific purposes and "separate engagement".

This guidance does not change the legal position of auditors, it just illustrates to whom auditors owe duties as established by *Caparo*. However, subject to certain limited exceptions, the Companies Act 2006 makes any attempt invalid to exclude or limit liability in that respect. According to Sweet, the updated guidance also considers the revised International Standard on Auditing (ISA) (UK and Ireland) 700 issued in June 2013 "The Independent Auditor's Report on Financial statements." This guidance obliges auditors reporting on companies which comply with the UK corporate governance code to provide considerably increased disclosure around risks, materiality and scope of the audit.[617] The structure of the auditor's report has now changed in ISA (UK) 700 (Revised June 2016) "Forming an Opinion and Reporting on Financial Statements", which concern audits of financial statements for periods starting on or after 17 June 2016.[618] Finally, it is worth noting that the use of disclaimers is common, both in audit and non-audit reports created by professional firms. ICAEW promotes their use so as to manage the risk of liability to third parties, but this view is not shared by the Association of Chartered Certified Accountants, which recommends that work prepared in accordance with the required criteria does not require a comprehensive disclaimer.[619]

To conclude this section, it is clear that the UK courts have relied heavily on *Bannerman* to reach conclusions which are in favour of the auditing industry and further limit the liability of auditors to third parties.

[617] Pat Sweet, 'Bannerman guidelines on third-party audit disclaimer revised', 24 May 2018, Accountancy Daily, available at: https://www.accountancydaily.co/bannerman-guidelines-third-party-audit-disclaimer-revised.
[618] Steven Collings, 'Auditors' reports: The rise of the disclaimers', 30th Jul 2018, Accounting Web, available at: https://www.accountingweb.co.uk/business/financial-reporting/auditors-reports-the-rise-of-the-disclaimers.
[619] Ibid.

4.8 The Civil Liability of Auditors in Canada

4.8.1 *Haig v. Bamford* [620]

According to Blackier and Paskell-Mede, the development of the Canadian common law tort of negligent misstatement was influenced by American and British jurisprudence.[621] To succeed in a claim for negligence, plaintiffs must show that they suffered harm as a consequence of the breach of a duty of care owed to them by the defendant.[622] For years, the landmark case in Canada in the area of auditors' liability towards third parties immediately following *Hedley Byrne* was the 1976 Supreme Court of Canada's ruling of the *Haig v. Bamford*.[623] The Supreme Court of Canada outlined three possible tests to determine the existence of an auditor's duty of care to third parties: foreseeability of the use of the financial statements by the third party; actual knowledge of the limited class that will use and rely on the statements; and actual knowledge of the particular plaintiff who will use and rely on the statement.[624] The Supreme Court of Canada adopted the broader "limited class test" as a basis for determining a duty of care.[625]

The first of the three tests was based on "foresight" - what the reasonable man would expect in the circumstances - the familiar test of responsibility for negligence in which physical harm to a person or his property was involved. The remaining tests rely on "knowledge" - actual appreciation of the facts and awareness that a specific consequence will occur.[626] The Supreme Court of Canada adopted the "limited class of users" test and rejected the "actual knowledge" test. The most important factor taken into consideration in reaching that decision was the purpose for which the statements were made by the accountants.[627]

[620] *Haig v. Bamford* (1976) 1 S.C.R. 466.
[621] Jack Blackier and Mindy Paskell-Mede, 'Auditor Liability in Canada: The Past, Present and Future' (1999) 48 University of New Brunswick Law Journal 65–94 at 67.
[622] Chung et al. (n274) 69.
[623] J H Leibman and Anne Kelly, 'Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle' (1992) 30 American Business Law Journal 11.
[624] *Haig v. Bamford* (1976), (1977) 1 S.C.R. 466 at 476; see also, Chung et al. (n274) 69; Pacini et al. (n330) 397; Blackier and Paskell-Mede (621) 70.
[625] Khoury (n417) 427.
[626] G H L Fridman, 'Negligent Misrepresentation: A Postscript' (1976) 22 Mcgill Law Journal 649, 652.
[627] Daniel Ish, 'Liability Arising Out of Negligent Misrepresentation' (1977) 42(1) Saskatchewan Law Review 147-53.

In *Haig*, the financial statements were actually used for the purpose for which the accountants intended; namely, for decision making by a lending institution and potential investors.[628] Significantly, the Supreme Court of Canada specified that no difference exists between the case in which the accountant conveys information directly to the suing party at the client's request and the condition in which the accountant brings information to the client who, with the auditor's knowledge, delivers it to unknown members of a limited class for use in a transaction of which the accountant is conscious of. Arguably, this proposition went beyond the reasoning in *Hedley Byrne* since the Supreme Court of Canada decided that even though the auditors could not have known of the existence and circumstances of the investor, Haig, when they performed their work, they still owed him a duty of care.[629] Providing a definition of the precise class of persons to whom a duty of care may be owed is vital.[630]

Finally, but not least significant, the Supreme Court of Canada left open the possibility of application of the foreseeability test in future cases.[631] It was the spectre of indeterminate liability which was invoked by such a test that had been of grave concern to the Canadian accounting profession.[632]

What effect has *Caparo* had to date in Canada and what effect is it likely to have on an accountant's third-party liability in the Canadian context? In Canada, it was still unclear, prior to *Caparo*, whether *Anns v. Merton London Borough Council*[633] was an appropriate test to govern cases involving recovery for pure economic loss despite having been applied on five occasions by the Supreme Court of Canada.[634]

It was, for example, held by the Supreme Court of Canada in *B.D.C. Ltd v. Hofstrand Farms Ltd*[635] that "proximity" requires a "special relationship" which "would arise in circumstances where the defendant, being so placed that others would reasonably rely on his judgment or skill, knows that the plaintiff will rely on his statements."[636] It was also precisely this sort of reference which led Mr Justice Harradence, delivering the judgment of the Alberta Court of

[628] Pacini et al. (n330) 397.
[629] Ibid 398.
[630] R D Brown, 'Haig v. Bamford' (1977) 15(2) Osgoode Hall Law Journal 474-484.
[631] Pacini et al. (n330) 398.
[632] Ibid.
[633] *Anns V. Merton London Borough* (1977) 2 All E.R. 472 (H.L.).
[634] For example, in *Rothfield v. Manolakos* (1989), all of the justices applied the *Anns* test (1977) as restated by Wilson J. in *City of Kamloops v. Nielsen* (1984). For a complete discussion see W S Schlosser, 'What Has Become of Anns?' (1991) 29 Alta L.R. 673 at 684; see also, Ivankovich (n323) 522.
[635] *B.D.C. Ltd. v. Hofstrand Farms Ltd.* (1986) 1 S.C.R. 228.
[636] *Haig v. Bamford* (1976), (1977) 1 S.C.R. 466, 72 D.L.R. (3d) 68 [hereinafter Bamford cited to S.C.R.]. at 238; see also, Ivankovich (n323) 522.

Appeal in *B.P.L Resources Ltd v. Merrill Lynch Canada Inc.*[637] to conclude: "There is debate as to what Lord Wilberforce meant in respect of this first branch, i.e., whether foreseeability of damage in itself is sufficient to raise a prima facie duty of care or whether a relationship of proximity must first be established before foreseeability of damage gives rise to a duty of care."[638] In addition, in *City of Kamloops v. Nielsen*,[639] Wilson J., for the majority, suggests that the reasonable foreseeability test is perhaps too broad.[640]

Caparo now provides a convenient opportunity to formally sanction proximity as the appropriate control mechanism in accountant third-party liability cases.[641] Certainly, the result in *Caparo* is consistent with the reasoning in *Bamford*.[642] In that case, the crucial finding was this: "Instructions were issued to the firm of R.L. Bamford & Co, (the accountants), of whom the respondents (defendants) were partners, to prepare the required financial statement and Scholler began a search for an outside investor. He made it known to the accountants that he was seeking an investor. The trial judge, MacPherson J., decided that the accountants knew, prior to completion of the financial statement, dated June 18, 1965, at the root of the present litigation, that the statement would be used by Sedco, by the bank with whom the company was doing business, and by a potential investor in equity capital."[643]

Mr Haig, although unknown specifically to the auditors at the time of the engagement, was a potential investor and, therefore, a member of a limited and identifiable class of persons whom the auditor knew would rely on the audited statements for the purpose of deciding whether or not to invest. That actual knowledge was sufficient, in the view of the Supreme Court, to establish the auditor's duty of care.[644]

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[637] *B.P.L Resources Ltd v. Merrill Lynch Canada Inc.* (1989), 95 A.R. 211 at 228, 67 ALTA L.R. (2d) 97.
[638] Ibid 120; see also, Ivankovich (n323) 522.
[639] *City of Kamloops v. Nielsen* (1984) 2 S.C.R. 2, 10 D.L.R. (4th) 641.
[640] Ivankovich (n323) 522.
[641] Brian R. Cheffins, 'Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow' (1991) 18 Canadian Business Law Journal 118.
[642] Remarks to the contrary are, indeed, puzzling. See, e.g., John Fleming 'The Negligent Auditor and Shareholders' (1990) 106 Law Quarterly Review 349 at 350, states that the assumption has also been challenged on the basis that the typical third party in accounting cases is a commercial concern which shares the accountant's ability to spread throughout its own consumer base the losses it incurs relying on a negligent audit; see also, Ivankovich (n323) 522.
[643] *Haig v. Bamford* (1976), (1977) 1 S.C.R. 466, 72 D.L.R. at 470. Dickson J. Martland J. attached particular importance to this finding in his concerning opinion, Ibid. at 484.
[644] Ivankovich (n323) 522-523.

The second potentially problematic issue concerns the outer limits of a "limited group or class."[645] *Caparo* correctly recognised that a public accountant's risk of liability should be quantifiable in part by reference to his or her knowledge of the number and character of the persons who relied on the information generated.[646] The potential difficulty, which can only be resolved by reference to policy considerations, is highlighted by contrasting the comments of MacCallum J. of the Alberta Court of Queen's Bench in *Akhtar v. MacGillivray & Co.*[647] with those of Boyd J. of the British Columbia Supreme Court in *Kripps v. Touche Ross & Co.*.[648]

In *Akhtar*, members of the public at large were invited in a prospectus to make loans to a mortgage company on the security of promissory notes, the value of which depended upon an asset valuation. Following the collapse of the mortgage company, the plaintiffs alleged, inter alia, negligence against the auditors in the preparation of the financial statements, which had appeared in the prospectus.[649] Although the action was dismissed on causation grounds, Mr Justice MacCallum expressed some doubt as to whether proximity could extend to an extremely numerous class: "Proximity is easy to establish when the investors are members of a very limited class as in *Haig v. Bamford* (1976), 9 N.R. 43, 72 D.L.R. 68 (S.C.C.). It is a good deal more difficult to establish when the investors are members of the public at large to whom had been extended an invitation to purchase the notes in question."[650]

In *Kripps*, debentures were offered for sale to the public by way of several prospectuses all of which contained audited financial statements asserting compliance with generally accepted accounting principles. In fact, the statements failed to provide for certain expected losses. The plaintiffs, having lost their investment when the superintendent issued a cease trading order, sued the accountants for negligence in the preparation of the financial statements. In refusing the accountant's application to strike out the plaintiff's claim as disclosing no reasonable cause of action, Madame Justice Boyd emphasised that a finding of sufficient proximity will vary with the facts and then focused on the auditor's knowledge of the purpose of the transaction. Adopting the following passage from the judgment of McColl J. in *Surrey Credit Union v. Willson*,[651] she held that, notwithstanding the potentially large class of persons who would

[645] Ibid 524.
[646] Ibid.
[647] *Akhtar v. MacGillivray & Co.* (1990), 112 A.R. 242, 77 ALTA L.R. (2d) 337 (Q.B.).
[648] *Kripps v. Touche Ross & Co.* (1990), 52 B.C.L.R. (2d) 291 (S.C.).
[649] Ivankovich (n323) 524.
[650] *Akhtar v. MacGillivray & Co.* (1990), 112 A.R. 242, 77 ALTA L.R. (2d) 337 (Q.B.) at 268.
[651] *Surrey Credit Union v. Willson* (1990), 73 D.L.R. (4th) 207, 49 B.C.L.R. (2d) 102 (S.C.).

obtain the prospectuses, it was not overly large and unidentifiable a class to form the foundation of a relationship of proximity between the parties: "In my view, once the defendants knew the purpose for which the consent to use the audited statements was being sought, they could no longer say that debenture purchasers were strangers. The debentures were being offered for the sole purpose of attracting capital. The defendants were auditors of international reputation. They knew the circumstances and purpose for which consent was sought."[652]

The outcome of the *Kripps*' decision for auditors' liability to third parties is that auditors can be liable for negligence if they know the specific use of the audited financial statements, even if they follow national accounting standards in their financial reporting. The appropriate standard of care against which the conduct of auditors was uncertain.[653] Also, in *Kripps v. Touche Ross & Co,*[654] unsecured bonds were sold to the public across a prospectus containing an unqualified audit report asserting compliance with GAAP. However, the financial statements failed to provide for certain losses. The court determined that the auditor owed a duty of care to the bond purchasers by captivating a broad view of the purpose of audited financial statements and the limits of the class of intended users.[655] *Kripps* is noteworthy, not only because its facts do not fall at either end of the spectrum, but because it indicates that the *Caparo* approach was itself subject to the exercise of judicial discretion which, depending on the views of the court, either expanded or restricted liability, by narrowly or broadly defining the purpose for which the statements were generated and the boundaries of the intended class of users.[656]

4.8.2 *Hercules Managements v. Ernst & Young*

Canadian auditor liability to nonclients for negligence experienced a change in the 1997 landmark case of *Hercules Management Ltd v. Ernst & Young*.[657] The Supreme Court of Canada adopted the two-prong *Anns* test[658] to determine whether an accountant or another

[652] Ibid 212.
[653] Chung et al. (n274) 69.
[654] *Kripps v. Touche Ross & Co.* (1994) 22 B.L.R. (2d) 86 (BSCS), aff'd (1997) BCJ No. 968 (BCCA).
[655] P C Wardle and Doris James, 'Professional Negligence: Has Hercules Given Judges More Discretion?'(1998) 27 International Commercial Litigation 32 at 34.
[656] Ibid.
[657] *Hercules Managements v. Ernst & Young* (1997) 2 S.C.R. 165.
[658] Joost Blom, 'Do we Really Need the Anns Test Duty of Care in Negligence?' (2016) 53 Alberta Law Review 895 at 906 recently argued that the current status of *Hercules* is debatable. First, it is pre-*Cooper*, and the considerations that the Court treated as second stage in *Hercules* — notably whether the defendant had knowledge of the precise purpose for which the plaintiff would use the information or advice — could now be seen as part of the proximity analysis at the first stage. Second, it is also arguable that *Hercules*' idea that *Anns* should be applied in this area, so as to better integrate the handling of duty in negligent misstatement cases with the handling of duty in other forms of negligence, has turned out not to be viable. In fact, given the Court's current view of the *Anns* test, *Hercules* actually does treat negligent misstatement differently because it uses

professional owes a duty of care to a third party for negligent misstatement purposes. Moreover, the court rejected the idea that accountants should be subjected to a broader range of liability than other professionals.[659] The first prong, the "at first sight" test, examines proximity, which determines whether the wrongdoer's negligence might reasonably cause damage to the person suing,[660] whereas the second prong analyses policy considerations that could limit or eliminate any duty of care owed by the accountant to the plaintiff.[661]

According to Pacini et al., accountants and their solicitors and barristers must note that the term "proximity" means that the professional has a duty to be aware of the third party's "legitimate interests".[662] Proximity likely exists when the accountant or other professional should reasonably foresee that a third party will rely on the accountant's representation, and reliance by the third party is reasonable. The court noted, however, that mere reliance on an accountant's representation is not, in all circumstances, reasonable. In many cases against auditors, the "at first sight" test will be satisfied and a duty will arise because most third-party users are reasonably foreseeable.[663]

In the second part of the *Anns* test, the court examines policy factors that could serve to limit or eliminate any duty established. The court opinion articulated the undesirable consequences of imposing limitless liability on auditors. Some of the noted consequences were increased liability insurance premiums, a reduction in the supply of accounting services, increased cost of accounting services, and a negative effect on the timeliness of attested business and financial information (as auditors would spend more time in the performance of services to reduce the risk of litigation).[664]Another consequence would be a serious logjam of court cases.[665] The

Anns as a determinant for a duty of care in individual cases, not categories of cases as it could be argued that this is an overstatement and *Hercules* should be seen as deciding on a duty of care in a category, namely, auditors' liability. If so, however, the category is not wide. Third, the Court's application of the second stage policy considerations was not geared to auditors 'opinions generally, but to a particular kind of auditors' report prepared for a particular kind of purpose. Fourth, it can also be added that, in practice, the lower courts have not taken *Hercules*' embrace of *Anns* to heart. Many lower courts dealing with negligent misstatement claims have seen no real difference between applying *Anns*, as *Hercules* said they should, and applying the special relationship criterion. Many have simply continued to use the latter despite *Hercules* having said that it ought to be superseded.

[659] Pacini et al. (n330) 398.

[660] Justice La Forest. indicated that "proximity" in negligent misrepresentation actions pertains to some aspect of the relationship of reliance: "... to my mind, proximity can be seen to inhere between a defendant-representor and a plaintiff-representee when two criteria relating to reliance may be said to exist on the facts: (a) the defendant ought reasonably to foresee that the plaintiff will rely on his or her representation; and (b) reliance by the plaintiff would, in the particular circumstances of the case, be reasonable" *Hercules Managements v. Ernst & Young* (1997) 2 S.C.R. 165. At 188.

[661] M E Deturbide, 'Liability of Auditors: Hercules Management Ltd et al. v Ernst & Young et al' (1997) 77(1/2) Canadian Bar Review 260 at 262.

[662] Pacini et al. (n330) 398.

[663] Ibid.

[664] Ibid.

[665] The traditional policy basis of the floodgate argument is spelled out by the Supreme Court of Canada in *Hercules* (1997) 2 S.C.R. 165, quoting two law articles: Brian R. Cheffins, 'Auditors' Liability in the House of Lords: A Signal Canadian Courts

court additionally noted that unlimited liability promotes "free ridership" on the part of relying third parties who lose their incentive to exercise vigilance. In the final analysis, the court signified that concerns over indeterminate liability would aid to negate any duty owed to nonclients in most cases.[666]

Some cases will occur, however, where policy considerations involving indeterminate liability will not be a relevant consideration.[667] For instance, if the accountant identifies the identity of the nonclient (or a class of third persons) and the accountant's representations are utilised for the particular purpose or transaction for which they were made, policy considerations will not be significant since the scope of liability can be readily circumscribed. Even if the particular identity or class of potential users is known to an accountant, use of the accountant's work product for a drive or transaction other than that for which it was set or intended could still lead to unspecified liability. In the court's view, the drive of audited financial statements is to assist the collectively of a corporation's shareholders in overseeing management, not to assist investors in making personal investment decisions. In reaching this conclusion, the *Hercules* court cited the reasoning in *Caparo*.[668]

In sum, after the *Haig* decision, Canadian courts continued to slowly widen the scope of an accountant's duty to third parties for negligent misstatements. The expansionist trend was reversed by the 1997 *Hercules Management* decision. The ruling obligates the application of the two-pronged *Anns* test to cases involving negligent misstatements by auditors to nonclients. Concerns over indeterminate liability will negate a duty owed to third parties by accountants in most cases.[669] The outcome of the *Hercules* case is that investors have no right to sue auditors

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Should Follow' (1991) 18 Canadian Business Law Journal 118 at 125-127; Ivan F. Ivankovich, 'Accountants and Third Party Liability – Back to the Future' (1991) 23 Ottawa Law Review 505 at 520-521. Giudici (n259) 533 thinks that the arguments assert that liability to third parties would increase insurance and litigation costs, consequently reducing the audit service supply and increasing the price paid by clients to incumbent auditing firms. These arguments are based on assumptions that remain very difficult to empirically prove and are, therefore, unconvincing.

[666] Deturbide (n661) 263.

[667] N Rafferty, 'Recent professional negligence decisions form the Supreme Court of Canada' (1998) 14 (2)Professional Negligence 67.

[668] Pacini et al. (n330) 399; see also Wardle and James (n655) 33 who said "Interestingly, *Hercules* also confirmed the continued application in Canada of the rule in *Foss v Harbottle* (1843), 67 ER 185; *Foss v Harbottle* provides that individual shareholders have no cause of action for wrongs done to the corporation and that shareholders can only recover for wrongs done to the corporation by way of a derivative action. Justice La Forest held that shareholders, when they collectively oversee the activities of a corporation through resolutions adopted at shareholder meetings, assume what may be called a "managerial" role and are not acting simply as individual holders of equity. Any duty owed by auditors in respect of this aspect of the shareholders' functions is owed not to shareholders as individuals, but rather to all shareholders as a group acting in the interests of the corporation. Since the decisions taken by the collectivity of shareholders are in respect of the corporation's affairs, shareholders' reliance on negligently prepared audit reports in taking such decisions will result in a wrong to the corporation for which the shareholders cannot, as individuals, recover."

[669] Deturbide (n661) 264.

for misstatements in financial statements since a duty of care does not occur between auditors and shareholders except if there are special circumstances within the facts of the case.[670]

One of the most recent cases to affirm the decision from *Hercules* was *Waxman v. Waxman*[671] which confirmed that auditors will not be liable to individual shareholders of their corporate client except if the mandate of the auditor has been precisely expanded prior to its usual role.[672] The *Waxman* decision represents a noteworthy progress in the continuum of auditors' liability jurisprudence in Canada in that auditors only owe a "duty of care" to their clients to reduce information asymmetry on material information.[673]

The newest development in this area is clarified in *Widdrington v. Wightman et al*.[674] also known as *Castor Holdings Inc.* ("*Castor*"). In the ruling, Justice Marie St-Pierre of the Quebec Superior Court said that Coopers & Lybrand (now PricewaterhouseCoopers) failed to perform their duties as auditors in accordance with auditing and accounting standards. She also went on to reason that Coopers & Lybrand issued "faulty opinion" about Castor's true financial position that prohibited investors from appraising its financial health. The Honourable Marie St-Pierre, renowned for her conservative approach, articulated that there was an exemption to *Hercules* founded on the specific factual situation offered in the case. She found that "the typical concerns surrounding 'indeterminate liability' do not arise" as they did in *Hercules*, for two key reasons: (1) Castor's financial statements were set for a broader purpose; and (2) the class of potential investors was recognisable to the auditors.[675]

To conclude the discussion about the *Haig* case in connection with the *Hercules* case, Solaiman has addressed the sources of liability in Canada.[676] Statutory law is the main source of liability for auditors and they are liable for misstatements in prospectuses under s.130 (1) of the Securities Act 1990-Ontario as an expert.[677] However, the judicial interpretation of auditor liability for negligent misstatements under Manitoba corporation legislation makes the enforcement of s.130 (1) difficult, as the victims of defective disclosures in which an auditor was a party would need to rely on a shareholder's derivative action. This is because the

[670] Ibid.
[671] *Waxman v. Waxman* (2004) 186 O.A.C. 201.
[672] Chung et al. (n274) 69.
[673] Lokanan (n1).
[674] *Wightman V. Widdrington (Succession de)*, 2013 QCCA 1187.
[675] Lokanan (n1).
[676] S M Solaiman, 'Statutory Civil Liabilities of Corporate Gatekeepers for Defective Prospectuses in Australia, the United States, the United Kingdom and Canada: A Comparison' (2014) 35(4) The Company Lawyer 100-122 at 119.
[677] Ibid.

Supreme Court of Canada in *Hercules Management Ltd v Ernst & Young* held that auditors owe a duty of care to the entity itself, not to any individuals such as shareholders, therefore they can use derivative action in order to sue auditors.[678] This interpretation should be relevant to the SA1990-Ontario in the absence of any clear provision that makes auditors directly liable to third parties. Thus, the *Hercules Management* decision inhibited the expansion of auditor liability to non-client third parties for negligent misstatements in prospectuses. This case offers the first legal test for the determination of the scope of civil liability of gatekeepers, and it apparently contradicted the trend towards investor protection.[679]

4.8.3 *Livent Inc. v. Deloitte & Touche*

The Ontario Court of Appeal landmark ruling in *Livent Inc. v. Deloitte & Touche*[680] affected auditors across Canada which ruled against the latter to pay creditors of the former more than $118 million in damages, including interest.[681]

According to the judge's findings Deloitte was negligent in its conduct of the 1997 audit resulting in a dramatic change in the way auditors carry out their duties because it was no longer enough just to be competent.[682]

Experts also say the *Deloitte/Livent* court ruling significantly changed the Canadian landscape for auditors after a former watershed ruling - the 1997 Supreme Court of Canada decision *Hercules Management[s] Ltd. v. Ernst & Young [1997] 2 SCR 165]*.[683]

Justice Gans attended that case in his 2014 ruling *Livent (Special Receiver and Manager of) v. Deloitte & Touche* [2014] ONSC 2176, noting that that a company's auditor did "not owe a duty of care to the shareholders of its corporate client."[684] Her further went on to say that "the purpose of audit reports is to allow shareholders... to supervise management... [and are]... not have individual causes of action against an auditor. If the corporation suffers losses attributable

[678] *Hercules Management Ltd v Ernst & Young 2 S.C.R.* 165 (1997) (Can) at 171–172.
[679] Solaiman (n676676) 119.
[680] *Livent (Special Receiver and Manager of) v. Deloitte & Touche* (2016) ONCA 11.
[681] J Buckstein, 'Livent Ruling Seen as Game Changer for Auditing Duties'(2016) 32(3) Bottom Line 1.
[682] Ibid.
[683] Ibid.
[684] Ibid 2.

to its auditor's negligence, then the corporation itself has the cause of action, which may if necessary be pursued by way of a derivative action."[685]

Deloitte reasoned that Livent had no right to sue since its own executives conducted the fraud, but the Court of Appeal - rejected that, resulting in the imprisonment of two of Livent's executives.[686] Joel Watson, a partner with Shibley Righton LLP in Toronto, alleged that Justice Blair provided a very well written judgment, which Watson doubts may be in anticipation of an appeal to the Supreme Court.

Watson noted that Justice Blair's decision confined a critical passage which said that "in accordance with GAAS [generally accepted auditing standards], Deloitte was under an obligation to have proper auditing procedures in place to reduce the risk of not detecting material misstatements to an appropriately low level ... Deloitte was retained to ... exercise reasonable care in relation to detecting fraud. This is underscored by the fact that Deloitte knew at all material times that the financial statements it prepared were being used to solicit investment in Livent."[687]

Watson also emphasised this portion of Blair's ruling, referencing a decision by Jonathan Mance, a House of Lords (now Supreme Court of the United Kingdom) judge in 2009.[688] "I find perceptive Lord Mance's view in *Stone & Rolls* ... that '[i]t would lame the very concept of an audit if the auditor could, by reference to the maxim ex turpi causa, defeat a claim for breach of duty in failing to detect managerial fraud at the company's highest level by attributing to the company the very fraud which the auditor should have detected,"[689] Justice Blair wrote.[690]

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[685] Ibid.
[686] Ibid.
[687] *Livent (Special Receiver and Manager of) v. Deloitte & Touche* (2016) ONCA 11, at para 160.
[688] Buckstein (n681) 2.
[689] *Livent (Special Receiver and Manager of) v. Deloitte & Touche* (2016) ONCA 11, at para 161.
[690] *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others* [2015] UKSC 23, [2016] AC 1 (*Jetivia*). confirmed that the illegality principle considered in Stone & Rolls would not apply in circumstances involving widely-held companies with innocent shareholders who took no part in or otherwise benefited from the unlawful act — an interpretation that Livent argued was already clear on the face of the judgment in Stone & Rolls itself. Howard and Kreaden (n547) 121. Furthermore, the decision in *Singularis* considers issues that the courts have also grappled with here in Canada. In the recent auditors' negligence case at the Supreme Court of Canada, *Deloitte & Touche v. Livent Inc. (Receiver of)*, the appellant, Deloitte, sought to bar Livent's negligence claim against it on the basis that the wrongful conduct of Livent's directors, Drabinsky and Gottlieb, should be attributed to Livent itself. *Deloitte & Touche v. Livent Inc. (Receiver of)*, 2017 SCC 63, para. 99 ("*Livent*"). The Supreme Court of Canada rejected that proposed attribution, reasoning that denying liability on the basis that an individual within the corporation has engaged in the very action that the auditor was enlisted to protect against would render the relevant statutory audit meaningless. ("*Livent*"), para. 103 The Supreme Court of Canada did, however, "leave for another day the question of whether the same is true in the context of a 'one man' corporation, where the sole director and shareholder hires the auditor to uncover the wrongful action which he, himself, carries out." ("*Livent*"), para. 104. Healy thinks that it would be

Rick Robertson argues that the lesson arising from these court cases is that when doubts and concerns arise, auditors need to pursue them, as detecting fraud is difficult.[691] Caylor and Kenney provided a summary of the Ontario Court of Appeal's decision in *Livent Inc v Deloitte & Touche* in January 2016 concerning the ex turpi causa defence.[692]

Building on earlier case law, the Court of Appeal's decision highlights the continued while limited role of the ex turpi causa doctrine in Canada, holding that the doctrine's application should be restricted to conditions demanding the maintenance of the integrity of the Canadian justice system. *Livent* arose as a result of the failure of Canadian-based entertainment business, Livent Inc "Livent". While Livent seemingly appeared to be a healthy and effective business, yet behind the scenes its finances were in disarray.

The principals of Livent -Garth Drabinsky and Myron Gottlieb- had been falsely manipulating the company's books in order to increase earnings and profitability. Doing so permitted Drabinsky and Gottlieb to attract substantial funding through capital markets. The scam was exposed when new management was selected. Soon after, Livent filed for insolvency protection in Canada and the US and was assigned into receivership. Drabinsky and Gottlieb were eventually criminally convicted of fraud and forgery, and imprisoned. Deloitte & Touche ('Deloitte') was Livent's auditor and supplied clean audited financial statements for approximately a decade. Consequently, subsequent its collapse, Livent - through its receiver - started an action in Ontario against Deloitte.

The action claimed that Deloitte was liable under the operative contract and in negligence as an outcome of Deloitte's failure to obey generally accepted auditing standards and discover the material misstatements in Livent's books. In its defence, Deloitte argued that it ought not be held accountable for the fraud committed by Livent. Its view was that knowledge of the misconduct of Drabinsky and Gottlieb must be accredited to Livent. On this basis, Deloitte

intriguing to see how our courts will consider that question of attribution, in the context of a 'one man' corporation, in the aftermath of *Singularis*. Healy, Patrick, 'A Question of Attribution: UK Supreme Court Clarifies Law on the Illegality Defence and the Quincecare Duty Owed By Financial Institutions', November 14, 2019, available at: https://www.mccarthy.ca/en/insights/blogs/canadian-appeals-monitor/question-attribution-uk-supreme-court-clarifies-law-illegality-defence-and-quincecare-duty-owed-financial-institutions.

[691] Buckstein (n681) 2.

[692] Caylor and Kenney (n545) 266-267.

argued that the doctrine of ex turpi causa applied, excluding Livent from succeeding in its action. After a 68-day trial, the Ontario Superior Court of Justice declined Deloitte's arguments and found Deloitte liable.

Deloitte then appealed, setting the stage for the Ontario Court of Appeal to canvass, including other things, the doctrine of ex turpi causa and its application to insolvent companies in Canada. When the illegality defence is invoked, courts must first contemplate whether the causal immoral or illegal conduct is in fact attributable to the corporation. The Court of Appeal in *Livent* explained that applying the corporate identification doctrine does this.

The prominent Canadian case on corporate identification, *Canadian Dredge and Dock Company et al. v R*,[693] the Supreme Court held that the doctrine of corporate identification was only employed when the action taken by the directing mind: 1. was in the field of operation assigned to him; 2. was not completely in fraud of the corporation; and 3. was by design or result somewhat for the benefit of the company.[694] In *Livent*, Deloitte said that the identification doctrine was engaged such as to permit it to raise the defence of ex turpi causa. The Court of Appeal opposed and decided that the corporate identification doctrine needs to be "tailored to the terms of the particular substantive rule it serves."[695] In cases of third-party facilitator liability, this indicates that corporate identification must be evaluated bearing in mind the bigger goal of preserving the integrity of the justice system.[696]

The Court of Appeal in *Livent* concluded that the ex turpi causa defence does not offer the court discretion to refuse a civil remedy for damages simply because the plaintiff had involved in misconduct. Relatively, the corporate identification and ex turpi causa doctrines, if applied, allowed a plaintiff's claim to be introduced resulting in an inconsistency in the law and a compromise the integrity of the justice system. No such discrepancy was existent in this case. In fact, if Deloitte was permitted to invoke the defence effectively, innocent shareholders would have been unreasonably denied a remedy, while the auditors would be permitted to escape liability for the very fraud they should have detected.[697]

[693] *Canadian Dredge and Dock Company et al. v R* (1985) 1 SCR 662.
[694] Ibid 714.
[695] *Livent (Special Receiver and Manager of) v. Deloitte & Touche* (2016) ONCA 11. at para 157.
[696] Caylor and Kenney (n545) 267.
[697] Ibid.

McFarland has delivered a report about the Supreme Court decision of the *Livent* case.[698] The Supreme Court said that Livent auditors were liable as well as the accounting firm Deloitte LLP for negligent work as the auditor of defunct theatre company Livent Inc. The ruling, for instance, said Deloitte could not be alleged liable for its work in 1997 to assist Livent raise new funds from investors – which comprised offering a comfort letter for investors – since Deloitte did not have legal duties to the company as an auditor in that role. However, the court alleged Deloitte did have a duty of care to the company in its work on the audit of Livent's 1997 financial statements.

"By negligently conducting the audit, and impairing Livent's shareholders' ability to oversee management, Deloitte exposed Livent to reasonably foreseeable risks, including losses that would have been avoided with a proper audit.... Deloitte owed Livent a duty of care, which it breached,"[699] the ruling believed.

The Supreme Court was divided in its decision, with four out of seven judges supporting the ruling and three others dissented and believed that Deloitte breached its duty of care but was not liable for covering such large losses principally produced by Livent's actions.[700] In its arguments before the Supreme Court in February, Deloitte's lawyer argued the courts have held the firm responsible for far too much of the loss at Livent, going well past the direct influence of its audit work. The Ontario Superior Court ruled in 2014 that Deloitte was negligent in its work for Livent, and gave a total of $130-million, which they appealed and lost. The Supreme Court held Deloitte responsible for $40.4 million in damages, which was the portion particularly connected to the work on the 1997 financial statement audit.

A 1997 Supreme Court decision concerning *Hercules Management Ltd*. set out very limited parameters for lawsuits against auditors to succeed, concluding auditors owed their duty to the company that employed them, and not to other stakeholders who also used the audited financial statements.[701] As a result of that decision, Livent's bondholders did not sue Deloitte directly. Instead, the legal action was initiated by the defunct company's special receiver on behalf of the company itself, while bondholders led and financed the litigation and will obtain much of

[698] Janet Mcfarland, 'Supreme Court Says Livent Auditors Liable But Sets Conditions' (2017) The Globe and Mail available at: https://www.theglobeandmail.com/report-on-business/supreme-court-says-livent-auditors-liable-but-sets-conditions/article37393018/; see also, *Deloitte & Touche v Livent Inc* (Receiver of) 2017 SCC 63.
[699] *Deloitte & Touche v Livent Inc* (Receiver of) 2017 SCC 63, P.859.
[700] Mcfarland (n698).
[701] Ibid.

the award.[702] The ruling has confirmed that the indirect route can be used in such cases, but Mr. Myers said it did not offer much help to shareholders because money recovered by bankrupt companies typically all goes to creditors.[703]

Black and Novek in their article stated that as there was no former duty of care known between an auditor and its corporate client for the drive of soliciting investment.[704] The Court found it crucial to undertake a full duty of care analysis within the framework set out in *Anns v. London Borough of Merton*,[705] and as refined in *Cooper v. Hobart*,[706] in order to determine the existence and scope of such a duty. Under the first stage of the *Anns/Cooper* test, the court must decide whether a prima facie duty of care exists in relation to, first, the proximity between the parties and, second, whether the plaintiff's losses were reasonably foreseeable.[707]

Where a prima facie duty of care is recognised, the court may yet refuse the imposition of that duty at the second stage of the test on the basis of residual policy considerations. The majority observed that this was the Court's first opportunity to apply the *Anns/Cooper* framework in a case of auditor's negligence, as *Hercules* was decided under the then-current *Anns* test. The key variance between the tests is that, while the *Anns* test only needed a ruling at the first stage that the injury was reasonably predictable, *Cooper* added proximity as an additional stand-alone requirement.[708] The majority noted that when applied to cases of negligent misrepresentation, *Cooper's* more exacting framework "will give rise to a far narrower scope of reasonably foreseeable injuries and, therefore, a narrower range of prima facie duties of care."[709] Furthermore, the majority emphasised that it was less likely to give rise to indeterminate liability, which was a significant concern for auditors who must be able to predict and manage their risk of liability.[710]

The majority also refused the auditor's arguments that recovery should be barred by the defence of illegality (which bars an otherwise valid tort claim on the basis that the plaintiff has engaged

[702] Ibid.
[703] Ibid.
[704] William D. Black, Mira Novek, 'The Supreme Court's Decision in Livent: a Framework for Deciding Auditor's Negligence Cases' (2018), McCarthy Tetrault, Available at https://www.mccarthy.ca/en/insights/blogs/canadian-appeals-monitor/supreme-courts-decision-livent-framework-deciding-auditors-negligence-cases.
[705] *Anns v. London Borough of Merton* (1977) 2 All E.R. 492 (H.L.).
[706] *Cooper v. Hobart* (2001) 3 SCR 537, 2001 SCC 79 (CanLII).
[707] Black and Novek (n704).
[708] *Deloitte & Touche v. Livent Inc.* (Receiver of) (2017) 2 SCR 855, 2017 SCC 63 (CanLII) at para. 23.
[709] Ibid at para. 36.
[710] Black and Novek (n704).

in illegal conduct) or, in the alternative, reduced on the basis of contributory negligence. Both arguments would rely on the Court attributing the fraudulent conduct of Drabinsky and Gottlieb, as the directing minds of Livent, to the corporation itself. While the majority agreed that the authoritative test for the corporate identification doctrine set out in *Canadian Dredge & Dock Co. v. The Queen*,[711] might ostensibly be met on the facts of this case, it reaffirmed a significant qualification to that test: "The principles set out in Canadian *Dredge* provide a sufficient basis to find that the actions of a directing mind be attributed to a corporation, not a necessary one."[712] In other words, courts still keep the decision not to apply the doctrine where it would not be in the public interest to do so. In this case, the majority determined that the application of the corporate identification doctrine would not be in the public interest:

"Where, as here, its application would render meaningless the very purpose for which a duty of care was recognized, such application will rarely be in the public interest. If a professional undertakes to provide a service to detect wrongdoing, the existence of that wrongdoing will not normally weigh in favour of barring civil liability for negligence through the corporate identification doctrine."[713]

Black and Novek believe that the full impact of the Court's decision in *Livent* remains to be seen.[714] Nonetheless, the Court did set out a principled framework that is adaptable to future cases and for that reason promises to bring some further certainty to the law in this area. Most notably, the case of *Livent* underscored that the purpose of an auditor's representation or undertaking to be critical to the determination of its liability in cases of negligent misrepresentation or performance of a service. Furthermore, where a novel purpose is claimed, the courts may not solely extrapolate from the duty recognized in *Hercules*. Rather, they must undertake a full duty of care analysis within the *Anns/Cooper* framework to conclude whether the plaintiff had a right to depend on the auditor's representation or services for that purpose. Moreover, even where a duty of care is recognised for a particular purpose, the plaintiff must still prove as a fact that it depended on the auditor's representation or services for their intended purpose.[715]

[711] *Canadian Dredge & Dock Co. v. The Queen* (1985) 1 SCR 662, 1985 CanLII 32 (SCC).
[712] *Deloitte & Touche v. Livent Inc.* (Receiver of) (2017) 2 SCR 855, 2017 SCC 63 (CanLII) at para. 104.
[713] *Deloitte & Touche v. Livent Inc.* (Receiver of) (2017) 2 SCR 855, 2017 SCC 63 (CanLII) at para. 104.
[714] Black and Novek (n704).
[715] Ibid.

The majority's determination that the corporate identification doctrine should not be applied on the facts of this case places a high bar for its application in prospective cases of auditor's negligence. While third-party claims may offer an alternative avenue of relief, their utility relies on the available resources of the fraudsters. Lastly, disclaimers of liability will no doubt receive renewed attention given the Court's description of auditing a large corporation as a "high risk undertakin[g]" that can attract significant liability, much similar to flying commercial aircraft or manufacturing pharmaceutical drugs.[716] Auditors may take some comfort, however, in the majority's suggestion that "contractual disclaimers limiting liability may often be warranted."[717] This is of course in addition to other inherent limitations built in to the duty of care itself. In this case, the majority remarkably found that liability for a statutory audit will be restricted to a single year.[718]

The Supreme Court considered extensive precedents, statutes and literature in reaching its conclusions.[719]

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[716] *Deloitte & Touche v. Livent Inc.* (Receiver of) (2017) 2 SCR 855, 2017 SCC 63 (CanLII) 1 at para. 43.
[717] Ibid.
[718] Black and Novek (n704).
[719] For example: Gascon and Brown JJ. have cited several cases:
Applied: *Hercules Managements Ltd. v. Ernst & Young* (1997) 2 S.C.R. 165; distinguished: *South Australia Asset Management Corp. v. York Montague Ltd.* (1997) A.C. 191; *Canadian Dredge & Dock Co. v. The Queen* (1985) 1 S.C.R. 662; *Hart Building Supplies Ltd. v. Deloitte & Touche* (2004) BCSC 55, 41 C.C.L.T. (3d) 240; explained: *Anns v. London Borough of Merton* (1977) 2 All E.R. 492; *Cooper v. Hobart* (2001) SCC 79, (2001) 3 S.C.R. 537; referred to: *Bow Valley Husky (Bermuda) Ltd. v. Saint John Shipbuilding Ltd.* (1997) 3 S.C.R. 1210; *Canadian National Railway Co. v. Norsk Pacific Steamship Co.* (1992) 1 S.C.R. 1021; *Kamloops (City) v. Nielsen* (1984) 2 S.C.R. 2; *Haig v. Bamford* (1977) 1 S.C.R. 466; *Edwards v. Law Society of Upper Canada* (2001) SCC 80, (2001) 3 S.C.R. 562; *Odhavji Estate v. Woodhouse* (2003) SCC 69, (2003) 3 S.C.R. 263; *Childs v. Desormeaux* (2006) SCC 18, (2006) 1 S.C.R. 643; *Hill v. Hamilton-Wentworth Regional Police Services Board* (2007) SCC 41, (2007) 3 S.C.R. 129; *Fullowka v. Pinkerton's of Canada Ltd.* (2010) SCC 5, (2010) 1 S.C.R. 132; *Saadati v. Moorhead* (2017) SCC 28, (2017) 1 S.C.R. 543; *Donoghue v. Stevenson* (1932) A.C. 562; *Caparo Industries plc. v. Dickman* (1990) 1 All E.R. 568; *Glanzer v. Shepard* 135 N.E. 275 (1922); *Ultramares Corp. v. Touche* 174 N.E. 441 (1931); *Yuen Kun Yeu v. Attorney-General of Hong Kong* (1988) 1 A.C. 175; *Edgeworth Construction Ltd. v. N. D. Lea & Associates Ltd.* (1993) 3 S.C.R. 206; *Gross v. Great-West Life Assurance Co.* (2002) ABCA 37, 299 A.R. 142; *Mustapha v. Culligan of Canada Ltd.* (2008) SCC 27, (2008) 2 S.C.R. 114; *Overseas Tankship (U.K.) Ltd. v. Morts Dock & Engineering Co.* (1961) A.C. 388; *Hughes-Holland v. BPE Solicitors* (2017) UKSC 21, (2017) 2 W.L.R. 1029; *Nykredit Mortgage Bank plc. v. Edward Erdman Group Ltd.* (No. 2), (1997) 1 W.L.R. 1627; *Platform Home Loans Ltd. v. Oyston Shipways Ltd.* (2000) 2 A.C. 190; *Clements v. Clements* (2012) SCC 32, (2012) 2 S.C.R. 181; *Rainbow Industrial Caterers Ltd. v. Canadian National Railway Co.* (1991) 3 S.C.R. 3; *Hall v. Hebert* (1993) 2 S.C.R. 159; *British Columbia v. Zastowny* (2008) SCC 4, (2008) 1 S.C.R. 27; *Stone & Rolls Ltd. (in liquidation) v. Moore Stephens* (2009) UKHL 39, (2009) 1 A.C. 1391; *373409 Alberta Ltd. (Receiver of) v. Bank of Montreal* (2002) SCC 81, (2002) 4 S.C.R. 312; *Bilta (U.K.) Ltd. (in liquidation) v. Nazir* (No. 2), (2015) UKSC 23, (2016) A.C. 1.

While McLachlin C.J. (dissenting in part) has cited other cases to take a different position:
Caparo Industries plc. v. Dickman (1990) 1 All E.R. 568; *Ultramares Corp. v. Touche* 174 N.E. 441 (1931); *D'Amato v. Badger* (1996) 2 S.C.R. 1071; *Hercules Managements Ltd. v. Ernst & Young* (1997) 2 S.C.R. 165; *Canadian National Railway Co. v. Norsk Pacific Steamship Co.* (1992) 1 S.C.R. 1021; *R. v. Imperial Tobacco Canada Ltd.* (2011) SCC 42, (2011) 3 S.C.R. 45; *Cooper v. Hobart* (2001) SCC 79, (2001) 3 S.C.R. 537; *BG Checo International Ltd. v. British Columbia Hydro and Power Authority* (1993) 1 S.C.R. 12; *South Australia Asset Management Corp. v. York Montague Ltd.* (1996) 3 All E.R. 365; *Hughes-Holland v. BPE Solicitors* (2017) UKSC 21, (2017) 2 W.L.R. 1029; *Hogarth v. Rocky Mountain Slate Inc.* (2013) ABCA 57, 542 A.R. 289; *Wightman v. Widdrington (Succession)* (2013) QCCA 1187; *Platform Home Loans Ltd. v. Oyston Shipways Ltd.* (1999) 1 All E.R. 833; *Mustapha v. Culligan of Canada Ltd.* (2008) SCC 27, (2008) 2 S.C.R. 114; *Citadel General Assurance Co. v. Vytlingam* (2007) SCC 46, (2007) 3 S.C.R. 373; *Westmount (City) v. Rossy* (2012) SCC 30, (2012) 2 S.C.R. 136; *Anns v. London Borough of Merton* (1977) 2 All E.R. 492; *Sutherland Shire Council v. Heyman* (1985), 60 A.L.R. 1; *Overseas Tankship (U.K.) Ltd. v. Morts Dock & Engineering Co.* (1961) A.C. 388; *Candler v. Crane Christmas &*

4.9 The Civil Liability of Auditors in Australia

4.9.1 *Mutual Life & Citizens Assurance Co Ltd v Evatt*

The first major attempt to ascertain the scope of misstatement liability in Australia was made in 1970 in *Mutual Life & Citizens Insurance Co Ltd v Evatt*. From the 1960s there was increasing acceptance among Australian and English judges that the common law of Australia was capable of independent evolution. In the High Court's 1968 decision of *Mutual Life and Citizens' Assurance Co Ltd v Evatt*,[720] in considering when liability may arise for negligent misstatement, Barwick CJ stated that: "There are indicative decisions in the courts of England ... the [High] Court's task is to express what is the law on this subject as appropriate to current times in Australia. This will not necessarily be identical with the common law of England."[721] Although the Privy Council reversed the High Court's decision in that particular instance,[722] there was, overall, an emerging sense that the High Court was in the best position to judge what should be the law for Australia.[723]

In this case, the High Court of Australia set out the first legal test for the liability of professionals for misstatements. The High Court established three conditions for the existence of the duty to care of professionals when owed to third parties. The conditions are: (1) the professional realises or ought to realise that the third party will rely on his/her (professional) skill and judgment; (2) the third party intends to act upon the information embodied in the statement; and (3) the reliance of the third party is reasonable.[724] The third party in this leading case received information through a direct request as opposed to public disclosure. Hence it does not represent typical third-party claims based on misrepresentation as mentioned in

Co. (1951) 1 All E.R. 426; *Burns v. Homer Street Development Limited Partnership* (2016) BCCA 371, 91 B.C.L.R. (5th) 383; *Aneco Reinsurance Underwriting Ltd. (in liquidation) v. Johnson & Higgins Ltd.* (2001) UKHL 51, (2001) 2 All E.R. (Comm.) 929; *Canadian Imperial Bank of Commerce v. Deloitte & Touche* (2016) ONCA 922, 133 O.R. (3d) 561; *Temseel Holdings Ltd. v. Beaumonts Chartered Accountants* (2002) EWHC 2642 (Comm.), (2003) P.N.L.R. 27; B.D.C. *Ltd. v. Hofstrand Farms Ltd.* (1986) 1 S.C.R. 228; *Asamera Oil Corp. v. Sea Oil & General Corp*. (1979) 1 S.C.R. 633.

[720] *Mutual Life & Citizens Insurance Co Ltd v Evatt* (1968) 122 CLR 556.

[721] Ibid 563.

[722] See *Mutual Life and Citizens' Assurance Co v Evatt* (1970) 122 CLR 628 (PC).

[723] Sonali Walpola, 'The Development of the High Court's Willingness to Overrule Common Law Precedent' (2017) 45(2) Federal Law Review 291-314.

[724] *Mutual Life v Evatt* (1970) 122 C.L.R. 556 at 571–573.

Esanda Financial Corp Ltd v Peat Marwick Hungerford, which is regarded as the most influential decision on gatekeeper liability in Australia. [725]

According to Pacini et al, this case did not involve auditor liability to third parties but established the first legal test applied to decide when a professional owes a duty of care to a third party for negligent misinformation.[726] In *Evatt*, the High Court of Australia ruled that a person owes a duty of care to another when the one providing information realizes, or ought to realize, that he or she is being trusted to provide information that will be acted upon by that third party. In this decision, the High Court was mainly concerned with information provided to a third party in response to a request for it. The potential scope of liability here is narrow because the *Evatt* case focuses on a direct request from a third party for information. Hence, *Evatt* is not an exclusive test of liability for negligent misstatements to third parties.[727]

The basic approach to the duty question in Australian law in cases in which information, opinion, or advice is supplied directly by the defendant to the plaintiff or one of the plaintiff's agents, is set out the judgment of Chief Justice Barwick in the *Evatt* case.[728] *Evatt* involved a demurrer, so that it did not technically decide the duty issue, but the High Court nonetheless held by a majority of 3:2 that an insurance company might owe a duty of care to a potential investor (also one of its own shareholders) when supplying financial information about an associated company at the investor's request.[729] The Privy Council subsequently overruled the decision in *Evatt*,[730] but that reversal has since been thought a mistake and Barwick CJ's reasoning had been affirmed in the High Court on several occasions.[731] In his speech, Barwick CJ said that he had derived "assistance" from their Lordships in *Hedley Byrne*, but he was

[725] *Esanda Fin Corp Ltd v Peat Marwick Hungerfords* (1997) 188 C.L.R. 241 at 255; see also, Solaiman (n6766676) 105.
[726] Pacini et al. (n330) 399.
[727] Kevin Nicholson, 'Third Party Reliance on Negligent Advice' (1991) 40(3) International and Comparative Law Quarterly 551-582.
[728] Kit Barker, 'Negligent Misstatement in Australia - Resolving the Uncertain Legacy of Esanda: Chapter 13'in Kit Barker, Warren Swain and Rose Grantham (eds), *The Law of Misstatements* (Oxford, Hart Publishing, 2015) 319-344, 327.
[729] CJ Barwick thought this would depend on the identity and capacity of the company officers that had supplied the information – a matter for trial: *Mutual Life and Citizens' Assurance Co Ltd v Evatt* (1968) 122 CLR 556 (HCA) at 259.
[730] *Mutual Life and Citizens' Assurance Co v Evatt* (1971) AC 793 (PC).
[731] See *Shaddock & Associates Pty Ltd v Parramatta City Council* (No 2) (1983) 151 CLR 590 (HCA), 250-1 (Mason J, Aickin J agreeing), 255-6 (Murphy J); *San Sebastian Pty Ltd v The Minister* (1986) 162 CLR 340 (HCA), 356-7 (Gibbs CJ, Mason J, Wilson J, Dawson J), 371-2 (Brennan J); *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241 (HCA), 249-50, 252 (Brennan CJ), 255 (Dawson J), 264 (Toohey & Gaudron JJ); *Tepko Pty Ltd v Water Board* (2001) HCA 19, 16-17 (Gleeson CJ, Gummow & Hayne JJ), 23 (Gaudron J) 46 (Callinnan & Kirby JJ, McHugh J agreeing). See also, more recently *City of Botany Bay v Jazambas* (2001) NSWCA 94; *BMW Australia Finance Ltd v Miller Insurance Broking Pty Ltd* (2009) VSCA 117 [180] (Robson AJA) (reversed on factual grounds: (2010) HCA 357); *Kestrel Holdings Pty Ltd v APF Properties Pty Ltd* (2009) FCAFC 144 [97] (Gray, Mansfield & Tracey JJ); *Mbakwe v Sarkis* (2009) NSWCA 330 [25]-[27] (Handley AJA); *Wayne Garry Meredith v Commonwealth of Australia* (No 2) (2013) ACTSC 221 [385] (Refshauge J); *Polon v Dorian* (2014) NSWSC 571 [645] (Hall J); *ABN Amro Bank NV v Bathurst Regional Council* (2014) FCAFC 65 ('Amro') [573] (Jacobson, Gilmour & Gordon JJ).

nonetheless setting out his own, distinct approach for Australia. In addition to the foreseeability of harm, his Honour referred to the need for a "special relationship" between the parties. In the following extract, he details the "essential elements" of that relationship:

"First of all, I think the circumstances must be such as to have caused the speaker or be calculated to cause a reasonable person in the position of the speaker to realize that he is being trusted by the recipient of the information or advice to give information which the recipient believes the speaker to possess or to which the recipient believes the speaker to have access or to give advice, about a matter upon or in respect of which the recipient believes the speaker to possess a capacity or opportunity for judgment, in either case the subject matter of the information or advice being of a serious or business nature. It seems to me that it is this element of trust which the one has of the other which is at the heart of the relevant relationship... [Secondly]… the speaker must realize or the circumstances be such that he ought to have realized that the recipient intends to act upon the information or advice in respect of his property or of himself in connection with some matter of business or serious consequence. Of course, utterances in the course of social intercourse with no thought of legal consequence could not satisfy such a condition. [Thirdly] … it seems to me that the circumstances must be such that it is reasonable in all the circumstances for the recipient to seek, or to accept, and to rely upon the utterance of the speaker."[732]

4.9.2 *Esanda Finance Corp. Ltd. v. Peat Marwick Hungerfords*

The High Court of Australia in *Esanda Financial Corp Ltd v Peat Marwick Hungerfords*[733] significantly narrowed down the liability of gatekeepers.[734] This case involves providing credit relied upon an audited account to a company, which went into liquidation. Then, the creditors claimed that the auditors owed a duty of care to all creditors of the liquidated company, because they (the auditors) did foresee or ought to have reasonably foreseen that creditors would rely on the accounts audited by them. The court unanimously held that in order to impose liability on auditors, two requirements were to be satisfied. They are the foreseeability of harm and the relationship of proximity. They were difficult to prove, because of which the decision in effect

[732] *Mutual Life and Citizens' Assurance Co Ltd v Evatt* (1968) 122 CLR 556 (HCA) at: 571.
[733] *Esanda v Peat Marwick Hungerfords* (1997) 188 C.L.R. 241; (1997) 142 A.L.R. 750.
[734] Andrew Greinke, 'Auditors' Liability to Third Parties: The View of the High Court' (1997) 15 Company & Securities Law Journal 309; see also, Solaiman (n676676) 105.

limits the scope of gatekeeper liability. Moreover, it concerned the creditors, rather than shareholders whose claim might have been even weaker as a residual claimant in the event of liquidation. The case was lodged under the previous Corporations Law (s.1006), which was similar to its current equivalent s.729 of the Corporations Act 2001 (Cth) (CA2001-Australia).[735]

Many aspects of the *Esanda* ruling were consistent with the *Caparo* decision except that the *Esanda* court directed more attention to various policy factors that weigh on the scope of an accountant's duty to nonclients for negligence. This case indicated a clear trend in the Australian law toward restriction of auditor liability to third parties for negligent misstatements.[736]

This may be explained by the comments of Dawson J in *Esanda Finance Corporation Limited v Peat Marwick Hungerfords*: "... mere foreseeability of harm does not, where the only harm is pure economic loss, give rise to a duty of care. The reason for this is that a duty of care imposed by reference to the mere foreseeability of harm in the form of financial loss would extend liability in negligence beyond acceptable bounds. Financial loss occurs as the result of legitimate commercial competition, and commercial activity would be stifled if the law were to impose a duty to take care to avoid that loss. .... Thus, for a duty of care to arise in cases of pure economic loss, the law requires, in addition to the foreseeability of harm, a special relationship between the parties which is described as a relationship of proximity."[737]

Esanda was a typical case of this sort. It involved a careless audit report relating to the financial affairs of a particular company that was detrimentally relied on by the company's financier. The confusion surrounding its contribution to the duty debate stems from several factors.[738] Firstly, the plaintiff's pleadings were struck out on a straightforward basis that did not require the court to address the finer points of the duty question. This renders virtually all of the court's reasoning on that issue obiter. Secondly, the five judgments in the case vary significantly in form and detail, although there are undoubtedly some commonalities. Thirdly, the case was decided at a time when "proximity" reasoning was still good currency in Australian law, which means that one must now bypass that language in order to extract any intellectual sustenance from the case. Finally, the judgments were all given several years before the *Tepko Pty Ltd v*

[735] Solaiman (n676676) 105-106.
[736] Pacini et al. (n330) 400.
[737] *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241 at 254 (Dawson J).
[738] Barker (n728) 17.

Water Board case,[739] in which the High Court affirmed the Barwick approach. It is unclear to what extent the principles articulated in *Esanda* in 1997 have been superseded by the more recent statements of the law in the latter case. Three members of the Court (Gummow, Gaudron and McHugh JJ) sat in both cases.[740]

Despite *Tepko*, *Esanda* is still regularly cited in cases of the three-party configuration.[741] This may be because *Tepko* is itself understood as a case of the more straightforward two party type– the plaintiff in that case had been in direct contact with the defendant and had previously requested the information supplied in a way that the plaintiff in *Esanda* had not. There is some controversy surrounding this issue.[742] In any event, the fact that courts continue to refer to the judgments in *Esanda* even after *Tepko*, implies that they see the former case as still having useful things to say about the relevant legal principles in cases of the remoter, three-party pattern. How, if at all, do the principles in *Esanda* differ from those postulated by Barwick CJ in *Evatt*? If one looks beyond the language of proximity and asks what it was that the judges thought might make a relationship proximate, the approaches of Brennan CJ, Dawson J, Toohey and Gaudron JJ are actually all pretty close to Barwick CJ's own.[743]

Dawson J thought that a proximate relationship would be triggered by a defendant's actual or constructive knowledge of a plaintiff's reasonable reliance on information provided. Indeed, he saw his reasonable reliance principle as simply a more modern way of expressing Barwick CJ's requirement of "trust". He rationalised the additional principles stated by the majority judgment in *San Sebastian Pty Ltd v. The Minister*[744] as simply assisting in the application of that approach in cases in which the plaintiff had not himself requested the information[745] – a circumstance that Barwick CJ himself had not addressed in any real detail.[746]

Upon examination of the *Esanda* case it appears that it influenced other subsequent Australian cases. For example, in *Bathurst Regional Council v Local Government Financial Services Pty*

[739] *Tepko Pty Ltd v Water Board case* (2001) HCA 19.
[740] Barker (n728) 17.
[741] Ibid.
[742] The information was furnished in a report to the Minister, who then passed its contents in the form of a letter to two other Members of Parliament. A copy of one of the letters was then passed to a consultant engaged by the plaintiff. The plaintiff had originally made a direct request to the defendant for the information it contained. Although it is clear that the information had been requested by the plaintiff, Gaudron J denied that, on the occasion it was given, it was provided by way in response to a request made on the plaintiff's behalf and treated it as if it had been volunteered at [79]-[80]. The fine-grained nature of these factual distinctions itself suggests that there is little traction in a firm two-party/three-party distinction.
[743] Barker (n728) 18.
[744] *San Sebastian Pty Ltd v. The Minister* (1986) 162 CLR 340 (HCA).
[745] *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241 (HCA) at 256-57.
[746] Barker (n728) 18.

Ltd,[747] Jagot J distinguished the case from *Esanda Finance Corporation v Peat Marwick Hungerfords*[748] which had held that it would be too removed for an auditor of a company to be liable to every person who placed reliance on its audit of a company and suffered loss as a result, as the rating by S&P in the *Bathurst* case was assigned to a financial instrument for the very purpose of communication to the class of potential investors and for them to take into account and rely on the rating in deciding whether or not to invest.

Also, the risk of loss by potential investors in the CPDO notes was foreseeable (that is, it is a risk of which S&P knew or ought to have known) by reason of a negligent rating. Jagot J held that in assigning a rating to the CPDO notes, S&P owed a duty of care to potential investors in those notes including the local council authorities. The Court concluded in its judgment that the councils proved that they suffered loss against LGFS, S&P and ABN AMRO, the damage being the amount each paid for the CPDO notes less than the amount they received on the cash-out of those notes. Although the Australian Court did not specifically cite the *Caparo* Industries test, the court applied in substance a similar test for establishing the existence of a duty of care.[749]

The Australian *Bathurst* case is a rare case where liability for financial loss was imposed on a bank and a credit ratings agency for losses suffered by professional or sophisticated investors who had relied on AAA ratings that were negligently issued by both the arranging bank and ratings agency in the wholesale securities market.[750] It shows the general common law test to determine whether there is a duty of care between a defendant and claimant for pure economic loss in a negligence and/or negligent misrepresentation action could potentially hold a credit ratings agency liable to a professional investor for negligent misrepresentation of complex securities on the grounds that the rating agency knew or should have known that its ratings would be disseminated to, and relied on, by certain investors.[751] The *Bathurst* case demonstrated how another common law jurisdiction with very similar principles of negligence law can apply the traditional duty of care test as set forth in the *Caparo* Industries to show how a duty of care was created between the defendant ratings agency and plaintiff investors. The

[747] *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200.
[748] *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) HCA 8.
[749] Kern (n471) 14.
[750] Ibid.
[751] Ibid.

decision in *Bathurst* would be persuasive authority, but not legally binding precedent, for an English court.

The imposition of liability by an Australian court is an important step in defining the content of the responsibilities that CRAs have in respect of one of the many roles that they perform in the financial market. The *Bathurst* Trial and the *Bathurst* Appeal provide important and useful analyses of the indispensability of CRAs in investment decisions. Although other jurisdictions may not have a statutory framework prohibiting misleading or deceptive conduct, the imposition of a duty of care and liability for common law negligent misstatement on a CRA for causing pure economic loss is noteworthy. Imposing a duty of care empowers investors to bring suits against CRAs, without having to rely on or hope for the investigations and decision-making of government regulators. The *Bathurst* Appeal appears to be an important point of reference for future litigation and continuing regulation.[752]

4.9 The Regulations and Statutory Requirements Related to Civil Liability of Auditors in Other Common Law Countries

There are some legal measures in Australia to limit auditor liability identified by Rajapakse and Gardner.[753] One of the continuing concerns of financial advisors is the threat of liability for potential losses suffered by clients. The ACCA has noted that this may be one of the consequences of the lack of competition in the industry and the market control of large "mega-firms".[754]

In Australia, the Professional Standards Act is in place in all States and Territories[755] and it provides that members of the accounting professional bodies (ICAA, CPA, IPA)[756] must set up an occupational scheme to reduce the potential financial liabilities of members by enhancing professional standards.[757] The provisions of these Acts are compulsory and the professional accounting bodies must apply the legislation to its members. Currently, the statutory capping figure imposed under the scheme for Category 1 services – i.e. financial statement reporting

[752] Sahore A, 'ABN Amro Bank NV v Bathurst Regional Council: Credit Rating Agencies and Liability to Investors' (2015) 37(3) Sydney Law Review 437-455, 455.
[753] Rajapakse and Gardner (n488) 195.
[754] ACCA, 'Accountancy Future, Audit Reform: Aligning Risk with Responsibility' (The Association of Chartered Certified Accountants, London 2011) available at: http://www.accaglobal.com.
[755] Professional Standards Act 1994 (NSW); 2004 (NT); 2004 (QLD); 2004 (SA); 2005 (Tas); 2003 (Vic); 1997 (WA).
[756] Rajapakse and Gardner (n488) 195.
[757] Ibid 196.

and auditing is $75 million.[758] It appears that the national system of statutory capping introduced by the Australian parliament may be effective in limiting liability of members of professional accounting bodies, with regard to economic loss for damages arising from occupational and civil liabilities.[759]

Despite benefits to the auditing profession in implementing a system of statutory capping, it is important to consider the associated policy implications. Firstly, third parties may be disadvantaged by not being able to claim the full amount of their damages. Secondly, as the capped amount will be calculated as the multiple of the audit fee, this may act as an incentive for auditors to charge lower audit fees (and premium amounts for other work) in anticipation of their liability to third parties.[760] Finally, the imposition of a cap would represent an unwarranted intrusion by the State, and could encourage other professions to seek similar concessions.[761] In this regard, caution must be taken in reforming the law to balance the interests of the auditing profession as well as third parties.[762]

According to Free, the system of joint and several liability was unjust as it imposed a liability on a defendant out of all proportion to that defendant's actual responsibility for the damage suffered.[763] Therefore, all States in Australia[764] and the Australian Federal Parliament[765] have amended the law of contribution to introduce proportionate liability in relation to claims for economic loss under contract, tort and statute.[766] Under proportionate liability, the financial advisor cannot be held liable for more than her or his proportionate share of responsibility for the loss suffered by the plaintiff. The proportionate liability regime allowed financial advisors to redistribute the risk to the plaintiff. Finally, the most important aim for the enactment of

[758] 'Category 1 services' means: all services required by Australian law to be provided only by a registered company auditor: for further details of statutory capping scheme, see Professional Standards Council of Australia, available at https://www.psc.gov.au, (September 2012).
[759] Rajapakse and Gardner (n488) 196.
[760] Ibid 197.
[761] Gurdarshan Singh Gill, *Modern Auditing in Australia* (6th ed, John Wiley and Sons, Sydney, NSW 2001).
[762] Rajapakse and Gardner (n488) 196.
[763] Clinton Free, 'Limiting Auditors' Liability' (1999) 11(1) Bond Law Review 118-135 at 130.
[764] Civil Liability Act 2002 (NSW), ss 34 - 39; Civil Liability Act 2003 (Qld), ss 28-33; Civil Liability Act 2002 (Tas), Pt 9A; Civil Law Wrongs Act (ACT, Ch 7A; Law Reform Contributory Negligence and Apportionment of Liability Act 2011 (SA); Wrongs Act 1958 (Vic), Pt IVAA; Civil Liability Act 2002 (WA), Pt IF; and Wrongs and Limitation of Actions (Insurance Reform) Act 2003 (Vic).
[765] Competition and Consumer Act 2010 (Cth) ss 137, 236; Australian Securities and Investment Commission Act 2001 (Cth), ss12GP to 12 GW; Corporations Act 2001 (Cth) ss 1041L to 1041S. These provisions apply in relation to 'misleading and deceptive conduct' by financial advisors.
[766] Civil Liability Act 2002 (NSW), ss 34 - 39; Civil Liability Act 2003 (Qld), ss 28-33; Civil Liability Act 2002 (Tas), Pt 9A; Civil Law Wrongs Act (ACT, Ch 7A; Law Reform Contributory Negligence and Apportionment of Liability Act 2011 (SA); Wrongs Act 1958 (Vic), Pt IVAA; Civil Liability Act 2002 (WA), Pt IF; and Wrongs and Limitation of Actions (Insurance Reform) Act 2003 (Vic).

proportionate liability legislation is the "deep-pockets" argument.[767] The reason auditors are regarded as having "deep pockets" is because they are required by law to carry professional indemnity insurance. Auditors are targeted by third parties because there is little advantage in bringing proceedings against a company that is insolvent, or whose assets are difficult to locate or realise.[768] This is despite the fact that there may be good arguable claims against a company, especially where the directors and management are clearly at fault.[769]

When apportioning liability under the system of proportionate liability, the courts will consider what is just and equitable, having regard to the extent of the financial advisor's responsibility for the loss. Thus, the financial advisor can reduce her or his liability by persuading the court that another party (tortfeasor) was at least partly to blame for the loss suffered by the plaintiff. For example, in *Frank Metzke and Russell Allen v Sam Selami Allen*,[770] the Court of Appeal (Vic) upheld the trial judge's decision on the reduction of the defendant accountant's liability for the plaintiff by 70% on the basis of the operation of the proportionate liability provisions. The plaintiffs had sued only the accountant and not their (negligent) co-director of the company in which they also held interests. Overall, the new system will provide a regime of full proportionate liability between all the parties "responsible for the loss" which will hopefully deal with the litigation and insurance crisis suffered by the auditing profession.[771]

At present, not all States have implemented identical schemes of proportionate liability; therefore, it is proposed that the Australian parliament introduce uniform legislation in response to pressure from the auditing profession.[772] The lack of uniformity between the States, as well as the slight variations that occur between State and Federal proportionate liability regimes are complicated issues. Therefore, it is proposed that the Australian parliament introduce uniform legislation in response to pressure from the auditing profession.[773] However, there are problems associated with implementing proportionate liability, as the full recovery of economic loss from wrongdoers by third parties will become increasingly rare. Thus, based on similar arguments

[767] Rajapakse and Gardner (n488) 196.
[768] Ibid.
[769] Michael Duffy, 'Proportionate Liability: A Disproportionate and Problematic Reform' (2003) 60 (8) Plaintiff 11-20 at 14.
[770] *Frank Metzke and Russell Allen v Sam Selami Allen* (2010) VSCA 267.
[771] O Hayford, 'Proportionate Liability – it's Impact on Contractual Risk Allocation' (2010) 26 Building and Construction Law Journal 11 – 22, 12. Detailed comparison between joint and several liability and proportionate liability systems is introduced in Chapter Five due to their connection with professional liability insurance products literature.
[772] K Cooper, 'Proportionate Liability- 5 years on' (2010) (A paper presented for The Continuing Professional Education Department of the College of Law, Sydney, NSW) 8 - 15.
[773] Rajapakse and Gardner (n488) 197.

regarding statutory capping, the system of proportionate liability should be reformed to ensure third parties are not disadvantaged.[774]

In Canada, there are five major sources of auditor's legal liability: (1) client liability under common law; (2) securities legislation, such as provincial and territorial Securities Acts, which imposes liability on auditors who participate in the production of offering memoranda or prospectuses. In some provinces/territories, there is now statutory civil liability under securities laws for secondary market disclosures; (3) criminal liability of an auditor, which may result from federal or provincial laws if an auditor knowingly defrauds a third party through involvement with the financial statements; (4) fiduciary duty, where one party (auditor) must act in the best interests of another party; and (5) auditor third party liability, which exists under tort law.[775]

With respect to Canadian regulations, the conduct of an audit is regulated by federal or provincial legislation. The federal statute is the Canada Business Corporations Act (CBCA). Provincial statutes are provincial Business Corporations Acts. Generally speaking, provincial statutes mirror the CBCA.[776] Recently, common law liability to shareholders and other investors buying or selling securities has been supplemented with statutory civil liability for secondary market disclosures under many provincial securities acts. In other situations of auditor third party liability, common law principles still prevail: auditors generally do not owe a duty of care to third parties, unless 'special circumstances' arise. This standard most closely corresponds to the near-privity standard found in the United States.[777]

Although each province has enacted its own statutes governing the auditing profession and provincial accounting bodies, provincial autonomy is overshadowed by the national professional body for one of the three accounting professional accounting designations in Canada, the Canadian Institute of Chartered Accountants (CICA).[778] This body published a document, the CICA Members Handbook, in which auditing standards for chartered accountants are set out. The handbook is referred to by both federal and provincial

[774] Rajapakse and Gardner (n488) 197.
[775] Alven Arens and others, *Auditing and other assurance services (Canadian)* (10th ed. Pearson Education Canada, Toronto 2006) ch 4; Blackier and Paskell-Mede (n621) 93-94.
[776] Chung et al. (n274) 69.
[777] Ibid.
[778] Ibid.

legislation.[779] These federal and provincial statutes and the CICA Members Handbook do not contain specific provisions that address auditors' liability to third parties. However, they do impose a fiduciary duty on auditors that requires them to abide by rules of professional conduct.[780]

Civil liability for secondary market disclosure has been revised recently in Canada with the Securities Acts of Ontario and Alberta. The Securities Acts of Ontario and Alberta contain proportionate liability provisions as well as provisions for capping liability limits. The liability limits for experts such as auditors is the greater of $1,000,000 CDN and the amount of fees received in the preceding 12 months.[781] Furthermore, a company that is a public issuer, the company's directors, and experts such as auditors and accountants will be liable potentially for misrepresentation if the statements they make to the public are inaccurate. The legislation is important because it introduced statutory liability to shareholders and investors for buying or selling securities other than under a prospectus.[782] Proportionate liability replaced joint-and-several liability under the CBCA as enacted in November 2001.[783]

In July 2003, the Auditing and Accounting Standards Board (AASB) of the CICA approved a Task Force project to establish standards and provide guidance on the terms of engagement letters for financial statement audits. As a result of this Task Force, a new section in the CICA Handbook, Section 5110, was created. This section states that an auditor engagement letter may include "any restriction of the auditor's liability, when such a restriction is possible." Presumably, a restriction of auditors' liability would include only known third parties rather than all third parties.[784]

In sum, auditor liability to third parties in Canada has increased because of the widened scope of disclosures in audit reports on which third parties can rely, and because of new securities legislation in several provinces which has increased penalties for fraudulent behaviour.[785]

[779] Khoury (n417) 416.
[780] Chung et al. (n274) 69.
[781] Poonam Puri and Stephanie Ben-Ishai, 'Proportionate Liability Under the CBCA in the Context of Recent Corporate Governance Reform: Canadian Auditors in the Wrong Place at the Wrong Time?' (2003) 39(1) Canadian Business Law Journal 36 at 49.
[782] Ibid 49.
[783] Chung et al. (n274) 70.
[784] Ibid.
[785] Ibid.

4.10 Conclusion

This chapter has addressed the English cases and scholars and practitioners' points of view about previous and current applications of precedents in connection with auditor civil liability towards third parties. The main contributions of this chapter are thus: to discuss relevant auditor liability theories towards third parties developed by courts; to provide scholars' critics about courts' different positions to protect auditors from being liable unless certain conditions are met; to evaluate if England needs to regulate the auditor civil liability towards third parties in the secondary market and not leaving it to courts; and finally to show that some developed principles were borrowed in other common law countries.

The effect that the English cases, whilst influential in common law jurisdictions, seem to provide only a limited and incomplete response to question of auditor liability to third parties, based on a narrow view of the purpose and effect of the financial statements, a view which perhaps overlooks the importance placed on the statements by third parties in commercial practice. Furthermore, the English approach is incomplete as far as the requirements of Sharia are concerned.

This Chapter has also shown that while common law countries extrapolate some principles and precedents from other common law countries such as the United States or the United Kingdom there remain variations in how they apply or interpret them. Moreover, the cases show tendencies towards limiting third parties' rights against auditors. Lastly, many common law countries are moving towards proportionate liability systems instead of joint and several liability systems and are thus capping and limiting auditors' liability. It is submitted, however, that these regulatory attempts and judicial interpretations are piecemeal, haphazard and uncertain and thus still insufficient to design an effective civil system that is fair and just for both auditors and third parties in general, and particularly for shareholders, as required by Saudi law and Sharia. In the next chapter, therefore, the nature of Takaful is examined in comparison with conventional insurance to assess how it may play a better role in indemnifying damaged persons or the company.

Chapter 5: Takaful (Islamic Insurance)- An Exploration of its Meanings, History and Differences with Conventional Insurance

5.1 Introduction

Islam is one of the main religions in the world. It contains principles and ethics that followers must abide by. The faith endorses equality, mercy, cooperation and shared responsibility and transparency among those undertaking business transactions. Since the beginning of Islam, Muslims have travelled East and West engaging in commerce and business. As early as the nineteenth century, Muslim traders began to regard insurance as a necessity, transporting their cargo via shipping across the seas to distant countries. These traders would mutually arrange for certain safeguards, covering their cargo and vessels against the risk of sinking.[786] Over the last five decades, a new form of Islamic insurance, known as Takaful, has emerged. Takaful has been growing in popularity throughout the world in Muslim majority and minority countries.

This chapter will begin with defining the concept of Takaful as an Islamic social institution and as an Islamic insurance system. Then, it examines in depth the position of Takaful with the Islamic tradition as an Islamic alternative to conventional insurance. A discussion on some of the contemporary Islamic legal issues associated with Takaful are explored. This will then be followed by a look at some of the important principles of Takaful and features that distinguish it from conventional insurance. Finally, regulation and supervision of takaful insurance in different countries, its models, historical development and some of the criticisms and contemporary challenges it faces will also be examined.

5.2 Takaful as an Islamic Provision

Islamic insurance (takaful) is based on the idea of shared responsibility, social solidarity, mutual cooperation or assistance, brotherhood and provides for mutual financial security and assistance to safeguard participants or members against a defined risk.[787] Insurance that is

[786] Ahmed Al-Ghadyan, 'Insurance: The Islamic Perspective and Its Development in Saudi Arabia' (1999) 14(4) Arab Law Quarterly 332-338.
[787] Wan Abdul Aziz, Azman Che Mat and Engku Wok Zin, 'A Study of Contributing Factors in Islamic Motor Insurance' (2011) 10(1) Gaziantep University Journal of Social Sciences 4, available at: http://www.acarindex.com/dosyalar/makale/acarindex-1423881360.pdf.

shariah compliant ought to follow particular guidelines as outlined by the Shariah. The four fundamental sources of Shariah are the Qur'an, Sunnah (Prophetic tradition), Ijmaa (consensus) and Qiyas (analogy) respectively.[788]

Ahmad indicates that literally, the word Takaful is an Arabic noun derived from the verb kefil, which has some different meanings.[789] Some of which are as follows:

1. Kafil - which could mean to multiply or share. The Qur'an states,
"O ye that believe! Fear God, and believe in his Messenger, and He will bestow on you a double (keflayni) portion of His Mercy" (57:28).[790] Also, the Quran says, "Whoever recommends and helps a good cause becomes a partner therein: and whoever recommends and helps in evil cause, shares (kiflun) in its burden..."[791]

2. Kafil can mean 'the witness' or 'the guard'. The Qur'an states,
"Indeed ye have made Allah your surety (kafila)."[792]

3. Kafil can also mean 'sponsor' or 'guarantor'. The Qur'an states,
"You were not with them when they cast lots with arrows, as to which of them should be charged with the care (yakfalu) of Mary..."[793] The Prophet Mohammed stated; "I, as the carer of the orphans in Heaven, will be like this", and indicated with his fingers, and divided them (Holding the index and middle fingers close together).[794]

According to Ahmad,[795] there are two Arabic terms that are associated with the concept of Takaful:

1. Tamin, which literally means 'solidarity and unity among a group of people'. According to the Shariah, the individual is responsible for the common welfare and prosperity of society. This responsibility is not only to the society but also to God. On the other hand, the

[788] Ibid.
[789] Asem Samih Ahmad, 'A Critical Study of Takaful (Islamic Insurance) and its Modern Implementation' (Unpublished PhD Thesis, University Of Birmingham 2006) 75.
[790] The Holly Quran (57:28).
[791] Ibid (4:85).
[792] Ibid (16:91).
[793] Ibid (3:44).
[794] Imam Muslim H261, Hadith no 2983.
[795] Ahmad (n789) 77.

society is also responsible to God for the welfare of the individual. This involves having a sense of responsibility and duty to one another and establishing civil relations based on mutual support. Undoubtedly, this solidarity and unity among Muslims was the driving force behind the mechanisms forming the first Islamic State in Madina. Allah stated in the Quran "And the believers, men and women, are protecting friends to one another; they enjoy the right and forbid the wrong, and they establish worship, and they pay the poor-due, and they obey Allah and His Messenger."[796]

2. Taawun literally means 'cooperation'. This is a fundamental principle of the Shariah. Allah says in the Quran, "Help one another in righteousness and piety, but do not one another in sin and rancour."[797]

There are numerous references and traditions in the Sunnah that can be used to support the concept and practices of Takaful. In this perspective too, it is imperative to examine the general principles that underpin an understanding of Takaful.[798] The Prophet said, narrated by Abu Hurairah (r): "Whosoever removes a worldly hardship from a believer, Allah will remove from him one of the hardships in the hereafter."[799] The Prophet also said: "The bonds of brotherhood between two Muslims are like parts of a house, one part strengthens and holds the other. He crossed the fingers of one hand between those of the other, to elucidate and illustrate the point."[800] Furthermore, it has been reported that the Prophet said: "Allah, the Dignified, has no mercy for one who show no mercy to others."[801] The Prophet also said, "Allah continues to help a servant so long as he goes on helping his own brother."[802] The Prophet is also reported to have told a Bedouin Arab, who left his camel untied, trusting the will of Allah (that it will not run away). He advised him by saying "tie your camel first and then put your trust in Him."[803]

Takaful is based on a donation contract. However, there are some donation contracts in Islamic law, such as ordinary almsgiving, agency, a loan, unrestricted gift, and Islamic will

[796] The Holly Quran (9:71)
[797] The Holly Quran (5:3).
[798] Ahmad (n789) 105.
[799] An-Nawawi (2003) hadith no. 240, Vol. 1, p. 159.
[800] Ibid hadith no. 222, 153.
[801] Ibid hadith no. 227, 154.
[802] Ibid hadith no. 245, 161-162.
[803] Tirmidhi, Hadith no. 2567, 225.

(wasiyyah).[804] The term tabarru or donation is the disbursement of wealth and the rendering of services without any monetary compensation but with the hope of a reward in the hereafter.[805] In other words, the immediate benefit of the donation goes to the beneficiary and the donor does not expect ab initio any financial compensation. Thus, the question of whether the takaful operation falls within this definition of donation necessitates an explanation on the nature of donation in takaful businesses and whether it is comparable to other donation contracts.[806] The rules and the relationships among the parties of takaful are dependent on the nature of the donation itself.[807] As al-Darir states that tabarru involves a contract between different parties that "are not aiming at profit making in isolation...[however] their intention is to cooperate on overcoming misfortunes of life... that has no parallel with the Shariah-nominated donations and contracts."[808]

Various understandings and definitions have been given for the term takaful. One of those is grounded in Islamic commercial law where members contribute money to a pooling system in order to guarantee each other against loss or damage.[809] Takaful insurance is modelled in the structure of mutual insurance. A group of persons with the desire to 'help one another' in times of distress, contribute money into a common fund which will be adequate to pay claims of members as they arise.[810] Others have defined it as "a type of joint guarantee insurance mechanism based on the law of large numbers in which a group of societal members pool their financial resources together against certain loss exposures."[811]

Technically, Takaful from the economic perspective means a mutual guarantee or assurance, based on the principles of al-Aqd "contract" provided by a group of people living in the same society, against a well-defined risk or catastrophe affecting one's life, property or any possession of value.[812]

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[804] Abdussalam Ismail Onagun, 'Concept of Tabarru Commitment in Takaful Undertakings' (2013) 9(4) Journal of Islamic Economics, Banking and Finance, Available at http://ibtra.com/pdf/journal/v9_n4_article4.pdf.
[805] Ibid.
[806] Onagun (n804).
[807] Ibid.
[808] Muhammad Al-Darir, *Al-Gharar wa Atharuhu fi Al-Uqud fi Al-fiqh Al Islami* (Dallah al-Barakah, Jeddah, 1995) 525-544.
[809] Muhammad Taqi Usmani, *The Historic Judgement on Interest Delivered in the Supreme Court of Pakistan* (Idaratul-Ma'arif, Karachi, Pakistan, 2000).
[810] Ramin Cooper Maysami and John Joseph Williams, 'Evidence on the Relationship Between Takaful Insurance and Fundamental Perception of Islamic Principles' (2006) 2 Applied Financial Economics Letters 229-232 at 230.
[811] Alberto Dreassi, 'Insurance Solvency Supervision, European Regulation and Takaful Products' (2009) 33(4) Savings and Development 469-491 at 472.
[812] Billah, M. M., GhlamAllah, E., & Alexakis, C. (2019). "Understanding the pillars of Takaful". In Encyclopedia of Islamic Insurance, Takaful and Retakaful. Cheltenham, UK: Edward Elgar Publishing. 1.

According to Manjoo, Takaful is not a new concept within Islamic commercial law, rather some similar practices date back to early Islamic Arabic society.[813] Takaful comes from the concept of Aqilah, which is a commitment from a clan or tribe, via an unwritten law of the Bedouins originating in the early stages of Islam, to pay the blood money for each of its members if it was required which is a type of pooling of resources), and Al-Diyyah, which also refers to blood money or a type of ransom, only applies when victim's family want to compromise with the guilty party, otherwise retribution applies.

Similarly, The Islamic Financial Services Board "IFSB" in its published guidelines entitled 'Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings', describes takaful as follows: "Takaful is the Islamic counterpart of conventional insurance, and exists in both Family (and "Life") and General forms. Takaful is derived from an Arabic word that means a joint guarantee. In a Takaful arrangement, the participants contribute a sum of money as Tabarru commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage. The underwriting in a Takaful is thus undertaken on a mutual basis, similar in some respects to conventional mutual insurance. A typical Takaful undertaking consists of a two-tier structure that is a hybrid of a mutual and a commercial form of company – which is the Takaful operator (TO) – although in principle it could be a pure mutual structure."[814]

Furthermore, the Accounting, Auditing & Governance Standards for Islamic Financial Institutions (AAOIFI) defines Islamic insurance as follows "Islamic insurance is a system through which the participants donate part or all of their contributions which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions."[815]

In Malaysia, the term Takaful is mentioned in Section 2 of the Malaysian Takaful Act 1984 as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual

[813] Faizal Manjoo, 'Why Different Takaful Models in The World' (2007) 10 CMIF.
[814]IFSB, 'Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings' (2009) Available:http://www.ifsb.org/standard/ED8Takaful%20Governance%20Standard.pdf.
[815] AAOIFI, 'Accounting, Auditing and Governance Standards for Islamic Financial Institutions' (2004/5) 376.

financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose."[816] While in the Saudi Arabian system, the term 'cooperative insurance' is employed in Article 1 of the Law on the Supervision of Cooperative Insurance Companies. Article 1 stipulates that insurance in Saudi Arabia shall be undertaken through registered insurance companies operating in a cooperative manner as provided in the Article establishing the National Company for Cooperative Insurance promulgated by Royal Decree M/5 dated 7/02/1985, and by the principles of Islamic Shariah.

5.3 A Historical Overview

The Ottoman Empire, which introduced the Western concept of marine insurance in its Maritime Code of 1863, was the first Islamic regime to introduce the Western concept of insurance within an Islamic jurisdiction. This was followed in 1874 by the Ottoman Law of Insurance, which sanctioned other aspects of non-life insurance.[817] The general view then was that only the Western concept of life insurance was unlawful in Islam.[818]

According to El Qora Daghi, in December 1906, the Egyptian Court resolved that the act of claiming compensation for life insurance is legally void due to being impermissible.[819] The Egyptian Higher Council of Endowments has supported this opinion, with successive views from its members based on the prohibition of insurance and debated over several conferences featuring insurance.[820]

When the practice gained popularity, Muslim scholars examined whether the marine insurance contracts that European agents purchased to protect their goods imported to the Islamic world were, in fact, in compliance with Shariah principles.[821] Ibn Abdeen was the first Muslim scholar to examine the matter, concluding that such contracts were not in strict compliance with Islamic principles.[822] Ibn Abideen stated that "it is tradition that if or when traders rent a boat from a

[816] This Act which came into force on 1st January 1985 was enacted to provide for the regulation of takaful business in Malaysia and for other purposes relating to or connected with takaful.
[817] Sayed H Amin, *Islamic Law in the Contemporary World* (Royston, Glasgow, 1985) 71-84.
[818] Nik Ramlah Mahmood, 'Takaful: The Islamic System of Mutual Insurance: The Malaysian Experience' (1991) 6(3) Arab Law Quarterly 280-296, at 281.
[819] A El Qora Daghi, *Islamic Insurance* (Dar Albashaer Alislamiah, Beiruit, Lebanon. 2006).
[820] Yuosef Alhumoudi, 'Islamic Insurance Takaful and its Applications in Saudi Arabia' (PhD Thesis, Brunel University, 2013) 71 available at: http://bura.brunel.ac.uk/handle/2438/7449.
[821] Al-Ghadyan, (n786).
[822] Mohammed Ameen Ibn Abdeen, *Hashiat Rad Al-Muhtar Ala Al-Dur Al-Mukhtar* (Al-Bolagy Print reprinted 1966) vol 3, 249.

non-Muslim, they pay him a wage, however, an extra amount is paid to another person living in the native country; this extra money was called (Sokrah "originally derived from a French word 'securite', and in Arabic dictionaries means insurance or guarantee").[823] Here, should any possessions/money perish via fire, wreckage or theft, the native guarantor holds this money against what has been lost." Although some differed with him,[824]Ibn Abideen was of the opinion that traders did not have any right to receive any compensation in this instance.[825]

The jurists are divided into three groups, which are:

1. The first group considers insurance practices entirely and absolutely lawful if it was free from any elements of riba (interest) and maysir (gambling).
2. The second group accepts general insurance practices but objects to life- insurance practices as they involve the elements of maysir, gharar (deceit), jahala (uncertainty) and riba.
3. The third group clearly and totally rejects any practice of insurance because it involves the four prohibited elements mentioned by the second group.[826]

Muslim scholars delivered several conferences over the status of conventional insurance. The first conference was in 1961, "The Second Fiqhi Week Conference" which took place in Damascus. Jurists were divided between those who see insurance as totally prohibited and those who believe that it is permissible if it is free of usury.[827] At the Second Conference of Islamic Research, under the World Islamic Association, held in 1965, the conference examined the issue of insurance, in which Ali El Khafeef, a member of the Islamic Research Academy, presented research on insurance. At this point, the conference formed a special committee, the Committee for Jurisprudential Researches.[828]

[823] Ibid.
[824] See, for example, Mohammed Bakheet Al-Moteei's opinion cited by Al Eisawi at (Eisawy Ahmed Eisawy, 'The Insurance Contract from Islamic and Legal Prospective, Majalat Al-Uloom Al-Qanooneah wa Al-Aqtasadiah' (1962) Journal of Economic and Legal Science 187-188; Mohammed Abu Zahrah, *Commentary on Al-Zarqa article on The Hadarah Al-Islam* (Damascus 1381H).
[825] Among concurring opinions see Abduh Al-Sheik Mohammed, 'Fatwa on Life Insurance', Majalat Al-Mohamah 5, No. 460, at p. 563); Mustafa AI-Zarqa, *The Insurance its Reality and the Islamic Fatwa* (Al-Resalah Est., Beirut1984); Ahmed Taha Al-Sunusi, 'The Insurance Contract under Islamic Law', Majalat Al-Azhar, Vol.25, 1953, 303. He allowed the insurance contract on the basis of analogy to Al-Moalat contract. Eisawy Ahmed Eisawy, 'The Insurance Contract from Islamic and Legal Prospective, Majalat Al-Uloom Al-Qanooneah wa Al-Aqtasadiah'(1962) Journal of Economic and Legal Science 167. See also Abdul Razaq Ahmed Al-Sanhuri, *Al-Waseet Fi Sharh Al-Qanoon (Commentary on the Civil Law)* vol 7, Part 2.
[826] Ahmad (n789); see also Al-Ghadyan, (n786) 336.
[827] A Altwajery, *Altaameen Almua'asir fi Mizan Alsharia* (king Saud University. Saudi Arabia, Riyadh. 2009).
[828] El Qora Daghi (n819).

In 1968, the Fatwa Committee at Al-Azhar issued a ruling prohibiting all kinds of commercial insurance. Then, in 1972, the Secretariat of the Islamic Research Academy demanded that the opinion of Muslim scholars must be respected in the world. Thus, more than 85 countries, including Egypt, Indonesia, Jordan, Syria, Iraq, Lebanon, Libya and Morocco, agreed to prohibit insurance.[829] In May 1972, at the University of Libya Symposium, a selected host of Shariah and economics scholars discussed the issues surrounding insurance contracts and reached a decision, including the prohibition of life insurance and also the permissibility of insurance contracts; to be temporarily replaced by cooperative insurance.[830] On 1976, the First Conference on Islamic Economics in Mecca advocated that that Conventional insurance, as practised in modern times, did not comply with the spirit of Shariah and did not fulfil the requirements, which might render it permissible.[831]

Based on this interpretation, particularly on the fatwa ("religious verdict") issued at the Muslim Jurists Conference held in Mecca in 1976, the Sudanese government granted licensure to the Islamic Insurance Company of Sudan in 1979 - the first known takaful insurer in the modern history. The mere presence of this company was the subject of a vigorous debate because Islamic jurists were not in agreement on the structural form of the Islamic way of insurance.[832]

In April 1977, the Council of Senior Scholars "Ulama" "The General Presidency of Scholary and Ifta" in Saudi Arabia issued a rule number 5/10 that confirms the permission of cooperative insurance and forbids commercial insurance. The Council put the following regulations on the decision related to the insurance contract as follows:

1. Cooperative insurance is a donation contract aimed at cooperation for the removal of dangers and a contribution to bear responsibility on the occurrence of disasters through financial contributions made by individuals to compensate a person(s) who sustains damage. The aim is not to realise profits but to "distribute" risks and cooperate on bearing damages.
2. Cooperative insurance is free of surplus and credit usury, so (financial) contributions should not be exploited in usury transactions.

[829] Ibid.
[830] Ibid.
[831] Abdulaziz Akhtarzaite, 'Al-Dharai and Maqasid Al-Shariah: A Case Study of Islamic Insurance' (2010) 18(2) Intellectual Discourse 272.
[832] Jean W Kwon, 'Islamic Principle and Takaful Insurance: Re-evaluation' (2007) 26(1) Journal of Insurance Regulation 53-81 at 70.

3. Ignorance of subscribers on the benefits of such transactions will not harm them because they are donors and no risk, fraud or gambling exists.
4. A group of subscribers in a cooperative insurance company may invest the collective funds for the realisation of the objectives of the company.

At the same year, the 10th Conference of Prominent Muslim Scholars, held in Saudi Arabia confirmed by consensus of opinion that conventional insurance in all its types is not permissible, whether it is life insurance or general insurance.[833] In 1985, the Islamic Fiqhi Academy of the Muslim World League issued a decree for the prohibition of all forms of commercial insurance, whether for self, for merchandise or otherwise, and the permissibility of cooperative insurance was confirmed. The International Islamic Fiqhi Academy then provided Resolution (9/2) stating that a commercial insurance policy with fixed-premium companies that deal in commercial insurance with an element of uncertainty invalidates any contract and therefore forbidden. The Islamic Fiqh Academy calls on Islamic countries to establish mutual cooperative institutions for insurance and reinsurance as well.[834] Many Islamic governments as well as several governments in Muslim populous countries, albeit not all, have responded positively to the Academy's resolution in 1985.[835]

5.4 Islamic Insurance vs. Conventional Insurance

The service provided by conventional insurance companies is to take over the risk of possible loss of assets because of the occurrence of an event in substitute for periodic payments of a determined amount by the beneficial owner of such assets.[836] The insurer pays to the owner, either an amount of money which had been previously determined between them or an amount that encompasses the actual loss experienced. Either way, the insurance company hopes to secure more in premium payments than it has to pay out as claims from policyholders, otherwise it would be operating at a loss. Any insured person, who never had to make a claim, loses the money he paid out, as premiums and profits are distributed to the shareholders of the company.[837] The insured may occasionally recover nothing or more or less than the actual value of the loss and may even eventually make a claim, but the amount paid as premium may be

[833] Akhtarzaite (n831).
[834] Ibid.
[835] Kwon (n832) 60.
[836] Mark Dorfman, '*Introduction to Risk Management in Insurance'* (Prentice-Hall New Jersey 1994).
[837] Hardy Ivamy, '*General Principles of Insurance Law'* (Butterworths, London. 1970).

greater than the claim.[838] This feature, unfortunately, has a lot in common with gambling (maysir) or wagering and some persons essentially buy insurance with the hope that they may gain more than they have risked in premium payments. Gambling is prohibited for Muslims as signposted in the Quran.[839] The possible absences of certainty concerning time and amount of payment and the amount the insured will claim at the time of loss raise enquiries as to the presence of gharar (uncertainty) in an insurance contract.[840] There is also the possible existence of elements of usury in the transaction as insurance is frequently an unequal exchange between the insured and the policyholder.

Finally, in conventional insurance, a beneficiary of life insurance is considered absolute and may deal with the benefits of the policy as deemed fit. This is in violation of Islamic rules of inheritance as the beneficiary may, in such a case, result in legal heirs of the deceased to lose their entitlement. These concerns do make conventional insurance problematic for Muslims.[841] Though Siddiqi and Al Zarqa, both eminent Islamic scholars, have made the distinction between insurance and gambling, but the fact that the insured may lose his premium payments if no claim is made and the fact that monies paid are invested into interest bearing or illegal transactions cannot be disregarded.[842]

A scheme whereby the members of a group jointly agree to guarantee that should one of them suffer a loss he would be compensated by money collected from all the members, is in fact neither a new nor a unique one.[843] A similar form of insurance is provided in the area of marine insurance by the Protection and Indemnity Clubs (P & I Clubs), which have been in existence since the middle of the last century.[844]

There are, however, two important differences between the system of mutual insurance as practised by the P & I Clubs and that provided by the Takaful scheme.[845] Firstly, the P & I

[838] George E Rejda, *Principles of Risk Management and Insurance* (11th edn, Prentice Hall, United States 2011).
[839] See chapter two known as surah al- Baqarah (The Cow), verse 219 and chapter five known as surah al-Maidah (The Tablespread, verse 90.
[840] Muhaimin Iqbal, *Takaful General Practice: Technical Approach to Eliminate Gharar (uncertainty), Maysir (gambling) and Riba (usury)* (Gema Insani, Jakarta 2005); see also, Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, (John Wiley & Sons (Asia) Pte Ltd, Singapore 2007).
[841] Maryam Dikko, 'An Analysis of Issues in Takaful (Islamic Insurance)' (2014) 6(15) European Journal of Business and Management 1.
[842] M Siddiqi, *Insurance in an Islamic Economy*, (The Islamic Foundation, Leicester, UK 1985); see also, M Al Zarqa, *The Insurance System: Its Reality and the Sahara Opinion*, (Al Resala Publisher, 1962); see also, Dikko (n841) 1.
[843] Mahmood (n818) 287.
[844] TG Coghlin, 'Protection and Indemnity Clubs' (1984) LMCLQ 403 at 404.
[845] Mahmood (n818) 287.

Clubs, little other insurers, invest their funds in interest-earning investments, which is unlawful in Islam.[846] Secondly, these Clubs reinsure their risks with commercial reinsurers whose activities are conducted in accordance with the Western concept of insurance.[847] Under the Takaful scheme, the funds collected from the participants are not invested in interest-earning enterprises but in profit and loss sharing ventures, based on the Islamic concept known as Mudharabah.[848] The profits from such investments are shared between the participants and the Takaful company in accordance with a pre-agreed ratio. Reinsurance facilities are also required to be arranged only with Takaful re-insurers.[849] This posed a problem when the first Takaful schemes were set up in other Muslim countries as there were no Takaful re-insurers then and the Takaful companies had, on the grounds of necessity, to re-insure with commercial insurers.[850]

Haberbeck and Mahmood shed the light on Shariah scholars with several complaints against insurance, in general, and against insurance for profit in particular:[851]

1. Riba (Usury): The most fundamental objection to the Western concept of insurance is that it has the element of riba. Literally the Qur'anic term Al-riba means an increase in or an addition to something.[852] There are, however, wide differences in perception as to its real meaning, and it has frequently been used to be synonymous with a variety of economic concepts.[853] Basically, riba means an increase in the principal sum of any transaction of a loan. Islam permits only interest-free loans (Qard-Al-Hasan), although service charges on such loans are permitted. Transactions, which involve physical capital, as opposed to money capital, such as the sale, hire or leasing of goods, do not amount to riba.[854]

In determining the extent to which riba pervades the Western system of insurance, a distinction must be drawn between life and non-life insurance.[855] While riba is inherent in life policies, its

[846] Andreas Haberbeck, 'Insurance Under Saudi Arabian Law' (1986) LMCLQ 246 at 247.
[847] Ibid.
[848] Mahmood (n818) 287.
[849] Mahmood (n818) 287.
[850] Ibid.
[851] Andreas Haberbeck, 'Risk Sharing in an Islamic Society' (1987) 2(2) Arab Law Quarterly 138-147 at 139, 140 and 141 Published by: BRILL Stable URL: http://www.jstor.org/stable/3381344; see also, Mahmood (n785).
[852] Afzalur Rahman, *Economic Doctrine of Islam: Banking and Insurance* (V.4, The Muslim Schools Trust, London 1979) 112.
[853] But see F Rahman, 'Riba and Interest' (1964) 3 Islamic Studies, 1, "any attempt to translate the Quranic term Riba in any language is not only futile but is also the source of much confused thinking on the subject."
[854] Mahmood (n818) 282.
[855] Ibid 283.

presence in non-life policies is purely incidental.[856] In life insurance, the insurer undertakes to pay to the insured or his nominees a sum of money either on the insured's death or on the maturity of the policy. This sum is always in excess of the total amount of premiums paid by the insured, irrespective of when the insured event takes place.[857] Sometimes bonuses and dividends are also paid to the insured at regular intervals.[858] Any sum of money that the insured receives, which is in excess of the amount of premiums paid is riba. This is because the premium, which the insured pays, is regarded as a loan given by him to the insurer and the policy money is the repayment by the insurer of that loan.[859] Repayment in excess of the amount of the loan together with the permissible service charges is also riba.[860]

Non-life insurance, however, is generally based on a yearly contract, and no repayment is in fact guaranteed on the premium that is paid by the insured.[861] If the insured event does not take place the insured loses his premium; if it does, the premium may sometimes cost more than the claim because of the principle of indemnity. However, it is the way in which non-life companies, like life companies, invest the premiums that they have received, in fixed interest-earning investments that taint even non-life insurance with riba.[862] By knowing that insurance companies invest their money in riba-related transactions, policyholders become accomplices of the insurer in participating in riba-related activities. Non-life insurance is acceptable in Islam if non-life insurers invest their funds only in riba-free investments.[863]

2. Gharar: Islam also prohibits transactions containing the element of gharar, which literally means risk, hazard or peril.[864] In the context of commercial transactions, gharar refers to the unknown or uncertain factors in such transactions.[865] Islam prohibits a party from taking a risk by entering into a contract without sufficient knowledge of the facts or without knowing exactly what the outcome will be.[866] This can arise when the contract itself is shrouded with doubt, uncertainty or indeterminacy. The other way by which gharar can arise is when the nature of the contract itself gives rise to the possibility of fraud or deceit by one of the parties,

[856] Ibid.
[857] Ibid.
[858] Mahmood (n818) 283.
[859] Ibid.
[860] Ibid.
[861] Ibid.
[862] Ibid.
[863] Ibid.
[864] Ibid.
[865] Ibid.
[866] Ibid.

such as when its terms are vague or uncertain. An insurance contract clearly has the first type of gharar as neither the insurer nor the insured know the precise nature and extent of their rights and obligations until after the occurrence of the insured event.[867] It has also been said that there is also gharar of the second type in a contract of insurance as in most cases the insured when entering into such contracts are unsure, if not totally ignorant of their terms. Most do not read the policy while among those who do read it; many do not understand its contents.[868]

3. Jahala: While one aspect of gharar refers to risk arising out of doubt, uncertainty and indeterminacy, uncertainty per se or jahala in transactions is also prohibited in Islam. The line of dissimilarity between the two is a very fine one of uncertainty resulting in risks and uncertainty generally. Jahala is also present in a contract of non-life insurance.[869] Although most non-life policies involve yearly contracts and so the insured knows the amount of premium that has to be paid for the year, yet is unaware of how much, if at all, the insurer will pay him within this period as this depends on whether the insured event takes place and the extent of his loss.[870] In further jurisprudential analysis concerning uncertainty and the commercial insurance contract, El-Qora Daghi has stated that uncertainty is influential in relation to financial indemnification contracts.[871]

According to the consensus of scholars, the most important forms of uncertainty are as follows:

a. Uncertainty in the existence of risk throughout the insurance process
b. Uncertainty in obtaining compensation
c. Uncertainty regarding the amount of compensation
d. Uncertainty regarding the time of payment of insurance amount (compensation)

4. Maisir: This means to court excessive risk by entering into a transaction with the hope of gain as well as the fear of loss or undertaking a risk in the spirit of speculation, such as gambling and betting.[872] Insurance is said to contain an element of maisir whenever the sum paid out by the insurer exceeds what the insured has paid in premiums. In non-life insurance if the insured event arises and results in a huge loss, the insured will recover more than that which

[867] Mahmood (n818) 283.
[868] Ibid.
[869] Ibid 284.
[870] Ibid 283.
[871] El Qora Daghi (n819).
[872] Mahmood (n818) 284; Siddiqi (n842) 34.

he has paid in premiums. On the other hand, if the insured event does not take place, the insured secures nothing tangible in return for his premiums.[873]

Ali identified some considerable similarities and differences between Takaful and conventional insurance.[874] With respect to similarities between takaful and conventional non-life insurance, they both adopt several key legal principles in terms of insurance. Most notably, both types of insurance employ the principle of insurable interest to minimise the problems of moral hazard, that is to separate insurance from gambling. Using the principle of uberrima fides "utmost good faith", both takaful and conventional insurers can render contract void if there is a material misrepresentation, concealment or breach of warranty made by the insured.[875] Regarding innocent misrepresentation or breaches of warranty, conventional insurers are either unlikely to void or are forbidden to do so by statute or code of law. Similarly, Takaful insurers may not void such a contract.[876] Further, those insured's that serve the Shariah supervisory board may object to their insurer exercising this option, as they represent other insured's contributing to the company.[877]

In conventional insurance, insurers use a "valued policy" for certain types of properties where the insurer agrees, total loss, to indemnify the value agreed upon at policy inception.[878] For partial loss, the insurer may pay more (or less) than the indemnity if the actual value of the property, at the time of loss, falls below (or increases above) the coverage limit.[879] Cash value arrangements are not permitted in takaful.[880] Takaful insurers are thus willing to extend coverage only after conducting a proper valuation of the property to be insured.[881] Further, Takaful insurers conduct a periodic evaluation of the insured property to eliminate any discrepancy between the existing insurance coverage and the current market value of the property insured, and adjust premiums accordingly.[882] These valuation restrictions compel that property insurance is placed on a replacement cost basis in order to suit Islamic principles.[883]

[873] Mahmood (n818) 285.
[874] Mortuza Kasi Mohammed., Ali, (1989). 'Principles and Practices of Insurance under Islamic Framework' Insurance Journal.
[875] Ibid.
[876] Ibid.
[877] Ibid.
[878] Alhumoudi (n787) 80.
[879] Ibid.
[880] Ali (n874).
[881] Alhumoudi (n787) 80.
[882] Ibid.
[883] Ali (n874).

5.5 Takaful Companies- Legal Structures, Regulation and Supervision

Masud argues that there are five key considerations for a takaful company.[884] First, the concept of mutual guarantee is the notion that the foundation of the insurance contract grows out of a cooperative spirit. So, the Islamic ideals of brotherhood, solidarity, mutual help, and shared responsibility function a central role.[885] The second consideration is ownership of the fund.[886] As the fund is constructed on a cooperative model, the fund is merely administered by a corporation, whilst the actual ownership lies with the participants of the fund who must pay out claims. Nonetheless, a takaful operator may be required to safeguard the fund is solvent by offering an interest-free loan in case of insolvency, which is paid back by participants' future contributions. A share of the profits, if there are any, is predetermined.[887] The third is eliminating uncertainty.[888] Fourth, the company must decide how the fund will be managed, whether to employ a wakalah arrangement, a mudharabah contract or a mixed model. Unlike conventional insurance models where underwriting surplus is the principal source of profit, takaful operators receive either an income through a wakalah arrangement, profit sharing through a mudharabah contract, or some other compensation based on the model used.[889] Lastly, the investment conditions of a given economy also play a role in determining how best to structure the takaful.[890]

The mutual practice has therefore become that persons locate money within a fund via tabarru and undertake to indemnify each other for identified losses. The fund is administered by a takaful operator, which is an entity distinct from the contributors to the fund. It is typically a company with shareholders (not inclusive of the contributors to the fund).[891] Therefore, the Islamic insurance company is a hybrid of a Shariah compliant mutual structure for participants and a Shariah compliant management company.[892] In administering the takaful fund, four general models have been adopted by Islamic insurance companies, with some variants of these

[884] Hania Masud, 'Takaful: An Innovative Approach to Insurance and Islamic Finance' (2011) 32 J. Int'l L 1143.
[885] See generally Mohd. Ma'sum Billah, 'Sources of Law Affecting 'Takaful' (Islamic Insurance)' (2001) 2(4) International Journal of Islamic Financial Services (describing how takaful can be justified through divine principles).
[886] Masud (n884) 1143.
[887] Ibid 1144.
[888] Ibid.
[889] Masud (n884) 1144.
[890] Ibid.
[891] Dikko (n841) 2.
[892] Ibid.

models.[893] The models are the methods designed for the purpose of offering remuneration for the takaful operator. Each model is expected to provide funds to cover not only operating expenses of the operator but also comprise profits that will be dispensed to its shareholders if any.[894] In all models, losses are finally borne by policyholders only. Despite this conclusion, the takaful operator is liable to contribute via an interest-free loan if losses in the takaful fund arise: repayment is based on future surpluses.[895] These models are explained as follows:

a. The Mudarabah Model constructs a partnership, where the contributors are deemed to be the rabb al-mal (owners of the money) and the takaful operator is the mudarib (manager of the money).[896] The takaful operator is expected to offer entrepreneurial skills to manage the fund by investing reserves from the fund so that profit is realised which the operator on a pre-determined ratio shares. Any loss suffered is absorbed by the takaful participants.[897] A modified mudaraba model permits the operator to receive remuneration that will cover operating and management expenses before calculating the deficit or surplus realised from underwriting and also shares profits made from investments.[898] With this contract both policyholders and the takaful operator share profits deriving from operations, whereas the former are capital

[893] There are in progress models suggested by scholars. For instance, the Maniḥah-based model is being developed by Iqbal and Pradier. Iqbal Munawar and Pradier Pierre-Charles, 'Comparative Assessment of Different Models of Insurance' Sept. 16 (2015) Chair of Ethics and Financial Norms - IEI-Sorbonne, Lecture with zero draft article. A brief introduction is provided. Maniḥah is another charitable institution in the Islamic system. The difference between tabarru and maniḥah is that in the case of tabarru, the ownership of the subject matter is transferred to the recipient. In the case of maniḥah, the ownership of the subject matter remains with the donor. The recipients can enjoy some or all of the benefits arising from the subject matter for a certain period of time. The donor may also impose some conditions with respect to the subject matter of maniḥah upon the beneficiary, such as taking good care of the subject matter. The scope of maniḥah is very wide. Muslims are encouraged to grant usufruct rights to others generously; especially when the subject matter is not in their usage (fully or partially; for a short period or long one). The type of assets, the usufruct of which can be granted to others is very wide, ranging from a free ride on one's car to free tenancy rights for hundreds of hectares of land.

Based on that, the basic features of the Maniḥah-based model would be that (i) the pricing of the insurance product (premium) should be based on "ability-to-pay" criterion. That means that a poor person will get the same coverage paying little or no premium that a rich person will get by paying a higher premium. (ii) Similarly, the payment for losses (extent of indemnity) will be based on "ability-to-bear the loss" criterion. That means that a rich person will have a higher "deductible" than a poor person carrying similar policies. They also suggest a "Hybrid Model" of insurance. The idea behind this model is to combine all Shariah-compliant means to provide funds for giving insurance services to the individuals. Each insured person will contribute as much as he can; then the aqilah, which may be defined along the lines suggested by Sheikh Mustafa Al-Zarqa, will contribute. This model will be more in line with Maqaṣid al-Shariah "Shariah Purposes".

[894] Fahmy and Sarkar, 'Islamic Modes of Finance and Financial Instruments for Resource Mobilization: A Survey' In (Ahmad Ausaf and Khan, ed), *Islamic Financial Instruments for Public Sector Resource Mobilization*, (Islamic Research and Training Institute, Jeddah).

[895] (n779) 476-477.

[896] Ahmad Tisman Pasha, 'Takaful Business Models: A Review, A Comparison' (2013) 3(4) Business Management Dynamics 24-32 at 25; see also, Shinsuke Nagoaka, 'Reconsidering Mudarabah Contracts in Islamic Finance: what is the Economic Wisdom (Hikmah) of Partnership-based Instruments' (2010) 13(2) Review of Islamic Economics 65-79 at 66; see also, Abdullah Chua, *A Critical Evaluation of Insurance and Takaful* (A paper presented at the International Conference on Takaful/ Islamic Insurance, Kuala Lumpur 2000).

[897] Haron Abdullah and Dawood Taylor, 'Risk Management in Takaful'. In (Archer Simon et al. Ed) *Takaful Islamic Insurance: Concepts and Regulatory Issues* (2009).

[898] Siddiqi (n842).

providers and the latter acts as an entrepreneur running the business on their behalf.[899] The contract explicitly specifies how profits are shared; instead, losses are borne by capital providers only (policyholders), if no misconduct and/or negligence are attributable to the Takaful operator.[900]

b. The Wakala Model is a management contract where the takaful participants hire the operator to manage the fund on their behalf as Wakeel (agent) and this is done following set guidelines laid down by them. In this model, the operator imposes an upfront fee for managing the fund.[901] The operator is not authorized to distribute the income generated from the takaful fund while the participants, on the other hand, undertake the risks involved with underwriting.[902] With this contract, policyholders' funds are kept entirely separated from the insurer's capital, with the latter getting a fixed fee for its management and investment services and net profits are therefore credited to policyholders only.[903] The contract usually involves a performance fee as an incentive to operator's efficiency.[904]

c. The Wakala Mudarabah Model combines the principles of mudarabah – sharing of profits realised from the investment of reserve funds- with those of wakala, which include the payment of agency fees for the management of the takaful funds. The principles of mudarabah are applied towards the investment of funds whilst wakala is applied for managing the business of the takaful operator.[905] This means that the operator not only gets its fees for services rendered, but it also becomes eligible to share in any profits made from investments as an incentive.[906] It is, however, not entitled to a share of any underwriting surplus. This model is commonly used in business practice by many Takaful schemes, and endorsed by several regulators and international organizations, as AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and IFSB (Islamic Financial Services Board).[907]

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[899] Dreassi (n811) 475.
[900] Ibid.
[901] Sheila Nu NuHtay and Hanna Rabittah Zaharin, Critical Analysis on the Choice of Takaful (Islamic Insurance) Operating Models in Malaysia (2011) retrieved from https://pdfs.semanticscholar.org/db4b/42f83eb302e5a740f67bb9c94cef907e9ecb.pdf; see also, B Mohd, 'Shari'ah Principles Governing Takaful Models' In (Archer, Simon et al.) *Takaful Islamic Insurance: Concepts and Regulatory Issues* (John Wiley & Sons (Asia) Pte. Ltd, Singapore 2009).
[902] Dreassi (n811) 475.
[903] Ibid.
[904] Ibid.
[905] Ibid.
[906] Waheed Akter, 'Takaful Models and Global Practices' (2010) MPRA 40010 at 9; see also, Razaleigh Kwangit and others, 'The Management of Takaful Models in Malaysia' (2012) 6(4) Advances in Natural and Applied Sciences 561-564 at 563, available at: http://www.aensiweb.com/old/anas/2012/561-564.pdf.
[907] P Casey, *Establishing a Robust Legal and Regulatory Framework for Takaful* (Presentation at the Financial Regulators Forum in Islamic Finance 2007) available on www.bnm.gov.my; see also, A R Tolefat, *Essential Elements for Effective*

d. The Wakala Waqf Model is an extension of Wakala that utilises the Tabarru fund on the premise of Waqf fund, for example a philanthropic contribution or endowment.[908] The shareholders of the takaful operator are the contributors to a fund, which they cede to be used to compensate persons who suffer loss. A party becomes a policyholder, not by contributing to the fund, but by filling out a form and taking out a subscription to the fund. The shareholders decide to whom and how much money should be paid. They also control investments and use of surplus.[909] The Wakala Waqf model implies that the takaful participants contribute money to the fund which is then considered as a contribution to be used for charity and could comprise the provision of compensation for loss of property by any member. The operator is entitled to payment of management fees and a percentage of returns on investment as mudarib.[910] Manjoo believes that this model has several advantages such as profit motivated; enhancement of the spending (Infaq) sector; ethical contracts; a savings pattern is created; capital mobilisation to help the needy and social institutions and support.[911] Alhumoudi thinks that this model is the only application of Takaful, which completely complies with Shariah, and receives no objections among Islamic experts.[912]

However, different countries follow different structures.[913] The practice of takaful in Malaysia is based on the Malaysian Tijari (commercial) model. Unlike takaful practices in the Middle East and other parts of the world, which are based on cooperative or non-profit making basis, Malaysia developed a model where the elements of investment and profit exist side-by-side with the cooperative element. The Malaysian Takaful model is based on mudarabah contract. In simple terms, mudrabah is a profit-sharing contract where the participant can enjoy both protection and profits from the Takaful operation.[914]

There are two types of mudrabah models applied by takaful operators in Malaysia.[915] The first is the pure mudarabah model, where the takaful operator and the participants share direct

Supervision of Takaful Operators (Presentation at the Financial Regulators Forum in Islamic Finance 2007), available on www.bnm.gov.my; see also, Dreassi (n811) 475.

[908] Apnizan Abdullah, Hakimah Yaacob, 'Legal and Shariah Issues in the Application of Wakalah-waqf Model in Takaful Industry: An Analysis' (2012) 65, 1040-1045 at 1042.

[909] Abdallah and Yaacob (n908)1042.

[910] Ibid 1043.

[911] Manjoo (n813); see also, Alhumoudi (n787) 129-130.

[912] Ibid 112.

[913] Mohammed Arbouna, *Regulation of Takaful Business: A Shari'ah Overview of Contractual Aspects of Takaful Models* (a paper presented at the Seminar on the Regulation of Takaful (Islamic Insurance), Dead Sea, 2005).

[914] Ibid.

[915] Ibid.

investment income only and the participant is entitled to a hundred percent share of the surplus. This model is usually adopted in the general takaful business.[916] The second is the modified mudarabah model, where the investment income is pooled back into the takaful fund and the takaful operator shares with the participant the surplus from the Takaful fund. This model is more popular in the family takaful business.[917] Accordingly, in Malaysia, and alongside the mudarabah model, the wakalah (agency) model is also adopted by some takaful operators.[918]

The Saudi insurance model is the cooperative model based on the Saudi Council of Senior decision stated earlier, which shares many similarities with the Sudanese takaful model. However, in the case of life insurance, the Saudi market adopted what is known as the Takaful to Tawuni model, which was introduced by Bank Al-Jazira in Jeddah.[919]

In the light of the above ruling, the Saudi insurance market is based on the cooperative principle, where all other forms of insurance, commercial and others, are seen as invalid under the laws of the Kingdom. Furthermore, the Law on Supervision of Cooperative Insurance, enacted in August 2003, stated in Article I that "Insurance in the Kingdom shall be undertaken through registered insurance companies operating in a cooperative manner as it is provided within the article establishment of the National Company for Cooperative Insurance... and in accordance with the principles of Islamic Shariah."

Furthermore, Article 6 of the Articles of Association of NCCI stipulates that, "The Company shall carry out insurance operations in accordance with the cooperative insurance method." The Saudi cooperative insurance industry, unlike the Malaysian Takaful industry, applies the principle of wakalah, agency, with regard to the management of the insurance operations. Wakalah could be defined as, "a contract of agency in which a person delegates his business to another and substitutes the other in his own place. The latter is called wakil, agent, and the former is called muwakkil, or principal". Therefore, the majority of countries in the Middle East prefer the wakalah model, while the mudarabah model is preferred by countries in South East Asia, Malaysia, Indonesia and Brunei.[920]

[916] Ibid.
[917] Arbouna (n913).
[918] Ibid.
[919] Ahmad (n789) 305-306.
[920] Ibid 309.

The Saudi Cooperative model remains conceptually different from Takaful insurance. Even though, the concept of redistribution of surpluses is considered, it does not incorporate in the Supervision Insurance Companies Act 2003 provisions relating to:

1. the separation of the funds of the participants and those of the shareholders;
2. the obligation to invest in accordance with the rules of Islamic finance;
3. the establishment of a Shari'ah supervisory board as recommended by the AAOIFI and IFSB standards in force.[921]

With respect to the contract of Takaful, it has a unique identity from many other financial contracts in that there are three different parties to the contract of Takaful as follows:

1. The Takaful Operator: Section 2 of the Malaysian Takaful Act 1984 provides that, "Takaful operator", "Takaful Agent" and "Takaful broker" means a person who carries on Takaful business as Takaful operator, Takaful agent and Takaful broker respectively.[922]

2. The Takaful Participant: It could be defined as any person who joins a Takaful scheme and accepts all the terms and conditions of the Takaful policy. When entering into a Takaful scheme, a participant must have the intention to offer mutual support to other fellow participants if and when they face hardships. Furthermore, the participant must not enter into the scheme with the intention of profit making and wealth-maximisation. Takaful is a scheme of social cooperation, and it is more concerned with the welfare of the group rather than the welfare of one participant. The Malaysian Takaful Act (1984), s. 64, states, "A person under the age of eighteen years shall not have the capacity to enter into a contract of Takaful." [923]

3. Members of Society: The Shariah acknowledges the right of every individual to livelihood, and guarantees the basic needs for every Muslim. Public welfare and social security are the foremost economic obligation of an Islamic State.[924]

[921] Billah et al. (n65) 41-42.
[922] Ahmad (n789) 134.
[923] Ibid.
[924] Siddiqi (n842) 62.

Alhumoudi provided an analysis of the nature of Takaful contracts in comparison with conventional insurance contracts.[925] From his points of view, he contends that:

1. Takaful cooperative insurance represents a qualified contract of donation (which has no exchange) because the element of uncertainty affects the contract of reimbursement (Muawadah).
2. There are recognised differences in procedure between Takaful cooperative insurance and commercial insurance.
3. Both employ an insurance operator (insurer, insured, risk, and premium).
4. The principles of donation tolerate elements of gharar and ambiguity. This feature renders the Takaful system different from conventional insurance with principles based on exchange.
5. Contracts have a bearing on actual commercial actions and are not produced solely for the sake of wording policies. Thus, the act of donation is an affective factor throughout these transactions.

According to Ahmad, Takaful operations can be divided into three broad categories according to their objectives.[926] Each one of these categories has its own rules and practices, which are different from the others. These categories are:

a. Family Takaful "Islamic Life insurance"
b. General Takaful "Islamic non-life insurance"
c. Re-Takaful "Islamic Re-Insurance"

In non-life insurance, Takaful insurers commonly offer coverage on an annual renewal basis, for everything from fire insurance and allied lines, automobile insurance, liability insurance, marine insurance, workers' compensation, fidelity insurance and even crop insurance.[927] In Takaful life insurance, the Mudarabah mode of financing is employed. In General Takaful, premiums are pooled into a Takaful fund managed by each insurer.[928]

[925] Alhumoudi (n787) 112.
[926] Ahmad (n789) 83.
[927] Alhumoudi (n787) 76.
[928] Ibid.

Re-Takaful is still being debated, as there is still a necessity to cooperate with conventional reinsurance. Mohammad Ajmal Bhatty provided the following reservations when dealing with a conventional reinsurer by saying that:

a. Reinsurance with conventional companies should be minimised, but the security of the Takaful fund must not be compromised.[929]

b. The premium reserve for unexpired risks should exclude the portion reinsured. The reinsurance arrangements must not allow interest on any delay in the settlement of reinsurance account.[930]

c. Reinsurance commission from conventional reinsurers should be deemed to be a discount on the cost of reinsurance. Similarly, the profit commissions from reinsurance should be used to form a reduction in the cost of reinsurance.[931]

Various reasons have been given for the limited growth in the re-Takaful industry such as:

1. The absence of a sufficient number of re-Takaful companies.
2. Lack of professionally rated re-Takaful operators.
3. Insufficient funds allocated to investment in re-Takaful operations.
4. Lack of a recognised regulatory framework for re-Takaful operations.[932]

A common legal structure of a Takaful company is to have a Shariah Supervisory Board, which guarantees that its practices do not depart from the Shariah accepted standard.[933] In countries which use the Islamic legal system, laws have been enacted which deal with issues varying from the establishment of, to registration and regulation of the takaful company. In others, it has been contended that as the operation of takaful company is analogous to the mutual cooperative, they should be regulated by the same mechanism that handles mutual companies.[934] The guiding principles of Takaful companies are not commonly located in

[929] Mohammad Ajmal Bhatty, *Aspects of Business Operations in Different Takaful Modalities* (presentation to the Global Islamic Financial Forum, Kuala Lumpur 2007) available on www.bnm.gov.my/microsites/giff2007/pdf/frf/07_06.pdf .
[930] Ibid.
[931] Ibid.
[932] Ahmad (n789) 99.
[933] Dikko (n841) 3.
[934] Ibid.

enacted laws but in rulings of scholars of Islamic law and finance. Though, a few countries like Malaysia and Pakistan have absorbed or enacted these into binding laws to regulate the companies.[935]

5.6 Various Issues Surrounding the Takaful and Re-Takaful Businesses

There are certain issues that exist both legal and regulatory with takaful. These concerns span questions as to the authenticity of certain practices from the point of view of the Shariah that conflict with laws and the adequacy of the framework from which takaful operates.[936]

A common practice is to refer to donations made by policyholders as 'tabarru', which means donation. The Shariah ruling on donation, similar to those concerning gifts and charity, is that once made, the maker loses any right to it and may not recall it or receive back any portion of it.[937] Hence, if paid contributions are denoted as tabarru, the policyholder would legally be unable to make a claim and receive compensation in cases of loss.[938]

Indemnification made from a fund to which donations are made annually is also an issue. However, where the fund is insufficient to cover all claims made on it, the donors to the fund are occasionally requested to give further compulsory donations to cover the deficit.[939] This indicates that the initial voluntary donation is tied to a potential future compulsory indeterminate amount.[940]

Third, the models used in takaful also raise some queries.[941] The mudarabah model makes conflict because tabarru is not intended to be a profit making and sharing relationship.[942] Thus, the tabarru fund cannot be mudarabah capital at the same time. The sharing of underwriting surplus between the takaful participants and the operator transfers the mutual insurance into a commercial venture not an agreement for mutual cooperation and assistance.[943] Jaffer and

[935] Dikko (n841) 3.
[936] Ibid.
[937] Mohd (n901); saee also, Renat Bekkin, 'Islamic Insurance: National Features and Legal Rgulation' (2007) 21 Arab Law Quarterly 109-134.
[938] Dikko (n841) 3.
[939] Ibid.
[940] Simon Archer, Rifaat Karim and Volker Nienhaus (Ed). *Takaful Islamic Insurance: Concepts and Regulatory Issues* (John Wiley & Sons (Asia) Pte. Ltd. 2009).
[941] Dikko (n841) 3.
[942] Ibid.
[943] Ibid.

others voice objections about the practice of the takaful operator advancing a non-profit loan to the fund in the case of deficit.[944] This technically converts the operator, as mudarib, to a guarantor, which is not a feature of the mudarabah contract. However, mudarabah is not legal for a party in an agreement to stipulate a certain amount as his proceeds from the arrangement.[945] Only ratios of possible profits may be fixed.[946] Though, in the practice of the modified mudarabah model, the fee of the takaful operator is fixed in advance and is paid even if no profits are realized. Again, the fact that the contributor has the right to payment of a fixed amount (particularly in family takaful) as compensation which amount is determined at the time of entering into the tabarru agreement also goes against this fundamental principle of mudarabah.[947]

The common practice among takaful operators is of mixing financing models so as to boost profits of operators.[948] Muhammad raises the important issue of whether the takaful scheme is really a mutual cooperation or proprietorship. One has the feeling that Islamic ideals have been sacrificed to ensure the economic viability of the takaful company.[949] Furthermore, in takaful, the question to which there is no common answer is whether the amount on the policy should be viewed as a gift to the beneficiary, or held in trust for the heirs of the deceases which may or may not include them.[950] A number of takaful company purchase reinsurance from conventional reinsurers due to the lack of adequate retakaful providers,[951] or the retakaful operator may not be subjected to the same rigor of scrutiny regarding Islamic principles as is done for the takaful company.[952] This indicates that though a person may seemingly obtain Shariah compliant insurance, yet there may be some aspect of illegality linked with it, as the operator does not enjoy the same.[953]

According to Billah et al., finding an optimal Takaful model is a must for Shari'ah scholars, researchers and industry players. However, the question of the ideal structure of the Takaful

[944] S Jaffer and others, 'Takaful (Islamic Insurance): Concept, Challenges, and Opportunities' (2010) Millman Research Report 20.
[945] Dikko (n841) 3.
[946] A L M Abdul Gafoor, Mudarabah-Based Investment and Finance (2001) cited in Dikko (n841).
[947] Dikko (n841) 3.
[948] Ibid.
[949] Ibid.
[950] Azman Bin Ismail, *Nomination and Hibah Issues in the Takaful Industry* (A Paper Presented at the ISRA Shari'ah Conference on Takaful, 2009) 4-5.
[951] M B Arbouna, 'The Operation of Retakaful (Islamic Reinsurance) Protection' (2000) 15(4) Arab Law Quarterly 335-362 at 338-339.
[952] Akoob Mohammed, 'Reinsurance and Retakaful' In (Archer, Simon et al.) *Takaful Islamic Insurance: Concepts and Regulatory Issues* (John Wiley & Sons (Asia) Pte. Ltd. 2009).
[953] Dikko (n841) 4.

model is an unresolved issue yet.[954] Olorogun has recommended that the Islamic insurance industry stakeholders should accept that the industry needs renovation. Thus, they should move ahead by formulating business models that are intellectually and economically convincing without quotation from the Quran and Sunnah. The appealing of these models should be through solid and holistic unification of all parts of its system. This would create market efficiency which has been a long-time target of the industry. The new models must be operational efficient and reliable to intellect and application. The policy must be connected to the operation in such a way that would lead to the realization of aims and objectives. None fragmented models would create a chance for unified governance and regulatory oversight at global level. All these would make the Islamic insurance politics appealing to people beyond the faith and continent.[955]

Fourth, a crucial issue is created by the conflict of laws regulating takaful.[956] In most cases, the company may be forced to follow regulations and implement practices that are not Shariah compliant. Furthermore, each takaful operator typically has a Shariah Advisory Board whose role is to ensure that the takaful company runs within and remains Shariah compliant. The issue here is that there is no principal Shariah board or body, which would ensure the uniformity of practices amongst the companies.[957] The lack of uniformity of laws regulating takaful, is also a deterrent to ensuring that the same service is obtained worldwide. Although certain jurisdictions may have reached a significant degree towards ensuring the system corresponds to every Islamic ideal, others are still far behind.[958]

This issue is related to the absence of standardisation of Takaful practices as the Takaful industry is relying heavily on the opinion of Shariah boards of operators, subject to any local regulatory constraints.[959] For more emphasis, different regulators have adopted different approaches for Takaful. In England, takaful operators are subject to the same regulation framework of traditional insurance. Malaysia have adopted a comprehensive Islamic financial system running in parallel with the conventional system; however, Bahrain prefers to take into

[954] Billah et al. (n65) 37.
[955] Olorogun, Lukman A., "Compatibility between Islamic Insurance Theory and its Current Models of Operation", Academy of Accounting and Financial Studies Journal, suppl. Special Issue; Arden Vol. 22, (2018): 1-11.
[956] Ibid.
[957] Ibid.
[958] Ibid.
[959] Ali Said and Rihab Grassa, 'Does Risk Sharing Model Have Contributed to the Growth of Takaful?' (2014) 4(2) International Journal of Excellence in Islamic Banking & Finance.

consideration the specificities of the Takaful industry.[960] The development of a suitable regulatory regime appears crucial for the protection and the stability of the Takaful industry.[961]

Ahmad thinks that the existing legal framework available for many Takaful operators was designed to govern the conventional insurance industry.[962] Such framework does not recognise the Shariah as the main governing law of Takaful operations. Furthermore, such framework, in many cases, does not recognise mudarabah, wakalah, tabbarru, tawun and other Islamic contracts as a part of the practised legal system.[963] Hence, Takaful operators are finding themselves in a predicament where they need to comply with both conventional laws and the Shariah, and where in many occasions both systems might clash and differ.[964]

In order to overcome these issues, uniform international standards should be adopted by all Takaful operators worldwide.[965] These are: A. Risk Management (IFSB standard on risk management could be amended to cover the operations of the Takaful industry). B. Capital Adequacy (also the IFSB standard should be considered). C. Transparency (the IFSB is already working on the issuance of this standard and Takaful should be an integral part of its coverage). D. Accountability (IFSB and AAOIFI could cooperate on this issue as both of them are qualified to cover this area). E. Disclosure. F. Customer Protection G. Market Discipline (the IFSB already working on this standard) H. Accounting and Auditing (AAOIFI already covered this area. However, more work needs to be done to make them internationally recognised standards by all Takaful operators). I. Insolvency.[966]

The General Council for Islamic Banks and Financial Institutions (CIBAFI) has conducted a survey in 2018[967] concerning risk perception, growth drivers and the impact of technology on 55 Takaful companies from 24 countries. Takaful companies in Group 7 (France, Turkey, United Kingdom) are mostly concerned about market infrastructure, reflecting the lack of regulations and laws to govern the emerging Islamic finance markets in these areas.[968] Respondents of this group reiterate that they play a constructive role in helping the authorities

[960] Ibid.
[961] Ibid.
[962] Ahmad (n789) 407.
[963] Ibid.
[964] Ibid.
[965] Ibid 411.
[966] Ibid.
[967] The General Council for Islamic Banks and Financial Institutions, CIBAFI Global Takaful Survey, May 2018, available at: http://cibafi.org/ControlPanel/Documents/Library/Pdf/GTSReportfinal-online-1.pdf.
[968] Ibid 35.

in the legislation processes to optimise new regulations for Takaful. However, regulatory concerns are not confined to this region.[969]

A GCC Takaful company identified the challenge of the lack of an effective supervisory body, while another commented on the possibility of regulatory changes which would impact the industry.[970] Two South East Asian companies (from Brunei, Indonesia, Malaysia) referred to regulatory frameworks (in different countries), one specifically drawing attention to the impacts on Takaful companies as opposed to conventional insurers. To a large extent, these concerns seem to reflect the fact that insurance regulatory standards are going through a period of relatively rapid change globally, and the changes do not always take account of the particular needs of the Takaful industry.[971] However, one company in West, Central and South Asia said that "the biggest challenge with reference to Takaful is introducing a Takaful regulatory model under a conventional insurance regulatory framework."[972] A company in North Africa commented particularly on the need for Shariah standards and a basis for implementing proper governance and compliance.[973]

In the same CIBAFI report, it states that domestic regulation is more important than cross-border issues.[974] For example, respondents were asked to identify the importance of improvements in various areas within their own jurisdiction. Overall, several areas ranked highly, with little to choose between them. However, the creation of a Takaful-specific regulatory system was the highest-ranked, and came at the top of the rankings in 5 of the 7 regions.[975] Issues of cross-border regulation and harmonisation of standards ranked towards the bottom, reinforcing the important perception from earlier questions that most firms are focused primarily on domestic markets.[976]

Areas of improvement in Takaful regulation as follows: Creation of a specific Takaful regulatory framework; Shariah governance framework; Consumer protection; Reporting and accounting requirements and standards; Capital requirements, and Solvency Margins; Transparency and disclosure; Consistent enforcement of regulation; Development of

[969] Ibid.
[970] Ibid.
[971] Ibid.
[972] Ibid.
[973] Ibid.
[974] Ibid 65.
[975] Ibid.
[976] Ibid.

supervisory competence within the regulator; Cross-border harmonisation of Shariah standards; Taxation, and Zakat, and Cross-border coordination of regulatory and supervisory approaches.[977]

Arbouna highlights two obstacles Re-Takaful operations face.[978] One obstacle is exemplified in the conspicuous absence of explicit legal principles and regulations for Re-Takaful operations in Islamic traditional legal compendia. As a result, the existing regulatory laws of Retakaful operation are limited as to the modem legal requirements of the reinsurance business. The nature of the reinsurance business appears to be that riba (interest), and non-Islamic activities are the main features of the transactions involved. This has posed a challenge to the legality of streamlining reinsurance arrangements with conventional reinsurance companies. The main task thus is to establish riba-free reinsurance portfolios within the parameters of Islamic law.[979]

The second obstacle is the lack of comprehensive reinsurance laws in compliance with the Shariah in most Muslim countries. The reinsurance laws of these countries are dependent on civil law and common law principles, a situation that has made the development of Islamic reinsurance laws more difficult. Islamic legal regulations are still felt on the state level in many Muslim countries to govern and regulate Retakaful operations, however, unless Retakaful codes are streamlined the Islamic insurance industry appears to remain underdeveloped.[980]

Fadun believes that the issue of re-takaful in accordance with requirements and practices of Shariah should be considered by operators in Nigeria as a country with a large Muslim population.[981] Like conventional insurance, sound re-takaful arrangement is a necessity.[982] Although in a situation where re-takaful is inadequate to meet takaful operators' needs, Shariah allows them to deal with conventional reinsurers. Since takaful is relatively new in Nigeria, Fadun recommends that takaful operators should collaborate to establish a re-takaful facility or pool in Nigeria as this would be beneficial and enhance mutual cooperation among operators and minimise capital outflow from Nigeria.[983]

[977] CIBAFI (n967) 35.
[978] Arbouna (n913) 335.
[979] Ibid.
[980] Ibid.
[981] Olajide Fadun, 'Takaful (Islamic Insurance) Practices: Challenges and Prospects' (2014) 4(2) Journal of Insurance Law & Practice 12-28, 22.
[982] Ibid.
[983] Ibid.

According to Khan and Hasan, another controversial issue in the GCC region is the use of Islamic windows by secular insurance companies yet there does not appear to be a clear consensus on the issue, although the trend appears to be against their use.[984]

Other regulatory concerns contain the offer of "Islamic insurance products" through Takaful windows rather than fully-fledged operators.[985] Windows permit companies to resolve several logistical issues, such as startup of operations, availability of skilled staff for critical tasks and so on.[986] Simultaneously, the whole business needs to be adapted, offering a suitable segregation of Takaful business from other operations, in order to conform fully with Shariah principles (although it is still disputable whether this could be accomplished even through a perfect separation). More separation, though, indicates that less loss-absorbing capacity is attributable to other funds, which, therefore, restricts eligible capital for solvency purposes.[987] On one hand, assets and liabilities could be without difficulty separated and attributed to a particular window, but on the other it is significant to define the role of shareholders' funds, particularly regarding the strength of financial responsibilities between various lines of business and Takaful windows.[988] It is reasonable to say that a full segregation of risks is not easily achievable, and, therefore, issues would arise as to the regulatory and supervisory treatment of Takaful windows, were this solution to be allowed.[989]

Other issues in Europe also arise for Mutual Insurance and Takaful schemes re Solvency II, such as a supervisory issue regarding investments arises.[990] Article 134 of its framework directive states that the pledging of assets by supervisors is prohibited, but assets held to cover technical provisions, if related to risks situated in the EU, must be localised within the EU.[991] No further guidance on this point has yet been provided, in particular whether localisation implies listing, issuance or other requirements. Nevertheless, it could be a hard entry-barrier for Takaful operators to find Shariah-compliant investments localised in Europe, given that even outside the community their number is limited.[992]

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[984] Bilal Khan and Badrul Hasan, *Shariah and Legal Analysis* (2nd edn, International Takaful Report 2012 –2013) Available at: http://www.domeadvisory.co.uk/images/downloads/itr_final_one_file_web.pdf.
[985] Dreassi (n811) 482.
[986] Ibid.
[987] Ibid.
[988] Ibid.
[989] Ibid.
[990] Ibid 485.
[991] Ibid.
[992] Ibid.

In Nigeria, appropriate accounting standard is another issue takaful operators should be concerned with.[993] The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has created a standard that is the default accounting standard for takaful businesses in some Middle East countries. Takaful firms in other countries account for takaful under International Financial Reporting Standards (IFRS).[994] However, applying IFRS to takaful is complex. It is therefore required that the appropriate skills are gained in addition to a sound understanding on how takaful operations can be accounted for.[995]

Limited short-term non-equity financial instruments in Nigeria pose additional challenge for Takaful companies.[996] This includes: sukuk and Shariah-compliant money market instruments equivalent to Treasury bills.[997] This indicates enormous challenges to operators in Nigeria, as takaful funds cannot be invested in conventional bonds and cash assets.[998] This portrays complicating for operators regarding management of takaful investment portfolio.[999]

Masud explained issues facing Takaful business in the United States.[1000] As Islamic insurance has already entered the United States insurance market without any substantive changes to insurance regulations in late 2008, AIG introduced the Takaful Homeowners Policy as a first step in bringing takaful to the United States.[1001] AIG plans to expand their offerings to include car and life insurance. However, legal challenges to AIG's takaful product may prevent further expansion.[1002]

In any case, takaful companies should be aware of the challenge raised against AIG under the Establishment Clause.[1003] There has been a legal challenge to AIG's takaful product under the Establishment Clause because takaful is explicitly described as a Shariah compliant product.[1004] While AIG is a unique situation that may make such a claim ripe, there is always the possibility that companies considering takaful or any other Islamic financial products would

[993] Fadun (n981) 22.
[994] Ibid.
[995] Ibid.
[996] Ibid.
[997] Ibid.
[998] Ibid.
[999] Ibid.
[1000] Masud (n884) 1156.
[1001] Ibid.
[1002] Ibid.
[1003] Ibid. 1157.
[1004] Ibid.

be wary of offering such products in the United States because of fear over litigation. The First Amendment's Establishment Clause provides that Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof.[1005]

There are scarce regulations that may cause a difficulty for takaful insurers attempting to commence a business in the United States. In terms of licensing, takaful companies may have difficulties demonstrating their financial soundness as compared to conventional insurance companies.[1006] As the members in a takaful arrangement accept to insure one another and share in risk and profits, there may be some impediments in establishing the company as a financially sound insurance provider; the financial soundness would rely on the number of participants, as well as the risk and profit-sharing structure agreed upon by participants and management.[1007]

Although the theoretical foundations for takaful insurance take the form of communal responsibility, the United States insurance industry is underpinned by opportunism.[1008] The conventional insurance contract furnishes the insurance company two profit-making advantages. First, the insurance company has all the authority at the point of claim and can benefit from the insured. Second, it has the information at the point of sale, which permits it to price its products at the highest value point.[1009]

Takaful as an Islamic product would be incapable to utilise either of these advantages to remain Shariah compliant, as the principal goal is not to turn a profit but to provide a community service.[1010] However, if takaful is envisaged as a tool desired by a few who are willing to pay extra, then competitive pricing is less important.[1011] The higher premium may also be tempered by the fact that policyholders have the opportunity to make a profit on their investment.[1012]

Mahmood highlights some issues resulted in numerous inconsistencies and incongruities in the Malaysian Takaful Act 1984 as in fact it follows the Insurance Act 1963, with additions and modifications being made only to accommodate the necessary changes.[1013] The Takaful Act

[1005] Ibid.
[1006] Ibid 1154.
[1007] Ibid.
[1008] Masud (n884) 1155.
[1009] Ibid.
[1010] Ibid.
[1011] Masud (n884) 1155.
[1012] Ibid.
[1013] Mahmood (n818) 291.

does not specify what is to be done if there is a lacuna in the law.[1014] The Insurance Act 1963 also does not have such a provision, but this is because such a situation is provided for by section 5 of the Civil Law Act 1956.[1015]

The Takaful Act does not mention or make any reference to Islamic law as a source of substantive law beyond the phrases elements "approved" or "not approved" by the Shariah.[1016] If, for instance, a problem arises relating to which there is no definitive pronouncement from the basic sources, that is, the Quran and Traditions of the Prophet should reference be made to the law as applied in other Muslim countries or to the opinions of Muslim jurists?[1017] This problem is further aggravated by the fact that the Takaful Act has not merely borrowed the regulatory provisions of the Insurance Act 1963 but also those relating to the substantive law of insurance.[1018]

Masud elaborated further about Section 67(2) of the Takaful Act, which states that the Insurance Act of 1963, which governs the conventional insurance operations in Malaysia, is not applicable to Takaful companies.[1019] However, Takaful rests within the purview of civil law jurisdiction. Disputes over takaful are handled by the Malaysian civil courts and legislation falls under the responsibility of the Federal government, although Shariah courts and, to some extent Shariah law, exists within the country.[1020] Further, the Takaful Act codifies the requirement of utmost good faith through a strict duty to disclose, imposed on both participants and operators.[1021] While this element is detailed in the Act, the origins of the requirement can be found in the common law rules that govern in Malaysia.[1022]

Lambak and Tahir discussed the Juristic Analysis on the Applications of Common Law in Malaysia Takaful Act 1984.[1023] This Act still has many dependencies on other laws (as stated under Section 67 of Takaful Act 1984) such as Insurance Act 1996 (superseded Insurance Act 1963), Companies Act 1965, Contract Act 1950, Road Transport Act 1987 (superseded Road

[1014] Ibid.
[1015] Ibid.
[1016] Mahmood (n818) 292.
[1017] Ibid.
[1018] Ibid.
[1019] Masud (n884) 1148.
[1020] Ibid.
[1021] Ibid.
[1022] Ibid.
[1023] Salman Lambak and Izah Mohd Tahir,' Juristic Analysis on the Applications of Common Law in Malaysia Takaful Act 1984 Based on Doctrine al-Urf' (2013) 9(9) Asian Social Science 262.

Traffic Ordinance 1958) and Co-Operative Societies Act 1948.[1024] These laws have indeed developed based on the English Common Law as it is a part of the Constitution of Malaysia laws as expressly written in the Sections 2 and 5 of Malaysia Civil Law Act 1956.[1025]

In the new Central Bank of Malaysia Act 2009, the role and functions of the Shariah Advisory Council "SAC" was further reinforced whereby the SAC has conferred the status of the sole authoritative body on Shariah matters pertaining to Takaful, Islamic banking and Islamic finance.[1026] While the rulings of the SAC shall prevail over any conflicting ruling given by a Shariah body or committee constituted in Malaysia, the court and arbitrator are also required to refer to the SAC rulings for any proceedings relating to Islamic financial business, and such rulings shall be binding (precedent).[1027]

The framework of having Shariah Advisory Council though is so far the best solution, but there is, unfortunately, no strict enforcement, direct supervision or involvement of neither Shariah judges nor scholars in the trial itself; hence, the court may not comply with Shariah rules.[1028] The closest example is the case law of *Teng Gia Hwa & 1 or v Syarikat Takaful Malaysia Bhd* (2010) that came after effect of the Central Bank of Malaysia Act 2009 (in respect of Shariah Advisory Council authority). The verdict by Judge Datuk David Wong did not make any reference to Shariah resolution in respect of valued policy and also had included the interest 4% of the judgement sum, which is usury (riba) and prohibited in Islam.[1029] Therefore, whether the use of common law principles in Takaful is permissible by Islam, this will be discussed in more details in Chapter Seven.

According to Alshamrani, there are some other related issues in addition to the regulation and administration of takaful.[1030] The issues are capital and solvency regulation, market entry regulation, market conduct regulation, corporate governance and investment regulation. The Saudi Arabian Monetary Agency "SAMA", for example, is considered the primary regulator of the Saudi Arabian insurance market under the Law on Supervision of Cooperative Insurance

[1024] Ibid.
[1025] Lambak and Tahir (n1023) 262.
[1026] Ibid 264.
[1027] Ibid.
[1028] Lambak and Tahir (n1023) 266.
[1029] Ibid.
[1030] Ali Saeed Alshamrani, 'Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice' (PhD Thesis, Brunel University 2014) 124.

Companies, promulgated by Royal Decree (M/32) dated 31 July 2003. Its implementing regulations were issued by the Ministerial Decision No. 1/596 on 20/04/2004.

Article 1 of this law stipulates that "insurance companies should operate in a cooperative manner in accordance with the principles of Islamic Shariah", but, in fact, there are multiple violations of the Decree in the implementing regulations themselves, resulting in cooperative insurance in Saudi Arabia being described as commercial and not cooperative. These violations are as follows:

a. Article (70-2/e) stipulates that: "10% of the net surplus shall be distributed to the policyholders directly, or in the form of reduction in premiums for the following year. The remaining 90% of the net surplus shall be transferred to the shareholders' income statement". This is a commutative contract on surplus which makes the cooperative insurance commercial; even though it is intended to be a cooperative insurance, the surplus must be in favour of the insured where the surplus returns to them or is transferred to a special reserve account with insurance operations, or transferred for the next few years to reduce the premiums that will be taken from the insured.[1031]

b. Article (1) of the implementing regulations defines the function of insurance as "transferring the burden of risk from the insured to the insurer, and compensating those who are exposed to damage or loss by the insurer". It also defines the contribution (premium) as the "amount offered by the insured to the insurer in exchange for the insurer's acceptance to indemnify the insured for loss/damages resulting directly from a covered risk". The insurance policy is defined by the same article as "a legal document/contract issued to the insured by the insurer setting out the terms of the contract to indemnify the insured for loss and damages covered by the policy against a premium paid by the insured." The insurer is defined by Article (1) of the implementing regulations as "an insurance company that accepts insurance contracts directly from insured (s)."

All of these definitions confirm that the concept of cooperative insurance in Saudi Arabia is considered to be commercial insurance and not cooperative, because insurance companies in Saudi Arabia charge insurance premiums in exchange for their commitment to compensation.

[1031] Ibid 140.

This makes the cooperative insurance commutative rather than cooperative, whereas the goal of cooperative insurance is solidarity and cooperation, managing takaful funds on behalf of the participants, and receiving a salary (wakala fee) for this service.[1032]

c. Article (61-1) of the implementing regulations stipulates that "if such investment policy was not approved by SAMA, the company shall adhere to the investment standards in Table (1), provided that investments outside the Kingdom shall not exceed 20% of the total investment and in accordance with Article (59-2)." The problem here is that some of these investment receptacles or investment types contradict Shariah because they include interest (riba), which, as mentioned, is forbidden in Islam.[1033] Some of these investment receptacles are Saudi Government Bonds 20% minimum, Foreign Government Bonds (Zone A) 5% maximum, Bonds Issued by Domestic Companies 5% maximum, and Bonds Issued by Foreign Companies 5% maximum.

d. Article (3-3) of the implementing regulations approved the practice of protection and savings insurance. This practice is regarded as life insurance, which is prohibited by the Council of Senior Scholars in the Kingdom of Saudi Arabia because it includes lack of knowledge, uncertainty and unlawful taking of others' money. The Council of Senior Scholars believes that life insurance is a form of commercial insurance. Fatwa no. 14839 stipulates that: "life insurance is a form of commercial insurance, and it is prohibited because it includes lack of knowledge, uncertainty and unlawful taking of others' money."[1034]

e. Article (42) of the implementing regulations identifies re-insurance controls, and does not specify that this should be re-insurance with the cooperative insurance companies, but opens the way for re-insurance with all companies, including commercial insurance companies.[1035]

Alshamrani believes that it is of paramount importance to have an Islamic Insurance Act in Saudi Arabia as in Malaysia, and one, which takes the multiplicity of Islamic references into

[1032] Ibid 140-141.
[1033] Ibid 141.
[1034] Portal of the General Presidency of Scholarly Research and Ifta, 'Fatwas of the Permanent Committee, Group 1, Volume 15: Transactions 3, Working with Riba dealers' http://www.alifta.net/Fatawa/FatawaChapters.aspx?languagename=en&View=Page&PageID=5454&PageNo=1&BookID=7.
[1035] Alshamrani (n1030) 141.

account.[1036] He also contends that the law of Supervision of Cooperative Insurance Companies 2003 and its implementing regulations need to be amended by specialist members in Shariah and Islamic economics as well, in order to be compatible with the principles of Shariah.[1037] With respect to his recommendations, the Malaysian Takaful Act 1984 is a procedural act and relies on the conventional insurance act as explained above. Therefore, his opinion is invalid unless substantial law that organises Takaful and ReTakaful operations is formed after considering the experiences of other Islamic and non-Islamic countries and be compatible with Islamic principles, in addition to considering relevant laws that cover specific areas as this thesis argues in general.

Alhumoudi criticised the Saudi insurance system from the perspective of Islamic Shariah Law from multiple perspectives:[1038]

a. There is a mistake in the Legal Constitution. Art. 1 in the Law on Supervision of Cooperative Insurance Companies stipulates "Insurance in the Kingdom shall be undertaken through registered insurance companies operating in a cooperative manner as it is provided within the article establishment of the National Company for Cooperative Insurance ...." This company was criticised by the author and others as it violated Islamic principles in its operation.[1039]

b. The concept of insurance in Saudi Arabia is similar with the conventional insurance from the logic and the application.[1040]

c. The Law on Supervision of Cooperative Insurance Companies and the Rules of the Council of Cooperative Health Insurance and their implementing regulations do not reflect what is supposed to be in insurance in an Islamic concept based on donation, but they reflect the concept of conventional insurance based on a clear financial reimbursement contract (Muawadah).[1041]

[1036] Ibid 143.
[1037] Ibid.
[1038] Alhumoudi (n787) 180-181.
[1039] Ibid 180-182.
[1040] Ibid 181.
[1041] Alhumoudi (n787) 181.

d. The relationship between the company and the total insured may be qualified as a fee-based agency for the management and regulation of insurance with the deceit (Gharar) in the wage, and thus the fee-based agency contract is void.[1042] It is still restricted in terms of time because the contract period is only one year, therefore, Alhumoudi confirms that according to Islamic rules of Mudarabah this invented application is void as well, for two reasons.[1043] The first is ignorance in the amount of capital and the second is that the company would take a share of the surplus, which it is not entitled to take.[1044]

e. The distribution of the surplus does not reflect what should be an Islamic insurance concept.[1045] The shareholders and the Cooperative Health Insurance Council has a right which is not allowed to them, and involves depriving policyholders of their rights, as insurance companies get a part of the surplus, which is not an income achieved by the company, and that is exactly the case for the Council of Cooperative Health Insurance.[1046]

f. The existence of investment funds is not following Islamic Shariah rules as this makes the treatment with companies forbidden as explained earlier by Alshamrani.[1047]

g. The legitimacy of cooperative insurance in Islamic thought does not necessarily mean the legitimacy of the applications of the Insurance companies.[1048]

h. The existence of an Islamic Shariah committee at insurance companies does not mean the legitimacy of the contracts or the financial treatments and transactions made by these companies.[1049]

Billah et al, have recently provided possible recommendations in the operations of Takaful, both in principle and in practice to be improved further in order to make the Takaful operation an alternative to the conventional insurance schemes. In brief, some of their suugesstions as follows:

[1042] Ibid.
[1043] Ibid.
[1044] Ibid.
[1045] Alhumoudi (n787) 181.
[1046] Ibid 181-182.
[1047] Alshamrani (n1030) 141; see also, Alhumoudi (n787) 182.
[1048] Alhumoudi (n787) 182.
[1049] Ibid.

1. Even though an insurance transaction is generally based on the principles of al-Aqd (contract), the nature of this transaction is quite different from other forms of commercial contracts. This is because an insurance policy is for the purpose of sharing responsibility in order to provide some material security against unpredicted loss or damage resulting from unexpected risks for both life and property.
2. In order to have a reliable authority relating to the principles of Takaful operations, it is suggested that statutory provisions should contain an express provision relating to the principles of Takaful operations for example an al-Mudharabah financing technique so that there should be no doubt as to whether Takaful operations are based on al-Mudharabah financing.
3. Al-Tabarru has a similar nature and also similar legal consequences to the terms of al-Sadaqah, al-Hiba and al-Khairat, which all generally carry the meaning of donation. Furthermore, in accordance with Islamic Law, the donor automatically ceases to have a right to the donated property once it is made as al-Tabarru' in favor of someone or something. Then, if the paid contribution in the general policy is regarded as al-Tabarru (in consideration of which the participant holds a right to claim the coverage against the risk on the subject matter of the policy from the operator), this may contrast with the fundamental principles of the Islamic Law of charity. It is therefore suggested that the paid contribution in the general Takaful may be regarded as al-Musahamah (contribution) instead of al-Tabarru (donation). This is because if the paid contribution in the general Takaful is regarded as al-Musahamah (contribution), the participant has no restriction in Islamic Law to make a claim against the risk on the subject matter of the policy. It is again strongly believed that there is no provision in the Shariah which may prohibit the contributor from making a claim or seeking a benefit over his own contributed fund.[1050]

In light of the above critics and issues, we found out that Takaful industry faces tremendous pressure to cope with Islamic principles in Islamic and non-Islamic jurisdictions. This thesis does not intend to solve existing issues that Takaful and Retakaful face as several researches are already in place and there are ongoing works from scholars to deal with local and cross-jurisdictional issues. However, in general, the Takaful industry is connected to other laws that work in parallel as argued. Hence, it could be noticed that common law precedents in Islamic "who are influenced by common law" and non-Islamic countries disincentivise the Takaful

[1050] Billah et al. (n65) 24-26.

industry as argued so that it is not only the issue of enacting legislation of Takaful in such countries but also to show that Takaful is different from conventional insurance in its essences and products to attract prospective policy-holders. The next section will illustrate the development since its appearance and opportunities arose in the Takaful sector.

5.7 Historical Overview of Takaful Development and Opportunities

Takaful is similar to mutual insurance as a risk sharing entity that allows for the transparent sharing of risk by pooling individual contributions for the benefit of all subscribers. Takaful has been established in its modern form for more than 25 years. Development of a Shariah compliant insurance sector provides the critical risk management supports needed across the various markets offering Islamic financial services.[1051]

Takaful operations first started in 1979 (late 1978) with the establishment of the Islamic Insurance Company of Sudan by Faisal Islamic Bank of Sudan.[1052] However, that did not mean in anyway the Islamisation of the Sudanese insurance market. The real shift from the traditional insurance (conventional insurance) industry to the Islamic cooperative insurance industry was in 1992 with the introduction of the new Insurance Supervision and Control Act (amended in 2001).[1053] This Act activated Article 487 of the Civil Transactions Act of 1984, which states that, "all civil transactions should be carried out according to Shariah principles."

Syarikat Takaful Malaysia (Takaful Malaysia) was the first to obtain licensure in 1985 under the Takaful Act. While MNI Takaful, licensed in 1993, is probably the first firm in the world that entered into the bancatakaful business via a strategic alliance with post offices to market its insurance products and to offer ancillary services to policyholders.[1054]

Luxembourg is home to two takaful insurers, including probably the first takaful insurance firm in Europe, Takaful S.A. (formerly Islamic Takaful), founded in 1982. Takaful UK (founded

[1051] TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (TheCityUK, 2015), 24, available online at:https://www.thecityuk.com/assets/2015/Reports-PDF/bd4af364ee/The-UK-Leading-Western-Centre-for-Islamic-Finance.pdf.
[1052] Bekkin (n937) 120.
[1053] Ibid.
[1054] Kwon (n832) 72.

1982) and Dar Al Maal Al Islami (1983) operate in the U.K. and Switzerland, respectively. Takaful T&T Friendly Society (1999) in Trinidad & Tobago and Takaful Islam Bahamas (1983) are two of the firms in the Caribbean.[1055] Takaful insurance is also observed in, among other places, Brunei, Egypt, Kuwait, Jordan, Pakistan, Qatar, Russia, Senegal, South Africa, Sri Lanka and Sweden.[1056]

Non-Governmental Organizations play a vital rule in the development of Takaful business.[1057] For example, Islamic Development Bank (IDB) in Jeddah plays a leading role in the Middle East in Takaful industry development. The IDB has been actively engaged in promoting the Takaful industry in both the Middle East region and the Muslim World. It aids the industry in two different procedures. The first is a financial procedure; the IDB provides financial assistance to new Takaful operators conducting business in 55-member countries of the IDB. The second is an academic procedure, which is provided through Islamic Research & Training Institute (IRTI). The IRTI plays a very significant role in encouraging the academic research in the field of Takaful and all related aspects. Another distinguished institution is the Islamic Financial Services Board (IFSB). The IFSB was officially inaugurated on 3 November 2002. IFSB issued guidelines related to the Takaful business.

Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) are another distinguished organisation in the development of the Takaful industry. The AAOIFI main role lies in the development of new standards for the Takaful industry and the encouragement to apply these standards. Furthermore, the AAOIFI continues to organise key conferences in regulatory and Shariah issues, which have now become a crucial forum for practitioners, scholars, academics and regulators to review and debate relevant topics driving the prospect of the industry.[1058]

The spread of Takaful operations spread worldwide. Saudi Arabia, Malaysia, Iran and the UAE are the largest global takaful markets. These four countries account for 90% of the global takaful market. Other smaller markets for takaful include Bahrain, Qatar, Indonesia,

[1055] Ibid.
[1056] Ibid.
[1057] Ahmad (n789) 234-235.
[1058] Ibid 236.

Bangladesh, Jordan and Kuwait. Penetration of takaful is nevertheless low in these and other countries with Muslim-majority populations.[1059]

According to Said and Grassa and also Jaffer, the potential growth for Takaful products in Muslim countries will be significantly related to the specific attributes of Takaful foundations: the ethic-based belief of solidarity, mutual help and cooperation among the members are the main characteristics of Takaful.[1060] Global insurance brands like AIG, Allianz, Axa, Prudential, Aviva and Fortis are now offering takaful products, but also international reinsurers Munich Re, Swiss Re, Hannover Re have developed suitable retakaful solutions. Major international banks such as BNP Paribas, Crédit Agricole, Société Générale, HSBC Amanah, Standard Chartered Saadiq and Barclays have become important distribution partners. For example, AIG Takaful and Allianz Takaful headquarter in Bahrain. Allianz offers takaful products along with its conventional product lines in Indonesia-an approach also used by HSBC in the U.K.[1061]

A strategic alliance between an insurer and a banking institution refers to Bancatakaful, both abiding by Islamic principle, where the latter markets the insurance products underwritten by the former.[1062] It is observed only in selected countries such as Malaysia, Oman, Saudi Arabia and the UAE. In Malaysia, for example, CIMB offers almost all lines of insurance products through its banking branches, and Bank Islam Malaysia markets selected personal insurance products.[1063]

In SAMA Insurance Market Report 2016, the Gross Written Premiums (GWP) in the Saudi insurance market reached SR 36.85 Billion, up from SR 36.49 Billion in 2015. This represents an increase of 1%, compared to a 19.7% growth rate in 2015.[1064] This report is based on the data collected from 34 insurance and reinsurance companies.[1065] More specifically, insurance

[1059] TheCityUK, 'Global Trends in Islamic Finance and the UK Market' (2017), available online at: https://www.thecityuk.com/assets/2017/Reports-PDF/6f3521f3f2/Global-trends-in-Islamic-Finance-and-the-UK-Market-FINAL.pdf25.
[1060] Said and Grassa (n959) 7; see also, Suhail Jaffer, 'Opportunities for Takaful Products' (2011) The European Financial Review, Available at: http://www.europeanfinancialreview.com/?p=2822.
[1061] Kwon (n832) 72.
[1062] Ibid 73.
[1063] Ibid.
[1064] In contrast, the insurance market witnessed a slight decline of 1 percent in gross written premiums (GWP) to SAR 36.5 billion in 2017 compared to a rise of 1 percent in 2016 (SAMA 54th Annual Report, 2018, p.73); Saudi Arabian Monetary Agency, 'The Saudi Insurance Market Report' (2016), Available at:
http://www.sama.gov.sa/enUS/Insurance/Publications/KSA%20Market%20Report_2016_English-vf.pdf 73.
[1065] A recent SAMA 54th Annual Report (2018) 75, has stated that the number of insurance and reinsurance companies approved by the Council of Ministers, up until the end of 2017, was 35. In addition, the number of those currently operating in the industry were 33 insurance and reinsurance companies, 41 insurance service providers, 97 insurance brokers, and 82 insurance agencies; Saudi Arabian Monetary Agency, the 54th Annual Report of the Saudi Arabian Monetary Authority, 2018,

companies underwrote SR 1.05 Billion in A&L[1066] and other general insurance premiums. In addition, insurance companies retained SR 525 Million of A&L and other general insurance underwritten premiums, a 50.1% retention ratio. Furthermore, A&L and other general insurance NEP totalled SR 523 Million, which represents a 1.7% contribution to total NEP. Lastly, insurance companies recorded SR 145 Million in A&L and Other general insurance's NCI, which translates into a 27.8% loss ratio.

In comparison, SAMA Insurance Market Report stated that Insurance companies retained SR 506 Million of A&L and Other general insurance underwritten premiums, a 48% retention ratio.[1067] In addition, Insurance companies underwrote SR 1 Billion in A&L and Other general insurance premiums. Moreover, A&L and Other general insurance NEP totalled SR 528Million, which represents a 1.7% contribution to total NEP. Lastly, Insurance companies recorded SR 182 Million in A&L and Other general insurances NCI, which translates into a 35% loss ratio. These statistics show that A&L represent a small percentage of the total GWP and more improvement might be seen in future once the regulatory framework in different businesses are well understood as well as mandatory provisions by regulators are introduced.[1068]

Compulsory third-party motor insurance was initiated in 2001 and other compulsory insurances have been consequently introduced for: Health insurance; Medical malpractice; Oil pollution; Professional indemnity (for insurance and reinsurance brokers, insurance agents, actuaries, loss assessors/adjusters, third party administrators and insurance advisors (Insurance and Reinsurance Service Providers)). These compulsory insurances were lately supplemented in 2013 by the Executive Regulations on the Activity of Contractors of Sea Goods Transport (Shipping Regulations) to necessitate a mandatory insurance policy covering the shipping contractor's financial liabilities stipulated in the Shipping Regulations. The exact scope of this insurance remains indistinct.[1069]

Available at: http://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Fifty%20Fourth%20Annual%20Report.pdf 73.

[1066] Accident and Liability (A&L) insurance includes the following lines of business: personal accident, work related, employer's liability, third party liability, general liability, product liability, medical liability, professional liability, theft & burglary, fidelity, safe burglary inside the premises and in transit and other liability products.

[1067] Saudi Arabian Monetary Agency, The Saudi Insurance Market Report, 2017, Available at: http://www.sama.gov.sa/enUS/Insurance/Publications/The%20Insurance%20Market%20Report%202017.pdf 27.

[1068] For example, in 2017, SAMA has issued an instruction to insurers working in Saudi Arabia to prohibit the issuance or reissuance of a policy to any commercial store unless it has security cameras installed, 71. See the 54th Annual Report of the Saudi Arabian Monetary Authority, 2018, Available at: http://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Fifty%20Fourth%20Annual%20Report.pdf.

[1069] The Commercial Maritime Law was enacted recently pursuant to Royal Decree no. M/33 dated 5 Rabi' II 1440H (corresponding to 12 December 2018G) and published in the Official Gazette on Friday, 4th January 2019 (the Law). The Law

Besides, from 2014 third party insurance for all government vehicles, and third-party liability insurance for all factories handling harmful materials in residential areas has been made compulsory. Moreover, the Ministry of Interior has recently imposed compulsory third-party liability insurance for premises that are residential, industrial, or populated. SAMA is yet to release the requirements for that insurance.[1070]

In 2017, SAMA issued a number of circulars and instructions, including some of the following: Requiring insurers to settle claims based on absolute judicial judgments in traffic cases; Requiring insurers to carry out implementable judicial judgments against the insured and Requiring insurers to amend medical malpractice insurance policies to include disputed medical services arising from medical care provided to war casualties if the physician works under normal circumstances.[1071]

The Saudi Cabinet (Council of Ministers) in its session dated June 5, 2018 has taken a decision to mandate contractors to insure their work in relation to non-governmental project. The minister of municipality will decide which kind of buildings are targeted, the geographical areas and the time of guarantee. Further, this step is important for real estate's buyers who may find hidden defects at later stage whether they are considered as structural or other covered defects.[1072]

This step may decrease legal cases that may arise before courts. It might be connected to the discussion of this thesis to assess how regulations interact with the insurance business as in this case with the Saudi Code of Buildings 2018 (and its Implementing Regulations), and in the remit of this thesis Companies, Capital Market and Accountant acts for auditor civil liability towards shareholders.

The Saudi government has also adopted recently the Financial Sector Development Program, which is one of the 12 executive programs launched by the Council of Economic and

covers insurance of (i) ships, (ii) rent. (iii) transported goods, and (iv) against liability, in terms of: when is it mandatory, such as in oil transportation; the insurance contracts; damages and liabilities; and insurance payments and settlements.

[1070]Clyde and Co, 'Insurance and reinsurance in Saudi Arabia: Overview' (2015) Available at: http://www.clydeco.com/uploads/Files/CC007080_PLG_KSA_Brochure_ME_V4_11-03-15.pdf.

[1071] Saudi Arabian Monetary Agency, 'The 54th Annual Report of the Saudi Arabian Monetary Authority' (2018) Available at: http://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Fifty%20Fourth%20Annual%20Report.pdf

[1072] On March 31, 2020 the Saudi Arabian Monetary Authority has issued the Standard Policy of Inherent Defects Insurance (IDI), available at: http://www.sama.gov.sa/ar-sa/Laws/InsuranceRulesAndRegulations/The_Standard_Policy_of_Inherent_Defects_Insurance.pdf.

Development Affairs (CEDA) to achieve the objectives for Vision 2030. The program seeks to develop the financial sector as a diversified and effective financial services sector to support the development of the national economy by stimulating savings, finance and investment.[1073] More importantly to this thesis, there are initiatives to support the insurance business in its delivery plan. For instance, in order to enable financial institutions to support private sector growth metrics, the government is willing to enforce health insurance for small and medium sized companies in addition to assume mandatory motor insurance coverage for all vehicles in Saudi Arabia to limit fraudulent practices and further develop existing insurance sector (e.g. additional GWP, increased scale, lower cost to income ratio) through tighter supervision by SAMA.

Another initiative is related to accelerating the launch of mortgages refinancing products. This initiative needs to introduce mortgage guarantee products currently not available in the market to provide access to mortgage financing especially for mid to low income earners. It also needs to adjust existing insurance regulations to link with mortgage law with a rational to increase protection level of individuals acquiring property and lenders with property as collateral. The third initiative is concerned with facilitating insurance market merger and acquisition to increase scale and solvency by enhancing existing rules and regulations around the M&A to facilitate consolidation in the insurance sector (by clarifying/easing process of winding up companies, resulting in better capitalised insurers with capacity and capability to better serve market needs). Lastly, the government is willing to enhance existing insurance laws and regulations through overhauling existing regulations and revisiting the allocation of responsibilities across regulators to reduce existing overlaps in mandates to make them in line with global standards.

On November 5th 2018, SAMA issued a clarification note in regards to amending some articles on implementing regulations of the Law on Supervision of Cooperative Insurance Companies 2003, which were issued by the Ministerial Decision No. 1/596 on 20/04/2004.[1074] This note was for public comment till January 2nd 2019 and it took into consideration other countries'

[1073] Financial Sector Development Program Charter – Delivery Plan 2020, available online at: http://vision2030.gov.sa/en/FSDP. Accessed August 1, 2019.

[1074] SAMA Clarification Note in regard of Amending Some Articles on the Implementing Regulations of the Law on Supervision of Cooperative Insurance Companies 2003, available at: http://www.sama.gov.sa/ar-sa/Laws/InsuranceRulesAndRegulations/المذكرة%20التوضيحية%20لتعديل%20%20بعض%20مواد%20اللائحة%20التنفيذية%20لنظام%20مراقبة%20شركات%20التأمين%20التعاوني.pdf.

experiences such as England, United States, Singapore, Malaysia, Indonesia, United Arab of Emirates, Jordan, Hong Kong, Turkey, India and Canada either as pioneers in insurance industry worldwide, or the extent of similarity of their sizes in the insurance industry with Saudi Arabia, or for cultural and societal purposes, or for being members within the G20. Furthermore, it has been referred in this note to the general principles issued from the International Association of Insurance Supervisors "IAIS" that provide general standards that enable supervisory authorities to recall as guidelines.

The proposed revision of the said implementing regulation comes to execute the initiative number 14 at the Financial Sector Development Program, which is one of the programs initiated by the Saudi government for Vision 2030. Considerable changes are planned to be made to improve the insurance industry to be compatible with best practises worldwide as well as the Takaful business nature. In relation to this thesis, three articles are addressed in brief. First, the revised article 2-1 indicates that one of the main goals of the law and the implementing regulations is to protect the insured persons and beneficiaries who benefited from the insurance coverage, while the old text referred to the insured persons and investors. This thesis agrees with SAMA's reasoning that investors are protected by the CMA, and the conflict of work and jurisdictions have caused issues to the SAMA's main rules.

The second amendment would be on article (70-2/e) which states "10% of the net surplus shall be distributed to the policy-holders directly, or in the form of reduction in premiums for the following year. The remaining 90% of the net surplus shall be transferred to the shareholders' income statement". This suggested text by SAMA is to distribute 10% of the net surplus to the policy-holders directly, and the general assembly of the insurance company will agree on the remaining net surplus ratio after getting a no-objection letter from SAMA. According to SAMA, this proposed amendment would comply with the right application of Tawuni "or Takaful" insurance. This research is in the opinion that this step is not enough to make the Law on Supervision of Cooperative Insurance Companies 2003 in full compliance with Shariah, as other legal provisions are not going to be changed. This point has already been addressed by Alshamrani and Alhumoudi in section 5.6, and the researcher agrees with their conclusions, and provides additional analyses on relevant laws that complement the right application of Takaful.

This brief discussion about the existing and future steps taken by the Saudi regulator to enhance the Takaful industry is to some extent vital to our analysis despite the fact these initiatives are not related explicitly to auditor liability insurance. However, it shows that there are still some issues in interpreting related articles in other supporting laws that impact the insurance industry. For instance, there is clarity in imposing civil liability to an auditor in case there is negligence from a party and then being able to indemnify the damaged persons/company, however, the application of the rules needs to be interpreted from a practical point of views.

Another important challenge in Takaful operation in Saudi is the establishment of SAMA Appeal Committees which assumed jurisdiction for all appeals from the first instance Committee decisions (which previously would have been heard by the Board of Grievances). According to Beswetherick and Alsaab, the new regulations for SAMA first and appeal committees is Article 9 of the New Regulations which stipulates that as well as applying the procedures and referring to customary practices of the courts, the Committees are also able to take into consideration recognised "comparative jurisprudence" with reference to the resolution of insurance claims.[1075] This is the first time that Saudi law has allowed judges to take into consideration international decisions and practice in any sector. As they understand it, in practice, this means that the Committees can look to the jurisprudence (i.e., a body of law and considered decisions) from other jurisdictions where, say, the guidance provided under Saudi law does not address the particular issues to be decided.[1076]

This is an interesting development that paves the way for parties to debate points of comparable insurance law from, say the English legal system, where there are inclusive law and precedent dating back several hundred years on a broad range of insurance law issues.[1077] That will, definitely, always be subject to the arguments, principles and decisions relied upon being consistent with Shariah principles and the requirements for cooperative insurance in Saudi Arabia.[1078] Nonetheless, this opens the door for the parties to look to other jurisdictions for guidance and best practice principles where Saudi law does not deal with the point and to argue

[1075] Mark Beswetherick and Saud Alsaab, 'The New SAMA Insurance Dispute Committee Rules in the Kingdom of Saudi Arabia' (2014) Available at: http://www.clydeco.com/insight/updates/view/the-new-sama-insurance-dispute-committee-rules-in-the-kingdom-of-saudi-arab at p. 3-4.
[1076] Ibid 3.
[1077] Ibid 4.
[1078] Beswetherick and Alsaab (n1075) 4.

that the Committees should embrace similar international principles and best practice in determining any dispute before it.[1079]

Ernst & Young think that both general and family takaful operators continue to broaden their distribution coverage and product offerings and therefore expect positive growth in the dynamic and resilient market.[1080] In particular, the Saudi Arabia, GCC and ASEAN markets are likely to maintain their current growth path in the next five years, but their growth quantum is highly subject to their economic growth. The Turkish Government's intention to triple the share of Islamic banking assets in the country by 2023 with the help of state-owned participation banks and incoming players will help support the gradual growth of Turkey's takaful industry.[1081]

The UK has set the stage to play a more active role within the global takaful market with the launch of the Islamic Insurance Association of London (IIAL) in 2015. Lloyd's, the Chartered Insurance Institute, the London Market Group, the London International Insurance Brokers' Association and TheCityUK have become associate members of IIAL. IIAL has been launched to support the work of those in the UK re/insurance markets that are transacting Islamic finance. As one of the largest insurance markets in the world and the leading global centre for wholesale insurance and reinsurance, the UK has the potential to support the growth of takaful business in the coming years.[1082]

[1079] Ibid.

[1080] Ernst & Young, 'Global Takaful Insights' (2014), available at: http://www.ey.com/Publication/vwLUAssets/EY_Global_Takaful_Insights_2014/$FILE/EY-global-takaful-insights-2014.pdf, 13.

[1081] According to the ThecityUK, 'Global Trends in Islamic Finance and the UK Market' (2017), available online at: https://www.thecityuk.com/assets/2017/Reports-PDF/6f3521f3f2/Global-trends-in-Islamic-Finance-and-the-UK-Market-FINAL.pdf at p.26, the global takaful market remains at an early stage of development with gross contributions estimated by EY to have reached around $19bn in 2016. The growth momentum in the Islamic banking and sukuk markets has lent support to the development of the takaful sector. The global takaful industry recorded double-digit growth in recent years, with premiums averaging 14% per year growth between 2012 and 2014. However, large segments of the insurance market in key Islamic finance jurisdictions remain untapped and mainly dominated by conventional insurance providers.

The growth in demand for Islamic insurance over recent years has seen a proliferation of new companies offering Islamic insurance products. The majority of these firms are fully-fledged takaful operators, but conventional insurance companies have also entered the market offering takaful window operations. As with traditional forms of insurance, re-insurance of a takaful operation may be used, known as re-takaful. Takaful assets under management totalled around $38bn at the end of 2015; ThecityUK (n1059) 26 ; see also, Ernst & Young (n1080) 13.

[1082] With the launch of the Islamic Insurance Association of London (IIAL) in 2015, the UK set the stage to play a more active role within the global takaful market. ING, Cobalt Underwriting, DAC Beachcroft, Clyde & Co, NDI Takaful & Retakaful, and Norton Rose Fulbright are members of IIAL, while Lloyd's of London, the International Underwriting Association of London and BSA Ahmad Bin Hezeem & Associates are IIAL partners. IIAL was launched to support the work of those in the UK insurance/reinsurance markets that are transacting Islamic finance. As one of the largest insurance markets in the world, and the leading global centre for wholesale insurance and reinsurance, the UK has the potential to support the growth of takaful business in the coming years. London is the pre-eminent home of speciality underwriting capacity and expertise. It also has a reputation and history for innovation, both in product design and approach. The UK takaful sector has been gathering pace recently; after receiving in-principle approval in 2016, Cobalt Insurance and Capita Managing Agency are in the process of

Among the GCC countries, competition, operational issues and the lack of qualified talents continue to pose a challenge.[1083] Profitability of takaful companies has been threatened not just by identical strategies but also by the lack of uniform regulations that will permit them to operate across different models.[1084] The main challenge with the Saudi Arabian market is the lack of scale, lack of access to capital and lack of profitability, especially in auto-related lines and other areas where, because of significant competition, companies do not show pricing discipline.[1085] With robust competition from conventional incumbents, takaful operators are likely to endure their struggle in the medium term, though some will look at alternative customer segments and search for merger options.[1086]

5.8 Conclusion:

This chapter sheds light on the Takaful sector, its various meanings, manifestations and historical development as well as some of the legal issues and challenges that it faces, particularly in both Malaysian and Saudi contexts. The next chapter explores the literature, practices, precedents and official and non-official reports of related conventional professional insurance liability products as well as discusses the impact of changing the liability system from joint to proportionate on auditors and the potential impact this has on their ability to be insured.

launching Cobalt Syndicate 1438, Lloyd's of London's first fully Shariah compliant syndicate. Prior to this, Willis, in conjunction with Cobalt Underwriting, launched the UK's first Shariah compliant commercial real estate insurance solution. Lloyd's of London opened an office in Dubai in 2015; see ThecityUK (n1059) 16.

[1083] TheCityUK (n1059) 13.

[1084] TheCityUK (n1059) 13.

[1085] Ibid.

[1086] Ernst & Young (n1080) 13.

Chapter 6: Auditor Liability in Light of Conventional Insurance Practices

6.1 Introduction

This chapter addresses several issues surrounding the auditing industry from conventional insurance perspectives. In section two the position of common law courts and their assumptions about auditors' capacity to be indemnified by professional liability insurance ("PLI") is discussed. Section three highlights, however, the issue of the unavailability of professional liability insurance for auditors because of the excessiveness of out of court settlements and lawsuits from third parties. Section four extends the discussion found in several reports in relation to the optimal legal system of auditor liability and examines whether it could assist auditors to be able to obtain PLI. Section five identifies the general insurance-based arguments as well as the cyclicality of the insurance market in regard to auditor liability insurance. Section six goes further to explain the influence of joint and several liability systems in comparison to proportional liability systems and their connection with the availability of insurance. Section seven discusses some of the literature on audit failure and the PLI position; and finally, the chapter concludes the discussion with a consideration of innovative insurance products that are still under study and not well supported in practise yet.

6.2 Obtaining Professional Liability Insurance in the Eyes of Common Law Courts and their Assumption of Insurance Hypothesis

The aim of this section is to show how common law courts have assumed the availability of professional liability insurance for auditors to develop theories of liability or to be one of the important criterions in assessing the extent of liability.

In *Rosenblum, Inc. v. Adler*,[1087] the court radically altered accountants' negligence liability by extending the accountant's duty of care to reasonably foreseeable third parties under certain conditions.[1088] Moreover, while noting that accountants have been able to adequately protect

[1087] *Rosenblum, Inc. v. Adler* 93 N.J. 324, 461 A.2d 138 (1983). More discussion about the case can be found in Chapter Three.
[1088] Hagen (n236), 189.

themselves from civil liability under the federal securities laws through malpractice insurance, the court in *Rosenblum* believed that accountants could similarly insure themselves against awards to reasonably foreseeable third parties due to negligence.[1089]

Under Section 11 of the Securities Act of 1933, a plaintiff need not prove scienter or negligence; rather, the burden of proof rests on the accountants to show "due diligence".[1090] Section 18 of the Securities Exchange Act of 1934 allows accountants to avoid civil liability if they act in good faith and have no knowledge that the financial statements are misleading.[1091] Neither of these statutes requires privity and, thus, accountants are exposed to substantial liability to third parties.[1092] As accounting firms have been able to obtain liability insurance covering these risks, the *Rosenblum* court reasoned that accounting firms could be able to purchase malpractice insurance covering common law negligence liability to foreseeable third parties.[1093] Accordingly, the *Rosenblum* court held that an accountant's duty of care for ordinary negligence extends to foreseeable users of audited financial statements, which were received, from a company pursuant to a proper business purpose.[1094]

According to Faussie, the courts originally applied the foreseeability standard and the Restatement standard (*Rusch Factors, Inc. v. Levin*)[1095] to provide an incentive for the auditor to tighten and improve auditing controls and procedures and to assert more care when undertaking an audit.[1096] However, time has shown that these doctrines have not served their purpose and harming the auditing profession, the very group the doctrines are intended to regulate.[1097] Courts, however, continue to justify extending auditors' liability on the premise that public accounting firms can best bear the loss.[1098] Many courts view auditors to be in the

[1089] Hagen, (n226) 190.
[1090] Cf. 15 U.S.C. §§ 77k, 771, 77o. See generally *Herman & MacLean v. Huddleston* 459 U.S. 375 (1983). The "due diligence" defense allows an accountant to avoid liability by showing a belief, after reasonable investigation, that when the registration statement became effective, the assertions therein were true.
[1091] 15 U.S.C. § 78r (a) (1982). The apparent effect of relieving an accountant of liability if he acted in good faith and without knowledge of a false or misleading statement is to make gross negligence the test of liability under Section 18 of the Securities Exchange Act of 1934.
[1092] See, e.g., *Escott v. BarChris Constr. Corp.* 283 F. Supp. 643 (S.D.N.Y. 1968) (liability of accountant under Section 11 of the Securities Act of 1933); *Fischer v. Kletz* 266 F. Supp. 180 (S.D.N.Y. 1967) (liability of accountant under Section 18 of the Securities Exchange Act of 1934); see also, Hagen (n236) 190.
[1093] Hagen, (n236) 190.
[1094] Ibid.
[1095] *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.C.R.I. 1968), More discussion about the case can be found in Chapter Three.
[1096] Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation* (1983) 20 San Diago L. Rev 233 at 256; see also, Faussie (n225) 1073.
[1097] Faussie (n225) 1073.
[1098] Ibid.

best position to spread the costs of imposed liability by purchasing insurance or increasing service rates.[1099] Unfortunately, the insurance industry is not in sync with the courts, and auditors have encountered increased difficulty in obtaining liability insurance.[1100] If auditors are fortunate enough to obtain insurance, many times the coverage is less than anticipated and the premium rates are astronomical.[1101] It is submitted, however, that liability insurance costs and limited availability of insurance coverage are two reasons behind the necessity for limiting third-party liability to accountants.[1102]

In another U.S case, *Fullmer v. Wohlfeiler & Beck*,[1103] investors in Giftmakers, a failed business, sued the company's auditors in negligence to recover their lost investment. The court found negligence on the part of the auditor and, based upon *National Surety*,[1104] refused to consider a comparative negligence defence.[1105] The rejected defence was predicated upon evidence that plaintiffs (who were not merely passive investors but had become members of the company's board of directors and in one case chairman of the board) had been contributorily negligent by handling their own transactions with Giftmakers carelessly, by obtaining no security for the loans to Giftmakers, and by paying more than book value for shares of stock.[1106] Thus, the court seemed to hold that once an investor has obtained audited financial statements from a company, he may carelessly invest in that company, and may even take control of the company and operate it foolishly - all without consequence, because the auditor's liability insurance will serve as a safety net.[1107]

Finally, in 1997, the High Court of Australia in *Esanda Finance Corp. Ltd v. Peat Marwick Hungerfords*[1108] outlined numerous policy factors to be weighed in judging whether an auditor

[1099] Ibid.
[1100] Ibid 1074.
[1101] Ibid.
[1102] See section 6.3 and subsection 7.5.2.1 for further discussion.
[1103] *Fullmer v. Wohlfeiler & Beck* 905 F.2d 1394 (10th Cir. 1990).
[1104] *National Surety Corporation v. Lybrand, 256 A.D. 226, 9 N YS.2d 554 (1st Dept. 1939)*.
[1105] *Fullmer v. Wohlfeiler & Beck* 905 F.2d 1394 (10th Cir. 1990).; see also, R A Prentice, 'Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?' (1995) 13(2) Wisconsin International Law Journal 359 at 415.
[1106] R A Prentice, 'Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?' (1995) 13(2) Wisconsin International Law Journal 359, 415-416.
[1107] Ibid 416; It has been pointed out that this result "creates the same reverse all-or-nothing distortion" as the traditional all-or-nothing contributory negligence rule by allowing a careless investor to foist her entire loss onto the accountant. For further discussion, see Dennis Dahle, 'Note, Comparative Negligence in Suits Against Accountants: A Statutory and Policy Analysis' (1991) 5 B.Y.U.J. PUB. L. 155 at 173.
[1108] *Esanda Finance Corp. Ltd. v. Peat Marwick Hungerfords* (1997) 71 ALJR 448. More discussion about the case can be found in Chapter Four.

owes a duty to a third party. One of them is the effect on the accountant's ability to obtain liability insurance.[1109]

Insurance applies when auditors are involved in litigation. It suggests that audit services provide investors with a form of protection in the event of an audit failure.[1110] In other words, the legal system allows the investors to recover their investment losses from the auditor if the audited financial statements contain a misrepresentation or a low-quality audit.[1111] The probability of recovering such claims increases if the auditors are among the larger audit firms or those known as "deeper pockets".[1112]

Wallace provides four explanations of why managers choose auditors as insurance in preference to insurance companies.[1113] Firstly, society assumes that managers who fail to guarantee that they are fully independent of their actions, without the auditors' attestation, are committing fraud or are involved in negligence.[1114] Secondly, the improvement in accounting and auditing firms that employ legal staff, legal services and in-house counsels, suggests that they are more efficient compared with insurance companies.[1115] Thirdly, the insurance companies use the cost-benefit approach when deciding whether to enter a legal defence or to decide on an out of court settlement. However, both the auditors and the firms that are involved in litigation will consider the effect on their reputation and thus, with a similar common interest, they will ensure that they protect their reputations.[1116] Fourthly, if investors suffer from losses because of an audited financial statement, the courts are likely to hold the auditors responsible

[1109] Pacini et al. (n330) 400; According to Pacini, these factors include:
- Liability insurance - the effect on the accountant's ability to obtain liability insurance.
- Supply of services - the likely reduction in the supply of accounting services.
- Standard of care - the likelihood of a reduction in the level of accountants' due professional care because of cost-cutting measures implemented to keep audit fees competitive.
- Legal system - the potential adverse effects on the administration of justice due to lengthy court hearings clogging the court system if a duty to a large number of third-party users is recognized.
- Investors and creditors - the realization that many plaintiffs are sophisticated and have other means of avoiding risks.
- Cause of loss - the understanding that the auditor's role in the third party's loss is secondary to that of the client's.
- Role of audit report - a recognition that the third party is likely influenced by a myriad of factors other than the audit report.
- Unlimited guarantee - an understanding that the imposition of a duty of care would amount to the creation of an unlimited guarantee in favour of non-clients from whom auditors receive no payment.

[1110] Wanda Wallace, *The Economic Role of the Audit in Free and Regulated Markets* (Touche Ross: New York, 1980) 21-22; see also, Krishnagopal Menon and Joanne Williams, 'The use of Audit Committees for Monitoring' (1994) 13(2) Journal of Accounting and Public Policy 121-139; see also J Stice, 'Using financial and market information to identify pre-engagement factors associated with lawsuits against auditors' (1991) 66 The Accounting Review 516-533, 518.

[1111] Rohaida Basiruddin, 'The Relationship Between Governance Practices, Audit Quality and Earnings Management: UK Evidence' (Doctoral thesis, Durham University 2011) 41.

[1112] Kenneth Schwartz and Krishnaopal Menon, 'Auditor Switches by Failing Firms' (1985) 60(2) The Accounting Review 248-261 at 251.

[1113] Wallace Wonda, *The Economic Role of the Audit in Free and Regulated Markets* (Touche Ross: New York 1980) 21-22.

[1114] Ibid 21.

[1115] Wallace (n1113) 21.

[1116] Ibid 21-22.

and to require them to bear the losses.[1117] An auditor's contributions to an investor's losses are viewed by the court as "socializing risk". As stated in Wallace "… because he is held responsible for business failures, the auditor in turn shifts this cost to clients through higher fees and then to society through higher prices and lower returns on investment."[1118]

Several studies have empirically tested the insurance hypothesis. For instance, Menon and Williams referred to the case study of Laventhol and Horwath (L&H) where they examined the effect of L&H clients' stock price (1) when L&H filed their bankruptcy and (2) on the announcement of a replacement auditor.[1119] They hypothesised that when L&H filed for bankruptcy, they came to the end of the operation and their investors no longer had access to recover their investment losses. Thus, their clients' stock prices were expected to decline. When the clients of L&H reappointed a new auditor, they assumed that the investment losses from L&H were not transferable to the new auditor, since investors can only claim from them if they have used the audited financial statement (prepared by the new auditor) for their investment decision.[1120] Their findings are consistent with the insurance hypothesis.[1121] The price reaction on both events supports the argument for the absence of the expected insurance coverage, thus, the disclosure of the L&H bankruptcy had negative impact on their stock prices and the announcement of a replacement new auditor did not provide any significant reaction.[1122]

In addition to this, Baber et al. suggest that such price reactions were also driven by the monitoring function of L&H in which the insurance and monitoring hypotheses were difficult to differentiate.[1123] They suggest that financially distressed auditors were more likely to perform low quality audits because they were more concerned with their current position than with their competence and independent judgement.[1124] For example, in order to retain their clients and minimise their audit cost, financially distressed auditors are less likely to report an error or a misstatement that they discover during the auditing work or they may reduce audit

[1117] Ibid 21.
[1118] Ibid.
[1119] Krishnaopal Menon and Joanne Williams, 'The Use of Audit Committees for Monitoring' (1994) 13(2) Journal of Accounting and Public Policy 121-139.
[1120] Ibid.
[1121] Basiruddin (n1111) 42.
[1122] Ibid.
[1123] William Baber, Krishna Kumar and Thomas Verghese, 'Client Security Price Reactions to the Laventhol and Horwath Bankruptcy' (1995) 33(2) Journal of Accounting Research 385-395.
[1124] Ibid 385.

testing in order to cut down the audit cost.[1125] They argue that if the investors were aware and if they perceived that L&H was incompetent and independent, then such a perception may have forced the stock prices to decline.[1126] However, Lai and Gul provide contradictory evidence to Baber et al.[1127] Using the likelihood of issuing modified audit opinion, the provision of discretionary accruals and the predictability of discretionary accruals for future earnings as proxies for audit quality, they suggested that the audit quality of L&H was not substandard.[1128]

6.3 The Impact of Lawsuits and Out of Court Settlements and the Lack of Unavailability of Professional Liability Insurance on Auditors

Faussie indicated that liability insurance costs and limited availability of insurance coverage are two reasons that demonstrate the necessity for limiting third-party liability to accountants.[1129] According to AUS Consultants, CPAs' liability insurance costs have continued to increase dramatically each year that tort reform in this area has been ignored.[1130] Hence, since the end of the twentieth century insurance premiums and deductibles have increased, and coverage has decreased.[1131]

Many policies cover on a "claims made" or a "discovery" basis as opposed to the occurrence coverage that was used in the past.[1132] This coverage only extends to claims reported within policy effective dates, and occurrence dates are not considered.[1133] Such a change in coverage

[1125] Ibid 387.
[1126] Ibid.
[1127] Kam-Wah Lai and Ferdinand Gul, 'Was Audit Quality of Laventhol and Horwath Poor?' (2008) 27(3) Journal of Accounting and Public Policy 217-237; see also, Baber (n1123).
[1128] Lai and Gul (n1127) 218-220, 236.
[1129] James Thompson and Laurie Henry, 'Professional Liability Insurance: Go Bare or Not?' (1991) 172(1), Journal of Accountancy 111. In response to the number of claims insurance companies now have to pay out to cover expanding accountants' liability, some insurers are either increasing insurance premiums or leaving the market. Under many circumstances, insurance may not be available for CPA firms, even at a high premium rate; see Werner Ebke, 'In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities' (1984) 79(4) Northwestern University Law Review 663 at 690-91; see also, Faussie (n225) 1083.
[1130] AUS Consultants, 'The Economic Effects of Scapegoat Litigation' (1992) The American Tort Reform Association, 7; For more discussion about the common-law courts' positions in different times see Chapters Three and Four.
[1131] Thompson and Henry (n1129); see also, Ebke (n1129).
[1132] Ibid 112.
[1133] Ibid 111; A "prior acts" exclusion clause that denies coverage for any work performed before the policy's effective date usually restricts the policy's scope. If a firm's policy is cancelled or the firm does not renew the policy, a gap in coverage can result. To assure a firm has insurance during the gap periods, most insurance companies offer tail policies that cover prior acts for earlier unreported claims. Two layers of liability insurance, primary and excess are available to accountants. Primary layers consist of a basis policy that states the risks, people covered, and the policy limits and period. "Additional coverage or endorsements for special risks or events may be purchased at additional cost." Ibid 112. Firms, depending on their size, can purchase several primary layer amounts of insurance. Excess layers can extend a firm's coverage if a firm's litigation risks exceed the primary layers.

severely limits the audit firm's ability to insure against prior acts that have not yet been reported.[1134]

One survey indicated that 96% of the surveyed firms with fifty or more accountants reported a 300% increase in liability insurance premiums since 1985.[1135] The survey also indicated that smaller firms must now carry larger amounts of liability insurance coverage.[1136] The high deductibles for the insurance have caused many smaller firms to forego extra insurance coverage, which results in the small accounting firms paying many of the medium-sized court awards themselves.[1137] The median deductible amount for smaller and medium-sized public accounting firms was $240,000, an amount that was nearly six times the 1985 median amount of $42,000. Larger accounting firms are hit even harder, with deductibles exceeding $25 million for the first loss.[1138]

These increases in liability insurance costs and expanded liability problems have caused CPA firms to dramatically raise service costs that are passed on to the client and then to the consumer.[1139] The courts originally assumed that accountants were an effective catalyst that would be able to effectively spread the cost of liability.[1140] However, imposing expanded liability on accountants results in a number of clients being unable to afford the higher service costs has negative effects on business growth.[1141]

In addition to the market effects, expanding liability has caused CPA's to engage in an alarming number of out-of-court settlements. Out-of-court settlements are no longer an option for many accounting firms, but are a necessity. The costs of litigation and the high risk for loss at trial

[1134] Ibid 111.
[1135] Arthur Andersen and others 'The Liability Crisis in the United States: Impact on the Accounting Profession' (1992) A Statement of Position 2 at 3; see also, Faussie (n225) 1085-1086.
[1136] Ibid.
[1137] Ibid.
[1138] Ibid.
[1139] AUS Consultants (n1130) 9.
[1140] For courts supporting the view that accountants can spread the cost of liability through purchasing insurance, see *International Mortgage Co. v. John P. Butler Accountancy Corp.* 223 Cal. Rptr. 218 (Cal. App. 4 Dist. 1986), overruled by *Bily v. Arthur Young& Co.* 834 P.2d 745 (Cal. 1992); *Rosenblum v. Adle*r 461 A.2d 138 (N.J. 1983); *Rusch Factors, Inc. v. Levin* 284 F. Supp. 85 (D.C.R.I. 1968). According to Faussie (n225), courts have premised their notion that the accountant maintains the superior position to bear the risk of liability on the following three factors: 1) the accounting profession can best spread the risk, 2) insurance is available to accountants, 3) expanded liability has not had an adverse effect on the accounting profession. Insurance is readily available to third parties, if not more than to accountants. The further advantage of shifting the risk to the third parties is the third parties have assumed the risk. Many of the third parties are institutional creditors and investors who have willingly accepted the risks in anticipation of gain; therefore, they should accept the losses as well.
[1141] AUS Consultants (n1130) 18.

have left settlement the only alternative for accounting firms.[1142] Many accounting firms would rather settle out of court than risk losing even more at trial.[1143]

The early 1990s have evidenced members of the Big Six accounting firms paying huge settlement fees to avoid litigation.[1144] In June 1991, Coopers & Lybrand was sued for failing to detect a client's shaky financial condition.[1145] As a result, Coopers agreed to pay the FDIC a total sum of $20 million over a three-year period.[1146] In another 1991 case, Ernst & Young settled a case involving Resolution Trust Corporation for $40 million.[1147] The year 1993 also saw several major out-of-court settlements.[1148] One major settlement involved the Lincoln Savings & Loan scandal, which produced an onslaught of suits against members of the Big Six.[1149] At that time, Deloitte and Touche has paid $7.5 million, Arthur Andersen has paid $22 million, and Ernst & Young has paid the record sum of $400 million in settlements involving the Lincoln scandal.[1150]

There was a two-thirds increase in lawsuits against smaller firms between 1987 and 1991 making it nearly impossible for the Big Six firms to find insurance which had caused approximately forty percent of smaller firms to go without insurance altogether.[1151] Interestingly, but not surprisingly given our interconnected world, the "litigation crisis" for accountants has become global.[1152] The liability increase seems greatest in nations with legal

[1142] According to Graham Ward, 'Auditors' Liability in the UK: The Case for Reform' (1999) 10(3) Critical Perspectives on Accounting 387-394 at 389, many of lawsuits are entirely without merit, but often settled out of court for the following reasons: it may be cheaper to settle than to defend a case and risk not recovering costs; defending cases invariably uses up large amounts of management and professional time; and there remains the risk of an unfavourable judgement as there is considerable uncertainty with regard to case law. See also, Faussie (n225) 1087.
[1143] See for example: *Standard Chartered PLC v. Price Waterhouse* No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992); *U.S. Nat'l Bank v. Miniscribe Corp.* No. 89-CV-103 1-A (Tex. Dist. Ct., Galveston Co. 1992).
[1144] Andersen (n1135) 2; see also, Faussie (n225) 1088.
[1145] S Woolley and Z Schiller, 'These White Shoes are Splattered With Mud' (1992) 7 Bus. WK. at 32.
[1146] Ibid.
[1147] For a discussion about out-of-court settlements, see Rick Telberg, E&Y Wins a Round in Lincoln S&L Failure, ACCT. TODAY, July 22, 1991, at 2; see also, Faussie (n225) 1088.
[1148] Faussie (n225) 1088.
[1149] Ibid.
[1150] Ibid.
[1151] R A Prentice, 'Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?' (1995) 13(2) Wisconsin International Law Journal 359,360-361.
[1152] Ibid 361.

systems very similar to that of the United States - such as the United Kingdom,[1153] Canada,[1154] Australia,[1155] and New Zealand.[1156] A discussion about these countries are crucial due to their connection with investigated common-law countries, which have similar auditor liability and insurance issues.

Pacini and others believe that the decades of the 1970s and 1980s may well be labelled the "dark ages" of auditor liability. As most accountants know, the accounting profession has confronted a litigation crisis for the past 25 years.[1157] For example, in the UK, the Big six accounting firms at that time faced more than 625 remaining legal cases claiming damages of 20 billion pounds by mid-1994.[1158] In 1999, PricewaterhouseCoopers paid 68 million pounds to settle litigation relating to work done for the empire of Robert Maxwell. UK accountants are concerned that they could be heading towards an environment as litigious as the US.[1159]

[1153] In the UK, only three professional indemnity claims were reported by the Big Six firms in 1982-83. By 1992-93, this number had grown to 210, with more than 600 remaining open at the end of 1993. Michael Beckett, 'Auditors Heed the Writs on the Wall', *The Daily Telegraph* (May 14, 1994) at 2; Roger Trapp, 'Soaring Legal Claims 'Could Bring Down Auditing Firms'; Report Says Accountants Need Restricted Liability Lifeline' *The Independent* (Feb. 25, 1994) at 33. By mid-1994, the Big Six accounting firms in the UK faced 627 outstanding legal cases claiming damages of £20 billion. Michael Beckett, 'Accountants Debate Move to Limited Liability' *The Daily Telegraph* (June 28, 1994) at 25. These firms in Great Britain pay around eight percent of their audit income to cover legal costs. Andrew Jack, 'Rise in Legal Claims Hits Top Accountancy Firms: Auditors Say They Are Turning Away High-Risk Clients' *Financial Times* (Feb. 21, 1994) at 18. Due to the inability to obtain adequate insurance against rapidly rising claims, there is currently a real fear that one or more of these Big Six firms will fall, throwing up to 8,000 employees out of work. Charles Raw, 'Risky at the Bottom Line' *The Independent* (May 22, 1994) 9. Price Waterhouse UK's senior partner was quoted as saying: "If we could produce a dead body we could convince people that there was a problem. But we would prefer to sort it out at the stage when people are not feeling too well." Robert Brue, 'Justice for All, and All for Justice' *The Times* (Mar. 10 ,1994).

[1154] The American notion of suing accountants when other defendants are insolvent has clearly been exported north of the border. Scott Haggett, 'Fears Raised Over Liability Issue: Trend is to sue the Accountant when Firm Goes Under', Financial Post (June 25, 1993) 17. By 1990, Canadian accountants faced over 100 lawsuits, a substantial increase in a short period of time. 'Auditors Must Deal with an Increasing Number of Lawsuits Charging Negligence' Financial Post (Mar. 20, 1990) 18. At the same time, there has been a "near-collapse of the liability insurance market also mak[ing] it more difficult for auditors to protect themselves." Gundi Jeffrey, 'Auditors Aim to Shake Off Liability Chill' Financial Post (May 27, 1994) 8. By mid-1994, at least $1.32 billion of unresolved claims were pending against Canadian accountants, causing the executive director of the Ontario Institute of Chartered Accountants to state: "There is no question legal liability has become the single most important issue facing our members in public practice today." Gundi Jeffrey, 'Accountants Want Relief From Legal Nightmare' Financial Post (Apr. 29, 1994) 12.

[1155] Australian accountants began facing a huge increase in lawsuits in the late 1980s. Mark Lawson, 'Australia: Accountants 'Top for Claims'' *Australian Financial Review* (Aug. 2, 1993) 3. By mid-1993, Australian accountants faced more than A$3 billion in claims. Bill Pheasant, 'Accountants Want to Stop the Damage' *Australian Financial Review* (Aug. 12, 1993) 14.

[1156] Even Halcyon New Zealand has seen an increase in lawsuits involving accountants. See Len Bayliss, 'Arthur Young Lawsuit Highlights Need for Better Standards' The Accountant (Feb. 1992) 7 (describing lawsuit for NZ $104 million against Arthur Young); '$5.5m Goldcorp Funds at Receivership', N.Z. Herald (Mar. 1, 1989) 4 (lawsuit by Goldcorp against accountants of a company it purchased). The chairman of the professional standards committee of the New Zealand Society of Accountants recently stated that one of the world's most litigious environments in the world had developed in New Zealand and that while "not many of the cases brought against auditors have been settled, the cost of defending actions brought against professionals has become one of the major business problems for them at the moment." John Lepper, 'NZ Auditors Straining Under Litigation Threat' The Accountant (Mar. 1992) 8.

[1157] Pacini et al. (n330) 394.

[1158] Micheal Beckett, 'Accountants Debate Move to Limited Liability' *Daily Telegraph,* (28 June, 1994) 8.

[1159] Micheal Peel, 'Auditors Find Lawsuits no Laughing Matter' *Financial Times* (London, 21 December 1999) 26.

By 1994, at minimum $1.3 billion (Canadian) of unsettled claims were pending against Canadian accountants.[1160] For example, Ernst & Young agreed to pay about $118 million (C$117 million) to settle claims of deficient audits at Chinese forestry company Sino-Forest, which collapsed within fraud allegations. It was considered to be by far the largest settlement ever by an auditor in Canada.[1161] The Sino-Forest case was part of a wave of class-action lawsuits alleging misleading accounting at China-based companies that were listed on U.S. exchanges.[1162]

In Australia, PricewaterhouseCoopers and its client Centro Retail FDC.AX, an Australian shopping center giant now known as Federation Centers settled to pay about $203 million (A$200 million) to shareholders who had sued over misleading accounting in 2012. PwC paid about a third of the total.[1163] It is estimated that the total amount of negligence claims that have been brought against Australian accountants totals approximately A$8 billion.[1164]

In New Zealand, the cost of defending legal actions brought against accountants has become a key business issue for many CPA firms.[1165] These international legal problems correspond to those of the US Big six accounting firms which spent $1.1 billion defending and settling lawsuits in just one year 1993.[1166] Large settlements have continued in the USA, including a $125 million payment by PricewaterhouseCoopers and Ernst & Young stemming from the collapse of the Bank of Credit and Commerce International[1167] and a $335 million payment by Ernst & Young to shareholders of CUC International over the audit of that firm.[1168] The increase in litigation in these countries has led to a number of detrimental effects including:

[1160] Gundi Jeffrey, 'Accountants Want Relief From Legal Nightmare' *Financial Post* (Apr. 29, 1994) 12.
[1161] Dena Aubin, 'Analysis: Knives out for auditors as class actions go global' Business News (New York, Mar 21 2013) Available at: http://www.reuters.com/article/2013/03/21/us-usa-accounting-lawsuits-idUSBRE92K0QB20130321.
[1162] Ibid.
[1163] Ibid.
[1164] Malcolm Miller, 'Auditor Liability and the Development of A Strategic Evaluation of Going Concern' (1999) 10(3) Critical Perspectives on Accounting 355-375 at 356.
[1165] Brenda Porter, 'An Empirical Study of the Audit Expectation-Performance Gap' (1993) 24(93) Accounting and Business Research 49-68.
[1166] Dan Dalton, John Hill and Robert Ramsay, 'The Big Chill' (1994) 178 (11) Journal of Accountancy 53-56.
[1167] R Trapp, *PwC faces pounds 400m lawsuit over Maxwell audit failure: FINAL Edition* (Independent Print Ltd, London (UK) 1999).
[1168] Micheal Peel, 'Auditors Find Lawsuits no Laughing Matter' *Financial Times* (London, 21 December 1999) 26.

- accounting firms being more antagonistic in declining to render services to high-litigation-risk firms;[1169]

- an availability decrease and a cost increase for professional liability insurance;[1170] and

- an increase in the number of experienced accountants departing the profession.[1171]

At the beginning of the millennium, debate existed concerning the relative probability of auditor liability in larger cases, which some confidently believe was high, while others were less certain.[1172] Federal securities fraud class actions against auditors were few, but the size of resulting damages or settlements can be staggering, with four recent settlements reaching into the $200 and $300 million range and two others also exceeding $100 million.[1173] Critics of the stated figures may note that these claims occurred before Stoneridge[1174] put an end to "scheme liability".[1175] Several recent cases have highlighted the persistence of auditor suits. KPMG, the smallest Big Four firm, faced a $1 billion suit after the collapse of subprime lender, New Century.[1176] A number of other New Century suits accompanied the billion-dollar case.[1177]

KPMG received suits related to the audits of other lenders[1178] where the firm settled a number of these suits for undisclosed sums and some for substantial amounts.[1179] Ernst & Young,

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[1169] Graham Ward, 'Auditors' Liability in the UK: The Case for Reform' (1999) 10(3) Critical Perspectives on Accounting 387-394 at 391; see also, A Jack, 'Rise in Legal Claims Hits Top Accountancy Firms: Auditors Say they are Turning Away High-Risk Clients' *Financial Times* (21 February 1994) 18.

[1170] D Wild, 'L68M Coopers' Payout Threatens to Lift Insurance Premiums' *Accountancy Age* (3 June 1999) 3; see also, Ward (n1169) 391.

[1171] Dan Dalton, John Hill and Robert Ramsay, 'The Big Chill' (1994) 178 (11) Journal of Accountancy 53-6, 54; see also, B Pheasant, 'Accountants Want to Stop the Damage' (1993) 12 Australian Financial Review J4 at 53; see also, Ward (n 1169) 391.

[1172] Cunningham (n371) 718.

[1173] See John Coffee, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms' (2004) 84 B.U.L. Rev. 301, 342 (detailing five settlements through 2004 exceeding $100 million: settlements of $110 million, $125 million, $217 million, $250 million, and $335 million); Eric L. Talley, 'Cataclysmic Liability Risk Among Big Four Auditors' (2006) 106 (9) Colum. L. Rev. 1641, 1643, at 1670 (noting Fortress Re settlement in 2005 of $250 million). Despite these figures, it is not uncommon for commentators or judges to speak of the potential of "billion-dollar judgments" against auditors. See, e.g., Bily, 834 P.2d at 764 (expressing concern about the "specter of multi-billion dollar" judgments against auditors); John Cummings, 'Top of Mind: Do Accountants Need Liability Protection?' *Business Financial* (Apr. 7, 2007) 10 (quoting Deloitte CEO Robert Kueppers as concerned about "a multibillion-dollar claim" and mentioning figures of $3 billion, $5 billion, or $10 billion).

[1174] *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc*., 552 U.S. 148, 159-60 (2008).

[1175] Hassen Al-Shawaf, 'Bargaining for Salvation: How Alternative Auditor Liability Regimes Can Save the Capital Markets' (2012) 2012(2) University of Illinois Law Review 501 at 520.

[1176] Donna Kardos, 'KPMG Is Sued Over New Century' *Wall Street Journal* (Apr. 2, 2009) C3.

[1177] See, e.g., In re *New Century*, 588 F. Supp. 2d 1206 (C.D. Cal. 2008).

[1178] See, e.g., In re *Countrywide Fin. Corp.* Sec. Litig., 588 F. Supp. 2d 1132 (C.D. Cal. 2008) (naming KPMG as a defendant in a class-action securities case).

[1179] See Plaintiffs' Memorandum of Points and Authorities in Support of Unopposed Motion for Preliminary Approval of Settlements at 7, In re New Century, No. 2:07-cv-00931-DDP (C.D. Cal. Aug. 30, 2010) (noting a $44.75 million settlement with New Century shareholders); Amended Stipulation and Agreement of Settlement at 17, In re Countrywide Fin. Corp. Sec. Litig., No. CV 07-05295 MRP (C.D. Cal. June 29, 2010) (agreeing to a $24 million settlement); Caleb Newquist, 'KPMG Resolves Lawsuit with New Century' Going Concern (June 30, 2010) http://goingconcern.com/2010/6/kpmgresolves-lawsuit-with-new-century (noting a confidential settlement with the New Century bankruptcy trustee). The reader should note several large investors pulled out of the Countrywide settlement thus signaling ongoing litigation. David Benoit, 'Big Investors Refuse

another Big Four auditor, was listed as a defendant in a suit over Lehman Brothers' failure.[1180] The civil suit by the attorney general of New York alleges Ernst & Young substantially assisted "Lehman Brothers" to engage in a massive accounting fraud where the suit sought $150 million in damages.[1181]

Park in his study has assessed the argument of auditors not having sufficient legal incentive to detect securities fraud and should be governed by a strict liability standard through examining a dataset of 554 class actions alleging an accounting restatement filed from 1996 through 2007 in the U.S. He stated that a more restrictive liability standard is linked with a modest reduction in the rate at which auditors are named as defendants and the rate at which auditor cases end in settlement. In addition, if a Rule 10b-5 case against an auditor is strong enough to conclude in a settlement, the legal standard does not affect the size of the settlement. The auditor's payment is connected with non-legal factors such as whether the issuer is bankrupt and the issuer's market capitalization. These results are best explained by the tendency of judges to read narrow liability provisions broadly in cases where the size and impact of the alleged fraud are remarkable. Therefore, the evidence does not favour the conclusion that a strict liability standard is imperative to generate sufficient incentives for auditors to detect substantial frauds.[1182]

Two studies cited in Park looked at past auditor settlements in order to project the risk an auditor would be subject to catastrophic liability.[1183] Talley collected data on 2,016 securities class actions filed from 1994 to 2005. He found that a Big Five auditor was named in 6.55 percent of the cases, and that the cases ended in dismissal 16 percent of the time. The average auditor settlement during that period was $13 million.[1184] In a later study, Donelson looked at aggregate settlement numbers for a similar time period, 1996 to 2007, finding a total of $1.733 billion in auditor settlements to resolve federal securities class actions. He presented summary statistics, noting that in Rule 10b-5 cases, auditor payments were equal to 23.5 percent of the total settlement, whilst auditor payments were equal to 4.2 percent of Section 11

Countrywide Settlement' *Wall Street Journal* (Feb. 25, 2011), http://online.wsj.com/article/SB10001424052748704150604576166382331877062.html.

[1180] Complaint at 1, *New York v. Ernst & Young LLP* (N.Y. Sup. Ct. Dec. 21, 2010).

[1181] Ibid 5.

[1182] Park James J., 'Auditor Settlements of Securities Class Actions', Journal of Empirical Legal Studies Volume 14, Issue 1, 2017, 169–198, 169.

[1183] Ibid 179-180.

[1184] Talley, E. L. (2006) "Cataclysmic Liability Risk Among Big Four Auditors," 106 Columbia Law Rev. 1641.

settlements.[1185] Both studies primarily focused on constructing models to estimate the probability that an auditor would be subject to catastrophic liability.[1186]

Delean has reported the victims of the financial-management company Mount Real Corp. and affiliated entities. The holders of worthless promissory notes through their lawyers have negotiated a $43-million out-of-court settlement with its auditors and security trustees, who have agreed to the payout with no admission of liability. Their lawyers initiated a class-action suit in 2008 on behalf of the more than 1,200 former holders of Mount Real notes stung in the Ponzi scheme perpetrated between 1996 and 2005. Investors likely will recoup about half of their invested capital, which totalled about $75 million, They won't be compensated for Mount Real's fictitious returns on investment. At the time of Mount Real's collapse, it's estimated it had about $130 million in notes outstanding. The settlement would effectively end the class action against the auditors and trustees (BDO Dunwoody LLP, Deloitte LLP, Schwartz Levitsky Feldman, B2B Trust and Services Financiers Penson Canada), but not against the authors of the fraud, including former chief executive Lino Matteo, now serving an eight-year prison sentence imposed this past summer after his conviction in the Cinar fraud trial.[1187]

In 2016, PricewaterhouseCoopers has reached a settlement in a multibillion-dollar lawsuit involving the 2009 collapse of Taylor Bean & Whitaker Mortgage Corp. Trustees for the bankrupt mortgage company sued PwC in 2013 for over $5 billion, claiming that PwC had failed to detect fraud at Taylor Bean during the firm's audits of Colonial Bank, which bought mortgages originated by the company. Both Taylor Bean and Colonial went bankrupt in 2009 after federal regulators uncovered rampant fraud. The size of the damages sought by the bankruptcy trustee threatened to undermine PwC, even though the firm pointed out that it never audited Taylor Bean. Taylor Bean's audit firm, Deloitte, settled with the bankruptcy trustee in 2013 for an undisclosed sum. A half dozen of Taylor Bean executives were convicted and sentenced to prison for the fraud. The plaintiffs contended otherwise. "PwC missed this massive fraud and the gross errors in Colonial's financial statements because it repeatedly ignored red flags in conscious and reckless disregard of its public duty as an auditor," the trustee's attorneys contended in an amended complaint. "Moreover, all the time that the Looters

[1185] Donelson, D. C. (2013) "The Potential for Catastrophic Auditor Litigation," 15 American Law & Economic Rev. 333.
[1186] Park (n1182).
[1187] Delean, Paul., Mount Real victims finally get some positive news, Montreal Gazette, October 4, 2016, available at: https://montrealgazette.com/business/mount-real-victims-finally-get-some-positive-news/.

were carrying out their fraud against TBW, PwC certified the existence of more than a billion dollars of Colonial assets that did not exist, had been sold to others, or were worthless."[1188]

Harvard Business School Working Knowledge has recently reported that investor lawsuits against auditors are falling, dismissals have increased, and settlements in recent years have declined," conclude the authors of a new research paper.[1189] The number of lawsuits specifically about Rule 10b-5, the antifraud regulation created under the Securities Exchange Act of 1934, dropped from 487 in the year 2001 to 80 in 2014. Another example: Some 70 percent of auditors in 1996 were likely to settle claims with some sort of cash payment. By 2016 the percentage of paid settlements had dropped to a little over 30 percent.[1190]

Two Supreme Court decisions, although not the only reasons, appear to have made a difference, according to the researchers. The rulings in *Tellabs v. Makor*[1191] and *Janus v. First Derivative*[1192] have effectively narrowed liability standards, requiring plaintiffs such as institutional investors to prove that auditors knew, or should have known, their clients' financial statements contained errors. These decisions affected Rule 10b-5 litigation in different ways; *Tellabs* related to pleading standards, while *Janus* related to liability rules. Both cases had potentially far-reaching effects for auditor liability under Rule 10b-5. In *Tellabs*, the Supreme Court attempted to resolve differences in pleading standards across the country. The court's ruling is considered to have benefited those auditors likely to be sued in the Second and Third Circuits courts, but to have disadvantaged those most likely to be sued in the Ninth and Eleventh Circuits. In *Janus*, the Supreme Court attempted to resolve intra-country differences in liability for secondary actors such as auditors. The court's ruling in *Janus* most benefitted those auditors likely to be sued in the Fourth and Ninth Circuits.

In the context of Rule 10b-5, a primary violator is defined broadly as the party who commits the fraud or misrepresentation, and a secondary actor is defined broadly as a party who was so

[1188] Cohn, Michael., PwC Reaches Settlement in Taylor Bean Lawsuit, Accounting Today, August 26, 2016, available at: https://www.accountingtoday.com/news/pwc-reaches-settlement-in-taylor-bean-lawsuit.
[1189] Lagace, Martha., Investor Lawsuits Against Auditors Are Falling, and That's Bad News for Capital Markets, Harvard Business School Working Knowledge, 2019, available at: https://www.forbes.com/sites/hbsworkingknowledge/.
[1190] Honigsberg, Colleen., Rajgopal, Shivaram. Srinivasan, Suraj., "The Changing Landscape of Auditor Liability", Working Paper 19-113, 2-3, Available at: https://www.hbs.edu/faculty/Publication%20Files/19-113_7d0bc97f-844c-43f8-9d2f-b30f429cc162.pdf.
[1191] *Tellabs, Inc. v. Makor Issues & Rights, Ltd* 549 U.S. 1105 (2007).
[1192] *Janus Capital Group, Inc. v. First Derivative Traders* 131 S. Ct. 2296. Although *Janus* specifically applied to misstatements in a limited number of documents such as quarterly filings, courts do not always recognize this distinction and have applied *Janus* to misstatements in other documents such as annual reports. See, e.g., Docket Num. 11-CV-0804; Decision and Order filed on 2/28/2013 (dismissing Deloitte & Touche LLP).

involved in the primary's actions that she is also liable. Auditors are rarely held liable as primary violators. Typically, they are only held liable as primary violators if there is evidence that the audit firm assisted the client in preparing the financials. However, auditors have much to fear from secondary liability. Thus, the impact of *Janus* is not immediately clear, as how courts resolve its uncertainty will determine its effect. If courts require that the auditor engage in the drafting or preparation of financial statements to be considered a primary violator, as would be consistent with prior caselaw, they *expect Janus* to reduce significantly auditors' litigation risk nationwide, but especially in the circuits that previously followed the substantial participation test—the Fourth and Ninth circuits. However, if courts apply *Janus* to auditors in a manner similar to how they have applied it to underwriters, the decision could have limited effect.[1193]

In regard of auditor settlements relative to settlements by other defendants over each three-year period, the total auditor payouts peaked at $1.37 billion for cases filed in 2002-2004, and have been far lower in the years following. Total auditor payouts were $260 million for cases filed in 2005-2007, $275 million for cases filed in 2008-2010, a mere $21 million for cases filed in 2011-2013, and just over $1 million for 2014-June 2016.[1194] The decline in settlement value is likely driven by two factors. First, because more cases are dismissed (and thus "settled" for $0), settlement values mechanically decline. Second, the reduced settlements likely reflect the change in bargaining power. Following auditor-friendly changes in law, plaintiffs know they must convince the court that their case meets the applicable new requirements before the case can be adjudicated or, in most securities cases, before discovery can even proceed. When plaintiffs are uncertain whether the case can proceed under the new requirements, it makes sense for them to be more likely to settle—and to settle for a lower percentage of potential damages—than to risk that the court will dismiss their claim.[1195]

In July 2919 and after three years in court, accounting giant Deloitte and others agreed to pay $234.6 million for allegedly enabling a giant Ponzi scheme run by now-defunct Aequitas Capital Management between 2010 and 2016. Deloitte audited the firm from 2013-2014, while Aequitas was allegedly moving money between myriad cut-outs and misrepresenting—and eventually lying—to investors about its finances. Aequitas used Deloitte's sign-off to give it "clout" when courting investors, the complaint alleges. "Former Aequitas insiders have already

[1193] Honigsberg et al. (n1190) 16.
[1194] Ibid (23).
[1195] Ibid (34).

pled guilty to perpetuating this fraud and hiding it from their investors and their auditors," a Deloitte spokesperson said in a statement. "We stand behind the quality of our audit work and are participating in this agreement to avoid the ongoing cost, distraction and uncertainty of extended litigation."[1196]

Cornerstone Research which is an economic and financial consulting and expert testimony has shed light on several reports conducted based on data gathered from the U.S. In their report titled: Accounting Class Action Filings and Settlements 2018 Review and Analysis, and under section: Factors Affecting Settlements of Cases Involving GAAP Allegations, they took a closer look at settlement amounts across two major categories of GAAP allegations—write-downs and restatements—and examines settlements across these categories in relation to a simplified proxy for plaintiff-style damages. According to the researchers, this relationship is important to consider because a proxy for damages is the single most important determinant of settlement amounts.[1197]

The proxy used in this report is referred to as "simplified tiered damages" and bases per-share inflation estimates on the value of a defendant's stock price movements for the dates detailed in the plan of allocation per the settlement notice.[1198]

[1196] Haldevang, Max de., Deloitte and others pay $235 million settlement over alleged role in Ponzi scheme, July 10, 2019, available at: https://qz.com/author/dehaldevangqz/.

[1197] Harwood, Elaine M., Mascari, Frank T., Simmons, Laura E., Accounting Class Action Filings and Settlements: 2018 Review and Analysis, Cornerstone Research, available at: https://www.cornerstone.com/Publications/Reports/2018-Accounting-Class-Action-Filings-and-Settlements.

[1198] Ibid, "Simplified tiered damages" bases per-share inflation estimates on the dollar value of a defendant's stock price movements on the specific dates detailed in the plan of allocation in the settlement notice. When there is a single alleged corrective disclosure date, the measure is calculated using a constant dollar value line that reflects the price change at the end of the class period. When there are multiple dates identified in the settlement notice, the measure is calculated using a tiered dollar value line that reflects the cumulative price changes associated with those dates. Generally, "simplified tiered damages" is smaller than the corresponding "estimated damages" upon which our historical reports have concentrated, due to differences in the methods used to estimate per-share inflation. As a result, settlements as a percentage of "simplified tiered damages" is larger than settlements as a percentage of "estimated damages." "Simplified tiered damages" uses simplifying assumptions to estimate per-share damages and trading behavior. It provides a measure of potential shareholder losses that allows for consistency across a large volume of cases, thus enabling the identification and analysis of potential trends. Our prediction models find this measure to be the most important factor in predicting settlement amounts. However, it is not intended to represent actual economic losses borne by shareholders. Determining any such losses for a given case requires more in-depth economic analysis. The methodology for "tiered damages" is also more consistent with certain considerations of the landmark decision in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005). "earlier discussion about the case in Fn191 and accompanying discussion in text", whereby damages must be linked to price changes caused by the alleged fraud (and thus, as generally interpreted by U.S. courts, cannot be associated with shares sold before information regarding the alleged fraud reaches the market); see also Bulan, Laarni T., Ryan, Ellen M., Simmons, Laura E., "Securities Class Action Settlements: 2017 Review and Analysis", Cornerstone Research, 6, available at: http://securities.stanford.edu/research-reports/1996-2017/Settlements-Through-12-2017-Review.pdf; see also Bulan, Laarni T., Ryan, Ellen M., Simmons, Laura E., "Estimating Damages in Settlement Outcome Modeling", Cornerstone Research, 1, available at: https://www.cornerstone.com/Publications/Research/Estimating-Damages-in-Settlement-Outcome-Modeling.

The proportion of accounting case settlements in relation to all settlements decreased in 2018 to the second-lowest level over the last 10 years.[1199] In terms of Accounting Case Settlement Size, it has been reported that with the addition of settlements in 2018, total settlement dollars for all post-PSLRA cases reached more than $100 billion, of which approximately $86 billion comprised accounting case settlements. Moreover, the total settlement dollars continue to vary substantially from year to year due to the presence or absence of very large settlements. Further, at $4.48 billion, the total settlement value of accounting cases in 2018 was the second highest over the last 10 years. Lastly, overall, in 2018, five settlements were $100 million or more (mega settlements). All five of these settlements involved alleged weaknesses in internal controls, and four out of the five involved allegations of GAAP violations.

The main argument in Moorthy et al. paper is that the settlement process is driven by the uncertainty in the legal system. Both Plaintiffs and Defendants try to use the uncertainty to drive a harder bargain. The ability to 'bluff' about willingness to go to trial is tested by both the parties. For example, if the auditor is reluctant to go to trial due to the perceived risks, the plaintiff attorney takes advantage of the situation to drive a hard bargain. The uncertainty in class action cases have been driven both by uncertainty about pleading standards and uncertainty about the size of damage awards. The other factor unique to auditors more than many other defendants in securities class action litigation is the number of times they are named as defendants usually by the same law firm representing the plaintiff. This repeated interaction provides an incentive for the auditor to build a reputation. One strategy is to never settle, so plaintiff law firms go after other easier targets. In this case it might be rational to accept additional costs to fight in court so as to deter future lawsuits. Another factor is evolving legal expertise. A small set of plaintiff law firms specialize in class action cases whereas legal consulting firms such as Cornerstone have developed models. [1200]

The next issue that they have examined is whether there are significant differences in the settlement patterns across the Big-4. They find that while the other Big-4 firms are indistinguishable, PwC has a statistically greater rate of settlement. The greater settlement rate could simply reflect a different bargaining policy rather than as a reflection on audit quality. Specifically, firms have to trade off the costs of defending themselves as compared with the

[1199] Harwood et al. (n1197).
[1200] Krishna Moorthy, Lakshmana and Sarath, Bharat Sarrukai, "Regulation, Auditor Litigation and Settlements" (November 30, 2015). Available at SSRN: https://ssrn.com/abstract=2811460 or http://dx.doi.org/10.2139/ssrn.2811460.

cost of settling. The optimal policy for the defendant is a mixed strategy of fighting some cases and settling others. The proportion depends on many factors including beliefs about what would happen should the case go to trial. Differences in settlement strategies are just as likely to arise out of perceptions of uncertainty in the legal system as they are to arise from the likelihood of audit failure.[1201]

Maksymov et al. interviewed attorneys, and results revealed that settling offers an additional advantage they did not previously consider, i.e., negotiating settlement amounts and terms tailored to defendant audit firm's ability to pay, which often depends on the nature and extent of the firm's insurance coverage. Furthermore, tailored settlement terms reduce audit firms' risk of insolvency and increase the plaintiffs' probability receiving full payment. These advantages of settlements over trials form the foundation of the descriptive norm to resolve audit disputes through settlements.[1202] In regard of assessing the value chain of a claim, plaintiff attorneys typically consider three main factors: (1) the amount of damages involved; (2) the merits of the claim; and (3) the defendant's (and/or its insurance carrier's) ability to pay. The three factors are not necessarily compensatory in their effect on the value of the claim. For example, completely lacking any one factor might nullify the value of the claim.[1203]

In terms of settlements and more specifically, by settling both sides to the dispute control the following aspects of audit litigation: (1) the uncertainty of trial outcomes; (2) the potentially devastating magnitude of alleged damages; (3) limitations of the professional liability insurance coverage; (4) certain audit firms' reputational concerns regarding firm competence and/or integrity; (5) the high cost of litigation; and (6) institutional features of the judiciary that facilitate and encourage settlements.[1204]

According to Coffee, these cases will likely continue to surface as auditor litigation tends to follow market bubbles and fluctuation. This litigation risk has effectively made large auditors uninsurable.[1205] Auditors, as a result, now self-insured via "captives," or insurance firms owned by the global audit networks and funded with premiums paid by member firms.[1206]

[1201] Ibid.

[1202] Maksymov, Eldar., Lowe, Jordan., Peecher, Mark., Reffett, Andrew., "Toward a More Complete Theory of Audit Dispute Resolution: Insights from Prominent Attorneys" September 21, 2017, 1, available at: http://gattonweb.uky.edu/Faculty/Payne/ACC603/Maksymov%20et%20al.%20...Insights%20from%20Prominent%20Attorneys.pdf.

[1203] Ibid 14.

[1204] Ibid 22.

[1205] Coffee (n1173) 303, 333.

[1206] Lawrence Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry before It Unravels', (2006) 106(7) Columbia Law Review 1698-1748 at 1741; see also, Aubin (n1161).

Cunningham suggested the inability of auditors to find external insurance was not only related to the magnitude of cases, but also related to case correlation. Auditor suits tend to correlate with market downturns.[1207] Thus, insurers would be stuck with a number of high dollar-value suits during recessions or larger market corrections. The insurance premiums necessary to cover such risks are simply too high for auditors to pay.[1208] Finally, it is possible that a Big Four firm could collapse because of criminal activities (e.g. tax sheltering), country bans or civil litigation costs[1209] in excess of their capital and insurance coverage.[1210]

As Big Four firms are unable to obtain liability insurance and entirely self-insured in the one hand, Non-Big 4 firms require traditional insurance coverage because they are unable to spread litigation costs across a large enough capital base to make self-insurance feasible on the other hand.[1211] Moreover, insurance companies charge higher premium and cap payouts more stringently as auditors take on larger corporate clients, which insurers regard as risky.[1212] This very high-cost and thin insurance coverage that comes along with auditing large clients discourages many non-Big 4 firms from retaining large corporate clients in the first place.[1213]

The last issue in this section is related to the self-insurance program chosen by Big 4 firms. Hard insurance markets, and perhaps other factors, lead insureds to strategy options other than transferring risk, often called self-insurance. This is a colloquial term that actually designates a complex variety of tools.[1214] Priest and Romano say that self-insurance involves setting aside a portion of revenues from activity to meet losses should they occur-a strategy that became increasingly common throughout the U.S. economy in the late 1970s and early 1980s.[1215] Risk-retention devices prevalent in general insurance contracts, such as deductibles and co-insurance, are a partial form of self-insurance.[1216] What distinguishes the strategy usually

[1207] Cunningham (n1206) 1741; see also, Coffee (n1173) 302-304.
[1208] Al-Shawaf (n1175) 521.
[1209] As a result of private litigation, Ernst & Young agreed to pay $99 million (£61.2 million) to the plaintiffs for the collapse of Lehman Brothers.
[1210] Hatice Kubra Kandemir, 'Understanding External Auditing and its Regulation in the EU and in Turkey: A Way to Convergence?' (PhD Thesis, Durham University 2014) 132 Available at Durham E-Theses Online: http://etheses.dur.ac.uk/10900/.
[1211] Bernard Ascher, 'The Audit Industry: World's Weakest Oligopoly' (2008) 37 American Antitrust Institute 6, 31.
[1212] Cunningham (n1206) 1739-1740; see also, D.M D'agostino on Public Accounting Firms: Mandated Study on Consolidation and Competition (U.S. Government Accountability Office, 2003) 6.
[1213] D'agostino (n1212) 45, 49.
[1214] Cunningham (n371) 745.
[1215] George Priest, 'The Antitrust Suits and the Public Understanding of Insurance' (1989) 63(5) Tulane Law Review 999 at 1005 documenting that "the extent of corporate self-insurance has increased substantially over time through the creation of firm or industry captive insurance subsidiaries and industry-wide mutual"; see also, Roberta Romano, 'What Went Wrong With Directors and Officers'(1989) 14(1) Delaware Journal of Corporate Law 1 noting that "the corporate purchase of commercial liability insurance has proven something of a puzzle because corporations have many potential methods of diversifying to reduce the effect of potential losses"; see also, Cunningham (n371) 745.
[1216] Cunningham (n371) 745.

described as self-insurance is a more comprehensive program of reserving funds to pay losses, more fully internalising those risks.[1217]

Large audit firms have embarked on comprehensive self-insurance programs (SIPs) using their own separately organised insurance affiliates.[1218] Public details of such programs are scarce, as the audit firms are privately held and do not produce the kinds of disclosure that public enterprises do.[1219] Participants contribute premiums to the mutual and it, in turn, covers member losses on prescribed terms. The program often is designed using retrospectively rated policies, meaning that each member pays premiums initially for agreed coverage, but the premiums are later adjusted based on actual loss experience.[1220] If the member enjoys a favourable loss experience, a portion of its initial premium is rebated, but if it suffers an unfavourable loss experience, it pays an additional premium surcharge.[1221]

If the four large auditing firms operate SIPs akin to the mutual form used by industrial enterprises, this could reflect decreased risk independence over time, which may be due to many factors including legal liability or increased uniformity in audit quality achieved by increasing homogeneity among the large firms.[1222] Mutual insurance may be better than external insurers at furnishing coverage for any loss category in which there is substantial correlation among members.[1223] The external insurer's solution to the challenge would be to offer coverage for some group losses, but with exclusions for the highly correlated type with some difficultly resulting in external insurers being a less effective discriminator enabling members to pool individual member risks of all sorts while also covering all group losses.[1224] As to moral hazard and monitoring, self-insurance bundles risk monitoring and risk distribution

[1217] Cunningham (n371) 745.
[1218] Ibid; see also, Eric Talley, 'Cataclysmic Liability Risk among Big Four Auditors' (2006) 106(7) 1641-1697 at 1643 noting "the stylized fact that, at least since the savings and loan crises of the late 1980s, auditing firms have been effectively self-insured, often through 'captive' (i.e., wholly-owned) insurance companies")
D.L Goldwasser and others, 'Professional Liability Insurance § 11.2.1' (2006) in Accountants' Liability (noting that "large [auditing] firms since the mid 1980s have been unable to purchase sufficient liability insurance to satisfy their needs").
[1219] Cunningham (n371) 746 used the analogy of the mutual form commonly used among industrial enterprises in given industries-members coordinate to form what are commonly called risk-retention pools to explain the SIPs.
[1220] According to Priest (n1215), "mutuals typically provide for subsequent assessments against firm members based upon the liability experience of the mutual for the year." Ibid 1007. That is, "mutuals set premiums by making assessments to member firms after, rather than before, the loss experience, thus insuring for variations in loss among the firms, but providing self-insurance for losses common to mutual members." Ibid 1012-13; see also, Cunningham (n371)748.
[1221] Cunningham (n371)748.
[1222] Priest (n1215) 1012.
[1223] Ibid 1012-1013.
[1224] Ibid 1013.

functions. Whereas E&O insurance separates risk monitoring from risk distribution, self-insurance combines the two.[1225]

The strategy requires insurers' ability to conduct sufficient monitoring of their customers. For the strategy to be cost effective, in turn, the cost of refining the classifications must be less than the gains from attracting targeted business. But high-risk variability pools limit an insurer's ability to compete effectively in this way and discourage low-risk customers from buying offered policies.[1226] Monitoring is central to this exercise, which supports the view that the capacity of SIPs to combine risk monitoring with risk distribution renders them a potentially superior model of insuring audit failure relative to E&O insurance.[1227] Although still not conclusive, this alternative approach casts analytical doubt upon the persuasiveness of insurance-based arguments favouring damages caps on auditor liability. Even if the alternative is incorrect, it seems premature to accept the damages caps argument without considering potential models of insuring audit failure that are yet untried.[1228]

6.4 Official and Non-Official (Governmental and Non-Governmental) Reports Related to Auditor Liability System and their Influences on the Availability of Professional Liability Insurance

Insurance crises are not unknown in the United Kingdom.[1229] In March 1994, the United Kingdom's largest accountancy firms were joined by the Institute of Chartered Accountants in England and Wales in submitting a report to the Department of Trade and Industry (ICAEW Memorandum). They urged the repeal of section 310 of the Companies Act 1985 so as to allow auditors to limit their liability. The firms argued that in a corporate collapse, other potential defendants, such as directors, often possessed minimal assets and auditors had become targets for plaintiffs because of their deep pockets (in the form of their accumulated resources or their professional indemnity insurance cover). This, they contended, had led to an insurance crisis - auditors had found that insurance cover for the full extent of their potential liabilities was

[1225] Cunningham (n371) 753.
[1226] Ibid 757.
[1227] Ibid.
[1228] Ibid.
[1229] Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors and Officers Liability Insurance' (1994) 57 (6) The Modern Law Review 880-915 at 905.

impossible to obtain at an affordable cost or, in many cases, at all and that a number of firms could not conduct audits because insurance cover could not be obtained.[1230]

The report stated that claims against auditors had risen in frequency from three in 1982 to 627 in 1993. For the largest eight firms, insurance premiums, negligence claims and legal costs as a proportion of audit fee income rose from 2.6 per cent to 8 per cent. The four major causes of the crisis were said by the Likierman Report[1231] to be a general lack of profit in the insurance market leading to a sharp fall in capacity for difficult risks; a cyclical hardening of the professional indemnity insurance market;[1232] increasing frequency of claims; and court decisions suggesting wider liabilities than previously estimated, yet leaving the legal position uncertain.[1233]

Finch asserts that three points are worth making.[1234] First, it is clear that "D & O" insurance has not been placed under the same stress as auditors' professional indemnity insurance.[1235] Second, if auditors have been targeted because of their deep pockets, D & O's may be liable to similar pursuit. Displacement from auditors to D & O's may indeed occur – resulting in auditors pressing the Government not only to allow them to limit their liability but also to encourage the uptake of "D & O" insurance. The effect of such developments would make D & O's and their insurers more vulnerable, even if the Government does not respond, the idea is to share some of the burdens and problems presently experienced in the auditors' professional sector.[1236] Third, Likierman's outline of the causes for the auditors' professional indemnity insurance crisis involves reference to difficulties from which the "D & O" sector is not immune. This in itself cautions against complacency.[1237]

IFAC commissioned London Economics (LE) in late 1997 to undertake an independent economic study (LE, 1998) of audit liability regimes.[1238] The focus of the study was on four

[1230] C Whelan and D Mcbarnet, 'The "Crisis" in Professional Liability Insurance' (1989) 14(4) Geneva Papers on Risk & Insurance 296.
[1231] See the Department of Trade and Industry, Professional Liability: Report of the Study Teams (1989) (Chairman Prof A. Likierman) (hereafter "Likierman Report") 3.
[1232] The market for Professional Indemnity Insurance (PII) has been said to be cyclical in the UK in relation to cover for auditors; construction industry professionals, such as architects and quantity surveyors; and surveyors.
[1233] Ibid 33.
[1234] Finch (n1229) 905.
[1235] Ibid.
[1236] Finch (n1229) 905.
[1237] Ibid.
[1238] London Economics, 'The Economics of audit liability. A report for the International Federation of Accountants' (1998) London Economics.

main issues. These include: 1. the reliance of institutional shareholders and others on the auditor as risk insurance in the case of fraud or collapse rather than exercising their role in the corporate governance process; 2. the rejection of some clients on the basis of the difficulty of auditing them, which in turn restricts their access to capital markets; 3. the use of defensive audit practices by audit firms to limit such liability, and 4. Whether the threat of liability has a role in improving audit quality.

LE claimed that professional indemnity insurance and LLP status were not effective in limiting liability as the former could lead to the deep pockets syndrome while the latter did not protect the assets of the firm.[1239] Consequently, LE claimed that there was an economic case for replacing joint and several liability with proportional liability and imposing a statutory cap on audit liability.[1240]

The auditing profession is campaigning to limit audit liability both nationally and internationally.[1241] The main changes sought inter alia are replacing the joint and several liability concept with a proportionate liability, placing a statutory cap on auditor liability, enabling the auditor to limit his liability by contracting with the client and allowing the auditor the freedom of organisational options.[1242]

The project report by London Economics concluded that the market for international audits was highly concentrated and effectively controlled by the large accounting firms. Such concentration was said to be linked to a growing gap between the value of legal claims against auditors and available insurance cover, with smaller accounting firms unable to cover the remaining amount claimed from their personal wealth. It was also claimed that unlimited auditor liability combined with only limited availability of liability insurance posed a serious risk to auditors, as they were left unprotected against growing litigation.[1243] The London Economics report claimed that limiting auditor liability could tackle the adverse effects of

[1239] Ibid.
[1240] Al-Husaini (n542) 29.
[1241] Ibid.
[1242] Ibid; In addition to the major amendments sought above, IFAC (1995) identified the following: Provide disincentives for plaintiffs filing frivolous lawsuits; adopt a statutory requirement for professional advisors and directors of companies to have adequate insurance cover.; limit auditor responsibilities to third parties; strengthen privity standards; and reduce the statute of limitations (for details, see IFAC, 1995) International Federation of Accountants (IFAC) Auditor's legal liability in the global marketplace: A case for limitation, (New York: IFAC 1995).
[1243] London Economics & Ralf Ewert, 'Study on the Economic Impact of Auditors' Liability Regimes', 2006, 134. Available at:https://londoneconomics.co.uk/blog/publication/study-on-the-economic-impact-of-auditors-liability-regimes/.

auditors' extensive litigation exposure by, inter alia, reducing concentration in the audit market, helping to ease staffing pressure on accounting firms, and ultimately, preventing another major accounting firm failure.[1244] That said, a "one-size-fit-all" approach (i.e. the imposition of a single liability arrangement) was deemed unhelpful in terms of adequately catering for the variety of legal environments and accounting firm characteristics in the Member States.[1245]

In another study, the Center for Audit Quality argued that commercially available insurance was not practical, as claims moved beyond insurance limits.[1246] The Center recalled in 2008 that the major audit firms faced 90 private actions with exposure of at least $100 million each, 27 actions with exposure of at least $1 billion each, and seven actions with exposure of at least $10 billion each.[1247] These exposures do not include third-party actions, such as claims brought by lenders against audit firms or their affiliates or claims not related directly to audit services.[1248]

In Europe, the 2006 Final Report (FR)[1249] supports auditor liability limitations as an efficient device of risk protection in favour of the Big Four. It compares strict liability to negligence, joint and several liability (JSL) to proportional liability, and discusses the extent of auditor liability, and liability insurance. The FR recommended not to move to a regime of strict liability and proposed the adoption of a proportionate liability regime (PLR) for auditors, while recommending restriction on limited liability through the adoption of liability caps.[1250]

The European Commission has recommended liability limitations despite some criticism.[1251] The Recommendation, presented as an instrument to reduce barriers to entry in the international audit market, is flawed.[1252] The main problem is that it not only covers liability towards third

[1244] Ibid 177.
[1245] Ibid 188; see also Taddei and Humphrey (n385) 66.
[1246] Center for Audit Quality, 'Comment Letter to the Advisory Committee on the Auditing Profession' (Center for Audit Quality, 2008) available at: https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.
[1247] Ibid 26.
[1248] Henock Louis and others, 'Do Extant Clauses Limiting Auditor Liability Impair Reporting Quality?' (2015) Available at SSRN:http://ssrn.com/abstract=2553562 or http://dx.doi.org/10.2139/ssrn.2553562.
[1249] Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F): Final Report to EC-DG Internal Market and Services (2006).
[1250] Ibid.
[1251] Giudici (n259) 518.
[1252] Ibid 521, highlighted the following passage of the Final Report: "Finally, audit liability risk and lack of liability insurance are viewed as a less serious barrier to entry by the middle-tier firms than by the Big 4 firms. This may reflect the fact that, in the absence of entry into the large company market segment, middle-tier firms have not yet had to address fully the issue of ensuring adequate liability insurance coverage for the liability that may arise out of statutory audits of large and very large companies. Indeed, in follow-up discussions with a number of the major middle-tier firms, some of these firms identified lack of insurance availability as a serious issue. When explicitly asked about the liability risk associated with the statutory audit of

parties and, in particular, secondary market investors, but concerns any kind of liability. As prospectus liability and liability to the company were not investigated by the FR. the Commission simply expanded the conclusions reached by analysing one layer (liability to secondary market investors) to all possible forms of liability.[1253] Moreover, it recommends limitations to liability to the company also in jurisdictions where shareholders, investors and other third parties are not entitled to sue the auditor, and where liability is thus already restricted.[1254]

The 2007 consultation with concerned parties revealed how opponents of liability limitation, such as users of audit reports, had started more aggressively to challenge the conceptualisations of risk[1255] attributed to unlimited auditor liability constructed by the large accounting firms.[1256] Such opposition was designed to undermine the chain of causal linkages that the accounting firms had sought to establish between unlimited liability regimes and what the firms claimed were the adverse consequences of litigation such as another accounting firm failure.[1257]

Instead, users of audit reports rationalised audit failure as something that was far more strongly related to the loss of reputation that follows from major exposes of poor audit quality. Representatives of the insurance and investment communities, for example, stood in particularly strong opposition to the prospect of liability limitation.[1258] The essence of their concerns was the possibility that a fixed cap on auditor liability would lead to situations where litigants could not be fully compensated for their damages by auditors and would, therefore, pursue damage claims against directors and officers of the audited company, with a subsequent pressure on insurance costs.[1259] They argued that it was far more important to place emphasis on the pursuit of better auditing standards and corporate governance.[1260]

large companies, the issue of liability insurance was more clearly focused." Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F): Final Report to EC-DG Internal Market and Services (2006) 46.

[1253] See also Walter Doralt and others, 'Auditors' Liability and Its Impact on the European Financial Markets' (2008) 67 Cambridge Law Journal 62, who note that the impact on the European capital markets of limiting auditor liability can be inclusive only when liability to all the potential claimants (company, shareholders, third parties) is taken into account; see also, Giudici (n259) 522.

[1254] Giudici (n259) 522.

[1255] Stephen Hilgartner, 'The Social Construction of Risk Objects: Or, How to Pry Open Networks of Risk.' In F James *Short and Lee Clarke,* (eds., Organizations, Uncertainties, and Risk, Westview Press, 40).

[1256] Stephen Hilgartner, 'The Social Construction of Risk Objects: Or, How to Pry Open Networks of Risk' (1992) Organizations, Uncertainties, and Risk, 39-53 at 4; see also, Taddei and Humphrey (n385) 66.

[1257] Taddei and Humphrey (n385) 66.

[1258] Directorate General for Internal Market and Services, 'Consultation on Auditors' Liability: Summary Report' (Brussels: European Commission, 2007) 13.

[1259] Taddei and Humphrey (n385) 66.

[1260] Ibid.

The Comité Européen des Assurances (CEA – the European Insurance and Reinsurance Federation) stated in its comment letter that "the risk of failure of a network, which could lead to a reduction in the audit offer, is mainly linked to a loss of reputation and simply limiting the liability for auditors in the EU does not solve the problems of reputation."[1261] Also, Peter Montagnon, Director of Investment Affairs at the Association of British Insurers (ABI), asserted that, while liability limitation would clearly offer auditors greater protection against litigation, the benefits of this to investors were somewhat less evident.[1262] In its formal response to the 2007 consultation, the ABI stressed that "a cap will not change the underlying problem that insurers have no appetite to insure the liability of the Big Four auditors, following heavy losses in the 1990s."[1263]

In 2008, the European Union officially recommended that its twenty-seven member-states adopt measures to limit auditor liability consistent with each state's own legal system.[1264] To date, ten European states have passed such legislation in various forms.[1265] The Commission issued its formal proposal, entitled "The Recommendation Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms" (2008/473/EC). It duly classified unlimited liability as a serious impediment to audit market competition and the smooth functioning of capital markets, noting that "increasing volatility in market capitalisation of companies has led to much higher liability risks, whilst access to insurance coverage against the risks associated with such audits has become increasingly limited."[1266]

The Recommendation, however, did not impose any binding restrictions upon the Member States to change their current position but only suggested that auditor liability "be limited except in cases of intentional breach of duties by the statutory auditor or the audit firm" by one of three methods: a cap on liability, proportionate liability, or limitation by contract (between the client and an auditor).[1267] Hence, the Recommendation did little to address the problem of

[1261] CEA 'CEA Response to the EC Consultation on Auditors' Liability and its Impact on the European Capital Markets' CEA (Brussels,15 March 2007), 2.
[1262] Taddei and Humphrey (n385) 66.
[1263] See http://old.abi.org.uk/Newsletter/Attachments/19.pdf.
[1264] Bernard Ascher, 'The Audit Industry: World's Weakest Oligopoly' (2008) 37 American Antitrust Institute 6, 48.; see also, Christopher Mckinnon, 'Auditing the Auditors: Antitrust Concerns in the Large Company Audit Market' (2014) 11 N.Y.U. J.L. & Bus 533 at 564.
[1265] Ascher (n1211) 48; Mckinnon (n1264) 564.
[1266] European Commission, Statutory Audits of Annual Accounts and Consolidated Accounts (Brussels: European Commission, 2008) 1, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2008.162.01.0039.01.ENG.
[1267] Ibid.

diversity of auditor liability regimes across Europe, the aim that had been a primary motive for its initial interest in the auditor liability issue. It has been said that "the most forgiving rules are often on the most controversial topics" and the difficulties of finding a shared policy position on a pan-European auditor liability arrangement ultimately led the Commission to produce a non-binding Recommendation offering multiple implementation options rather than any binding Directive.[1268]

6.5 Issues Related to the General Insurance Based Argument and the Cyclicality of the Insurance Market and How They Could be Overcome: An Emphasis on the Professional Liability Insurance

Moizer and Hansford-Smith believe that unpredictability can impair insurance effectiveness and present catastrophic risk that insurance cannot cover.[1269] Analysis and empirical evidence, however, articulate that costly or limited insurance is not due merely to unpredictably escalating liability and associated catastrophic risk, but also to traditional insurance limitations arising from moral hazard, adverse selection, and the rarity of catastrophic cases.[1270]

While these complications pose problems for existing and potential insurance to address significant risk from audit failure, they also reduce the insurance-based argument to the basic claim of expense or limited availability of insurance, rather than implicating the more subtle or dramatic theories about legal uncertainty or unpredictably expanding liability.[1271]

However conceived, the insurance-based argument resonates forcibly during periods when insurance markets contract. Insurance markets expand and contract cyclically through periods designated as either "hard" or "soft" markets, in cycles that approximate seven years.[1272]

The market for professional liability insurance for auditors hardened considerably from the late 1970s through the early and mid-1980s, in partial response to increasing risk of negligence

[1268] Taddei and Humphrey (n385) 68; see also, Terence Halliday and Bruce Carruthers, *Bankrupt: Global Lawmaking and Systemic Financial Crisis* (Stanford: Stanford University Press, 2009) 411.
[1269] Peter Moizer and Lisa Hansford-Smith, 'UK Auditor Liability: An Insurable Risk?: UK Auditor Liability' (1998) 2(3) International Journal of Auditing 197-213 at 197.
[1270] Ibid 205-209.
[1271] Cunningham (n371) 730.
[1272] Cunningham (n371) 730, See Frank Crystal & CO., Insurance Market Overview 5 (Winter/Spring 2006) Cited in Cunningham (n371) "A hard market is one in which insurance rates increase (net written premiums increase substantially) and coverage tends to be relatively restricted. A soft market is one in which rate reductions are common (net written premium increases only nominally) and broad coverage terms are readily available. The cycle from hard market, to soft market, and back to hard market occurs regularly at a peak-to-peak or trough-to-trough interval of approximately seven years."

liability for audit failure.[1273] The market then softened in the late 1980s[1274] and it hardened again in the early 1990s in response to the dissolution of the firm of Laventhol & Horwath.[1275] The market remained hard for a few years-and this appeared to be global rather than U.S.-specific,[1276] then it softened again in the late 1990s in partial response to the PSLRA, but has hardened yet again since the early and mid-2000s amid both accounting scandals and resulting regulatory reform.[1277]

Cunningham contends that the professional liability insurance market for auditors should soften further to the extent that such reforms increase audit effectiveness and reduce liability risk from audit failure.[1278] Moreover, this cyclicality presents a preliminary implication. Proposals to cap liability that are supported by arguments about a lack of insurance may be unable to respond to the dynamics of those markets.[1279] A legal mechanism would have to be in place to suspend and reinstate caps as insurance markets fluctuate.[1280] It could be desirable to develop mechanisms that reduce insurance market volatility, if not strategies that would expand and sustain availability for all time.[1281]

Cunningham[1282] argues that the insurance-based argument for caps raises numerous issues, including the following: Are insurers really not willing to provide this insurance? Is there really

[1273] John Siliciano, 'Negligent Accounting and the Limits of Instrumental Tort Reform' (1988) 86(8) Michigan Law Review 1929-1980 at 1950 (reciting evidence from: (1) the late 1970s, of a "sharp premium rise and exit of some firms from insurance market"; (2) the early 1980s, of loss claims that "resulted in insurance becoming unavailable or prohibitively expensive"; and (3) the mid-1980s, that the number of E&O insurers to small and mezzanine firms shrunk from twelve to three).
[1274] D Goldwasser, *Accountants' Liability 1989: The Year in Review* (PLI Corporate Law and Practice Course Handbook Series 11, 1989) 28-29 (noting market softening which led to: (1) insurers writing policies for small and medium-sized firms with larger limits of liability; (2) insurer Crum & Forster, under an AICPA sponsored program, being induced to increase limits to $5 million from $1 million; and (3) entry of Home Insurance Co. and Orion Insurance Co.; yet, still noting difficulty of large firms obtaining high limit coverage and facing large deductibles, so that insurance covered only catastrophic loss levels-meaning large firms must "in essence" self-insure smaller claims).
[1275] Robert Prentice, 'Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?' (1995) 13(2) Wisconsin International Law Journal 360-361 (claiming high level of unresolved claims plus legal costs and demise of Laventhol & Horwath "made it nearly impossible for the [large auditing] firms to find insurance, and has caused approximately forty percent of smaller firms to go without insurance altogether"); Ibid 13 (citing Michael Schachner, *Big Six Losses Don't Add Up To Cover Crisis for Small Firms* Bus. INS. (Nov. 22, 1993) 3 (suggesting that "capacity has all but evaporated for Big Six firms, causing several to entirely self-insure")); Ibid ("Those who do buy insurance are paying much more than previously. Auditors, for example, are paying three times the premium with six times the deductible as compared to 1985. Some firms are paying premiums of $150,000 per year-more than is paid by most surgeons-for the reduced coverage." (citations omitted)).
[1276] Pacini et al. (n330) 220-221.
[1277] D L Goldwasser, M T Arnold and J H Eickemeyer, 'Professional Liability Insurance § 11.2.1' , in *Accountants' Liability* (2006) said ("Although the market for professional liability insurance softened in the late 1990s, it has become tighter in the wake of the accounting scandals in 2001-2002 and the subsequent regulatory response.").
[1278] Cunningham (n371) 731.
[1279] For more information about the general insurance cycle applicable to the professional indemnity market, see Moizer and Hansford-Smith (n1269) 200-203.
[1280] Cunningham (n371) 731.
[1281] Ibid 732.
[1282] Ibid.

little or no insurance available? How does the existence of large firm self-insurance programs affect the analysis? Are damage caps really necessary to support the efficacy of the audit function? If rejuvenating insurance is appealing, are there alternatives that would enable doing so? For example, could insurance cover financial statements rather than auditors? This could contribute a mechanism other than fiat to establish caps, assuming caps were desirable, and thus at least address risks of ordinary audit failure. Finally, could audit failure risk be distributed more widely by securitising this risk through capital markets? Could insurance-based securitisation reduce the volatility of professional liability insurance markets? Could it at least be used to address the specific concerns associated with catastrophic audit failure risk?

In addition to the issues surrounding the professional liability insurance market for auditors, there is also inadequacy of professional indemnity insurance product. Enright and Jess explain that professional indemnity insurance is third-party insurance, differing from first-party insurance.[1283] In first-party insurance there is an immediate loss or damage of property or interest, resulting in a loss that the insurer has to pay for.[1284] In third-party insurance, both the type of risk and the subject-matter of the contract are different. Namely, in third-party insurance there is no immediate loss or damage in property but rather the risk is identified as a situation in which the insured would have to make a payment or transfer a benefit owing to a claim against him. In this scenario, the insurer would have to pay the claims that the insured would become liable to pay.[1285]

Within this framework, when the sum agreed to be received from the insurer is equal to the sum that the insured has to pay, the insured is adequately insured and no difficulty arises. However, when the sum to be received by the insured is less than the sum to be paid, a case of inadequate protection of the insured arises.[1286] The latter is the case of uninsurability, which occurs not only in the case of inability to obtain adequate coverage, but also when the available policies are of high cost.[1287] These are some of the problems that auditors argue that they are facing.[1288]

[1283] Ian Enright and Digby Jess, *Professional Indemnity Insurance Law*, 2nd ed. (Sweet & Maxwell, 2007) 78-81.
[1284] Ibid.
[1285] Enright and Jess (n1283) 78-81.
[1286] Psaraki (n567) 234.
[1287] Jan Holsboer, 'Insurability and Uninsurability: An Introduction' (1995) 20(4) The Geneva Papers on Risk and Insurance 407-413, 407.
[1288] According to Lee Roach, 'Auditor Liability: The Case for Limitation' (2010) 31(5) The Company Lawyer 136 at 137, evidence shows that large audit firms cannot obtain adequate coverage either through the insurance or reinsurance market or through "captive" insurance companies. Despite the fact that the reinsurance market could provide valuable help by covering

In identifying the reasons for uninsurability, the criteria that have been set by Faure provide a useful guidance.[1289] As long as the predictability of the insured risk and the assessment of the potential size of damages are among the determinants of the insurability or not of audit firms, certainty regarding this assessment will lead to insurability.[1290] Conversely, uncertainty regarding these determinants will lead to uninsurability.[1291] The latter is the case for auditors: there is no sufficient record of successful claims against auditors that could provide guidance with respect to the insured risk and there is an ill-defined legal regime regarding the calculation of potential damages, which can always be subject to changes.[1292] Hence, uncertainty has resulted in problems regarding the coverage of auditors against potential claims: for the larger audit firms only partial insurance is available, accompanied by restrictions, whereas for the smaller companies an adequate coverage is available.[1293]

Another area of concern is related to auditing the financial statement and its relationship with insurance monitoring. Baker and Griffith think that with regard to the expense of getting sufficiently inside the corporation to do effective monitoring, they observe that accounting firms are already deep inside the corporation.[1294] For that reason, the most cost-effective way to bundle monitoring and risk distribution may involve a combination of accounting and insurance functions. One possible approach is the Financial Statements Insurance (FSI) concept suggested by Joshua Ronen and elaborated by Lawrence Cunningham.[1295] This idea has received considerable attention in legal academic writing,[1296] but insurers and accounting firms

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the losses in excess of these covered by the insurer. Also, according to Swiss Re, which is a leading reinsurance company, the coverage through the reinsurance market for claims against auditors is extremely limited, Roach (n1288) 136. Last but not least, a solution might have come from "captive" insurance companies, but this did not happen either, Roach (n 1288) 136.

[1289] Micheal G Faure, 'The Limits to Insurability from a Law and Economics Perspective' (1995) 20 (77) The Geneva Papers on Risk and Insurance. Issues and Practice 454-462 at 454.

[1290] Ibid.

[1291] Moizer and Hansford-Smith (n1269) 204-209.

[1292] Ibid 209-210.

[1293] Moizer and Hansford-Smith (n1269) 197.

[1294] Tom Baker and Sean J. Griffith, 'The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer' (2007) 95 GEO. L.J. 1795 at 1837.

[1295] Lawrence A. Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability' (2004) 52 UCLA Law Review 413 (elaborating the FSI concept first suggested by Ronen); Joshua Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Re-visited' (2002) 8 Stanford Journal of Law, Business & Finance 39 (describing the FSI concept); see also Lawrence A. Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' (2006) 106 Colum. L. Rev. 1698, 1738 (arguing that FSI should be mandatory).

[1296] See Joseph A. Grundfest, 'Punctuated Equilibria in the Evolution of United States Securities Regulation' (2002) 8 Stanford Journal of Law, Business & Finance 1, 7 (describing FSI with approval but noting "that the current structure of D&O insurance and auditor liability has failed to give rise to incentives comparable to those [Ronen] predicts would arise under his FSI proposal" even though "D&O insurers could today easily make the retention of insurer-approved auditors a condition of coverage"); David B. Kahn & Gary S. Lawson, 'Who's the Boss?: Controlling Auditor Incentives through Random Selection' (2004) 53 Emory L.J. 391, 424–25 (noting that "Professor Ronen is on the right track" but arguing that insurers would not be willing to serve the role that Ronen envisions); Patricia A. McCoy, 'Realigning Auditors' Incentives' (2003) 35 Conn. L. Rev.

have not embraced the idea. One reason is that the proponents have emphasised the novelty of their idea and the legal and institutional change required for implementation. In addition, they have predicted that it would lead to dramatic improvements in the accuracy of financial statements that may seem unrealistic to these firms.[1297]

In Baker and Griffith's view, the concept of bundling monitoring and risk distribution is simpler and less novel than Ronen and Cunningham suggest.[1298] At least since Mayers and Smith, economists have understood that monitoring can be an important benefit that corporate insurance provides to shareholders, and the obvious candidates to perform monitoring in the D&O insurance context are the accountants who are already deep inside the corporation. Accounting firms already provide a limited amount of "insurance" (in the form of professional liability), and D&O insurance companies already provide a limited guarantee of the financial statements (in the form of coverage for securities violations related to inaccuracies in the statements).[1299] The challenge is to identify incremental ways to bring these two functions closer together, without the need for legal reform or dramatic changes in existing institutions.[1300]

Baker and Griffith note that an accounting firm could agree by contract to provide a warranty that a particular financial statement does not contain material misrepresentations.[1301] The warranty could be drafted so that it provides protection that is equivalent to existing D&O insurance.[1302] For example, the warranty could be limited to a specified dollar amount (recognising that the firm would remain potentially subject to additional liability on a traditional malpractice basis), and the warranty could be made subject to conditions that would be similar to the exclusions in D&O insurance policies.[1303] The firm could obtain contractual liability insurance coverage from an insurer that would indemnify the firm for any warranty payments. From an underwriting perspective, this contractual liability insurance coverage would be similar to D&O insurance and thus could be offered by D&O insurance companies

989, 1010–12 (discussing the various advantages and disadvantages of FSI); Larry E. Ribstein, 'Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (2002) 28 J. Corp. L. 1, 55 (same); Amy Shapiro, 'Who Pays the Auditor Calls the Tune? Auditing Regulation and Clients' Incentives' (2005) 35 Seton Hall L. Rev. 1029, 1085–86 (endorsing FSI).

[1297] Baker and Griffith (n1294) 1837.

[1298] Baker and Griffith (n1294) 1838.

[1299] Ibid.

[1300] Ibid.

[1301] Ibid.

[1302] Ibid.

[1303] Ibid.

with relatively little change in their operations.[1304] This limited warranty could bring the monitoring and risk distribution functions closer together without the need for legal change.[1305]

6.6 The Delusional Link of Applicable Liability Systems and their Impacts on Auditor Insurance

Literature about the impact of joint and several liability in relation to auditor liability as discussed in earlier reports and studies at section 7.4 is extensive. In addition, some countries have already replaced their joint and several liability system to proportionate one. In practice, it has been observed that there are additional alternatives for every legal rule, regulating the dimensions of the auditor's civil responsibility.[1306] Such alternatives differ amongst themselves in regard to the responsibility level imposed upon the auditor and the compensation level, which must be paid, if it is judged that an auditor was responsible for the injury incurred by the plaintiff. Regulating the auditor's civil legal responsibility depends on combining the rules regulating the dimensions as follows:[1307]

Determination of the scope of the parties with the right to litigate the auditor civically; we can see that there are many alternative rules for this dimension, including: a. The rule of participation in the contract (particularly by contracting); b. Beneficiary rule – near privity (primary user); c. Rule of beneficiary who must be expected, and d. Rule of beneficiary who can be expected. These rules were discussed earlier in Chapter Three.

Based on these rules, the allocation of compensation and responsibilities could be determent as follows:

1. Incident creating the auditor's responsibility: a. Full responsibility rule, and b. Negligence responsibility rule.

[1304] Ibid.
[1305] As the accounting firm would simply be providing a warranty of the audit, Baker and Griffith do not believe that this warranty would violate the Sarbanes-Oxley prohibition on the provision of non-audit services. See 15 U.S.C. §78(j)–(l)(g) (2000 & Supp. 2004). The warranty would not contravene the three principles that the SEC has stated that it will use in defining non-audit services: "an auditor cannot (1) audit his or her own work, (2) perform management functions, or (3) act as an advocate for the client." Strengthening the Commission's Requirements Regarding Auditor Independence, 67 Fed. Reg. 76,780, 76,783 (Dec. 13, 2002) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274).
[1306] Matar (n220) 81.
[1307] Ibid 81-82.

2. Scale used in estimating damage necessitating compensation: a. The scale of real damage related with investment – OOP (full compensation), and b. Independent measure from real investment – IOI.

3. Responsibility for paying compensation determined by the court for the sake of the plaintiff: a. Joint and several liability rule; b. Pure proportional rule, and c. Hybrid proportional liability rule.

These rules are considered from the aspect of insurance amount against the deficit firm (client) which the auditor must make available in favour of the plaintiff.[1308] It must be observed that, in the case of the financial ability of all defendants who must pay all their shares in the compensation, there are no differences in terms of applying the previous rules (paying compensation rules), as there are no unpaid sums in terms of compensation.[1309] In this case, the responsibility for paying the compensation is allocated according to contributions to the errors and the fraud in which they participated, as determined by the court.[1310]

The joint and several liability rule offers insurance that can be described as complete insurance for the plaintiff (investor) since the auditor (defendant) ought to pay his share of the compensation determined by the Court, in addition to the unpaid share that must be paid by other defendants regardless of the amount of injury caused by the auditor and ratified by the court. This means that auditors may afford the bankruptcy of other defendants, whatever their share of responsibility.[1311]

According to the pure proportional liability rule, the defendant (auditor) who is responsible is required to pay only a share that represents a percentage of the compensation sum ratified by the court. This sum is determined depending on the degree of their participation in the error or fraud. This percentage may be 10%, 20% or 30%, but not 100%. This rule is applied currently in Canada. It is clear that this percentage does not present insurance from the auditor against the deficiency of other defendants. Thus, the auditor's responsibility is exclusively his or her share of damages ratified by the Court, and so plaintiffs must afford the full risk of bankruptcy

[1308] Matar (n220) 82.
[1309] Ibid.
[1310] Ibid.
[1311] Stephen A Hillegeist, 'Financial Reporting and Auditing under Alternative Damage Apportionment Rules' (1999) 74(3) The Accounting Review 347-369 at 348.

of other defendants.[1312] In other words, the proportionate liability regime allows auditors to redistribute the risk to the plaintiff. In addition, the most important aims for the enactment of proportionate liability legislation is the "deep-pockets" argument.[1313] The reason auditors are regarded as having "deep pockets" is because they are required by law to carry professional indemnity insurance. Auditors are targeted by third parties because there is little advantage in bringing proceedings against a company that is insolvent, or whose assets are difficult to locate or realise.[1314] This is despite the fact that there may be good arguable claims against a company, especially where the directors and management are clearly at fault.[1315]

The hybrid proportional liability rule is placed between the other two rules, where the auditor is responsible for only a share of the bankruptcy of other defendants; thus, the auditor provides a limited insurance for investors against the deficiency of other defendants.[1316]

From the above-mentioned, under the existence of more alternatives for each legal rule composing the system, it may be stated that there are many alternative systems determining the auditor's legal responsibility, where the legislative authority in the state differentiates between them when selecting the most appropriate legal system, as it is supposed that every alternative system has a different effect on both the auditing quality and the investor's decisions in terms of determining the volume of his investment.[1317]

Cunningham has addressed the deterrence strategies taken by the U.S in terms of formulating the ideal type and scope of legal duties and liabilities that should be placed on auditors and others.[1318] As to proportionate liability, in 1995, the Private Securities Litigation Reform Act (PSLRA) removed joint and several liability for negligence, substituting it with liability in proportion to fault.[1319] This is, in substance and effect, a functional damages cap.[1320]

[1312] Hillegeist (n1311) 348.
[1313] Rajapakse and Gardner (n488) 196.
[1314] Ibid 197.
[1315] Duffy (n769) 13-14.
[1316] Hillegeist (n1311) 348.
[1317] Matar (n220) 83.
[1318] Cunningham (n371) 723.
[1319] Cunningham (n371) 723.
[1320] Ralf Ewert, *Study on the Economic Impact of Auditors' Liability Regimes* (Final Report To EC-DG Internal Market and Services, 2006) at 205-206.

Proportionate liability bounds auditor liability at the scale of culpability so that auditors are not exposed to all losses from financial catastrophe arising after an audit failure occurs.[1321] A theoretical defense of this drawback was made in 1984 by Professor Ebke.[1322] The analysis emphasised the need for a link between the extent of auditors' fault and the resulting liability.[1323]

As to stated damages caps, these have been questioned since at least the 1970s.[1324] Three varieties can be acknowledged: fixed dollar, variable dollar, and fixed percentage. They can be implemented by legislation, regulation, or contract.[1325] A major critique of any range of caps is that they reduce the deterrent effect of the liability threat. However, this criticism misses the point, which is to design the system to achieve optimal deterrence, not maximal deterrence.[1326] A cap could contribute to the optimum.[1327]

Ebke also evaluated fixed dollar caps.[1328] He observed that the core advantage of fixed caps is to improve risk analysis, by either the auditing firms or their insurers.[1329] Optimal design would ensure that auditor exposure is not out of proportion to auditor gain. Nevertheless, to be effective for risk analysis, the amounts of both would have to be reasonably low.[1330] But this means, in turn, that fixed caps per case would be equally unfair and ineffective. When the limit is too low, it would lead to nominal recoveries; though, even low limits that provide fair recoveries could still pose a calamitous risk for auditors.[1331]

If the central concern is the catastrophic case, then the cap would be some fairly large number today, in the range of $450 million to $2 billion; for smaller firms, perhaps $30 to $100

[1321] Cunningham (n371) 725.
[1322] Ebke (n1129) 663.
[1323] Ebke also recommended that state courts adapt federal law's scienter standard into their analysis of non-privity cases. Ibid 696. He proposed that if scienter could be demonstrated, then liability could expand to parties not in privity with the auditor, however that privity should be required in all other cases, comprising negligence cases. Ibid. Doing so is appealing because the scienter standard keeps auditor liability within reasonable bounds while extending it to all foreseeable third parties; since insurance generally excludes coverage for scienter, liability's deterrent effect remains.
[1324] T J Fiflis, 'Current Problems of Accountants' Responsibilities to Third Parties' (1975) 28(1) Vanderbilt Law Review 31; see also, Constantine Katsoris, 'Accountants' Third Party Liability-How Far Do We Go?' (1967) 36 Fordham L. Rev. 191. Available at: http://ir.lawnet.fordham.edu/flr/vol36/iss2/3; see also, Micheal Mess, 'Accountants and the Common Law: Liability to Third Parties' (1977) 52 Notre Dame L. Rev. 838; see also, Howard Wiener, 'Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation' (1983) 20(2) San Diego Law Review 233.
[1325] Cunningham (n371) 725.
[1326] Ibid 726.
[1327] Ibid.
[1328] Ebke (n1129).
[1329] Ibid 694-695.
[1330] Ebke (n1129) 694.
[1331] Ibid 695.

million.[1332] That could help with cutting out the mega-claim, but does not meet Professor Ebke's objection about being sufficiently low to allow greater risk analysis. Risks below that level are just as analytically tractable or intractable as without any cap.[1333]

In contrary, Professor Fiflis's 1975 proposal presented a variable dollar cap proposal. It would cap damages either (1) for a particular client's audit, at a multiple of fees received from that client throughout a specified period, or (2) for all clients, at a multiple of revenues from all clients for a period.[1334] Critics of Professor Fiflis's proposal demonstrated that investors in companies audited by smaller auditors stand to recover less than investors in companies audited by larger ones.[1335]

That would increase audit industry concentration, as enterprises would incline to appoint larger firms. That would, in turn, damage smaller firms and increase prices, and could reduce audit quality and hurt investors if demand is relatively rigid. This critique is particularly apt today, when encouraging additional rivals to the dominant four firms is, for many, an important policy objective.[1336]

Partnoy suggests a fixed percentage method to establishing caps on auditor liability for audit failure.[1337] He envisages statutory authorization authorising auditors and their clients to contract for allocation of damages from audit failure according to an identified split.[1338] A fear from the fixed percentage method is how publicity of such arrangements could also damage smaller firms, which are less able to commit to high allocations; if such harm is possible, this method poses the same adverse effects as multiples-based caps.[1339] Debate has also addressed the ideal vehicle to establish any caps. Examples of alternate means of executing a cap are by regulatory formula, as in the proposals by Professors Fiflis and Coffee; contractual negotiation,

[1332] Eric Talley, 'Cataclysmic Liability Risk among Big Four Auditors' (2006) 106(7) Columbia Law Review 1641-1697 at 1679 estimating viability thresholds of large auditing firms in terms of what level of damages they could support before likely electing to dissolve, with estimates from $454 million to $2.15 billion; see also, Cunningham (n371) 726.
[1333] Cunningham (n371) 726.
[1334] T J Fiflis, 'Current Problems of Accountants' Responsibilities to Third Parties' (1975) 28 Vand. L. Rev. 31 at 113.
[1335] Ebke (n1129) 695.
[1336] U.S. General Accounting Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition* (U.S. General Accounting Office, 2003) 46, available at https://www.gao.gov/new.items/d03864.pdf.
[1337] Frank Partnoy, 'Strict Liability for Gatekeepers: A Reply to Professor Coffee' (2004) 84(2) Boston University Law Review 365 at 365-366.
[1338] Ibid 365-366.
[1339] Cunningham (n371) 727.

as in Professor Partnoy's proposal; or by insurance-driven measurements, a proposal by Professor Ronen[1340] that Cunningham have endorsed.[1341]

Proponents of modified strict liability believe the regime will create robust insurance and reinsurance markets.[1342] By moving to a modified strict liability regime, auditors would essentially become financial statement insurers.[1343] The market dynamics might then generate a robust reinsurance market.[1344] Recall that under the current liability regime, auditors are virtually uninsurable.[1345] A modified strict liability regime would further reduce litigation, and possibly audit costs. Auditors would no longer have diligence-based defences.[1346]

These diligence-based defenses generate significant litigation costs and may consequently induce excessive levels of auditor precaution.[1347] Removing diligence-based defenses will likely reduce litigation and audit costs. Proponents believe a modified strict liability regime induces efficient levels of auditor precaution.[1348] While strict liability tends to over deter, proponents of modified strict liability argue capping strict liability optimizes auditor effort.[1349] The reduced liability associated with caps offsets the general overdeterrence of strict liability.[1350]

Eyal in his article stated that auditor liability is limited in approximately thirty-three countries.[1351] Liability is limited either through specific legislation that regulates auditor liability or general legislation using one or more of the following approaches: contractual stipulations; setting a statutory compensation cap; adopting a proportionate liability rule; and permitting association of accountants in a limited liability corporation.[1352] Eleven countries out of the thirty-three with limited auditor liability use a statutory cap, either alone or with other

[1340] Joshua Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Re-visited' (2002) 8 Stanford Journal of Law, Business & Finance 39 at 48-60 (arguing issuers should obtain insurance at prearranged levels to cover their financial statements with benefits that comprise increased investor monitoring of financial statement reliability).
[1341] Cunningham (n371) 728.
[1342] Frank Partnoy, 'Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime' (2001) 79(2) Washington University Law Quarterly 491, 514.
[1343] Ibid 216.
[1344] Lawrence A. Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' (2006) 106 Colum. L. Rev. 1698, 1738.
[1345] Ibid 1741; see also, Talley (n1218); see also, Coffee (n1173).
[1346] Partnoy (n1342) 492.
[1347] Partnoy (n1342) 492.
[1348] Ibid 511.
[1349] Partnoy (n1342) 502.
[1350] Ibid 517.
[1351] Nili Eyal, 'Setting a Statutory Cap on Auditors' Liability: What Method Should Be Used' (2013) 10(1) Rutgers Business Law Review 56-99 at 56.
[1352] Ibid.

methods.[1353] Other countries, such as the UK, allow parties to cap auditors' liability through contractual stipulation.[1354] Finally, auditor liability caps are also under consideration in additional countries.[1355]

He also addressed a number of issues in relation to the appropriate method for setting a cap; the appropriate method for applying a cap; and the desirable level for a cap.[1356] In brief, Eyal thinks that one or more of the following criteria can be used to calculate the cap:[1357]

a) Setting a fixed, uniform sum that would apply in all cases;[1358]

b) The type or size of company under audit.[1359] When the cap is set according to the type of company, the possible categories are as follows: listed companies, unlisted companies and public-interest entities (such as banks and insurance companies). When the cap amount is set according to company size, the following criteria can be used to determine its size: equity,

[1353] Ibid.
[1354] According to the law in the UK, parties to an audit contract can choose their desired limitation, a proportionate liability rule or a liability cap, and base it on a contract. See Companies Act, 2006, c.46, §535 (Eng.).
[1355] Eyal (n1351) 56.
[1356] Ibid 64.
[1357] Ibid 65-66.
[1358] One of the disadvantages of adopting this method is the lack of flexibility, which is typical for this method, is an additional factor that may generate an unfair result. Strictly applied, this method is expected to set a cap identical for all injured parties, "regular" and "sophisticated" injured parties, even when distinguishing between these groups is fair. "Sophisticated" injured parties are aware of the risks involved in their business activities; they incur such risks willingly and can protect themselves (Eyal (n1351)). For example, sophisticated injured parties can insist on external financial statement audits or include the damage risk in the transaction conditions (Siliciano (n1273) 1956-1958); Leibman and Kelly (n623) 423). Given such characteristics, setting a lower cap for this category of injured parties is likely more reasonable. However, it is impossible to distinguish between "regular" and "sophisticated" injured parties under a fixed and uniform cap (Eyal (n 1351) 77). Moreover, according to Eyal (n1351) 77, "Regular" and "sophisticated" injured parties have been distinguished, for example, in federal legislation for Canada. See Canada Business Corporation Act [R.S.C.], c. C- 44, Part XIX.1, schs. 237.3 (1), (2), (3), (4), 237.2, 237.5 (1985).
[1359] As stated by Eyal (n1351) 79-81, there are difficulties involved in setting the cap according to the size of the audited company. For example, for listed companies, this criterion may generate certain difficulties. The market value for listed companies changes occasionally, and it can only be roughly predicted. As a result, this criterion involves a number of difficulties. First, adoption of market value as a criterion can lead to uncertainty in the scope of liability for an auditor. This uncertainty could render it difficult to acquire effective insurance at a reasonable cost. For instance, if the market value for a cap calculation is not clarified, the insurance company can only roughly assess the risk involved in the audit work. Further, clarification on the market value is not expected to improve the insurance company's ability to assess the risk involved in audit work because the company value at a certain point in time in the future cannot be accurately assessed when insurance is sold. Therefore, even if setting a statutory cap using this criterion improves access to insurance to a certain extent, the improvement is likely only partial. Second, this criterion could lead to inefficient deterrence. Using market value as a criterion for setting the cap enables the auditor to roughly assess the extent of liability exposure, which is its advantage over unlimited liability. Nevertheless, it could lead to uncertainty in the exact compensation limit the auditor is liable for. Therefore, it would only partially improve the parties' incentives for effective precautionary measures. Third, the company's market value at a certain point in time (e.g., the eve of preparing financial statements) likely does not reflect the damage eventually caused by a negligent audit. For example, on the eve of preparing the financial statements, the company's market value may be low (for example, from a crisis in the capital market), while on the day the misrepresentation is discovered, the company value is higher. In this situation, the damage caused by the negligent audit may be significantly higher than a cap based on the company's market value on the eve of preparing the financial statements. This may violate the injured party's right to compensation.

market capitalization, net turnover, total annual revenue, total assets, and the average number of employees during the fiscal year; or

c) The audit fee received by the auditor. This alternative requires an answer to an additional question. How is the fee for calculating the cap determined? The possible alternatives are as follows: a reasonable audit fee or acceptable audit fee for audit services of the extent and type underlying the claim; the audit fee received by the auditor for the audit services underlying the claim; the total fee received by the auditor from its clients for audit services in the relevant fiscal year; and finally, a function of the total fee (for audit and non-audit services) received by the auditor (from a specific client or all of clients) in the relevant fiscal year.

Moreover, with a given criterion for setting the cap, a method for applying the cap must be determined; the options for applying the cap are as follows:[1360]

a) The cap is applied separately to each successful claim against the auditor;
b) The cap is applied to all successful claims against the auditor in a calendar year, even if they are for different actions or omissions; or
c) The cap is applied to all successful claims against the auditor that originate with the same action or omission. For this alternative, if one audit leads to several misrepresentations, the cap applies to each misrepresentation individually.[1361]

The primary purpose for limiting auditor liability is to ensure that capital markets function appropriately through preservation and development of a stable, competitive and high-quality audit market. Pursuant to this consideration, adoption of a limited liability rule has a number of objectives.[1362]

[1360] According to Eyal (n1351) 66-67, the question, what method is used to apply the cap has not always received a clear answer in the legislation that he has reviewed. In fact, in certain cases, the legislation did not mention a method. In countries where this is the situation, this issue is decided by the courts. Respectively, the comparative information available on this issue is partial. For example, in Germany, the law states that the cap applies "Per Audit". From information provided to him by the Accountants Association in Germany, it is evident that the courts and the literature have not decided which method should be used to apply the cap (i.e., does the cap apply once to all claims related to the same audit or to each claim separately). This information has been submitted to the author by Email from the Institut der Wirtschaftsprufer (Sep. 20th, 2011). The law in Poland does not address this issue either, and the courts have not decided it. This information was submitted to the author by E- mail from the Poland national Chamber of Statutory Auditors (Sep. 19th, 2011).
[1361] Eyal (n1351) 67.
[1362] Ibid 69 addressed some of the objectives as follows:
a) Reducing the risk of large claims or many major claims that would result in the collapse of one or more of the major Big-4 networks or a large national firm;
b) Enhancing the ability of audit firms and auditors to purchase effective insurance at a reasonable cost by reducing the risk of liability and increasing the predictability of future claim sizes;

To conclude this section, Leibman and Kelly addressed the issue of shifting risk among the parties.[1363] They argue that the sudden raising of the stakes of litigation by tearing down privity barriers while maintaining the joint and several rule is likely to be highly distorting.[1364] Furthermore, undo such a regime the real cost of audits will have to increase no matter which parties absorb the costs.[1365] Although increased exposure to tort liability will no doubt cause auditors to spend somewhat more on quality control, it is likely that the greater response will be for auditors to shift the risk of complete disaster by purchasing additional Professional Liability Insurance (PLI).[1366]

The effect of liability insurance on the cost of accidents is not clear. Insurers can help reduce costs by suggesting and insisting upon loss control measures, but the beneficial effect of this monitoring is probably not great. On the other hand, insurance carries administrative costs. In addition, economists speak of the "moral hazard" attaching to the already insured; "an insurer who has liability insurance...will have a reduced incentive to deter accidents." Insurance overhead plus moral hazard costs less monitoring benefits is an amount properly assigned to "accident" costs.[1367]

Calculating the risk shifting component of PLI is also problematic. If the risks of firm negligence and client insolvency are difficult for auditors to calculate, they are even more difficult for the auditors' insurers.[1368] Faced with extraordinary uncertainty because of their limited experience with the new relaxed privity rules and the leveraged balance sheets of many of today's corporations, underwriters will generally be cautious; they will try to err on the high side, especially in the wake of large-stakes lawsuits.[1369] An alternative strategy is for some insurers to drop the professional liability line altogether, perhaps making coverage more

c) Fostering competition by removing or softening blocks as well as negative incentives to forming additional networks and the entrance of middle-tier firms in the international public corporations auditing market. Reducing the risk of liability and enhancing the ability to purchase effective insurance at a reasonable cost can accomplish this.

[1363] Leibman and Kelly (n623) 370-371.

[1364] Ibid.

[1365] Ibid.

[1366] According to Leibman and Kelly (n623) 371, there are three reasons why the latter strategy is attractive to accounting firms: First, expenditures on auditing quality control are likely to run into diminishing returns fairly early on. Part of the reason is that accounting firms, like most organizations, must depend on individuals associated with the firm whose interests could differ from that of the firm's. Second, accounting firms are not limited liability organizations; the partners are personally responsible for judgments rendered against the firm. Third, individuals and businesses are usually risk averse at least before they are faced with specific losses; risk spreading with liability insurance is considered prudent even when mathematically suboptimal. Only liability insurance can raise the comfort level in the face of these effects.

[1367] Leibman and Kelly (n623) 371.

[1368] Ibid.

[1369] Ibid.

expensive because there will be fewer providers.[1370] As insurance coverage becomes more costly, passing through its cost in audit fees becomes more difficult.[1371]

A perverse counter-approach by some auditors will be to adopt a risk preferring strategy by gambling that their clients will keep their heads above water; that their firms will not be sued; but if sued, will prevail without incurring excessive litigation expense.[1372] These firms will "go bare" or greatly underinsure. Because such firms are unlikely to be able to meet massive third-party judgments, they will have succeeded in shifting most of the risk of client insolvency back onto the third parties.[1373] Traditionally, such a strategy has been associated with small firms with small clients, but recent financial pressure from litigation experience reported for a number of larger CPA firms, indicates that underinsuring in the present legal (and business) environment has become an inadvertent de facto strategy.[1374]

Alzola contends that under certain conditions, private parties may arrange for private gatekeeping by contract.[1375] If it were possible to buy insurance against losses coming from accountant's negligence -and accountants were legally liable- accountants could buy insurance and pass the costs onto their clients. Furthermore, if accountants were not liable, then the clients could insure directly (or third parties can buy insurance and pay less to the client). As Goldberg suggests, the incentives to monitor the accountant's performance would be the same in these cases.[1376] Hence, if insurance is perfect and the insurer's capacity to monitor for negligence is unaffected by the locus of liability, it is conceivable to have accountants assume liability by contract rather than imposing tort liability.[1377]

One of Alzola's main goals has been to highlight that the gatekeeper strategy is only one of several enforcement measures and that it raises concerns about fairness for at least two reasons.[1378] First, imposing liability on accountants is justified in terms of the accountant's superior ability to spread risks. Accountants, according to this argument, can pass the cost of insuring against the risk onto their clients, who can in turn pass the cost onto the public. While

[1370] Ibid.
[1371] Ibid.
[1372] Ibid.
[1373] Ibid.
[1374] Ibid.
[1375] Miguel Alzola, 'Beware of the Watchdog: Rethinking the Normative Justification of Gatekeeper Liability' (2017) Journal of Business Ethics 705-721, 713.
[1376] Goldberg (n261) 300.
[1377] Ibid 312.
[1378] Alzola (n1375) 713-714.

it makes sense to say that victims in other contexts find it difficult to spread risks by diversification or contract, this does not seem to be a major problem in the securities market where the victims are sophisticated financial professionals and where the use of contracts may be more effective than tort liability to control and adjust risks.[1379] Second, there are also fairness concerns about the proportionality between liability and fault. Given the auditor's secondary role in the crime, the complexity of professional audit opinions, and the potentially vague relationship between audit reports and economic losses from investing and lending decisions, it seems disproportionate that the auditor faces liability to all foreseeable third parties.[1380]

Barker and Steele believe the nature of the pragmatic arguments is equally evident when it comes to assertions that proportionate liability is necessary to control escalating insurance premiums, avert insurance "crisis", and thereby ensure that defendant businesses and governments are able to continue to provide services (affordably or at all) to the community.[1381] It is too commonly assumed that there is a clear link between the level of defendants' tort liabilities in general (and their "extra" liabilities under a joint and several liability system), the recent collapse of major insurers, and exponential rises in the rate of liability insurance premiums. Actually, there is little, if any, empirical evidence to back up this assertion in Australia at least.[1382]

Arguments about insurance effects are also apparently specific to certain sectors of the insurance market and to particular time frames.[1383] They are not perennial (indeed it seems most likely that they are cyclical) and they are not generalisable.[1384] From this point of view, the Australian reforms are merely irrational in their existing form because they present a generalised proportionate liability regime when the "insurance" case for change was only ever made with respect to specific sectors of economic activity such as professional service provision, building, and public liability.[1385]

What is more, economic conditions and insurance markets change and adjust easily over time so that, even if proportionate liability was a rational reaction to insurance conditions in

[1379] Ibid 714.
[1380] Ibid.
[1381] Kit Barker and Jenny Steele, 'Drifting Towards Proportionate Liability: Ethics and Pragmatics' (2015) 74 CLJ 71.
[1382] Ibid.
[1383] Ibid 72.
[1384] Ibid.
[1385] Ibid.

Australia in 2001, this does not prove that it is correct in 2015 (at the time of writing this article), nor that it is appropriate for other jurisdictions.[1386] Echoing on this point recently, the Ontario Law Commission has pointed to new market solutions (such as financial statement insurance and catastrophic bond securitisation) offered in Canada and which are perhaps better suited to deal with particular sectors of insurance risk.[1387] In fact, one issue with using proportionate liability regimes to deal with such risks (the risks of auditors' liability flowing from failures to identify enormous malpractice in financial markets is a contemporary example) is that they may not reduce liabilities to whatever like a manageable size.[1388] A small percentage of liability for a billion-dollar loss is still a very serious thing and additional control mechanisms, such as liability caps, may be required. The Commission's conclusion is that the market can handle these issues more accurately and more effectively through traditional contractual risk-allocation mechanisms and new insurance products than through the use of any "bludgeoning" proportionate liability scheme.[1389]

6.7 Overview on the Current Conventional Professional Liability Product and its Association with Audit Failure

The accountant also has a better opportunity than the third party to prevent a loss from occurring.[1390] Although the accountant can detect irregularities and defalcations through the auditing process, the third party has very limited access to the corporate records.[1391] Since a third party cannot protect himself from a negligent audit, the risk of loss should be shifted from the blameless creditor or investor to the accountant, the party who can prevent the loss by performing a more thorough audit.[1392]

Furthermore, the cost associated with the risk of loss can more easily be spread by imposing it upon the accounting profession, rather than upon indiscriminate investors.[1393] Although an investor may attempt to incorporate the possible cost of overstated financial statements by

[1386] Ibid.
[1387] Law Commission of Ontario, Joint and Several Liability Under the Ontario Business Corporations Act (2011) ("LCO Report") 32-33
[1388] Ibid 72.
[1389] Ibid 72-73.
[1390] Hagen (n236) 207.
[1391] Ibid.
[1392] Ibid.
[1393] Ibid.

offering a lower price for a security, the likely effect of such action would be the investor's non-acquisition of the security because of the enormous number of competing investors in the market place.[1394]

On the other hand, the accounting profession can include the cost of their malpractice insurance in their billing rates, thereby apportioning the cost of the risk of liability based on the amount of audit work necessary to prevent misleading financial statements.[1395] The audited entities having weak internal accounting control will then be allocated the cost associated with the risk of loss.[1396]

Since the cost of malpractice insurance is significantly influenced by the frequency of claims filed,[1397] the possibility of increased malpractice premiums would also promote carefulness in auditing and encourage adherence to the standards of the accounting profession.[1398] In order to effectively compete with prudent accounting firms, negligent accounting firms would have to individually incur the additional malpractice premiums resulting from their negligence.[1399]

If negligent accounting firms attempted to pass on the cost of their additional malpractice insurance, their increased billing rates would deter demand for their services.[1400] Absorbing the additional malpractice insurance would lower the profits of negligent accounting firms, because the standards of the accounting profession require the exercise of "due professional care" without limitation on the parties to whom it is owed, basing accountants' negligence liability on the reasonable foreseeability of the consequences would also foster compliance with the accounting standards.[1401]

Furthermore, since liability insurance rates are based on a pooling of risks, there would be an inequitable distribution of insurance costs with strict liability for accountants.[1402] More careful accountants would be bearing a greater proportion of the total cost of insurance because with

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[1394] Ibid.
[1395] Ibid 208.
[1396] See generally Albert G Besser, 'Privity - An Obsolete Approach to the Liability of Accountants to Third Parties' (1976) 7 Seton Hall L. Rev. 507 at 534-37 (accountants can pass on their malpractice insurance costs to their clients, who in turn can pass on such costs to the public); see also, Hagen (n236) 208.
[1397] For a discussion of accountants' malpractice insurance, see Dennis Horan & Marianne Guerrini, 'Accountants' Professional Liability: Insurance Issues' (1980) 15 Forum 516 at 517-31; J P Dawson, 'Comment, Auditors' Third Party Liability: An Ill-Considered Extension of the Law' (1970) 46 Wash. L. Rev. 675, 682-85.
[1398] Hagen (n236) 208.
[1399] Ibid.
[1400] Ibid.
[1401] Ibid.
[1402] Ibid 209.

absolute liability the carefulness of the insured would be irrelevant in setting the insurance premium.[1403] Consequently, strict liability would provide less incentive for accountants to exercise reasonable care.[1404]

The discussion above and in previous sections are related to the existing insurance for audit failure. A brief discussion is needed to proceed later with an innovative product that could be used in Takaful and conventional insurance businesses. Cunningham states that auditors have long used insurance to transfer and distribute risk of legal liability arising from audit failure.[1405] The insurance is variously dubbed professional liability insurance, malpractice insurance or, most broadly, errors and omissions (E&O) insurance.[1406] Auditors buy malpractice liability insurance to backstop their exposure to such legal claims, using general policies for specific time periods that are not tailored to particular engagements and associated risks of audit failure. Such coverage generality may pose adverse incentive effects to calibrate auditing tasks to risks of particular engagements.[1407] Such insurance is accompanied by two general limitations-moral hazard and adverse selection-plus several limitations that raise issues of peculiar significance to the audit function concerning monitoring.[1408]

In the audit function, moral hazard can cut multiple ways. For example, expansive liability presents moral hazard to shareholders ex ante.[1409] If shareholders know they will be able to successfully sue an issuer's auditor to recover losses due to audit failure, they enter the picture with fewer incentives to self-protect.[1410] This is a theoretical defense not only of the privity rule for auditor negligence as in *Ultramares*,[1411] but also to support a case for limiting liability in other ways-either doctrinally, such as through tort law's economic loss doctrine, or by fiat using damages caps.[1412] With such public policies in place, investors have increased incentives both to monitor issuers and their auditors, and to effectively self-insure through investment portfolio diversification.[1413] On the other hand, such doctrinal or fiat limitations pose a different problem of moral hazard, increasing moral hazard among auditors on an engagement who are

[1403] Ibid.
[1404] Ibid.
[1405] Cunningham (n371) 738.
[1406] Ibid.
[1407] Cunningham (n1295) 423.
[1408] Cunningham (n371) 738.
[1409] Ibid 739.
[1410] Siliciano (n1273) 1948.
[1411] *Ultramares Corp. v. Touche* 174 N.E. 441 (N.Y. 1931). For a detailed discussion about this case, see section 3.2.3.
[1412] Cunningham (n371) 739.
[1413] Ibid 739-740.

aware that their loss exposure is capped.[1414] One issue is whose behaviour is more likely to be influenced by such moral hazard. This hinge, in large part, on the strength of other incentives that shareholders face to self-protect on the one hand, and auditors have to avoid conduct leading to audit failure on the other.[1415]

An additional complication concerns auditors' capacity to pass insurance-related costs through to clients. Shifting financial risks from auditors to insurers would not diminish deterrence so long as auditors as a group suffered when one auditor failed. But group suffering will not occur if auditors can pass insurance costs on to their clients, and, in turn, the public.[1416] Cost-passing reduces the deterrent effect of imposing the costs on auditors, although some deterrence may remain from risk of harm to reputation. Expanding auditor liability would not help much, either. Whether auditors can pass costs through is uncertain, even though public enterprises do not have any choice but to hire an auditor, and that choice is limited. On the other hand, insisting that auditors retain some liability risk, through retentions, might incrementally frustrate their cost-passing ability. It may be more convincing to defend high audit fees by citing high insurance premiums than by citing losses incurred on liability claims.[1417]

The monitoring-related limitations of using E&O insurance to address audit failure risk are serious. First, auditor E&O insurance addresses an audit firm's exposure using general policies for specific time periods.[1418] They are not tailored to particular audit engagements or associated risks of audit failure.[1419] Such coverage generality may pose perverse incentive effects that prevent calibrating auditing tasks to the risks of audit failure arising from particular engagements.[1420]

Second, and more importantly, this method separates the risk monitoring function from the risk distribution function. That is, auditors are in control of their insured activities with little or no oversight by insurers. Monitoring is a way to control risk, but when risk monitoring is separated from risk distribution, moral hazard increases.[1421] The theoretical appeal of bundling

[1414] Ibid 740.
[1415] Cunningham (n371).
[1416] Kent D Syverud, 'On the demand for liability insurance' (1994) 72(6) Texas Law Review 1629 at 1644-1649.
[1417] Cunningham (n371) 740.
[1418] Ibid 742.
[1419] Ibid.
[1420] Ibid.
[1421] Cunningham (n371) 742; see also, E Mackaay, *The Economics of Information and Law* (Springer Netherlands, 1982) 179-180.

monitoring and distribution evaporates to a point at which even second-best strategies of retentions are impaired.[1422]

Exposure from audit failure is more difficult for insurers to evaluate, as it involves matters of investor demographics.[1423] Estimating the magnitude of audit failure is more uncertain when gauging the scope of claims is difficult.[1424] This can occur due to limited information about the number, identity, or type of third-party shareholders or other investors who may assert claims. Such informational asymmetry can lead insurers to increase premiums or retentions, limit coverage, or add exclusions.[1425] When asymmetry is acute, premium surges may occur, which increase the adverse selection that leads to lower-risk insureds withdrawing from pools.[1426] With only high-risk insureds left, pools unravel; self-insurance becomes the preferred route for the low-risk insureds, and insurance for the high-risk evaporates.[1427]

Consider an analogy from directors and officers (D&O) insurance. Premiums and coverage may provide clues about liability risk to the extent that they are valid proxies for corporate governance quality.[1428] Yet scholars observe that D&O insurers do not appear to have or act upon any monitoring incentives.[1429] Although similar data on E&O insurance does not appear to have been published, it is reasonable to suppose a similar phenomenon in this line.[1430]

Finally, Cunningham thinks that E&O insurance and self-insurance programs are the extant models used to address liability for audit failure, there are two alternatives deserve further exploration as a matter of public policy: financial statement insurance and insurance-based securitization.[1431] Financial statement insurance would be discussed as it relates to the scope of this thesis and may provide a solution to the Saudi liability system if it has been modified.

[1422] Cunningham (n371) 742.
[1423] Ibid.
[1424] Cunningham (n371) 742.
[1425] Ibid.
[1426] Ibid.
[1427] Ibid 743.
[1428] Tom Baker & Sean J. Griffith, 'Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Insurance Market' (2007) 74 U. Chi. L. Rev. 487, 489-90.
[1429] See Tom Baker & Sean J. Griffith, 'The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer' (2007) 95 Geo. L.J. 1795 1807-1808.
[1430] Cunningham (n371) 743 A policy parallel appears: Commentators who lament unavailability of auditor E&O insurance and/or rising liability risks dramatize their arguments by warning that the combination may drive auditors out of the auditing business with calamitous effects, while those lamenting the unavailability of D&O insurance amid rising liability risks do so by warning that the result may discourage talented and capable persons from serving on corporate boards of directors.
[1431] Cunningham (n371) 757.

6.8 Financial Statement Insurance and Auditor Civil Liability Towards Third Parties- A Conventional Perspective

Ronen suggested that Financial Statement Insurance (FSI) would make for a significant change in the principal-agent relationship.[1432] Instead of appointing and paying auditors, companies would purchase financial statement insurance that provides coverage to investors against losses suffered as result of misrepresentation in financial reports.[1433] The insurance coverage that the companies are able to obtain is publicized, along with the premiums paid for the coverage. The insurance carriers then appoint-and pay-the auditors who attest to the accuracy of the financial statements of the prospective insurance clients.[1434]

Ronen described how the FSI scheme plays out in the decision-making process of each of its participants: the insurer, the auditor, the capital market, and the insured as follows:[1435]

1. The Insurer

[1432] Ronen (n1340) 48.

[1433] Dan Palmon and Ephraim Sudit, 'Commercial Insurance of Financial Disclosure: Auditors' Independence, and Investors' Protection' (2009) 18 Group Decision and Negotiation 27-30 has proposed in 2000 another insurance product called commercial insurance of financial disclosures (CIFD) and subsequently elaborated by Ronen and Cherny (J Ronen and J Cherny, 'Can insurance solve the auditing dilemma' (2002) 106 (29) Nat Underwrit 12–14 in 2002 and 2003 under which users of financial information (owners and potential owners of business enterprises) and providers of financial information (managers of business enterprises) would be able to purchase insurance policies from private insurers (commercial insurance companies). These insurance policies would be constructed to protect users of financial statements from specific, well-defined losses directly attributable to their use of financial disclosures that fail to conform to contractually defined standards. To reduce their own risks, insurance companies will likely purchase from assurance experts (certified public accountants, financial analysts, and management consultants) services assuring adherence to standards.
Without getting into the details of this product, it is noteworthy to say that some aspects of the financial statement insurance are similar to the CIFD. More relevant arguments to support the indemnification of damaged investors, Palmon and Sudit (2009) 32 have considered an economic environment in which a variety of commercial insurance policies for financial disclosure are attached to shares held by owners of business enterprises. Providers of financial information (the managers of the disclosing firms) will have the option to negotiate the purchase from commercial insurers, insurance policies for shares held by owners (investors) (Palmon and Sudit, 2009, 32). Mangers may choose to insure all shareholders or to issue two distinct classes of stock: insured shares and uninsured shares (Palmon and Sudit, 2009, 33). Investors will be automatically insured upon their purchase of the insured shares. Their insurance will expire when they sell these shares and be transferred to the purchasers (Palmon and Sudit, 2009, 33). Holders of insured shares will be compensated for losses caused by non-adherence to disclosure standards within the limits specified by their insurance policies (Palmon and Sudit, 2009, 33). Disputes between the insurers and the insured could be adjudicated internally within the insurance review system as well as externally in the courts (Palmon and Sudit, 2009, 33).

This research is in the opinion that the civil liability of auditors in the case of financial statement default exists till the company makes a restatement in its annual financial statement (whether some shareholders have sold their shares to others or not between the release of the financial statement and its restatement) and therefore, shareholders would be able to get indemnified. Hence, the insurance product if any must be connected with liability rules' in orbit with Islamic perspective as argued in Chapter Seven. Otherwise, it becomes an option for the company or its shareholders to insure because insurance is considered as a tool to complement the auditor liability system.

[1434] Ronen (n1340) 48.

[1435] Ronen (n1340) 51-60.

First, consider the insurance carrier. Having extended coverage at a certain premium, the objective of the insurance carrier would be to minimize its claim losses.[1436] Accomplishing this objective is tantamount to minimising shareholder losses. Hence, the interest of the insurance carrier is aligned with the interests of shareholders. By aligning the interest of the auditors with the interest of the insurance carrier who hires the auditor's services, it is possible to align the interest of the auditors, by extension, with the interests of shareholders.[1437]

If this hypothetical "*ceteris paribus"* condition is relaxed and it is allowed for the possibility that the coverage extended under the proposed regime would exceed the insurance coverage under the current regime. Will the insurance industry have the capacity to pay? The answer to this question is yes because, unlike property and casualty insurance for example, the losses insured against-decreases in the valuation of companies resulting from omissions or misrepresentations in the financial statements can be hedged in the capital markets with properly constructed derivatives, the exercise of which can be made contingent on the same triggering events that cause loss to shareholders, i.e., the financial statement and audit failures that are manifested in omissions or misrepresentations.[1438]

2. The Auditor

Under the proposed regime, the auditor would choose the audit quality so as to maximise his expected compensation.[1439] Because the compensation scheme is designed by the insurance carrier, the auditor would decide on the quality that is optimal from the perspective of the insurer, and hence the shareholders. Specifically, the auditor would attempt to maximize the difference between the audit fee revenue he expects from the insurer and the expected costs of misrepresentations and omissions. This attempted maximisation would induce him to choose the optimal audit quality. The insurer has at its disposal potent penalties to deter the auditor from deviating from the desired quality.[1440]

[1436] Ibid 52-53.
[1437] Ibid 53.
[1438] According to Ronen (n1340) 54-55, the insurer can buy a special put option with a duration that corresponds to the period covered under the policy. The put would be exercisable upon a stock price fall of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements. Investment funds (pension funds, mutual funds, and the like) would be willing to sell these puts for less than the price of general puts (that are not conditional on misrepresentations) and would thus enable the insurer to reinsure whichever portion of the coverage he wishes not to retain at an affordable cost. The put sellers can minimize their exposure on these written puts by constructing portfolios that are well diversified with respect to the risk of misrepresentations and omissions. The assessment of such risks can be provided by independent rating organizations akin to bond rating agencies, such as Standard & Poor's Corp.
[1439] Ronen (n1340) 56.
[1440] Ibid 57.

3. The Market

Since the FSI procedure requires that the coverage be approved by the shareholders, and since the coverage is common knowledge, in that it is publicised both in the proxy and in all financial reports issued by the insured, the market is made aware of the coverage, and having priced it into securities, an implicit contractual agreement would have been formed.[1441] The market would come to understand the limit to which it is to be indemnified in the case of loss. Although a plaintiff class may still be able to sue for damages beyond the limits of the policy, it seems less likely that it would prevail: the investors were put on notice regarding the limit of the policy coverage and will have paid less for the security with the lower coverage and thus protected themselves in advance against the risk of misrepresentations. This would have the effect of practically limiting the exposure to the policy coverage and hence decreasing the dead weight loss to society caused by lengthy litigation.[1442]

4. The Company-The Insured

Under the proposed regime, a company with better quality financial statements would have an incentive to signal its superiority to the marketplace by demonstrating that it can obtain higher coverage at a lower premium relative to other companies in its industry.[1443] It would do so because it reckons that the coverage it obtains and the premium it pays would be made public, and, furthermore, would be viewed by the market as credible signals of the true quality of its financial statements.[1444]

Cunningham believes that in order for the FSI to be effective, it must contrast with prevailing insurance policies used in corporate governance such as directors' and officers' ("D & O") insurance and related entity-level policies.[1445] Main distinctions comprise that FSI policies must be occurrence-based (not claims-made) and must be primary insurance (not excess insurance or otherwise limited by other insurance clauses). Illustrative implementation differences comprise interpreting insurance law's fortuity requirement (concerning the

[1441] Ibid 58.
[1442] Ibid.
[1443] Ibid 59.
[1444] Ibid.
[1445] Lawrence Cunningham, 'Model Financial Statement Insurance Act, A' (2004) 11(1) Connecticut Insurance Law Journal 69-106 at 71.

insurability of intentional acts) and assessing traditional insurance law issues such as application fraud and other insurer defences.[1446] Other differences concern the determination and meaning of insurance premiums paid and coverage bought (for example, as to requirements for self-insurance through deductibles and retentions) and the claims-settlement process.[1447] The Model FSI Act use traditional insurance practice and state insurance law in the service of federal securities regulation. Three tools assist accomplishing the requisite marriage between state insurance law and insurance markets on the one hand and federal securities regulation on the other: contract, disclosure and some judicial/regulatory adaptation. For each, a federal regulatory overlay achieved primarily through the Model FSI Act is designed to make a streamlined process by which FSI policies are originated, qualified, become effective, and are enforced in the interest of investors.[1448]

Some of the deemed terms were also explained by Cunningham as follows:[1449]

1. Occurrences, Not Claims Made: All FSI policies must be occurrence-based policies. FSI insures a year's financial statements, with coverage expanding to discoveries made in future periods. In insurance phrasing, this means FSI is retroactive coverage, to be provided on an "occurrence" basis. There invariably will be a time lag between the event causing damages (a material financial misstatement) and their manifestation (revelation with value-destroying effects on securities). As retroactive coverage, FSI covers a year's financial statements, and extends coverage for several consequent years. The Model FSI Act considers defining the coverage period in parallel with analogous statutes of limitation and repose.[1450]

2. Claims: In conventional insurance law and practice, processes to determine, measure and pay recoveries for losses pursue a firm pattern: the insured must inform the insurer of a claim; the insurer investigates; the insurer becomes liable only when the insured is held liable; the insurer normally defends the claim; and settlements are reached or the case goes to trial. The Model FSI Act envisions a more efficient approach. The FSI policy mirrors joint selection by the FSI insurer and the issuer of a fiduciary organization to assess claims, notify the insurer of claims, and represent investor interests. When losses are claimed and notice given, the FSI

[1446] Ibid.
[1447] Ibid 71-72.
[1448] Ibid 72.
[1449] Ibid 76-79.
[1450] Ibid 76.

insurer and fiduciary organisation cooperatively chose an independent expert to determine the claim's validity and amount. The expert report results to the FSI insurer, which then provides funds to the fiduciary organisation to compensate investor losses.[1451]

3. No-Action Clauses: Insurance policies typically include no-action clauses limiting rights of third-party loss victims to recover directly from the insurer, requiring them instead to obtain judgments against the insured. This way would reduce the utility of FSI as a device to protect investors from issuer misconduct, manifested in its materially misstated financial statements that trigger FSI loss payouts. To avoid this result, the Model FSI Act considers FSI policies to authorise direct actions against FSI insurers by investors or their fiduciary representative.[1452]

4. Loss Payees: For FSI, companies are the insured and policies name as loss payees those investors holding the company's securities within the reporting period for a set of covered financial statements. The Model FSI Act tackles apportionment concerns among investors in issuers with complex capital structures by reflecting appropriate voting rules determining FSI approval. FSI policies are deemed to incorporate such apportionment provisions.[1453]

5. Good Faith to Investors: In third-party insurance, insurers are obliged to show good faith towards the insured and may be subject to tort liability to insureds when acting in bad faith. For FSI, good faith requirements are crucial - not so much for the insureds - but for the loss payees (the investors). Enlisting insurers so directly in the auditing function under FSI requires imposing on them the public watchdog and investor protection functions accompanying with traditional financial statement auditing.[1454] Therefore, the Model FSI Act considers to be part of FSI policies provisions imposing on FSI insurers the duty of good faith towards investors, not issuers.[1455]

Cunningham has discussed the liability for misleading statements.[1456] He sees that "any person who shall make or cause to be made any statement in any application, report, or document filed with the Commission (SEC) pursuant to any provisions of this Model FSI Act, or any rule,

[1451] Ibid 77.
[1452] Ibid.
[1453] Ibid 78.
[1454] Ibid.
[1455] Ibid 78-79.
[1456] Ibid 102-103.

regulation, or order there under, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or who shall omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall be liable to any person (not knowing that such statement was false or misleading or of such omission) who, in reliance upon such statement or omission, shall have purchased or sold a security covered by an FSI policy to which such application, report, or document relates, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading or of such omission.[1457] A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit and assess reasonable costs, including reasonable attorneys' fees, against either party litigant, having due regard to the merits and good faith of the suit or defense. No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued."[1458]

FSI moves auditors into the liability background.[1459] Auditors become insurer employees, subject to termination, as well as to legal claims by insurers for breach of contract, negligence, fraud, and other cognizable transgressions.[1460] FSI differs from the warranty-auditing proposals by setting auditor public liability at zero and establishing insurance coverage in its place.[1461] FSI would also cover damages assessed against the issuer itself.[1462] However, FSI would not alter the liability position of any other existing actors in the financial reporting process, including officers, directors, underwriters, and attorneys.[1463] In other words, financial statements are prepared in the first instance by management, not auditors.[1464] Virtually every case of misleading financial statements involves complicity by officers and/or the board. For this reason, officers and directors would need to remain separately liable for their own misconduct. Furthermore, to forestall frivolous litigation, accountants' malpractice claims

[1457] Ibid 102.
[1458] Cunningham (n1445) 102-103.
[1459] Cunningham (n1295) 428.
[1460] Ibid.
[1461] Ibid.
[1462] Ibid.
[1463] Patricia A. McCoy, 'Realigning Auditors' Incentives' (2003) 35 Conn. L. Rev. 989 at 1010-1011.
[1464] Ibid 1010.

would need to be limited to suits by shareholders, not by management.[1465] Thus, for example, officers and directors falsely certifying financial statements would remain exposed to direct liability and would forfeit bonuses and salaries received during periods covered by materially misstated financials.[1466]

A related issue concerns the effects of security holder approval. At minimum, approval would relieve the registrant of obligations to provide FSA in the traditional manner (as amended federal securities laws would expressly permit).[1467] More difficult is the question as to whether approval should also limit investor recoveries against auditors or issuers for financial misstatements to the amount of coverage stipulated in the FSI policy.[1468] In theory, at least, a proxy vote manifests security holder notice and knowledge of approved proposals, and the effects could be designated as binding.[1469] This assumes the resolution of rational apathy and collective action problems afflicting all shareholder decision making in corporate governance. State courts, at least, have not treated shareholder approval as guaranteeing any particular result in subsequent litigation.[1470]

In this context, however, abundant policy analysis supports the concern that damages awards for many accounting-related claims overcompensate and imperfectly deter.[1471] This shows a strong need for seeking a mechanism to improve damage measures imposed on the auditor and issuer, which FSI provides using a market-based and publicly disclosed mechanism, accompanied by minimum federal standards. FSI would not, moreover, preclude recovery from persons other than the auditor, issuer, or FSI carrier, so that directors, officers, attorneys, and underwriters would remain potentially liable.[1472]

For the shareholder (or security holder) vote, the proxy statement disclosure and balloting would offer three choices: (1) take the maximum offered coverage, paying the related premium; (2) take lower levels of coverage recommended by management; or (3) take no insurance. For companies deciding to take no insurance, traditional FSA procedures and related liability rules would remain in place for that year. For companies opting for one of the insurance alternatives,

[1465] Ibid.
[1466] Cunningham (n1295) 428.
[1467] Ibid 431.
[1468] Cunningham (n1295) 431.
[1469] Ronen (n1340) 58.
[1470] Cunningham (n1295) 431.
[1471] Ibid 432.
[1472] Ibid.

the next step would be for the insurer to appoint an auditor to conduct a full audit of the company's Year X financial statements.[1473]

Another issue is related to the claims-settlement process that begins when losses are claimed (that is, when financial misstatements are alleged). Ronen does not describe how shareholders (or other security holders) solve collective action and rational apathy problems in bringing a claim.[1474] Presumably, the process follows the traditional securities law model, with large investors acting or class action lawyers rounding up claimants. In any event, in Ronen's model, the fiduciary organization becomes aware of the potential claim and notifies the insurer.[1475] At this point, Ronen indicates that the insurer and the fiduciary would "mutually select an independent expert" to determine the claim's validity and amount.[1476] Then, Ronen concludes, "Within a short time after receiving the expert's report, the FSI carrier compensates the fiduciary up to the face amount of the policy for the damages."[1477]

Ronen obviously intends to provide a thumbnail sketch of the claims process, hinting at perceived limitations in existing securities law litigation.[1478] In suggesting the alternative, however, major differences between the proposed model and standard principles of insurance law and practice appear. Insurance practice, by custom and contract, follows a fairly rigid pattern. In the traditional pattern, the insured must notify the insurer of a claim; the insurer then investigates; the insurer becomes liable only when the insured is held liable; the insurer usually defends the claim; and settlements are reached or the case goes to trial. Whether FSI could be streamlined using Ronen's approach or be constrained to follow this traditional insurance claim model is uncertain.[1479]

Another significant factor affecting premiums relates to stacking, circumstances where particular claims are covered by overlapping insurance policies. Questions arise concerning which are primary and which, if any, cover only losses in excess of certain amounts or other coverage. To truncate related disputes ex ante, policies typically attempt to specify their rank in such overlapping insurance situations using various types of so-called other-insurance

[1473] Ibid.
[1474] Ronen (n1340).
[1475] Ronen (n1340).
[1476] Ibid 51.
[1477] Ibid.
[1478] Ibid.
[1479] Cunningham (n1295) 441.

clauses.[1480] For example, D & O policies usually contain excess clauses, meaning they apply only when and to the extent other applicable insurance is exhausted.[1481] Despite contracting efforts, disputes frequently arise when insurers facing claims resist providing coverage by pointing to the existence of other policies to be drawn on first.[1482]

Overlapping insurance would likely occur in FSI-coverage situations.[1483] D&O insurance would likely apply along with FSI, covering directors and officers participating in preparing or certifying misstated financials.[1484] The interplay between policy types can affect premiums.[1485] If investors focus on FSI's premium-coverage mix, and not on D & O premium-coverage data, managers could obtain a superior FSI premium-coverage mix by making FSI excess while making D & O insurance primary, or pursue other combinations using other insurance clauses that cloud the reliability of FSI's premium-coverage mix as a signaling device.[1486]

Given the central role FSI would play in financial reporting and securities trading, and the importance of the premium-coverage signal, FSI should probably be designated as primary, not excess, and not contain any other insurance clauses.[1487] This would both avoid the uncertainties of outcomes common to overlapping policy disputes and prevent biases in the premium coverage signal that would otherwise arise.[1488] Accordingly, it may be desirable for federal securities law authorizing FSI as an alternative to Financial Statement Audit (FSA) to specify that qualifying FSI policies must contain a policy provision specifying primary coverage and omit any other-insurance clauses.[1489] In any event, requisite disclosure would be necessary.[1490]

[1480] According to Cunningham (n1295) 459 other-insurance clauses vary widely, typified by pro rata, excess, and escape clauses. Their interpretation by judges also varies widely. Pro rata apportions coverage across overlapping policies; excess makes one primary and others secondary, the secondary policies covering only losses not covered by the primary one; and escape clauses void coverage if other valid collectible insurance exists.
[1481] Cunningham (n1295) 459.
[1482] According to Cunningham (n1295) 459-460 courts attempt to construe overlapping policies to implement the intention of other insurance clauses; sometimes they harmonize (as where all contain pro rata clauses) but not always (say all contain excess or escape clauses). When clauses are mutually repugnant, however, courts often treat them as cancelling each other and impose pro rata coverage.
[1483] Cunningham (n1295) 460.
[1484] Ibid.
[1485] Ibid.
[1486] Ibid.
[1487] Ibid.
[1488] Ibid.
[1489] Ibid.
[1490] Ibid.

In 2006, Mainelli and Ronen stated that the UK's reaction to FSI has been that it is too complex and more suited to the US's litigious market, which is rules-based rather than principles-based.[1491] However, there are three potential ways to launch FSI in the UK that require no regulatory changes whatsoever but would benefit, through competitive advantage, three distinct commercial constituencies: audit firms, stock exchanges and investment funds. Moreover, they think that in some ways, the critics are right. FSI as proposed for the US is not suited to the UK. However, if capital markets professionals or exchanges or auditors can enlist insurers to provide FSI cover they may well gain competitive advantage. It would be fascinating to see financial services innovation proposed in the US taken up first, with appropriate modifications, in the UK. Even more fascinating would be to watch an initiative bogged down in the US regulatory quagmire provide competitive advantage in the UK.[1492]

Cunningham thinks that one of the advantages of using the FSI is to eliminate moral hazard.[1493] FSI moves auditors into the liability background. Auditors become insurer employees and are subject to supervision, compensation, and termination. Auditors no longer face any insurance-based decisions that are prone to creating moral hazard. FSI also essentially eliminates the traditional concerns of adverse selection, because it is an entirely different product compared to traditional categories of insurance such as professional liability insurance, casualty, or property insurance.[1494] Rather, among insurance products, FSI is akin to title insurance, an otherwise sui generis insurance line.[1495]

This conclusion need not rule out the possibility of sustaining SIPs, however, FSI and SIPs both could be used, as they are not mutually exclusive.[1496] Audit firms could keep on operating SIPs but also commence on an FSI regime by holding out their SIPs among those FSI insurers competing for issuer audit insurance work.[1497] Consequently, for instance, Procter & Gamble could hire Chubb Insurance to write FSI for it, and Chubb could in turn hire Deloitte's auditing arm to provide the investigation. Otherwise, Procter & Gamble could hire Deloitte's SIP

[1491] Michael Mainelli and Joshua Ronen, 'Put your Money where your Audit is: Financial Statement Insurance in the UK?' (2006) 7(4) The Journal of Risk Finance 446.
[1492] Ibid.
[1493] Cunningham (n371) 759.
[1494] Ibid.
[1495] Ibid 760.
[1496] Ibid 762.
[1497] Ibid.

affiliate to write FSI and have it, in turn, engage Deloitte's auditing arm to provide the assurance.[1498]

Financial statement insurance can offer a mechanism to create the functional equivalent of a damages cap for audit failure.[1499] The cap does not directly apply to auditors, of course, for although they may run across contractual and other liability for transgressions to their insurer employers, they face no liability to investors.[1500] The cap is established through the policy terms concluded between issuers and insurers. The cap would be disclosed to public capital markets ex ante and allow investors to make capital allocation decisions accordingly.[1501] Decisions would be based on measurable resources available in the event of audit failure and the transparent financial statement reliability index.[1502] To this extent, FSI provides support for quotidian cases of audit failure, but perhaps not catastrophic cases. Insurance-based securitization can tackle the latter problem.[1503]

Ben-Shahar and Logue have endorsed the FSI.[1504] They asked the question of whether government regulation of auditors' conduct can be outsourced to insurers. They said that under Ronen's proposal, the law would not have to determine when a conflict of interest arises, and how to divide the blame between the auditors and the audited firms.[1505] Instead, the law will need to set clear rules of strict liability (for firms, not auditors) for misrepresentation, and it has to mandate that firms purchase liability insurance.[1506]

Faboyede and Mukoro believe that it should be made mandatory for Nigerian banks to adopt Financial Statement Insurance.[1507] This will offer a level playing field and comparability of information. For every bank, investors will know that the auditors work for insurers and that FSI coverage and premium information are obtainable for comparison. The Securities and Exchange Commission (SEC), Central Bank of Nigeria (CBN), Corporate Affairs Commission

[1498] Cunningham (n371) 762.
[1499] Ibid 763.
[1500] Ibid.
[1501] Ibid.
[1502] Ibid.
[1503] Ibid.
[1504] Omri Ben-Shahar and Kyle D Logue 'Outsourcing Regulation: How Insurance Reduces Moral Hazard' (2012) 111(2) Michigan Law Review 197-248 at 246.
[1505] Ibid.
[1506] Ibid.
[1507] Olusola Samuel Faboyeda and Mukoro, 'Financial Statement Insurance: Restoring Investor Confidence in Nigerian Banks' (2012) 3(4) Research Journal of Finance and Accounting 140-150, 149.

(CAC), and the association of insurance companies should come together to map out a FSI-underlined blueprint that could get them out of the business of usual auditing regulation and disclosure oversight, freeing resources for other uses, including prosecution of what should be a very small number of deceptive financial disclosure cases.

6.9 Conclusion

The aims of this chapter were to shed light on several aspects related to conventional auditor liability and financial statement insurance products. It started by indicating the importance of being insured from a court perspective so that compensation can be given to specific groups of identified users. The chapter explored relevant official and non-official reports in terms of the implications for the availability of liability insurance as well as exploring whether the overall liability system can be improved. Further discussion examined also issues related to the general insurance-based argument and whether the professional liability market deeply relies on the cyclicality. Then, discussion moved to give an overview of the association of conventional insurance with audit failure. Lastly, financial statement insurance was introduced to examine how this relatively new product can be beneficial to the auditing industry as well as in compensating damaged persons. It seems that Takaful and conventional insurance have similar prospects for financial statements insurance. This innovative product aligns the interest of the auditors with the interest of the insurance carrier, so it is possible to align the interest of the auditors, by extension, with the interests of shareholders. In addition, the losses insured against, which comes from the decreases in the valuation of companies resulting from omissions or misrepresentations in the financial statements, can be hedged in the capital markets with properly constructed derivatives. Therefore, Takaful and conventional insurers share the same view but with different means of hedging, that should be Shariah complaint in Takaful.

Chapter 7: Discussion, Analysis and Synthesis of Auditor Liability Rules and their Connection with Insurance Principles and Practises

7.1 General Introduction

7.1.1 Overview

This chapter has two main themes for analysis based on what has been discussed in previous Chapters. First, further analysis and synthesis are needed to connect auditor liability rules with Insurance principles and practises. This will include a brief discussion outlining how certain common law principles of Companies law differ fundamentally in Saudi Arabia. This is necessary to clarify and eliminate confusion that may otherwise arise from the common law practitioner's perspective, and to support the researcher's premise that Saudi Arabia should have different understanding with respect to auditor civil liability towards shareholders as well as the role of Takaful in compensating damaged persons. Hence, such subjects must be examined before moving on to discuss the main themes.

Earlier Chapters identified relevant literature with respect to auditor civil liability towards third parties in general, and the focus here (The first theme) will be on the shareholders' rights to be economically indemnified. The common law cases and regulations were considered, as were the Islamic principles of tort and Saudi legislations. It was noted that the Saudi legal infrastructure differs to the common law with respect to auditor civil liability towards shareholders and others. Now we come to consider whether the common law cases supply learnings that may be applied in the Saudi context. This comparison will be done through general comparison of related concepts rather than analysing on a case by case basis. As liability and accountability concepts are different in Islamic, civil, common and mixed jurisdictions in corporate, securities and insurance laws, a new reading and analysis are needed to assess which system provides greater protection for third parties.

The second theme is related to the practices and principles in conventional and Takaful insurance in the context of auditor liability insurance. The literature has indicated that there are different concepts in conventional and Takaful insurance despite the fact there are a number of similarities also. The conventional insurance literature with respect to professional liability

insurance is quite rich in comparison with Takaful where there is none. Hence, the use of conventional insurance is vital to evaluate how Islamic insurance principles are different in terms of applicable principles and products and more importantly in indemnifying shareholders as the end resort. It is worth noting that the system of liability and insurance is not connected in the conventional literature. The availability of insurance, or lack thereof, has played a significant role in shaping the common law principles and policies of civil liability for auditors, yet few studies have examined the realities, limits or potential of the conventional insurance market in this area, and none in the takaful market.

This study aims to harmonise the civil liability of auditors with insurance markets and to identify how the issues might be addressed in Saudi Arabia having regard to Islamic principles.

Though common law cases support the protection of third parties in some respects as regards the negligence of auditors, it was noted earlier that some civil law countries go further.[1508] It is argued in this thesis, that the correct application of Islamic principles requires protection for shareholders beyond that achieved in the common Law countries. This will also lead to different understanding in Takaful business practices through professional liability products.

It is hoped that this research will assist in the development of just liability principles and appropriate insurance products in Saudi Arabia that conform with Islamic principles.

7.1.2 Challenges and Limitations of the Research

Issues arise due to involving several areas in this research. For example, the researcher is not a specialist in Islamic Law or the field of accounting, however, he intends to make a tentative analysis and give an indication about Shariah perspectives as it relates to auditor liability. The lack of literature and the unavailability of court cases in the researched area from the Islamic point of views brings uncertainty of the final outcomes. Thus, further researches are needed in

[1508] For example, Khoury (n417) has compared the liability of auditors beyond their clients between common and civil law jurisdictions. This thesis has noted as well a recent thesis that compare auditor liability to third parties in Spain and the United States, however, this extensive work is considered as a mere comparative study that does not supply practical solutions to raised matters in terms of compensation methods and how liability rules are connected to insurance. This thesis shows how auditor civil liability rules towards third parties are different in common and civil law countries but unable to conclude which system is better and whether Spanish civil law would be able to identify damaged persons. In this work, the researcher argues in general that civil law countries are unable to bring further analysis even though civil liability rules are clear and could be connected to auditing business. Abdussamad (n231).

other fields to assess if the findings of the thesis are viable and could be applied in practice. Another hurdle comes from the interpretation, application and distinction of common law cases that arrive to different conclusions.

The Saudi liability system is solidly based on Islamic principles and regulations that were never investigated or tested. The importance of this investigation is to discuss advantages and disadvantages of compared systems so that gaps in the Saudi legal system can be filled. Indeed, the researcher thinks that there is a current trend in the Saudi current insurance in non-life products to be similar to civil and common-law countries despite the differences. This also can be said for the securities market. This trend has become controversial as it intends to deviate completely or partially from Islamic principles.

Furthermore, the technicalities of insurance are not extensively presented due to the fact the researcher believes that there is no need to indulge into them at any detailed length,[1509] but rather providing relevant information on various rules in order to sufficiently understand litigation risk and areas of pricing was the overall aim. Finally, there is support from the insurance industry itself to mitigate the floodgate of claims as well as from the auditing industry to reduce litigation risk and provide better protection for auditors. However, finding accessible and relevant supporting documents and ranging opinions was difficult to obtain, particularly those with opposing views in favour of third-party indemnification for their loss based on the wrongdoings of auditors. In addition, common-law judicial and regulatory attempts could not prove their positive impact yet, and this thesis casts strong doubts about them in providing just treatments to all involved parties such as auditors, companies, shareholders, and insurers. Therefore, previous judgments and legal statutes do not adequately serve the justice and future research may prove the researcher's opinions, which are considered challenging tasks in bringing new theories, empirical evidence and legal changes.

As Saudi Arabia is considered a fully-fledged Islamic country, the essence of Shariah principles must lead the discussion with assistance from enacted regulations in Saudi Arabia. Furthermore, one may argue that Saudi judges or quasi-judicial members may interpret Shariah principles differently according to specific school of thoughts or examine other principles that

[1509] For instance, see Billah, Mohd Ma'Sum., GhlamAllah, Ezzedine. and Alexakis Christos., 'Takaful and ReTakaful', Encyclopedia of Islamic Insurance, (1ed, 2019), Elgar Publishing.

lead to a different conclusion as it is considered as a subjective matter. One of the significant features of the Saudi court system is that no Saudi court applies judicial precedent (stare decisis)[1510] as there is nothing in the law compelling judges to follow such a doctrine, and judicial rulings make no reference to precedent. By implication, this means that Saudi judges are not bound by previous decisions or the decisions of a superior court.[1511] In relation to non-codified rules of Islamic origin, judicial rulings are not considered to be a source of Sharia law and the authority to develop the Islamic law belongs to jurists rather than judges who refer to the former for statements of law.[1512] Accordingly, given the lack of judicial precedent, Islamic law is best described as a 'jurists' law', not a 'judges' law'.[1513]

With respect to codified rules of foreign origin, in the absence of the doctrine of judicial precedent, Saudi judges apparently have relatively limited power within the context of written legal codes since they simply tend to enforce codified rules. The courts' power is limited to interpreting the law and does not extend to the entitlement to change the law, as the power to introduce new laws and amend existing rules lies with the Saudi regulatory branch.[1514]

In addition, Saudi Companies Law comprise a combination of rules and principles. Though a law that contains open-ended concepts and standards might be appropriate to jurisdictions where the enforcer (e.g., courts) have strong 'residual law making power',[1515] which includes the recognition of legal precedent as a source of law, this is not the case in Saudi Arabia.[1516] Open-ended legal norms normally require an enforcer who possesses the capability to exercise 'wide discretion to deal with matters as they fit on a case-by-case basis', which, again, is problematic within the Saudi context.[1517]

The researcher has used common law cases and regulations to identify some gaps not studied in the civil liability and Takaful literature as of yet. Moreover, a review of common law cases

[1510] See D J Karl, 'Islamic Law in Saudi Arabia: What Foreign Attorneys Should Know' (1991) 25 George Washington Journal of International Law and Economics 131, 149.
[1511] Ibid.
[1512] F Vogel, Islamic Law and Legal System : Studies of Saudi Arabia, (Leiden, Brill 2000).
[1513] Ibid 24.
[1514] Aleshaikh (n208) 29.
[1515] See generally, K Pistor and C Xu, 'Incomplete Law: A Conceptual and Analytical Framework and its Application to the Evolution of Financial Market Regulation' (Working Paper No. 204, 2002) 4.
[1516] G Dari-Mattiacci and B Deffains, 'Uncertainty of Law and the Legal Process' (2005) Amsterdam Center for Law & Economics Working Paper No 2005/10, 2005, 9 and 10 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=869368> accessed 15 August 2018.
[1517] B Cheffins, *Company Law: Theory, Structure and Operation* (Oxford, Clarendon Press 1997) 282.

shows how non-religious based law may err in understanding basic principles so it leads to weak infrastructure in the area of liability as well as in insurance businesses.

7.1.3 Specific Goals of this Chapter

The first aim of this Chapter is to analyse the extent of suitability of common law principles in civil liability of auditors towards shareholders application in Saudi Arabia. The second aim is to extend the discussion of conventional insurance practises and products with respect to auditor's civil liability and how they could be modified and then applied in Takaful industry.[1518] The third aim is to address the issue of vagueness among the liability system and insurance in common law countries, and then the discussion intends to synchronise the liability system of auditors with insurance from an Islamic perspective.

The above aims are relevant to justify the main thesis question. Besides, the ongoing discussion, analysis and synthesis of this Chapter combined with previous Chapters would then provide a comprehensive insight on how this research seeks to answer the sub-questions raised in Chapter One and which will also be revisited in Chapter Eight.

7.1.4 Basic Assumptions in this Chapter

As a starting point of the discussion, the researcher would like to emphasise a general Islamic principle in the Islamic business environment, which is the principle of risk-sharing.[1519] This main principle should be applied in the worlds of corporate law and insurance. In this section, the thesis discusses the position of ordinary shareholders compared with preferred shareholders and creditors who are considered as third parties in the west, while in my opinion an ordinary shareholder is an owner in a company who has rights and obligations from Shariah perspective. This will impact on the concept of the separate legal entity and if it must not be separated from

[1518] Further technicalities of Takaful products in connection with auditor liability might be subject to further studies as this current study explains in detail other general and life Takaful products e.g.: accident, fire, motor, healthcare and travel insurance, education, endowment, mortgage, personal accident, critical illness and senior citizen policies, see Billah, Mohd Ma'Sum, Islamic Insurance Products, Exploring Takaful Principles, Instruments and Structures (1ed, 2019), Palgrave Macmillan.

[1519] TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (TheCityUK, 2015), available online at: https://www.thecityuk.com/assets/2015/Reports-PDF/bd4af364ee/The-UK-Leading-Western-Centre-for-Islamic-Finance.pdf, 24.

ordinary shareholders' positions in a listed company. Further, Takaful practises should also be dealt with risk sharing rather than risk shifting applied in conventional insurance.

A shareholder of a listed company intends to share the profit and loss with a group of other shareholders who enjoy similar rights and obligations. The ordinary shareholder whether an individual or institutional is the one who has a special relationship in a listed company in addition to getting specific rights and obligations as stated in the Saudi Companies Law 2015 and Corporate Governance Rules 2017.[1520] Moreover, a current shareholder is similar to a former shareholder or potential shareholder who acquire(d) stocks in listed company in our analysis. This is really important in later discussions to show that whenever a shareholder buys stocks in the secondary market and then intends to sell them, similar rights and obligations transfer to a potential buyer with their risks.

The researcher intends to exclude preferred shareholders as they have different incentives and do not share the same risks and voting rights. In addition, from an Islamic point of view, acquiring preference shares is prohibited despite the fact they are permitted as stated in the Saudi Companies Law 2015. Hence, those shareholders who have preferred stocks are unable to be indemnified unless they convert their ownership status to ordinary shareholder. To clarify, the recent Regulatory Rules and Procedures[1521] issued pursuant to the Companies Law 2015 relating to Listed Joint Stock Companies by the CMA on 20 May 2019 has stated in article thirty-three several conditions for converting preferred shares to ordinary shares as follows "The Company may issue or buy-back Preferred Shares, convert ordinary Shares into Preferred Shares or convert the Preferred Shares into Ordinary Shares, in accordance with the following rules:

1. The Company's bylaws must provide and permit it;
2. Obtain the extraordinary General Assembly's approval;
3. Obtain the approval of holders of Preferred Shares convened in a Special Assembly if the resolution relates to converting Preferred Shares into ordinary Shares or amending the rights of any holders of such Shares;
4. The Preferred Shares must not exceed 10 % of the Company's share capital;
5. The Company's share capital must be fully paid; and

[1520] Earlier discussion about these laws could be found in section 2.9.
[1521] https://cma.org.sa/en/RulesRegulations/Regulations/Documents/LJSCRulesEn.pdf.

6. Compliance with other relevant laws and regulations."

In terms of voting right for the holders of preferred shares, article thirty-five of the Regulatory Rules and Procedures has stated that "Preferred Shares shall not grant its holders the right to vote in General Assemblies unless the Company fails to pay to holders of such Shares the specified percentage of the Company's net profits after setting aside the statutory reserve for three consecutive years." In terms of rights, the holders of Preferred Shares must vote on a special assembly to ratify certain resolution taken by the general assembly as highlighted in article thirty six "If the General Assembly resolution results in amending the rights of holders of Preferred Shares, including the liquidation of the Company or conversion of Preferred Shares into ordinary Shares or vice-versa, such resolution shall not be effective unless ratified by holders of Preferred Shares allowed to vote in a Special Assembly." Lastly, article thirty seven gives the preferred shareholder the right to vote in the Company's General Assembly conditioning the following "If the Company fails to pay holders of Preferred Shares the specified percentage of the Company's net profits after setting aside the statutory reserve for three consecutive years, the Special Assembly of holders of Preferred Shares, held in accordance with the provisions of Article 89 of the Companies Law, may resolve either to allow them to attend the Company's General Assembly and participate in voting, or to appoint representatives in the Board in proportion to the value of their Shares in the share capital, until the Company is able to pay all profits allocated to holders of such Shares from all previous years. Each Preferred Share shall have one vote in the General Assembly, and the holder of a Preferred Share may, in this case, vote on all agenda items of the General Assembly without any exceptions." This new article brings a new right to those who are categorised as preferred shareholders that contradict with the definition stated in this regulation as well as not being explicitly stated in the Saudi Companies Law 2015. Hence, it is argued that this category should not be compensated unless the transfer to ordinary share being made.

The same rule applies to creditors who may convert their debts to equity so then they could be considered as ordinary shareholders.

In the Islamic insurance industry, Takaful is intended to share the risk between an insurer and insured persons, while, in conventional insurance, the practice is to transfer the risk. For example, an auditor buys a professional liability insurance to protect him and pay a specific amount of money in case of compensation. The insurer has considered similar risks to price his product. Hence, both an auditor with a group of other auditors, for example, have contributed voluntarily in an insurance fund through the insurer to assist them in case of default occurred to one of them or some of them.

The researcher understands that an incorporated company is a separate legal entity with limited liability and notes the principle firmly rooted in the common law that duties of company officers are owed to the entity and not to individual shareholders. However, the discussion illustrates that obligations and liabilities of the company cannot by any means be separated from its ordinary shareholders who are the truly owners of it. To put it simply, the legal entity of a company is connected with its shareholders in sharing the risk of loss and profit, despite the fact that there is a separation from internal and corporate cases against its creditors or employees. Hence, this should not be interpreted as a separation of shareholders from the entity so they are then identified as third parties.

7.1.4.1 The Differing Understanding of Legal Separate Personality and Limited Liability of Joint Stock Companies from Islamic, Saudi and Common Laws Perspective and their Influences on the Shareholders' Economic Ownership Positions

One may question whether the concept of separate legal personality of a corporation enables only the company to demand the auditor for compensation in case of negligence in the financial statements. Conventional wisdom in western Companies law is that ordinary shareholders can take action through class action or personal actions only when the loss they seek to remedy is personal. When the loss is corporate, the correct plaintiff is the company only, though a shareholder can initiate an action on behalf of the corporate plaintiff by means of a derivative action. This then begs the question whether the duty of the auditor is owed to the shareholder personally or to the corporation; this thesis argues that auditors' duties to shareholders are separate from their duties to the corporation and can be actioned by shareholders personally, particularly in the Saudi Context. This subsection starts with examining the general concepts of legal personality and limited liability of corporation and if it differs from partnership in classical Islamic law and then Saudi legislations. After that, the same principles are discussed from the common law perspective through English law and its principles as an example to the broader understanding of such relevant concepts.

Legal personality and limited liability are often presented as the most significant elements of the company.[1522] Classical Islamic law recognises legal personality in the form of the waqf 'endowments',[1523] bayt al-mal[1524] and masjid.[1525] However, Imran for instance has opposed the existence of separate legal entity in Shariah law, although named it as fictitious person or artificial person. The notion of separate legal entity that a company is a fictitious person relied on the instances of waqf, baitul mal and the estate of deceased has been regarded as misplaced assertions by modern Muslim jurists.[1526] According to him, the concept of sharikah will lose its significance if the separate legal entity concept acknowledged in Shariah law. As a result, the acceptance of the principle will shatter the whole structure and violates the fundamental principles of Shariah law mainly law of contract. Therefore, there is a potent opposition to the concept of legal personality for a corporation.[1527]

In Islamic law, the word Sharikah is a generic term that refers to participation in a business of any type which includes corporations, companies, and partnerships. Classical Islamic law addresses in a general manner the provisions of corporation and in detail the provisions of partnership. Sharikat as a legal term includes businesses which are Sharikat Al-milk[1528] (non-contractual), Sharikat Al-uqud (contractual) and companies,[1529] neither of which is mentioned expressly, either in the Holy Quran, or in the Sunnah. However, when these types of Sharikat emerged, Muslim scholars engaged in ijtihad, which are scholarly efforts to demonstrate the

[1522] Hassan Halyani and Abd Ghadas Zuhairah Ariff and Abdul Rahman Nasarudin 'The myth of corporate personality: a comparative legal analysis of the doctrine of corporate personality of Malaysian and Islamic laws' (2012) 6 (11) Australian Journal of Basic and Applied Sciences 191-198. ISSN 1991-8178.

[1523] For further discussion about Waqf in Shariah see: Hassan Halyani and Abd Ghadas Zuhairah Ariff and Abdul Rahman Nasarudin 'The myth of corporate personality: a comparative legal analysis of the doctrine of corporate personality of Malaysian and Islamic laws'(2012) 6 (11) Australian Journal of Basic and Applied Sciences 191-198. ISSN 1991-8178; see also: Zainal A. Zuryati, Mohamed Yusoff and Ahmad N. Azrae, 'Separate legal entity under Syariah law and its application on Islamic banking in Malaysia: a note' (2009) 6(2) The International Journal of Banking and Finance 139-154; see also M Albrahim 'The enforcement of directors' duties in the context of shareholders' rights: a comparative study between UK and Saudi law' (PhD thesis, Lancaster University 2016) 89-91.

[1524] Bayt al-mal is an Arabic term that is translated as "House of money". It is a financial institution, responsible for dealing with the revenues and all other economical matters of the state and which served as the treasury. For further discussion see: Halyani, Ariff and Nasarudin (n1522); see also: Zuryati, Yusoff and Azrae (n1523).

[1525] Masjid refers here to the mosque as a public institution, possessing elements of a public corporation in relation to the collection and management of public funds such as charity. For further discussion see: Halyani, Ariff and Nasarudin (n1522); see also: Zuryati, Yusoff and Azrae (n1523) 139-154.

[1526] Imran Ahsan Khan, *Islamic Jurisprudence* (The Other Press, International Institute of Islamic Thought. Petaling Jaya 2003) 13.

[1527] Ibid.

[1528] This type of Sharikat is usually created by way of inheritance, wills, or other situations where two or more persons come to hold an asset in common.

[1529] Gulf-Law.com website, [Companies in Islamic (Shariah) Law], Accessed at: http://www.gulf-law.com/uaecolaw_shariah.html. Accessed on: 10.08.2018.

rule of Islamic law concerning those types of Sharikat.[1530] Thus, in order to identify the specific form intended, it is the practice of jurists to qualify this term.[1531]

Further, when classical jurists use the word Sharikat in their sources to mean co-ownership, the usage of that word is a qualified term referring to co-ownership, commonly through inheritance, wills, or other situations where two or more persons hold an asset in common. Therefore, the joint ownership arises from the fact of the parties holding the benefit in common.[1532] The legal situation between the parties involved is known as "khalt" in Arabic, which literally means "mixed", referring to the mixture or combinations of ownership that exists between the parties.[1533] However, when the jurists want to indicate that the basis of participation is a contract between two or more persons, the term is qualified as Sharikat Al-uqud (contractual) which is divided into five kinds: ; Sharikat Al-inan, Sharikat Al-wojooh, Sharikat Al-mufawadhah, Sharikat Al-mudarabah and Sharikat Al-a'maal.[1534] This type of Sharikat is understood in English law as a partnership.[1535] Bilal has concluded that under Islamic law, there is no assumption in the contract that liabilities will never exceed assets. The liability of a partner for the debts of a partnership is unlimited; Islamic law does not legitimize the concept of limited liability.[1536]

The provisions of sharikat are subject to the partners' agreement based upon the dicta of Prophet Mohammed: "... and the Muslims will be held to their conditions, except the conditions that make the lawful unlawful, or the unlawful lawful."[1537] This means that any participation in a business of any type whether company or partnership is subject to the partners' terms and agreement.[1538]

[1530] Halyani, Ariff and Nasarudin (n1522) 20.
[1531] Ibid.
[1532] Ishaq Alhesain and David Milman, 'Dissolution of companies and partnerships : a comparative study between Saudi law and English law in the light of Islamic law' (PhD thesis, Lancaster University 2018) 160.
[1533] Ibid, see also: G Bilal, 'Business Organisations under Islamic Law' (Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities, Cambridge, Massachusetts: Harvard University, 1999) 83-89. Accessed at: http://ifpprogram.com/login/view_pdf/?file=Business%20Organizations%20under%20Islamic%20Law.pdf&type=Project_Publication.
[1534] Alhesain and Milman (n1532) 161 see also: Bilal (n1473).
[1535] Bilal (n1533).
[1536] Ibid.
[1537] Jami at-Tirmidhi, The Chapters On Judgements From The Messenger of Allah Vol. 3, Book 13, Hadith 1352, Accessed at: http://sunnah.com/tirmidhi/15/32, Accessed on: 12.11.2018.
[1538] Alhesain and Milman (n1532) 161.

It could be also argued that the classical Islamic law began to acknowledge the concept of limited liability 1300 years ago.[1539] This is clearly apparent from Sharikat Al-modaraba, a situation in which two or more persons provide finance to the business whilst at least one other provides entrepreneurship and management of the venture. The venture may be a trade, an industry or a service and is intended to be profit-making, where profit is shared in agreed proportion. Any loss incurred by the business is borne only by the financiers in proportion to their share in the total capital.[1540] This means that the provider of entrepreneurship and management has limited liability in the case of the company losing financially or in the case of insolvency.[1541]

On the notion of Sharikat Inan, there are various categories of companies which are close to the meaning of company under common law, namely, Sharikat Al-tawsiyyah Al-basitah (Company Limited by Guarantee), Sharikat Al-musahamah, Al-tawsiyyah bil-Ashum and Zat Masuliyyah Al-mahdudah (Company Limited by Share). The several names of the Sharikat/Company limited by share are due to flexibility and compatibility of Islam based on the principle of urf (custom) to suit the changing nature of modern world of trade and business.[1542] The shareholders of these companies have limited liabilities according to the portion of shares held just as in English laws.[1543] However, Zuhayli does not particularly state the principle of neither separate legal entity nor juristic person (Shakhsiyah Manawiyah) on the nature of these companies, but it is inferential from the nature of the companies, they are similar to the principle of separate legal entity under common law. This is due to the fact that the basis for Sharikah Inan as propounded by Wahbah Zuhayli is in fact a form of limited partnership.[1544]

According to Wahbah Zuhaily while referring to Ibn al-Mundhir that 'Inan' is a form of partnership, where the partners share the capital, as well as profits and losses, is approved by consensus. These partners in a Sharikah Inan need not be equal in their contributions to capital, nor equal in their legal rights for using the property. Thus, one party may contribute more than

[1539] Alhesain and Milman (n1532) 12; See also M Albrahim, 'The enforcement of directors' duties in the context of shareholders' rights: a comparative study between UK and Saudi law' (PhD thesis, Lancaster University 2016) 93, 95-110. In the context of duties of Director of a company.
[1540] Saleem Shahid 'Role of Islamic Banks in Economic Development' (MPRA Paper No. 7332, posted 25. February 2008 16:16 UTC), p.67, Accessed at: https://mpra.ub.uni-muenchen.de/7332/2/MPRA_paper_7332.pdf.
[1541] Alhesain and Milman (n1532) 12.
[1542] Zuryati, Yusoff and Azrae (n1523) 151.
[1543] Wahbah Al-Zuhayli, *Financial transaction is Islamic jurisprudence (*vol. 1. Beirut, Lubnan: Dar al-Fikr al-Mouaser 2003)882-887; see also Zuryati, Yusoff and Azrae (n1523), 151.
[1544] Al-Zuhayli (n1543) 451- 452; see also Zuryati, Yusoff and Azrae (n1523) 151.

another to the partnership, and one of the partners may have the exclusive right to run the affairs of the partnership. Given this potential for great variation in legal rights of dealing in the joint property, each party is only responsible for dealings that he himself performed. Thus, while they share the profits according to any rule they agreed upon in the contract, the only share losses in proportion to their contributions to the partnership's capital. The general rule is summarized thus: "profits are shared according to the parties' conditions, but losses are shared according to their shares in the capital."[1545]

Thus, the general concepts of corporation, legal personality and limited liability are recognised by classical Islamic law. However, they were perceived differently from English law because the concept of corporation had not yet emerged in those days and so jurists (fuqaha) had no reason to describe its legal components. Nowadays, the concept of corporation has emerged, the International Islamic Fiqh Academy[1546] has issued a statement and conducted research about the modern corporate as a joint-stock company, a limited company or as a limited liability partnership. The Fiqh Academy has recognised them along with the concept of companies as having legal personality in Resolution No. 130 (4/14) on January 2003.[1547]

More importantly, this decision has defined the modern types of corporations. One of those types is the Capital-Based Corporation. Among the three main types of the latter is the Joint Stock Company, where it has been defined as a company, which its capital is divided to equal shares that could be exchanged, and every partner is responsible according to his portion of that company. In the same decision, it also stated that in case of a loss has occurred to the capital "in all types of companies", then every partner must bear the loss according to his contribution to the capital. Lastly, it has further articulated that every shareholder "contributor" in the company owns a mutual share of its assets and is measured based on his equity ownership, and his ownership remains till it is transferred to someone else.

[1545] Al-Zuhayli (n1543) 452; Zuryati, Yusoff and Azrae (n1523) 151.

[1546] The International Islamic Fiqh Academy (IIFA) is an international body of Muslim experts on subjects of both religious and secular knowledge. Besides traditional Islamic sciences, the IIFA seeks to advance knowledge in the realms of culture, science, and economics. The IIFA based in Jeddah, Saudi Arabia, was created in 1981 and contains 61 experts from 43 Islamic countries. IIFA website at: http://www.iifa- aifi.org/, Accessed on 10.08.2019.

[1547] International Fiqh Academy Resolution # 130 (14/4) of the Islamic Fiqh Academy in its meeting (14) dated 16 January 2003 in Doha, Qatar, Available at: http://www.iifa-aifi.org/2120.html, Accessed on 10.08.2019.

The International Islamic Fiqh Academy has earlier issued a statement and conducted research concerning the Capital Market, then it issued its Resolution No. 63 (7/1) (1) on May 1992.[1548] In relation to this thesis, it has explained that the subject matter of the share's sale contract is the common portion of the company's assets, and the share certificate is considered as a right document in this portion.

The Saudi General Presidency of Scholarly Research and Ifta through its research journal has been asked to provide an opinion of Joint Stock Companies from Shariah perspective, and if Zakat[1549] has to be paid by the company or must be paid by the shareholder.[1550] They said that modern Islamic jurists were divided to two main groups, where the first group thinks the company must pay the Zakat as it has a legal entity that owns the capital, while the second group believes the Zakat must be paid by the shareholders for being the true "real" owners of the capital. One of the reasons provided by the second group is that the real owner for the share is its owner and not the company, besides the company itself belong to them "shareholders". They further emphasised that there is no presence of the legal personality, and it came for economic and social circumstances with legal necessities because modern corporations are created by a large number of partners without almost knowing each other, and those partners continuously change without informing each other. Hence, a distinct structure has to be created to represent the partners, and delegate on behalf of them in bearing responsibilities and gaining rights. This framework concerns the legal personality, and it does not concern Zakat, which is a worship that a Muslim does to his lordship. Based on the strong evidence presented by the second group, which obliges the shareholder himself to pay the Zakat because the status of his ownership of the share and because it is a worship that does not need intention. However, the shareholder could delegate the management of the company to pay it on his behalf. This decision has been concluded by the Fiqh Academy at the fourth conference session as well.

After discussing the general rules of corporation and partnership from the Islamic perspective, the thesis moves to discuss similar principles from the Saudi law perspective. In brief, it could

[1548] International Fiqh Academy Resolution # 63 (7/1) (1) on May 1992 of the Islamic Fiqh Academy in its meeting (7) dated 14 May 1992 in Jeddah, Saudi Arabia, Available at: http://www.iifa-aifi.org/1845.html, Accessed on 10.11.2018.

[1549] Zakat is the fourth of the five pillars of Islam, and has been explained as "the most cardinal and vital system in an Islamic order". See Muhammed Abdullah & Abdul Quddus Suhaib, 'The Impact of Zakat on Social life of Muslim Society', (2011) 8 Pakistan Journal of Islamic Research, 85. Every Muslim is obliged to give 2.5% of their savings (not income) to those in need, as a way of redistributing wealth amongst society and discouraging hoarding of wealth.

[1550] The Saudi General Presidency of Scholarly Research and Ifta, Zakat on the Joint Stock Company as Being Considers as a Legal Entity that Owns its Capital, available at:http://www.alifta.net/Fatawa/FatawaSubjects.aspx?languagename=ar&View=Page&HajjEntryID=0&HajjEntryName=&RamadanEntryID=0&RamadanEntryName=&NodeID=2918&PageID=13769&SectionID=2&SubjectPageTitlesID=109824&MarkIndex=1&0#الزكاةعلىالشركةالمساهمةبصفتها. Accessed on 10.11.2018.

be argued that Saudi Companies Law 1965 has been developed under a number of successive and overlapping influences (French, Ottoman, Egyptian, and Sharia) which have modified its provisions and its operation.[1551] However, Saudi law does not necessarily treat Islamic Sharia law always as applicable. In addition, some laws from those systems have been transplanted into Saudi law. Therefore, Saudi law and Islamic Sharia law are not synonymous, and areas of conflict occur where they do not match.[1552]

The Companies Law 2015 as the main source of legislation governing companies and partnerships in Saudi Arabia shows that it uses the Arabic word Sharikat (companies) for both companies and partnerships. This is in contrast of the English law, which divides business entities expressly into companies and partnership.[1553] Article 2 of the CL 2015 defines a company as "a contract under which two or more persons undertake to participate in an enterprise for profit, by contributing a share in the form of money, work, or both, and share profit or loss resulting therefrom."[1554] It denotes that a company is a contractual agreement between two or more parties; their commitment is to work together in order to achieve profit, and those same people contribute with shares in the capital in the form of money or services, with the aim of sharing profits or losses resulting from the project.[1555]

Types of business in Saudi law can be categorised into the following entities according to how they form: Sharikat Al-ashkhas (Companies of Persons) based upon personal consideration and the identities of their partners. In this type of Sharikat, the contract of association is of significant importance: the Sharikat Al-ashkhas and its partners are interdependent. Thus, if one died or was declared bankrupt this Sharikat would terminate. The second business entity in Saudi law is Sharikat Al-amwal (Companies of Capital) which forms on the basis of contributions of capital by its members. This Sharikat operates independently of its members, is not controlled by a contract and therefore remains unaffected by the status of the members or any change in it.[1556]

[1551] Alhesain and Milman (n1532) 16; Hanson (n8) 272 has elaborated on the general structure of the Saudi Companies Law (now 2015; formerly 1965), which was originally promulgated through French and Egyptian Law.
[1552] Alhesain and Milman (n1532) 16.
[1553] Alhesain and Milman (n1532) 21.
[1554] Most civil law countries consider the company as a contract between two or more people; for instance, the French Civil Law in Article 1832 stipulates, "Company is a contract between two or more persons agreeing to constitute a common stock with intent to sharing any profit arising therefrom".
[1555] Youseif Al-Zahrani, 'Rights of Shareholders under Saudi Company Law 1965' (PhD Thesis, Brunel University 2013) 58.
[1556] Alhesain and Milman (n1532) 21.

From these explanations of both Sharikat Al-ashkhas and Sharikat Al-amwal, it could be said that Sharikat Al-ashkhas are understood in English law as partnerships. According to Alhesain and Milman, there is a slight difference between partnership in English law and Saudi law. The characters of a partnership in Saudi law are the same as in Scottish law. A partnership in Saudi Arabia and Scotland is a legal entity separate from its members. However, a partnership in England is not a legal entity separate from its members.[1557] In comparison, Sharikat Al-amwal are perceived in English law as companies and corporations.[1558]

Concerning the joint stock companies, the CL 2015 contains an entire chapter containing 98 articles (52–150) that cover the central regulation of joint stock companies in the Kingdom. The CL 2015 defines this type of company as one whose capital is divided into transferable shares of equal value, where the liability of its members for the company's debt is limited to the value of their shares.[1559] Saudi CL 2015 provides joint stock companies with a legal form that possesses the core legal characteristics of a large modern company:[1560] (i) a separate legal personality,[1561] including limited liability of members for the company's debt;[1562] (ii) full transferability of shares[1563] with some restrictions on the transferability of shares;[1564] (iii) the delegation of management to the board;[1565] and (iv) the relationship between the right of its members to control the company and to receive the profit in return for the supply of the company's capital.[1566]

Within the structure of the Joint Stock Company, two fundamental elements are identified in the CL 2015. The first is the creation of the body of shareholders. Although the CL 2015 does not give a definition of a shareholder, there is a close link between equity ownership and the acquisition of the capacity of a shareholder,[1567] in which a shareholder can be described as any person, which includes both natural persons or legal persons, such as corporate entities, who

[1557] Ibid 21.
[1558] Ibid 21.
[1559] Article 52 of the CL 2015. The exact article reads "The capital of a joint-stock company shall be divided into negotiable shares of equal value. A joint-stock company shall be solely liable for debts and liabilities arising from its activities."
[1560] Aleshaikh (n208) 22; see also: J Armour, H Hansmann and R Kraakman, 'What is Corporate Law?' in R Kraakman et al. (eds), The Anatomy of Corporate Law: A Comparative and Functional *Approach* (2nd edn, Oxford, OUP 2009) 5, 1, 5–16.
[1561] Article 14 of the CL 2015.
[1562] Article 52 of the CL 2015.
[1563] Article 52 of the CL 2015.
[1564] See articles 107 and 108 of the CL 2015
[1565] Article 68 (1) of the CL 2015.
[1566] See particularly articles 11(1), 88 (a)(1), 110, 113 (1) of the CL 2015.
[1567] See The Board of Grievances, Case No. 592/1/S, Appeal Division Decision No. 7/V/940 2007(1429H), <http://bogcases.bog.gov.sa/JudicialRules/1428/classification2/Volume1/Folder2/57_1.pdf> accessed 1 February 2015.

owns at least one share of the company's capital stock.[1568] The second essential organisational element of Joint Stock Companies is that the main power over the company's affairs must be vested in a delegated board structure, namely the board of directors.[1569]

As a way of comparison to show the different understanding of a Company, in England, it is common to distinguish between Company and Partnership.[1570] The Company refers to an artificial person and corporate body, invisible, intangible, created by or under law, with a discrete legal entity, perpetual succession and a common seal. It is not affected by the death, insanity or insolvency of an individual member.[1571] Section 1 of Companies Act 2006 states that: "company" means a company formed and registered under Companies Act 2006. Additionally, Companies House has defined the company as "a legal entity with a separate identity from those who own or run it".[1572] However, the distinction between companies and partnerships is not always clear. The quasi-partnership company in English Law is an example of this. This idea was confirmed in *Ebrahimi v Westbourne Galleries Ltd*.[1573]

The word "company" originally implied persons coming together for a common purpose but does not always contain certain legal meaning; even an association that is formed, whether to make profits or not, and whether or not it is legal person, might be referred to as a company.[1574] The term "company" can also refer to a big corporation with the legal status of a person, or to a partnership organization or other association.[1575] A company is formed under a particular national company law. All companies must be established in accordance with relevant national company law because companies are traditionally subject to control by national sovereignty.[1576]

The principle of company independence has been agreed upon among various legal jurisdictions for a long time, particularly in developed countries; for example, in the UK, in the case *Salomon v. A Salomon & Co Ltd*, Lord Macnaghten said, "The company is at law a

[1568] S Yahea, *The Brief in Saudi Commercial Law* (Arabic), (6th edn, Arabian Modern Office 2010) 147.
[1569] Aleshaikh (n208) 23.
[1570] Alhesain and Milman (n1532) 23.
[1571] 'A company is A Form of Business Organization', Law Teacher website, Accessed at: https://www.lawteacher.net/free-law-essays/business-law/a-company-is-a-form-law-essays.php, Accessed on: 01.08.2019.
[1572] Incorporation and names, Companies House website, July 2016, p.4, Accessed at https://www.gov.uk/government/publications/incorporation-and-names/incorporation-and-names, Accessed on:01.08.2019.
[1573] *Ebrahimi v Westbourne Galleries Ltd.* [1973] A.C. 360
[1574] Alhesain and Milman (n1532) 23.
[1575] G Minkang, *Understanding Chinese Company Law* (Hong Kong: Hong Kong University Press, 2nd ed., 2010) 17, Accessed at: https://books.google.co.uk/books?id=xoAzzE78uUQC&pg=PA163&dq=company+definition&hl=en&sa=X&ved=0ahUKEwinuOft8XMAhUGJcAKHQfCDBc4ChDoAQgbMAA#v=onepage&q=company%20def inition&f=false, Accessed on: 12.11.2018.
[1576] Ibid 19.

different person altogether from the subscribers to the memorandum."[1577] The *Salomon* ruling established the principle that a company validly incorporated possesses a separate legal personality regardless of the number of its members.[1578] There were also earlier several cases confirmed the separation of company from its shareholders. One of these cases is *Foss v Harbottle,*[1579] where the court considered the company as a separate legal entity and established the proper plaintiff principle by holding that only the corporation can sue for wrongs done to it, not the shareholders. This rule is based on two fundamental principles of law, which are the principles of a company's separate legal personality and the principle of majority rule.[1580] As Mellish LJ explained it in *MacDougall v Gardiner*: '… if the thing complained of is a thing which in substance the majority of the company are entitled to do … there can be no use in having a litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes'.[1581]

In *Prudential Assurance Co Ltd v Newman Industries Ltd,*[1582] the court confirmed the corporate separate personality by ruling that: "The rule (in *Foss v. Harbottle*) is the consequence of the fact that a corporation is a separate legal entity. Other consequences are limited liability and limited rights. The company is liable for its contracts and torts; the shareholder has no such liability. The company acquires causes of action for breaches of contract and for torts, which damage the company. No cause of action vests in the shareholder. When the shareholder acquires a share he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence over the fortunes of the company by the exercise of his voting rights in general meeting."[1583] The *Prudential Assurance* judgment reveals both sides of the corporate separate personality.[1584] The company assets are separated from the shareholders, and the company as a distinct personality from its shareholders has its own obligations.[1585] Hence, shareholders liability for the company's unpaid debts is limited to

[1577] *Salomon v. A Salomon & Co Ltd*, [1897] AC 22.
[1578] Neshat Safari, 'Reconsidering the role of the derivative claim in the United Kingdom. A comparative study with the United States and New Zealand' (Unpublished Doctoral thesis, City, University of Londo 2018), 6. For a detailed discussion about Salomon case see Dignam, Alan. And Lowry, John., 'Corporate personality and limited liability': Company Law (10th edn, 2018), Oxford University Press, 18-22. Some other good examples of the consequence of separate personality are *Lee v Lee's Air Farming* [1960] UKPC 33 and *Macaura v Northern Assurance Co Ltd* [1925] AC 619.
[1579] *Foss v Harbottle* [1843] 2 Hare 461.
[1580] Awolalu, Oludara, Ajibike, 'Understanding and Evaluating the Enforcement of Corporate Law in Nigeria: the Case for Enhanced Public Civil Enforcement' (Durham theses, Durham University 2017). Available at Durham E-Theses Online: http://etheses.dur.ac.uk/12287/, 166.
[1581] (1843) 2 Hare 461.
[1582] *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] 1 Ch 204.
[1583] Ibid 210-211.
[1584] Safari (n1578) 8.
[1585] Ibid.

the amount of shares they have in the company,[1586] and the shareholder assets are not available to meet the company's debts.[1587] Such judicial decisions clearly explain that shareholders of JSCs do not legally possess any portion of the company's assets according to the relevant laws, and the corporation is the only owner of all assets in it; therefore, all the property is under the name of the company.[1588]

Shareholders are not allowed to have a direct remedy in situations that the company is harmed by the wrongdoers' conduct. In such situations, shareholders loss is only reflective of harm to the company for which only company could sue and get a remedy. Even in a situation that shareholders are allowed to initiate a claim on behalf of the company, they could only benefit from the recovery through an increase in their share values. The principle knows as the "reflective loss" principle.[1589] The rule prevents a person other than the company getting any direct remedy for the harm to the company, even if that person has a separate personal cause of action against the wrongdoer that is different from that of the company.[1590]

Several rationales for the principle were identified by Goudkamp.[1591] The first justification for it is that it prevents unfairness to the defendant by insulating the defendant from being held liable more than once in respect of what is essentially the same loss (the "unfairness rationale").[1592] As it has been expressed by Lord Millett, "Justice to the defendant requires the exclusion of one claim or the other".[1593] A second rationale is that the principle protects the collective interests of the company's creditors and other shareholders.[1594] By allowing only the company to sue, a given shareholder cannot deplete the defendant's assets and hence diminish the defendant's capacity to meet its other liabilities to the detriment of the rest of the company's shareholders and its creditors (the "protective rationale").[1595]

[1586] Brenda Hannington, Company Law (Oxford University Press 2015) 45.
[1587] Ibid 46.
[1588] Paddy Ireland, *Company Law and the Myth of Shareholder Ownership* (62 M.L.R 1999) 32; Stephen Mayson, *Company Law* (15th Edn, London, Blackstone Publishing 1998)175.
[1589] Brenda Hannington, *Company Law* (Oxford University Press 2015) 46; The reflective loss principle is a common law rule, which was established under *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] especially at 222–223, per Cumming-Bruce, Templeman and Brightman LJJ. The rule indicates that shareholders should not get a double recovery for the same harm to the company and to their personal interests.
[1590] *Day v Cook* [2001] EWCA Civ 781, [2004] EWCA Civ 592, [2002] I BCLC 1, 791.
[1591] J Goudkamp, 'The contributory negligence doctrine: four commercial law problems' (2017) 2 Lloyds Maritime and Commercial Law Quarterly 213, 234-235.
[1592] Ibid.
[1593] *Johnson v Gore Wood & Co* [2002] 2 AC 1 (HL), 62.
[1594] Ibid, 36, per Lord Bingham of Cornhill, 54, per Lord Hutton, 62, per Lord Millett.
[1595] Goudkamp (n1591), 234.

A third rationale is that the reflective loss principle recognises that shareholders whose shares fall in value due to a wrong committed against the company have not suffered any damage in the law's eyes.[1596] A diminution in the value of shares does not constitute damage for the law's purposes because, technically, shares are only a right to participate in a company and that right is unaffected when a company suffers loss. Whereas the first and second rationales for the reflective loss principle are compelling, the third rationale is obviously highly suspect. It involves an excessively technical view of the concept of shares.[1597] It is false to say, as Charles Mitchell points out,[1598] that a person whose shares fall in value does not suffer any loss because that decline in the shares' value does not affect his or her rights of participation in the company. Moreover, the third rationale cannot explain why, when a defendant engages in conduct that wrongly diminishes the value of the claimant's shares, the damages are measured by reference to the extent to which the value of the shareholding has been diminished.[1599] This third rationale can be dismissed.[1600]

The reflective loss principle, despite being of relatively recent origin, it is now a firmly established and significant part of English law.[1601]

In *Johnson v Gore Wood Lord*,[1602] Lord Bingham summarised the reflective loss principle as follows: "(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. (2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it. (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other." One of the issues, which the court dealt with in this case, was ensuring that the company's creditors are not prejudiced by the action of individual

[1596] Endorsed in *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] Ch 204 (CA), 222; *Perry v Day* [2004] EWHC 3372 (Ch), [41].
[1597] Goudkamp (n1591) 234.
[1598] C Mitchell, 'Shareholders' Claims for Reflective Loss' (2004) 120 LQR 457, 459.
[1599] H McGregor, *McGregor on Damages*, 19th edn (Sweet & Maxwell, London, 2014), para.27.003.
[1600] Goudkamp (n1591) 235.
[1601] Leading cases concerning the principle include *Johnson v Gore Wood & Co* [2002] 2 AC 1 (HL); *Day v Cook* [2001] EWCA Civ 592; [2001] Lloyd's Rep PN 551; *Ellis v Property Leeds (UK) Ltd* [2002] EWCA; Goudkamp (n1591) 233.
[1602] *Johnson v Gore Wood Lord* [2001] 1 B.C.L.C. 313.

shareholders and ensuring that a party does not recover compensation for a loss, which another party has suffered.[1603] Lord Bingham clearly ruled "a shareholder cannot sue to make good a loss which would be made good if the company's assets would be replenished through action against the party responsible for the loss, even if the company has declined or failed to make good that loss."[1604]

The only known exception to the corporate separate personality is piercing the corporate veil. In the case of piercing the corporate veil, the rights and liabilities of the company could be attributed to other natural or legal persons. Such circumstances could happen through a contract, or statutory provisions or if the company is agent of its members or in the case of beneficial ownership of trust property. However, in *Prest v Pedrodel Resources Ltd*[1605] and *Antonio Gramsci Shipping Corporation v Recoletos Ltd*,[1606] the courts have brought the concept of the piercing the corporate veil into questions because of the difficulty of finding any underlying principle for the rule and by holding that it does not necessarily happen that much in practice.[1607] In relation to this thesis, the Supreme Court of Canada in *Hercules Management Ltd v Ernst & Young* has confirmed the auditors' duty of care to the entity itself, not to any individuals such as shareholders, hence, shareholders can use derivative action in order to sue auditors.[1608] It should be noted that there are no certain provisions under related to the cost of the derivative action.[1609] In an earlier case before the enactment of the English Companies Act 2006, Lord Denning, in the case *Wallersteiner v Moir*, indicated: "Minority shareholders, being an agent acting on behalf of the company, are entitled to be indemnified by the company against all costs and expenses reasonably incurred by him in the course of the action. This indemnity does not arise out of a contract explicit or implied, but it arises from the plainest principles of equity. But what if the action fails? He should himself be indemnified by the company in respect of his own costs even if the action fails."[1610]

[1603] *Johnson v Gore Wood Lord* [2001] 1 B.C.L.C. 313. at 337f-338b per Lord Bingham.
[1604] [2002] 2 AC 1 (HL) 35-36.
[1605] *Prest v Petrodel Resources Ltd* [2013] UKSC 34, [2013] 2 AC 415.
[1606] *Antonio Gramsci Shipping Corporation v Recoletos Ltd* [2014] EWCA Civ 730 2014.
[1607] Awolalu, Oludara, Ajibike, 'Understanding and Evaluating the Enforcement of Corporate Law in Nigeria: the Case for Enhanced Public Civil Enforcement' (Durham theses, Durham University 2017) 166. Available at Durham E-Theses Online: http://etheses.dur.ac.uk/12287/
[1608] *Hercules Management Ltd v Ernst & Young 2 S.C.R.* 165 (1997) (Can) at 171–172.
[1609] Brenda Hannigan. *Company Law*. 2ed. (Oxford. Oxford University Press. 2009) 459.
[1610] *Wallersteiner v Moir* [1975] QB 373.

In *Abouraya v Sigmund*[1611] David Richards J reviewed the authorities on fraud on the minority and concluded that:

"financial or other loss to the shareholders, albeit normally of a reflective character, is essential to give a claimant shareholder sufficient interest in the proceedings to make the shareholder an appropriate claimant on behalf of the company, whether he is a member of that company or of its holding company. Equally, the authorities require that, in the absence of actual fraud or an ultra vires act, the wrongdoers should themselves have benefitted from the wrongdoing. The significance of this requirement is that their breach of duty cannot be ratified by a majority vote which depends on the votes of the wrongdoers. It is essential to the exception to the rule in *Foss v Harbottle* that the alleged wrongdoing is incapable of lawful ratification …"[1612]

In *Abouraya v Sigmund,*[1613] the claim was brought by a shareholder in a parent company with respect to alleged breaches of duty by a director of a wholly owned subsidiary (a so-called multiple derivative claim). The alleged wrongdoing concerned the transfer of assets and the taking of opportunities of subsidiary A and transferring/giving them to subsidiary B. As both subsidiaries were wholly owned by company C, that parent company suffered no reflective loss, as any loss to the value of its shareholding in subsidiary A was matched by a corresponding gain in value of its shareholding in subsidiary B. There was also no evidence that the director in question benefited personally from the transactions.[1614] Unusually, then, the alleged wrongdoing caused no loss to the company and no benefit to the alleged wrongdoers was established. Permission for a derivative claim was refused.[1615]

In *Harris v Microfusion* 2003-2 LLP[1616] the Court of Appeal endorsed the boundaries to the fraud on the minority exception to the rule in *Foss v Harbottle* identified by David Richards J in *Abouraya v Sigmund* as a correct statement of the position.[1617] The boundaries are actual

[1611][2015] BCC 503.
[1612] [2015] BCC 503 at [25]; see his review of the authorities at [16]–[25], including *Daniels v Daniels* [1978] Ch 406 at 414, per Templeman J: "The principle … is that a minority shareholder who has no other remedy may sue where directors use their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company."
[1613] [2015] BCC 503.
[1614] [2015] BCC 503 at [6], [52], [56], [57].
[1615] Hannigan, Brenda., The derivative claim and the rule in *Foss v Harbottle:* Company Law (5th edn), Oxford University Press, 2018. 551.
[1616] [2017] 1 BCLC 305, CA, at [31].
[1617] The court rejected counsel's submission that the ambit of the exception had been too narrowly stated by Richards J, see [2017] 1 BCLC 305 at [21], [31].

fraud in the sense of deliberate and dishonest breaches of duty or wrongdoing which results in a loss to the company and benefit to the wrongdoers.[1618]

The derivative action[1619] became a statutory remedy under the English Companies Act 2006; it is now introduced under sections 260 to 264.[1620] Minority shareholders can bring a derivative suit, "only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company."[1621] Under the English Companies Act 2006, shareholders can initiate such an action, which will cover a more extensive range of conduct and circumstances than currently exist under common law.[1622] As such, a derivative proceeding can be brought in respect of an alleged breach of any of the directors' general duties under Part 10, "A company's directors" in the Act, which includes the duty to exercise reasonable care, skill and diligence; the inclusion of negligence means that any instance of a director's breach of his duty of care and skill can be prima facie.[1623] In fact, a derivative action can be initiated against any director, including a former director or a shadow director, and may be against any company official.[1624] They can also claim against third parties implicated in any breach, in the company's name, such as auditors.[1625]

Despite the reforms to the derivative claim, ratification of the directors' breach of duty by shareholders plays an important role in defining whether permission should be granted by the court to hear a derivative claim.[1626] Section 263(2)(c) of the English Companies Act 2006 provides that the court must refuse to give permission to the derivative claim if the cause of action arises from an act or omission that has been ratified by the company. At the next stage,

[1618] Hannigan (n1615) 551.
[1619] A derivative action through which shareholders, especially minority shareholders, can sue directors for their wrongdoing on behalf of the company is an essential mechanism to enforce the company's rights and ensure directors' accountability. A Reisberg, *Derivative Actions and Corporate Governance* (Oxford, OUP 2007) 18.
[1620] Melissa Hofmann, 'Statutory Derivative Action in Australia: An Empirical Review of its Use and Effectiveness in Australia in Comparison to the United States, Canada and Singapore' . Corporate Governance eJournal. p.29. Available at<http://epublications.bond.edu.au/cgej/13>accessed 12 November 2018. For comprehensive comparisons on Derivative action principles among the U.K, the U.S and New Zealand or with Class action, see Safari (n1578).
[1621] 260 (3) of the UK CA 2006.
[1622] Ohrenstein Dov, 'Derivative action, Shareholders now have a statutory right to sue directors in derivative actions. Will they use it?' 2007 New Law Journal.
[1623] Arad Reisberg, 'Derivative Claims Under the Companies Act 2006: Much Ado About Nothing? Rationality in Company Law: Essays in Honour of DD Prentice', J. Armour, J. Payne, eds., (Hart Publishing, 2009; University College London Law Research Paper No. 09-02) 11.
[1624] S. 260 (3, 5) of the UK CA 2006.
[1625] Freshfields Bruckhaus Deringer, 'Class Actions and Third Party Funding of Litigation: An Analysis Across Europe' (June 2007).
[1626] Safari (n1578) 243.

section 263(3)(c)(ii) provides that, in its discretion to whether to give permission, the court must have regard to whether the act or omission is likely to be ratified.[1627]

After presenting the essence of the derivative action from the English Companies Act 2006, a recent study has argued that this type of claim should be considered in Saudi Arabia if the Saudi CL 2015 is going to be reformed.[1628] He stated four main reasons to support his point of view. First, there is uncertainty within this area of Saudi CL, and it comes from the absence of a clear detailed legislative statement and inactive role of courts in developing the law. Second, he thinks that there might be clear intention from the Saudi state to reform its company law system, especially in relation to directors' accountability and legal protection for shareholders. Third, a legal reform approach based upon legal transplantation can be regarded as a good way of importing the highest-quality legal solutions for solving deficiencies in the Saudi law of directors' duties and the enforcement thereof. Fourth, his research only concerns the duties of care and of loyalty.[1629] The focus of his study was primarily on the following issues: (i) the duty to act in good faith in the general interest of the company; (ii) the duty to avoid conflicts of interest with particular focus on the exploitation of corporate opportunities; and (iii) the duty to avoid conflicts of interest in self-dealing transactions. These problems were selected on the basis that they pose particular problems in the Saudi context. Moreover, in regard of the enforcement of directors' obligations, the scope of his research was limited to breaches of duties owed to the company and, accordingly, to the company's actions against directors and litigation commenced by a shareholder on behalf of the company (i.e. derivative litigation). It is most worthy to note that his analysis of personal actions brought by shareholders against directors was not within the scope of his thesis.

Lastly, Safari has recommended recently to modify the English Companies Act 2006 to include the employees among those who are able to use the derivative action. He also thinks that further avenue of research is the question of whether derivative claims could be extended to the creditors of a company as their interests could be harmed by directors' opportunistic behaviour

[1627] The second stage involves the courts considering the list of factors under Companies Act 2006 sections 263(2) and (3). Section 263 provides the list of matters which should be taken into account by the court when deciding whether to give permission to a derivative claim. These important matters are: (1) The good faith of the derivative claim's applicant; (2) Whether a person acting in accordance with the duty to promote the success of the company would continue the claim; (3) Whether there has been or could be authorization or ratification of the act or omission giving rise to the claim; (4) Whether the company has decided not to pursue the claim; (5) Whether the claim is one which the member could pursue in his own right rather than on behalf of the company; (6) The disinterested member's view towards the claim; and (7) Whether the claim would promote the company's success. For detailed discussion about the derivative claim, see Hannigan (n1615) 582.
[1628] Aleshaikh (n208) 3-4.
[1629] See further discussion about article 29 of the Corporate Governance Rules 2017 in sub-section 7.2.2.

and wrongful conduct. Therefore, creditors could have strong incentive to save the company from the wrongdoers' harm.[1630]

Next, a reflection on raised subject in this section to show how the thesis intends to achieve its goals, which is in favour of shareholders' position as economic ownership to get compensated from the negligence of an auditor or others if associated in conducting the annual financial statement.

7.1.4.2 Reflection on the Differing Understanding of Legal Separate Personality and Limited Liability of Joint Stock Companies from Islamic, Saudi and Common Laws Perspective and if the Use of Derivative Action Could be Transplanted to Saudi

Deep understanding and critical analysis of the raised issues should consider the Shariah point of views due to its supremacy as the main legal source that Saudi laws must consider to interpret relevant provisions within the scope of this research. Then, the discussion gives particular attentions to related common law concepts that are not suitable to the Saudi legal system. It would be helpful to recall again the essence of risk-sharing principle that apply in the corporate and insurance worlds.

This previous section has shown the Shariah position in regard of early understanding of companies and partnership that confirm the indifference positions of partners in both types. Moreover, late Islamic jurists and well-known Islamic institutions elaborated on the modern types of corporations.

In Sharikah Inan, the general rule is that the profits are shared according to the parties' conditions, but losses are shared according to their shares in the capital. The researcher believes in this concept and this concept must be reflected on the shareholder position in a public company too. The International Islamic Fiqh Academy resolution in 2003 has recognised the Joint Stock Company with its own legal personality, however, the decision stated the status of a shareholder "i.e. a contributor" within the company as an owner of mutual share of its assets

[1630] Safari (n1578) 313.

and is measured based on his equity ownership. Furthermore, the same Academy in 1992 has reflected on the share certificate as right of common portion of the company's assets. This mean that the shareholder is considered as an owner. The Saudi General Presidency of Scholarly Research and Ifta has also agreed on the shareholders' position as owners of the company, and the legal personality came for economic and social circumstances with legal necessities to represent the partners and delegate on behalf of them in bearing responsibilities and gaining rights.

The Saudi CL 2015 has defined the meaning of company in general as a contractual agreement between two or more parties with the aim of sharing profits or losses resulting from the project. This definition is in harmony with Shariah principles in regard of a shareholder as a partner in a company. Hence, a legal personality of a Joint Stock Company cannot be separated from the shareholders position as they themselves delegate the board of directors to run the corporation, and to bear responsibilities or gain rights. Those type of work allow the company to work freely within limited powers before their employees, creditors etc. However, the auditing contract must be approved at the general assembly, for instance. In any event, any loss occurred to the company would be reflected on their shares' value. It is illogical to accept the idea that a company has lost financially from an error occurred on the annual financial statements, and also impossible to measure the damage without connecting it to shareholders.

In England, the Companies House claimed that the company as a legal entity with a separate identity from those who own or run it. The *Salomon* case has confirmed this concept as well as other cases examined.[1631] Such judicial decisions explicitly demonstrate that shareholders of JSCs do not legally possess any portion of the company's assets, and the corporation is the only owner of all assets in it as they are under the name of the company. More interestingly, in *Prudential Assurance Co Ltd* case, this judgment has emphasised that if the shareholder acquires a share, then he agrees that the value of his investment goes with the fortunes of the company and that he can only exercise his influence over the fortunes of the company by the exercise of his voting rights in general meeting. Hence, shareholders liability for the company's unpaid debts is limited to the amount of shares they have in the company, and the shareholder assets are not available to meet the company's debts. Reading these ideas differently, the researcher does not accept the idea of sperate legal identity, especially that shareholders agree by law that their personal assets are not available to meet the company's debt. In addition, a

[1631] Previous common law cases presented in Chapters Three and Four.

creditor also accepts the same idea while he deals with a specific joint stock company, so it is up to him to get an additional guarantee or not to share the risk of getting his money back from the corporation unless a fraud has occurred from the management of the company. Moreover, if a shareholder gets the right to vote in general meetings, then a question about his position to be treated as third parties in auditor liability cases arise with no logical answers provided.

Concerning the derivative action from common law perspective, the literature has repeatedly argued that the court in *Foss* case has based its judgment on two fundamental principles of law, and one of them is the company's separate legal personality. Furthermore, the "reflective loss" principle bans a person other than the company to get any direct remedy for the harm to the company, even if that person has a separate personal cause of action against the wrongdoer that is different from that of the company. Even, Lord Bingham clearly ruled "a shareholder cannot sue to make good a loss which would be made good if the company's assets would be replenished through action against the party responsible for the loss, even if the company has declined or failed to make good that loss."[1632] Simply, would it be obvious if a shareholder has occurred a loss in his investment then he is not entitled to get anything. Another argument put forward is why for example a shareholder sues an auditor on his misconduct for the benefit of the company. If it is impossible to determine the exact amount of damages occurred to the company, then how the company or a shareholder claim against the auditor before court could be established without any specific amount, or is it going to be on a discretionary basis?

Concerning the justifications for the reflective loss provided by courts and literature, the first justification in respect of unfairness, if an auditor becomes liable to a shareholder, then he is going to be liable for other shareholders according to their actual losses, hence, their losses are not the same. A second justification is about the protective rationale by allowing only the company to sue, so a given shareholder cannot deplete the defendant's assets and hence diminish the defendant's capacity to meet its other liabilities to the determent of the rest of the company's shareholders and its creditors. This thesis supports the company action conditioning connecting its loss with shareholders loss as no other viable ways able to identify relevant damages. In addition, in case a shareholder sues an auditor and got indemnified, then he will not diminish the defendant's capacity to meet its other liabilities due to the fact there is no other liabilities surrounded other than his misconduct in certain annual financial statement. Therefore, other shareholders stand with the same reasons to sue the auditor. In relation to

[1632] *Foss v Harbottle* [1843] 2 Hare 461 337f-338b per Lord Bingham.

creditors' position, it could be argued easily that a mere negligence is not connected to their loss directly as well as their abilities to secure their financial positions if they wish against the company or by contract with the auditor.

A third rationale recognises that shareholders whose shares fall in value due to a wrong committed against the company have not suffered any damage in the law's eyes, and being argued that it includes a technical view of the concept of shares. This thesis has shown that common law courts and literature could not bring sufficient and plausible arguments to support their views in this respect. To illustrate, the concept of understating the shareholders position from common law perspective is the one of the major issues that led to unconvincing arguments that categorised them as third parties instead of being partners in the company.

The English Companies Act 2006 has stated specific rules about the derivative action with certain criteria in regard of an alleged breach of any of the directors' general duties. Moreover, the competent court may refuse to give permission to the derivative claim if the cause of action result from an act or omission that has been ratified by the company. One may ask a simple question which is how a shareholder argue before court in relation to a mere negligence act from an auditor only in the annual financial statements and connect his lawsuit with a breach of directors' general duty. It is impossible to connect both incidents unless there are joint negligence among the management and the auditor, and then how the court would be able to examine the breach of exercising reasonable care of wrongdoers, and decide fairly how the damage has occurred to the company. In this scenario, it seems that the court will not be able to measure the damage occurred to the company.

There are notable evidences provided by Saudi scholars to transplant the derivative action to the Saudi CL 2015. However, the discussion did not extend to assess why the Saudi regulator still keeps the shareholders' personal action in this law.[1633] The first reason is the lack of a detailed legislative statement and inactive role of courts in developing the law. This argument is basically right, however, if the CL 2015 has been amended, then, is it going to solve the issue of auditor civil liability if he has done a mistake in the annual financial statement or should the law include other provisions in relation to services' providers of the joint stock company. In regard of the inactive role of the courts in developing the law, it could be right in general. However, what kind of financial benefits would litigants seek from other countries experiences

[1633] Previous discussion were presented in section 2.10.

as several issues are not solved by this type of action (derivative), in particular how much the company would gain if succeeded. Hence, in this respect, I disagree with the presumption as the researcher has attempted to examine the rich literature coupled with court precedents and if they are viable to be transplanted without finding the end aim of bringing a lawsuit which is based on determining the fair amount of compensation.

The second reason is in regard of revising the CL 2015 to add specific conditions to directors' accountability and legal protection for shareholders. It could be accepted to add specific legal provisions to directors' accountability, however, the protection of shareholders does not come solely from those intended articles without connecting them with shareholders personal right to be indemnified. This analysis would be viable even without bringing the derivative action on board. Third, the researcher does not share the view in respect of the derivative action as a high-quality legal solution for solving deficiencies in the Saudi CL 2015 in respect of directors' duties and its enforcement. This conclusion comes again from the fact of not reaching plausible and acceptable solutions that satisfy all parties involved in a concerned dispute. It only brings very sophisticated discussions about certain issues without going into the compensation method in detail. Fourth, the argument provided by the researcher only concerns the duties of care and of loyalty. Moreover, in regard of the enforcement of directors' obligations, the scope of his research was limited to breaches of duties owed to the company and, accordingly, to the company's actions against directors and litigation commenced by a shareholder on behalf of the company (i.e., derivative litigation). Hence, his research does not draw a full picture of the intended use of personal actions brought by shareholders against directors from Shariah and legal perspectives, and then be compared with other countries of why they do not have the same litigation route, and providing additional critics about the transplanted provisions. Therefore, I disagree with due respect to their views about the viability of derivative action, and bring to attention again the idea of company's action or shareholder's personal action would solely benefit the shareholders. Even if there are going to be multiple lawsuits against the auditor for example but with one legal base, easy and accessible measurement of damages in Saudi Arabia.

To illustrate, according to Goudkamp, no English court has expressed directly on the interaction between the reflective loss principle and the contributory negligence doctrine.[1634]

[1634] Goudkamp (1591) 213.

Submissions were made in this connection in *Day v Cook*[1635] but the Court of Appeal did not rule explicitly upon them. However, Arden LJ said:

"It is not simply the case that double recovery will not be allowed, so that, for instance if the company's claim is not pursued or there is some defence to the company's claim, the shareholder can pursue his claim. The company's claim, if it exists, will always trump that of the shareholder."[1636]

The researcher in simple terms denies the idea of double recovery due to the fact whether the lawsuit arise from the company or its shareholders, then every shareholder must be compensated according to his actual loss. This analysis extends to refuse out of court settlement that benefit some shareholders only too.

The last point is in connection to include employees with shareholders to use the derivative action as well as making further studies if creditors are able to use it by reforming the English Companies Act 2006.[1637] These arguments are not sufficiently supported with how they would be able to get indemnified, even if they have strong incentive to save the company from the wrongdoers' harm. Third parties excluding shareholders have several rights to protect themselves and to be indemnified stated in concerned laws. Hence, it is hard to see if they would be able to get any benefit from the use of derivative action as minority shareholders could not. In short, the use of derivative action before the English Companies Act 2006 or even after is not convincing to be transplanted as an effective legal tool.

Based on these general principles, the discussion moves to examine if common law principles are suitable to be applied in the Saudi context and if not, how should they be according to the researcher's point of view.

[1635] *Day v Cook* [2001] EWCA Civ 592, [47], per Arden LJ.
[1636] Ibid, [38].
[1637] Earlier suggestion presented by Safari (n1578) discussed in 7.1.4.1.

7.2 First Main Theme: Literature related to Civil Liability of Auditors towards Third Parties

7.2.1 Related Subthemes: The Selection of Common Law Cases and Regulations in the Area of Auditor Civil Liability Towards Third Parties to be Compared with Islamic Law and Saudi Regulations

This thesis has focused on the principles of common law to be compared with Islamic law of tort and Saudi laws. There are several reasons the researcher intends to gain benefits from rich discussions in the literature and common law cases. First, a few studies have compared the civil liability of auditors towards third parties in major common law countries with civil law countries such as France, German and Italy. These studies, addressed in Chapters Three and Four, did not compare civil law countries' precedents with common law countries' precedents. Instead, they referred only to relevant statues/legal principles in the civil law countries.[1638] Second, the authors of these articles either highlighted only the main common-law theories of auditor liability towards third parties to asses if a civil law country should adopt a specific theory of liability, or criticised the common law countries' directions in this area by highlighting the different civil law treatment of liability based on a legal code in their own country as in Italy.[1639] Third, Saudi Arabia intends to work forwards to build sufficient precedents in the commercial arena to rely on based on Islamic principles and applicable regulations, especially after the official launch of commercial courts under the umbrella of general courts in early 2018.[1640] Arguably, the commercial courts have the potential to contribute significantly to the codification of Sharia rules and principles in the field of commercial law.[1641]

Saudi has already started setting relevant precedents/decisions in different areas.[1642] However, the exemption of a few quasi-judicial committees such as the Committee for the Resolution of

[1638] Earlier discussion in section 4.8 has referred to Janne Chung and others 'Auditor Liability to Third parties After Sarbanes-Oxley: An International Comparison of Regulatory and Legal Reforms' (2010) 19 Journal of International Accounting, Auditing and Taxation 67.
[1639] Earlier discussion has referred to Giudici (n259) 534.
[1640] For example, the Ministry of Justice research centre had published a selected commercial court held in 1439 H (2017-2018) as a starting point to improve the Saudi commercial arena, and it intends to translate these judgments into other languages at a later stage. Available at: https://www.moj.gov.sa/ar/Ministry/Departments/ResearchCenter/Pages/Documents.aspx.
[1641] Aleshaikh (n208) 33.
[1642] The Committee for Resolution of Securitas Disputes has published some of its previous decisions in its website. See: http://crsd.org.sa/en/ResolutionsCommittee/Decisions/Pages/default.aspx. The Appeal Committee for Resolution of Securitas Disputes has also published some of its previous decisions in its website. See:

Securities Disputes and the Committee for Resolution of Insurance Disputes and Violations from being under the general court jurisdiction and allowing them to hearing specific disputes impose some delay to achieve the full harmony of the Saudi judicial system to hear cases before one competent court. There might also be different understanding and difficulty among Saudi judges in commercial courts (who must have a degree in Shariah law thus far) and members of quasi-judicial committees (who either have a degree in Shariah or in Law but most likely to have a law degree due to the sophisticated nature of concerned disputes) of interpreting relevant Shariah principles and legal codes and how to combine between them to activate relevant legal codes "and with the use of comparative jurisprudence permitted lately" as in the case of auditor liability towards a company and/or its shareholders and available sources of compensation. In addition, precedents issued by relevant courts in Saudi are not strictly binding in comparison with common law countries as there are supremacy to Shariah principles and legal codes.[1643] Hence, it would take a considerable time to assess the impact of referred precedents on prospective disputes. Furthermore, there is also an expected long process for a shareholder to proceed with his case to get indemnified as judgments must be made from different competent authorities. So, a shareholder might be reluctant to proceed with his case in addition to the costly and complexity nature of this type of litigation. Lastly, it is not obvious at the time of writing this thesis whether commercial court precedents and quasi-judicial committees' decisions will be used as reference for judges and members of concerned committees to rely on for prospective cases strictly or just for guidance. It is important to justify that some vagueness as in the case of common law precedents shown in this thesis appear from taking major principles in one specific case and be applied in other cases that have different facts and must be distinguished clearly. Thus, this thesis takes the position to take precedents for guidance and if reliance is needed then facts of a case should be distinguished to draft a fairer decision.[1644]

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http://crsd.org.sa/en/AppealsCommittee/Decisions/Pages/default.aspx. Similarly, the Committees for Resolution of Insurance Disputes and Violations published some of its decisions through its website. See for example decisions held in Riyadh region and other cities that the committee has authority to hear cases under its jurisdiction: http://www.idc.gov.sa/en-us/CommitteesDecisions/Pages/Riyadh.aspx. However, the Appeal Committees for Resolution of Insurance Disputes and Violations did not start publishing any of its decisions yet.

[1643] As expressed by Wayne Jones and others, 'An Overview of Medical Malpractice in the Kingdom of Saudi Arabia' (2014) available at*:* https://www.clydeco.com/insight/article/an-overview-of-medical-malpractice-in-the-kingdom-of-saudi-arabia, "There is no doctrine of binding precedent, nor comprehensive reporting of cases as would be the case in common law jurisdictions. Higher court decisions in Saudi Arabia and other Middle Eastern countries are persuasive, but not binding in contrast to others such as England."

[1644] There are continuing debates in Saudi Arabia that started a few years ago about the importance of codification of Shariah principles and the use of court precedents as reference for judges. It is well-understood that scholars and practitioners' point of views are clear whenever cases are concerned with the discretionary authority of a judge especially in limited criminal cases (i.e. there is no specific legal code but a punishment is stated in the Shariah primary sources and the judge does not want to apply this punishment, and instead, he replaces it with a fine, or an imprisonment sentence or an alternative punishment such as a corrective punishment. This point is obvious when there is not enough evidence of committing a specific crime stated in

Putting that in mind, discussion of auditor liability cases from common law countries' perspective is vital as the Saudi Appeal Committee for the Resolutions of Securities Disputes (ACRSD) has recently issued a judgment with respect to *Al-Mojil*'s directors and officers, the auditor personally and his auditing firm in their fraud roles at the IPO process.[1645] It centers on "practices that created a misleading and incorrect impression regarding the value of Mohammed Al-Mojil Group Company's security during the IPO stage of the company's shares."[1646] In relation to the thesis, the ruling prevented Deloitte and Baker Bin Abdullah Abu Al-Khair from providing any legal accounting for authorized persons or any securities' issuer in Saudi Arabia for two years, in a ban that started in June 2015. In addition, separate fines amounted SR 300,000 for each with respect of Deloitte authorization no. (96) issued by SOCPA and Baker bin Abdullah Abu Alkhair.[1647] The Capital Market Authority in cooperation with the public prosecutor has initiated another action to seek for damages occurred after the

the Shariah primary sources) or in cases connected with violation of civil conducts where there is no specific legal code. Moreover, precedents may provide a helpful tool of guidance to a judge for choosing penalties and sanctions between the lowest and the highest levels where there are legal codes. In relation to this thesis, there are general Shariah principles beside legal codes, therefore, the referral to precedents would be helpful as a guidance in the case of an auditor civil fault in the annual financial statement due to the fact that concerned laws have stated their liabilities to the companies and their shareholders.

[1645] Alessa (2017) has summarised some of the main principles held by the Appeal Committee for the Resolutions of Securities Disputes (ACRSD) in *Almojil*'s case as follows:

1. The liability of board of directors during the IPO stage about the correctness of the prospectus with their declarations.
2. The liability of auditing firm during the IPO about the prospectus based on their report in it.
3. The liability of board of directors about the soundness of the financial statement.
4. The liability of board of directors about the soundness of the financial statement, even if they plea for not knowing about fault in the prospectus, and this principle applies for other mistakes from the company.
5. The criminal liability of board of directors about the faults and offences when they knew about them without taking actions. Alessa (2017) thinks that this might be interpreted as some of members of the board – according to the judgement- were imprisoned while others are not despite the fact they have admitted their responsibilities for mistakes in the financial statement and other faults in the company prospectus.
6. The liability of board of directors about the integrity of the company's assets evaluation.
7. The liability of external auditor about the verification with respect to integrity of the application of internal control procedures (standards).
8. The ACRSD has the authority to correct the financial statement retroactively according to the correct financial data.
9. The liability of external auditor about the faulty financial statements of the company, and binding him to compensate the damaged shareholders jointly.
10. The joint liability of the external auditor (Deloitte and their Associates) and other sentenced to compensate damaged shareholders in case money collected from ill gains acquired by the founder and owner of the company is not enough.

Aleissa (2017) has concluded his article by addressing an important question which is whether shareholders must prove their damages and the causal link for what have been established against the convicted defendants, if they (the CMA or the ACRSD) would allocate fair and suitable mechanism with easy process without cost to compensate those who were damaged, and when this would happen. Alessa was representing the shareholders in this case, however, he stated clearly at the beginning of this article that he does not take any position here and only summarised the main principles of the said verdict. Asem Aleissa, 'Some Legal Principles from Al-mojil's Case', Argaam Website (28-02-2017) available at: https://alphabeta.argaam.com/article/detail/102417/بعض-المبادئ-القضائية-المُستفادة-من-قرار-المعجل.

[1646] Lulwa Shalhoub, 'Saudi Market Regulator Confirms Fines, Jail Terms in MMG Case' *Arab News* (Jeddah, 9 February 2017) available at: http://www.arabnews.com/node/1051686/business-economy.

[1647] Ibid.

IPO stage (in the secondary market), so this step enables damaged shareholders to claim their economic loss.[1648]

According to Alamri et al., this resolution against *Mohammad Al Mojil Group Company* has created a big debate in the Saudi capital market and may disclose the extent of concerns in this regard, when strict sanctions including fines of billions and many years of imprisonment can be issued by a mere administrative authority. This resolution gave 5 years' imprisonment for each of the chairmen of this company and the deputy, and a fine of 1.5 billion Saudi riyals ($400 million) to be deposited in the CMA account as well as a variety of other strict sanctions for auditors and some board of directors' members. In addition, the resolution invites any individual shareholder or third party who sustained damages from this violation to file a case before the CRSD and to claim compensation.[1649]

On the other hand, there are other cases related to the civil liability of D&Os of listed companies before Committee for the Resolutions of Securities Disputes (CRSD), the Appeal Committee for the Resolutions of Securities Disputes (ACRSD), General and Administrative courts. From the researcher perspective it is hard to predict the outcome of potential judgments and if they are in favour of shareholders. Moreover, the focus of this thesis is on the default occurred in the annual financial statement, hence, there are many subjects are out of this thesis remit due to word space. However, this research intends: to draw a road map of how many existing forums should address this type of cases; to predict the near future of hearing a dispute before one competent court and if certain issues may arise especially in the first few years of transfer due to Shariah judges background as mentioned above; to examine the use of precedents issued by different forums as a starting point to discover Shariah principles in other professions;[1650]

[1648] The ACRSD has not published the full judgment in its website yet despite the fact it has published other later judgments in the same year, and this also apply on the primary judgment issued from the CRSD. However, a press release about the final judgment can be found at: https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_2182.aspx. Accessed 08 July 2018.

[1649] Khalid Alamri and David Milman and Philip Lawton, 'The board of directors in listed companies under the corporate governance system in Saudi law as compared to English law and global standards' (PhD thesis, Lancaster University 2018) 80-81.

[1650] For instance, medical malpractice cases that heard before Sharia Medical Panel. The Law of Practicing Healthcare Professions 2005 specifically provides that healthcare professionals will be liable in the event they commit malpractice causing harm to a patient. Furthermore, under the same Law, a healthcare professional is obliged to "exert due care in line with commonly established professional standards." This is therefore an objective standard Jones and others (n1643). See articles 15-23 about the duties of Healthcare Professionals towards Patients. A final point should be addressed and criticized in brief is in respect of Jones's conclusion about the lack of certainty regarding damages in Saudi Arabia when they stated "In general, the lack of certainty regarding damages means the litigation risk is significantly higher in Saudi Arabia compared with other jurisdictions. In comparison, however, the level of damages awards remains much lower than in those jurisdictions which means the uncertainties will affect both parties." This thesis has addressed the lack of certainty in common-law countries regarding damages occurred to the company and how damages should be calculated from one side. From the other side of the token, shareholders were considered as third parties and then unable to be indemnified. Therefore, the litigation risk in these countries are higher not only because of the lack of certainty regarding damages but also due to the reliance of precedents that

to facilitate and expedite benefiting from addressing common law precedents and alerting concerned parties of a dispute and judges that common law precedents' principles may not match the facts of cases so that careful reliance should be taken. Finally, Saudi courts are now open to hear debates and principles coming from other countries, however, related judgments must be in conformity with Islamic law.[1651] This way has opened recently and more specifically in the committee for Insurance Resolution Disputes and Violations.[1652] Thus, a discussion of common law cases before a Saudi court/ quasi-judicial committee has to highlight the Islamic point of view to assess if those principles could be able to apply in Saudi Arabia.

7.2.1.1 The Relevance of Common Law Principles in the Saudi Context

In this section, the researcher will explain (partly for the benefit of readers who are less familiar with the common law system, or *vice versa* for readers who are less familiar with the Saudi legal system) as to why he chose the case law of common law countries in a study primarily concerned with the development of legal principles and commercial practices in Saudi Arabia. It should be observed that the common law may be applied differently from time to time depending on the facts presented, moreover it may change and develop. Furthermore, judges of lower courts must abide with higher court decision. However, there might be a great confusion from other researchers from non-common law jurisdictions especially the reference to old cases related to other subject matters. This may impact on the final analysis of the intending benefits from related judgments. Hence, despite the fact that there are no general principles in a specific matter, the discussion of various judges in several common law countries' precedents encourage a researcher to think outside of the box.

do not share similar facts. See: https://www.clydeco.com/insight/article/an-overview-of-medical-malpractice-in-the-kingdom-of-saudi-arabia.

[1651] Beswetherick and Alsaab (n1075) 3-4.

[1652] Articles 9 of Rules and Procedures of the Insurance Disputes and Violations Settlement Committees based on Resolution No 190 dated 9/5/1435H stipulates: "1. Lawsuits shall be considered in the light of presented written requests, defenses or whatever raised during the proceedings. They shall be decided on in accordance with the laws and regulations regulating the nature of dispute, the applicable rules and rulings reached at by the judiciary and the comparative jurisprudence for settling insurance disputes and violations…" For a discussion about the meaning of comparative jurisprudence in addition to compliance with Shariah principles as they noted "That will, of course, always be subject to the proviso that the arguments, principles and decisions relied upon should be consistent with Shariah principles and the requirements for cooperative insurance in KSA.", see previous discussion in Chapter Five, Beswetherick and Alsaab (n1651).

Another related important topic to some countries that are considered as mixed jurisdictions applying common law beside Shariah. The consideration of comparative common law principles in Islamic jurisdictions is not unknown in the scholarship in such jurisdictions, and the way in which it is considered there are either binding (as in the Malaysian civil courts "other than Shariah courts that hear family cases only" or instructive "as in the Saudi Arabian courts and quasi-judicial committees." For instance, Lambak and Tahir discussed the interaction between Shariah and common law in relation to the Malaysian Takaful Act 1984 as the Act itself is not standalone and comprehensive.[1653]

Common law principles may thus be of assistance both in interpreting Saudi regulations and in the shaping of insurance practices in a way which accords with Islamic fundamental principles. For example, Lambak and Tahir concluded that:[1654]

1. The application of the Common Law in Takaful Act 1984 or other law is permitted from Islamic perspective based on the doctrine al-Urf "Custom". This is on the basis that the common law has been established for more than eight hundred years based on the public interest which is in line with Islamic teachings and been received by many countries worldwide. "And cooperate in righteousness and piety, but do not cooperate in sin aggression."[1655]

2. The concept of compensation, which is the common and main objective of both Takaful and common law so far, does adhere with all four of the Urf conditions.

3. For the application of the common law in Takaful Act 1984, it has to pass the full test of four conditions particularly the first i.e. not contradicting with any Islamic text. Otherwise, the application of the law shall be deemed as invalid. "Take what is given freely, enjoin what is good, and turn away from the ignorant."[1656]

[1653] For example, the Takaful Act 1984 in Section 67 (1) accords that the provisions herein shall prevail if there is any conflict or inconsistency with other acts namely the Insurance Act 1963 (superseded by Insurance Act 1996), Companies Act 1965, the Contract Act 1950, the Road Traffic Ordinance 1958 (superseded by Road Transport Act 1987) and the Co-Operative Societies Act 1984. This impliedly means if there is no provision made in the Takaful Act 1984, hence, other laws will apply. This is supported by subsection (2) of the Act that all insurance and Takaful operators are still subject to all applicable written law; see also, Lambak and Tahir (n1023) 264.
[1654] Lambak and Tahir (n1023) 267.
[1655] Holy Quran Ch 5, Verse 2.
[1656] Ibid (7):199.

Lastly, Lambak and Tahir recommended that a comprehensive study of the Takaful cases be conducted and brought onto civil liability court in Malaysia and subsequently analysed for their influence on the common law court verdicts and their compliance with Islamic rulings.[1657]

The application of common law is quite different in the Malaysian context in comparison with Saudi Arabia. In Malaysia, liability cases must be referred to civil courts while in Saudi all courts and quasi-judicial committees must adhere to Islamic principles. Hence, results may vary in these two countries. In particular, Saudi regulations must not violate Shariah so the court judgments have to adhere with Islamic rules in any area and then Takaful products will be able to provide compensation based on Islamic principles as the Takaful regulations are procedural in Saudi. Hence, the application of Urf to get benefit from common law cases is quite different from the Malaysian experience and it should be better for Saudi judges to extract Islamic rulings in a particular area in addition to referring to foreign precedents.[1658]

More generally, the study of legal principles in and across mixed jurisdictions can provide deeper insights into the issues at stake. It is of note that Canada (of the investigated countries in this thesis) is considered as a 'mixed jurisdiction' mixing civil law and common law approaches. Du Plessis and Palmer indicate that civil liability is particularly interesting from the mixed legal systems' point of view, because this field of private law (of civil law origin) belongs to the branches that have been most affected by common law.[1659]

As Palmer puts it, "precise tort rules had a relatively easy time insinuating themselves in the principles of la responsbilite. As compared to the English rules, the general Aquilian principle may seem to be mute on many sub-issues in connection with fault, causation and damage," which is why the "subject of tort in a mixed jurisdiction is of greatest interest to the comparative lawyer and to those interested in the modern ius commune."[1660]

[1657] Lambak and Tahir (n1023) 267.

[1658] To elaborate on this point, the relationship between common law and Shariah is well known in mixed jurisdictions, such as Malaysia, where the common law is applied as well as, or alongside Sharia before civil courts to very limited degree. In the Malaysian civil courts, the mixed approach is not capable of assisting in the interpretation of regulations in a way which best meets the requirements of Shariah and which may not lead to more sharia compliant commercial practices as judges may rely on common law precedents without referring to Shariah principles especially if there is no specific legal code as in the case of auditor civil liability towards shareholders or the act is procedural. On the other hand, in Saudi Arabia, if the application of common law principles is instructive, then, they can often assist in the development of principles and practices which compliment Shariah principles and legal codes.

[1659] Vernon V Palmer, 'The Fate of the General Clause in a Cross-Cultural Setting: The Tort Experience of Louisiana' (2000) 46:3 Loy. L. REV 538; see also, Jacques Du Plessis 'Comparative Law and the Study of Mixed Legal Systems' in Reimann & Zimmermann, eds., *The Oxford Handbook of Comparative Law* (Oxford: Oxford Univ. Press, 2006) 505.

[1660] Vernon V Palmer, 'Introduction to the Mixed Jurisdictions' in Vernon V Palmer ed., *Mixed Jurisdictions Worldwide, The Third Legal Family* (Cambridge: Cambridge Univ. Press, 2001) 535.

The discussion would lead us to highlight the issue of pure economic loss. According to Fuglinszky hermeneutical equalization which is "a methodological pattern, i.e., a way or modality in which one system can influence another"[1661] points towards a more general approach even considering pure economic loss in the common law provinces of Canada.[1662] Hence, pure economic loss is traditionally regarded in common law jurisdictions as irrecoverable.[1663] As Major J summarized in the *D'Amato v Badger* case,[1664] there are four reasons for refusing these claims. "First, economic interests have been seen as less worthy of protection than bodily security and property. Second, liability in indeterminate amount for an indeterminate time towards an indeterminate class is feared. Third, it may be more efficient to place the burden of economic loss on the victim. Pure economic loss is often seen as an ordinary business risk which can be expected and for which business people make plans. The fourth reason stated was that the restrictive approach discouraged a multiplicity of lawsuits, in favour of channelling claims into one action."[1665]

On the other hand, Linden and Feldthusen outlines five case groups, wherein pure economic losses can be recovered; these are: negligence misrepresentation, negligent performance of services, defective products or buildings, independent liability of statutory public authority, and the last but not least, the so called relational economic losses.[1666] More interestingly, they have argued that in some cases some additional requirements have to be met in order to recover the damage even within these case groups. For instance, the variety of cases and issues of life quite challenge the judiciary, especially concerning whether the cases fall under one of the case groups or when an appropriate classification is not possible due to the complexity of the case. Sometimes the claim had to be rejected due to the rigidity of case-by-case analysis, although the general consensus required recovery.[1667]

Fuglinszky has concluded that there is no surprise that the (common law) judgments on pure economic loss are generally very long and elaborate.[1668] In contrast, the classification of damage does not play such important role in civil law. In Quebec, just like in French law,

[1661] Adam Fuglinszky, 'Civil Liability in a Mixed Jurisdiction: Quebec and the Network of Ratio Communis' (2013) 28(1) Tul. Eur. & Civ. L.F. 13.
[1662] Ibid 33.
[1663] Ibid.
[1664] *D'Amato v. Badger* [1996] 2 S.C.R. 1071.
[1665] *D'Amato v Badger* [1996] 2 SCR 1071 paras. 17-20.
[1666] Allen M Linden and Bruce Feldthusen, *Canadian Tort Law,* 8th ed. (Markham: LexisNexis Butterworths, 2006) 442-43.
[1667] Ibid 442-443.
[1668] Fuglinszky (n1661) 35.

according to art. 1607 of the CCQ, creditors are entitled to damages for bodily, moral or material injury, which is an immediate and direct consequence of the debtors' default. Tremblay asserts that there is no distinction between personal injuries, property damage and pure economic loss, therefore, other legal instruments in general, such as the requirement of direct and immediate consequences, function as a floodgate against damage claim lawsuits entirely lacking merit.[1669] According to Fuglinszky, she believes that in Canada, this general approach attracts the attention of common law judges and even supreme court judges with a common law background.[1670] For example, McLachlin J made a comprehensive comparative analysis on pure economic loss in the *Canadian National Railway Co. v Norsk Pacific Steamship Co.* case.[1671] She voted against the so-called exclusionary rule and against insisting on narrow outlined case groups. She preferred a more general approach where the proximity should be a reasonable limiting factor. In her analysis, she referred to the civil law several times, detecting functional equivalence between the requirement of direct and immediate consequences in civil law and proximity in common law.[1672]

O'Byrne and Schipani have recently emphasized that courts are reluctant to permit recovery of pure economic loss for negligence for a number of policy reasons.[1673] According to Johnson, the rule prevents limitless, disproportionate, and often speculative liability for unforeseeable economic[1674] handled this matter in *Ultramares v. Touche*, where he warned of damages resulting from the negligence. Justice Cardozo famously extending "liability in an indeterminate amount for an indeterminate time to indeterminate time to an indeterminate class"[1675] The second rationale believed by Esquibel is the "deeply rooted jurisprudential belief that contract remedies are superior to tort remedies for dealing with issues of economic loss."[1676] That is, "[a]pplication of the economic loss tort actions between commercial parties is … [intended] to encourage the party best situated to assess the risk of economic loss, the

[1669] Gerald R Tremblay, 'Economic Loss: Legal Considerations' (1999) J. Bus. Valuation 345 at 357; see also, Fuglinszky (n 1661) 357.
[1670] Fuglinszky (n1661) 35.
[1671] *Canadian National Railway Co. v Norsk Pacific Steamship Co*. [1992] 1 SCR 1021.
[1672] Ibid.
[1673] O'Byrne, Shannon Kathleen. and Schipani, Cindy A., "Personal Liability of Directors and Officers in Tort: Searching for Coherence and Accountability", Ross School of Business Working Paper Working Paper No. 1395 December 2019 Forthcoming in 22 University of Pennsylvania Journal of Business Law (2020) 18-19, available at: http://ssrn.com/abstract=3493249.
[1674] Johnson, Vincent R., *"The Boundary-Line Function of the Economic Loss Rule"*, 66 WASH. & LEE L. REV. 523, 542–43 (2009).
[1675] *Ultramares Corp. v. Touche* N.E. 441 (N.Y. 1931) 179-180.
[1676] Amanda K. Esquibel, The Economic Loss Rule and Fiduciary Duty Claims: Nothing Stricter than the Morals of the Marketplace, 42 VILL. L. REV. 789, 793 (1997).

commercial purchaser, to assume, allocate, or insure against risk."[1677] Flourishing this principle is the argument that "the law of contract is better equipped than the law of tort to redress a buyer's financial disappointment when a deal turns out badly."[1678]

A third less prominent argument for the rule deals with the normative value of the tort system.[1679] Cases comprising economic loss, while probably resulting in unfair decisions where one-party benefits at the other's expense, do not necessarily result in a social cost but as Rhee stated "simply a transfer payment - a private cost to one but an equal private benefit to another."[1680] Furthermore, personal injury and property loss are qualitatively different.[1681] Courts are therefore cautious of over-deterring non-negligent activities or activities that are "otherwise efficiently deterred for the purpose of mitigating social cost." [1682] This may be in particular true where other areas of the law already provide[1683] loss has faced widespread criticism. For example, scholars like Robert J. Rhee note that "the practice which, in many instances, denies recovery for pure economic loss in negligence cases is hard to reconcile with the recovery for potentially large economic losses resulting from negligently caused physical injury."[1684]

The above discussion was necessary to evaluate how common law principles are dominant in the area of economic loss so that it would be logical to be compared with an Islamic jurisdiction.[1685]

7.2.1.2 The Imposition of Liability for Economic Loss as a Regulatory Tool

[1677] *Daanen & Janssen, Inc. v. Cedar Rapids, Inc.*, 573 N.W.2d 842, 846 (Wis. 1998); Johnson, Vincent R. Johnson, The Boundary-Line Function of the Economic Loss Rule, 66 WASH. & LEE L. REV. 523, (2009) at 545.
[1678] Ward Farnsworth, "The Economic Loss Rule", 50 VAL. U. L. REV. 545, 553 (2016).
[1679] O'Byrne and Schipani (n1673) 19.
[1680] Robert J. Rhee, "A Production Theory of Pure Economic Loss", 104 NW. U. L. REV. 49, 62 (2010).
[1681] O'Byrne and Schipani (n1673) 19.
[1682] Ibid.
[1683] Ibid.
[1684] Ibid.
[1685] Different approach of economic loss from Canadian perspective has been emphasised in England in this recent case, where the principles applicable to the assessment of damages held on the basis of 'loss of a chance' rather than assessment of the probability third parties' actions having taken place by reference to 'the balance of probabilities' test. *AssetCo v Grant Thornton UK LLP* [2019] EWHC 150 (Comm). This research does not respond to above tests applied or not applied in this case due to the fact such principles are not suitable to be measured for compensating damaged parties, and it is expected to bring additional confusion in upper courts from the one hand, and from the other hand, it may shows additional non clarity and incomplete analysis, when applied in prospective cases. The researcher thinks that principles taken from contract law are sufficient in auditor civil liability cases, and this research clearly endorse the actual loss occurred to damaged persons.

In addition to the above objectives, the thesis has addressed to what extent existing corporate and securities regulations, rule, precedents and professional standards applicable in Islamic and common law jurisdiction provide effective means in minimising auditors' risk failure and being civilly liable. We saw in Chapter two that shareholders who appear to be capable of being indemnified for economic loss in Saudi Arabia if an auditor is found to have been civilly liable for mistakes in the annual financial statement, unlike in the compared common law countries. Saudi judges should thus have different understanding with respect to economic loss of shareholders.

7.2.1.3 Summary so Far

The importance of this thesis comes from the rarity of studies that focus on auditor liability and professional liability insurance products in Saudi Arabia. Furthermore, most compared studies and legal articles focus both on auditor liability and mainly on criminal aspects. Moreover, precedents are changing from time to time as yet no clear methods and tests present justifiable approaches to protect third parties such as shareholders. However, common law precedents failed to design a clear liability and indemnification system. The importance of this investigation is to discuss advantages and disadvantages of compared common law systems so that gaps in the Saudi legal system can be filled. As Saudi judicial system is open to other precedents and applications from other countries, cautious and deep analysis should be in place as regulations, precedents, applications and concepts are different. This study would help Saudi judges and quasi-judicial members to draft better judgments and decisions.

7.2.2 Literature Related to Whom Should be Considered as Damaged Person from an Auditor's Misconduct

In brief, the term 'securities' in Saudi laws and regulations refers to several financial instruments. For example, in the Saudi Capital Market Law 2003 and connected implementing regulations, securities mean any of the following: "1) shares, 2) debt instruments; 3) warrants; 4) certificates; 5) units; 6) options; 7) futures; 8) contracts for differences; 9) long term

insurance contracts; and 10) any right to or interest in anything which is specified by any of the paragraphs (1) through (9) above."[1686]

The researcher has specified in his analysis during the thesis the focus on ordinary shares. This is a very crucial choice as other types of securities are well protected either through the Saudi Capital Market Law 2003, the Companies Law 2015, and the Bankruptcy Law 2018 or other statutory regulations in addition to existing Shariah principles. The definition of the share in the Regulations and Rules of the Saudi Capital Market Authority is "Share of any company wherever incorporated. The definition of "share" includes "every instrument having the characteristics of equity."[1687]

According to Al-Zahrani, there is no specific definition of the term share within SCL 1965 "nor the SCL 2015", as is the case in many countries, and in general, jurists define share in several ways.[1688] It is defined as an instrument issued by JSCs with a certain nominal value, representing a partner's share in the capital.[1689] A share is also considered as a part of the company's capital, and it gives its owner the right to a share of the profits achieved by the company (and approved by GM) to be distributed to shareholders.[1690]

In contrast, a definition of share is not included in the English Companies Act 2006.[1691] One of the most common judicial definition is that of Farwell J. in the case *Borland's Trustee v Steel Brothers & Co Ltd*,[1692] where he says, "A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with Companies Act (now the English Companies Act 2006, S.33 (1)). The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money, but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of

[1686] See the Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority, updated version, 2018.
[1687] Ibid.
[1688] Youseif A. M. Al-Zahrani, 'Rights of Shareholders under Saudi Company Law 1965' (PhD Thesis, Brunel University, 2013).
[1689] Faread Alarini, *Commercial Companies* (Cairo, Dar Aljamah Publishing 2007) 314.
[1690] Mohamad Almajmah. *Moajam Almustlahat Alislamieh* (Obeikan Publishing 2010) 210.
[1691] S.540 of the CA 2006 of the UK provides "(1) In the Companies Acts "share", in relation to a company, means share in the company's share capital".
[1692] *Borland's Trustee v Steel Brothers & Co Ltd,* [1901] 1 Ch. 279.

money of a more or less amount."[1693] Pennington deems that in formally registered companies, shares are a kind of immaterial tradable ownership that result in a group of rights and obligations associated with some benefit in a company with economic activities and owned by certain people, laying no debts.[1694]

A shareholder has not been generally defined except in a specific context as "Shareholder: means in the Rules for Special Purposes Entities, a person who owns shares in the capital of the special entity."[1695] However, the same regulations indicate the meaning of a substantial shareholder as "any person who owns (5%) or more of the shares of the Company or voting rights therein."[1696] Preferred stocks in the Saudi Companies Act 2015 are stocks that can be created by the Extraordinary General Assembly if a company wishes to raise its capital, however, such stocks will not have voting rights.[1697] With respect to convertible debt/sukuk, the Saudi Companies Law 2015 in Article 122/2 states that a company may not issue debt instruments or sukuk that are convertible into shares except upon a decision by the extraordinary general assembly prescribing the maximum number of shares that may be issued against such instruments or sukuk. Article 123 explains how a company could convert these instruments to shares according to the Capital Market Law 2003. However, they cannot be transferred if the holders do not agree for the conversion or if is not stated in the EGA decision for the purpose of increasing the capital. In article 124, it states that any stakeholder may petition the competent judicial authority to nullify any action in violation of the provisions of Articles 122 and 123 of the Law, and compensate the holders of debt instruments or sukuk for sustained damages.

[1693] Sealy and Worthington. *Cases and Materials in Company Law.* 8th Ed.(Oxford: Oxford University Press, 2292) 518.

[1694] Robert Pennington, 'Can Shares in Companies be Defined?' (1989) 10 Co. Law. 144. For further discussion about principles of shares and a recent precedent, French in chapter 6 of his book has described how companies issue shares to members. Shares have to give members benefits in return for the obligation to contribute capital. The standard benefits are the right to participate in corporate governance, the right to return of capital on winding up, the right to a dividend of annual profits and the right to transfer shares. Many varieties of shareholder rights have been tried and a company may have different classes of shares with different rights. A share has been defined as a bundle of rights (*Blackwell v Commissioners for HM Revenue and Customs* [2017] EWCA Civ 232, [2017] 4 WLR 164) and is intangible personal property. Issuing a share is carried out by allotting it to an allottee. Allotment may require authorisation by a members' resolution or by the company's articles and may be subject to existing shareholders' pre-emption rights. Partly paid shares may be forfeited for failure to pay calls. Public companies must have a minimum share capital. A person who has taken an allotment of shares as a result of a misrepresentation may be able to sue for rescission of the allotment. There are only seven permissible ways of altering share capital. French, Derek., 'Mayson, French & Ryan on Company Law (36th edn, 2019), Oxford University Press, 149.

[1695] Ibid.

[1696] Ibid.

[1697] The Regulatory Rules and Procedures issued pursuant to the Companies Law relating to Listed Joint Stock Companies by the CMA on 20 May 2019 has defined the Preferred Shares as "shares issued by the Company which entitle their holders the right to receive a larger percentage of the Company's net profits than the percentage received by holders of ordinary shares, after setting aside the statutory reserve, without entitling them to vote in the General Assembly.", available at: https://cma.org.sa/en/RulesRegulations/Regulations/Documents/LJSCRulesEn.pdf, Accessed on 28 May 2019.

In our analysis, we could notice that debt/sukuk holders will not be able to have a voting right similar to a shareholder unless the transfer is made. Hence, if there is a default in the prospective financial statement, they automatically will be considered as ordinary shareholders. In contrast, if the transfer happens after the issuance of financial statement and before a press release made in connection with stating the default, then the assumption of knowing must be understood from an auditor and then they will be able to get indemnified as other ordinary shareholders. In another way, if a bond/sukuk holder knew before the transfer about the default in the annual financial statement, they could have objected to transfer their debts/sukuk to ownership as they were protected by other regulations. Lastly, potential shareholders/investors are not defined in Saudi laws, however, the same liability rules according to the researcher understanding will be applied conditioning that they acquire their shares before the press release of the default in the annual financial statement.

A 'stakeholder' on the other hand according to Article one of the Corporate Governance Regulation "CGR" 2017 includes "any person who has an interest in the Company, including employees, creditors, customers, suppliers and the community."[1698] For instance, the CGR 2017 brings to the attention specific provisions in connection with the relationship of a listed company to its stakeholders as stated in article 83-85. Article 83 is related to regulating the relationship with stakeholders. Article 84 is about reporting non-complaint practices, while article 85 is specifically related to employee's incentives.

In relation to this thesis, Article 83 stipulates that "the Board shall establish clear and written policies and procedures regulating the relationship with Stakeholders with the aim of protecting them and safeguard their rights, which shall include the following, in particular: 1) methods to compensate Stakeholders when their rights established by laws or protected by contracts are infringed; 2) methods for resolving complaints or disputes that may arise between the Company and the Stakeholders;…" Article 84 also states " The board shall, based upon a proposal from the audit committee, develop the necessary policies and procedure to be followed by Stakeholders when submitting complaints or reporting any violations, taking the following into consideration: 1) facilitating the method by which Stakeholders (including Company

[1698] As expressed by Abdullah and Valentine, it involves "any group or individual who can affect or is affected by the achievement of the organisation's objectives" H Abdullah and B Valentine, 'Fundamental and Ethics Theories of Corporate Governance'.(2009) 4 Euro Journals Publishing, Middle Eastern Finance and Economics, ISSN: 1450-2889, 91.

employees) report to the board conducts and practices of the Executive Management's that violate applicable laws, regulations and rules or raising doubts as to the financial statements or the internal audit controls or others, whether such conducts or practises are against them or not, and conducting the necessary investigation in that regard;…" These two provisions could be read with relevant laws to adequately measure the damages if any occur to any stakeholder. To clarify, a creditor can be indemnified according to the Saudi Companies Law 2015. However, the person cannot be treated as an identified user of the financial statement by default unless he asked for a confirmation from the auditor of the listed company. In addition, according to this analysis, the creditor would be then able to measure his economic loss in case of default and whether he secured his position through security interest or not. Hence, various regulations are in place and there is also a role can be played for the auditor professional liability insurance if an auditor wishes to give a confirmation to other third parties excluding shareholders. Based on this brief analysis, the researcher will remove the creditor's rights of compensation from an auditor due to the limitation of the thesis.

The last point in this section is related to the duties of the external auditor of a Saudi listed company. As explained in Chapter Two, Article 82 of the CGR 2017 highlights such duties but here the focus on "The external auditor shall: 3) Request the Board to call for a General Assembly meeting if the Board has not facilitated his mission; and shall be liable to compensate the Company, the shareholders or third parties for the damages resulted from errors it commits in the course of its engagement." The Saudi regulations did not identify specifically who could be considered as a third party. It could be argued to include all stakeholders in addition to others such as financial analysts and credit agencies. Hence, the researcher believes that stakeholders and third parties are well protected by tort and contract laws in the Saudi legislations. However, they cannot be considered to have special relations to a corporate like shareholders based on ownership so that liability through profit and loss is connected to it.

According to Boynton and Kell, they generally define the third party as those with the right to litigate the auditor legally such as: 1- Primary beneficiary: indicates a known person, his name given in advance to the auditor reports. For example, a client informs an auditor before beginning the auditing.[1699] Then, this auditing report will be used in obtaining a loan from a particular bank. In this case, the bank is considered as the primary beneficiary of the auditing.

[1699] W Boynton & W Kell, *Modern Auditing* (New York: John Wiley & Sons, Inc.1999); see also, Matar (n220) 61.

2- Other beneficiaries: a category of users, their names are not given in advance to the auditor, but they depend on his opinion when making their decisions related to audited firms. Examples of this category are stockholders, prospective investors, creditors and others who use financial statements.

From the above-mentioned, it is clear that the third parties who have the right to legally sue the auditor, due to injuries resulting from their reliance on misleading financial statements accredited by the auditor belong to different categories and conflicting interest. Nobody calls an auditor to reconcile between the interests of these categories or to take care for their interest to the same degree. Moreover, opening the door to legal responsibility for the third party to litigate the auditor ultimately exposes the auditor to arbitrary requirements, causing the greatest injury to the auditing profession.[1700]

After identifying the damaged person in the context of this thesis, the researcher would like to explain the duties of the external auditor to shareholders. In the Saudi CGR 2017, article 82 states that "The external auditor shall: 1) owe the duties of loyalty and care to the Company; …" The regulation was not clear about these duties; however, it could be interpreted and borrowed from a company's board member duties towards his company. In article 29 of the CGR 2017, it stipulates "Each member of the board shall comply with the principles of truthfulness, honesty, and prioritise their interests over his/her personal interest. This shall include, in particular, the following: 1) Truthfulness: is achieved when relationship between the board member and the Company is an honest professional relationship, and he/she discloses to the Company any significant information before entering into any transaction or contract with the Company or any of its affiliates. 2) Loyalty: is achieved when the board member avoids transactions that may entail conflicts of interest and ensures fairness of dealing, in compliance with the provision relating to conflict of interest in these Regulations. 3) Care: is achieved by performing the duties and responsibilities set forth in the Companies Law, the Capital Market Law and their implementing regulations and the Company's bylaws and other relevant laws." As the duty of care is concerned, an auditor should perform his duties and responsibilities as set forth in the Companies Law, the Capital Market Law and their

[1700] The Accounting Standard Board (FASB, 1978) defines users of accounting information as: "members and potential members of some group such as owners, creditors, and employees – have or contemplate having direct economic interests in particular business enterprises…Members of other group – such as financial analysts and advisors, regulatory authorities, and labour unions – have derived or indirect interests" Braiotta, L., Gazzaway, T., Colson, R., Ramamoorti, S. (2010). 'The Audit Committee Handbook, 5th Edition. New Jersey: Jhon Wiley and Son, Inc.; see also, Matar (n220) 61.

implementing regulations and the Company's bylaws and other relevant laws.[1701] As indicated in Chapter Two, an auditor has to prepare his annual financial statement report by applying the prevailing accounting standards. Article 80 of the Saudi CGR 2017 states that "The Company shall assign the function of auditing its annual accounts to an independent and competent external auditor who possesses the necessary expertise and qualifications to prepare an objective and independent report to the Board and shareholders, setting out whether the Company's financial statements clearly and impartially express the financial position of the Company and its performance in the significant areas." From this article, it is clearly noticed that the annual financial statement is reported to the board and shareholders and not to other stakeholders and third parties such as creditors. Hence, the presumption of auditor's liability towards shareholders is known in addition to being voluntarily accepted once the signing of engagement letter has made between the company's representative "Board of Directors" and the auditor, as they needed a prior approval from the Ordinary General Assembly, which means that shareholders delegate their authority to them.

Following the above discussion of the legal codes in Saudi Arabia, a few emphases would highlight the meaning of accountability in Shariah. According to Falgi, accountability is arguably not a company choice; it is an obligation by a company to meet its responsibility toward the society in which it does business.[1702] Accountability can be seen as a contract between the company and interested parties, enforced by the rules and regulations including civil law, company law, implementing regulations, professional standards, internal rules (constitution, contracts, etc.), ethical codes, conventions and customs.

The Islamic Accountability Framework on the other hand considers two sides of the relationship, the 'accountee' and the 'accountor'. The former could be based on a religious authority, such as scripture, in this case the Qur'an accountable to the government, the community, investors, shareholders or other stakeholders, who delegate tasks for others to do on their behalf. The accountor could be an individual human, a board of directors, a manager or any party who accepts a delegation on behalf of another. Thus, accountors ought to look

[1701] In the literature, due professional, as one of the general principles governing the auditing process, indicates the care level, diligence, personal judgment, skills and professional competences familiar to other auditors working in the same conditions in which the auditor works or in similar conditions, Matar (n220) 60. This means that the auditing process and the compiling of reports is carried out with the same degree of care, competence, learning and experience available to other members in the auditing and accounting profession, as required by professional standards, Dan Guy, C. Wayne Alderman and Alan J. Winters. *Auditing*. 5th ed. (Fort Worth, Texas: Dryden Press of Harcourt Brace & Company, 1999).

[1702] Khalid I Falgi, 'Corporate Governance in Saudi Arabia: A Stakeholder Perspective' (University of Dundee, 2009).

after the work delegated to them and protect their delegator's interests.[1703] The accountors are required to discharge their accountability. For example, within the accountability relationship between Allah and humans, the latter, as accountors, are required to discharge their accountability, so that they are accountable for their creation to their creator and therefore ought to worship their creator in order to discharge their accountability.[1704] In the same way, managers are accountable for their actions and performance to their stakeholders and they have to accomplish what they are charged to do. In addition, they have to report to their accountees about the actions that they have taken in order to discharge their accountability.[1705] Lewis claims that companies (or manager) (the accountors) could use financial reporting as an obligation for full accountability to the Ummah.[1706] However, Muslim managers (accountors) believe that they are held answerable to their stakeholders in addition to their answerability to God in the afterlife. Therefore, they ought to do what is necessary to discharge their accountability. In this context, Baydoun and Willett argue that Islamic regulations require companies to make full disclosure in order discharge their accountability.[1707]

Based on what has been discussed, we have seen that Directors and Officers duties and liabilities are explicitly drafted into the Saudi legislations. Furthermore, the concept of accountability and civil liability of auditors in listed companies is well embedded in Shariah and legal codes. It could be understood that Shariah principles have to be examined in particular contexts, and provided analysis in this thesis must be based on main Shariah principles, which come from primary and secondary sources in order to reach an acceptable conclusion.

Napier has raised further important questions in relation to liability for negligent misstatements.[1708] From the point of view of this research, the auditor's duty of care is owed without question to ordinary shareholders. There are no specific circumstances for the duty of care to arise as the auditor assigned to verify the annual financial statement from the shareholders collectively at the Ordinary General Assembly. Any act or omission from the auditor in his performance of the audit particularly in the annual financial statement that is

[1703] Falgi (n1702) 78.
[1704] Ibid.
[1705] Abbes Al-Jirari, *Accountability in Islam* (Abbesjirari, 1996) (Online) Available at: http://www.abbesjirari.com.
[1706] Mervyn Lewis, 'Accountability and Islam' (2006) Forth International Conference Accounting and Finance in Transition Adelaide at 8, April 2006. Available at: http://search.ror.unisa.edu.au/record/UNISA_ALMA51109298130001831/media/digital/open/9915911835001831/12143355150001831/13143350630001831/pdf.
[1707] Baydoun, N., Willet, (2000), 'Islamic Corporate Reports, Abacus, 36(1):71-90.
[1708] Napier (n389) 110. Questions were addressed in section 4.1.

considered material to shareholders and may cause economic loss to their investments is the base for any potential claim. The damage can be evaluated individually based on each shareholder's transaction made between the occurrence of the default and the later press release regardless of the ownership status of shares if prior or post the occurrence of default. The expected reasonable level of care from an auditor is to follow the prevailing accounting standards.

7.3 Analysis of Specific Arguments and Information in Relation to Auditor Civil Liability Towards Third Parties in Common Law Countries from Shariah and Legal Perspectives

The first theme in this chapter presents several arguments with respect to auditor civil liability towards shareholders. As indicated in previous chapters, there are different approaches common law courts took in holding concerned judgments. Here, the researcher would like to further argue how common law countries' precedents are interpreted from an Islamic point of view and if some concepts can be helpful to Saudi judges.

7.3.1 The U.S Cases and the Suitability of its Principles in the Saudi Jurisdiction

The U.S courts have developed four main theories of liability as addressed in Chapter three. In the case of *Landell vs. Lybrand,*[1709] the only party with the right to litigate an auditor owing to negligence was the client according to the rule established by the court of Pennsylvania that of privity of contract. This rule requires the existence of a contractual relation or direct connection between the auditor and any other party, and so this party litigates the auditor owing to his negligence and his overall responsibility of damages incurred by this party.[1710]

[1709] *Landell vs. Lybrand,* 264, Pa. 496, 107 Atl. 783 , 1919.
[1710] *Landell vs. Lybrand,* 264, Pa. 496, 107 Atl. 783 , 1919. For more discussion about this case, see section 3.2.

From the researcher's point of view, the contract of auditing the annual financial statement is between the auditor and the company. The law of contract and law of tort with respect to economic loss must be the same. First, the company signs this contract for the benefit of shareholders and by their own monies as the company were established by them or by former shareholders. Second, in a case a company must sue the auditing firm, the collected money should be distributed to damaged shareholders. Third, there is no need to evidence that the auditor report has the intention to cause damage in case of negligence. As discussed earlier,[1711] it is impossible to calculate the damage done to a company while this is not the case with ordinary shareholders. Ordinary shareholders' economic ownership cannot be separated from the company even though a company may have its own legal personality. But that does not mean they are not connected in sharing the risk of all transactions so any loss could be distributed equally to them as argued earlier from an Islamic point of view. Hence the privity rule should be applied intuitively whether the company or its shareholders in Saudi Arabia raise the case.

In *Ultramares Corp. v. Touche*,[1712] the court established the identity of the primary beneficiary as any person considered to be the main receiver of the auditor report, with auditor needing to know the name of this beneficiary prior to auditing.

The researcher has several comments on this judgment. First, shareholders are considered primary beneficiaries from the annual financial statement[1713] and an auditor must have known that before the delivery of his report.

[1711] See subsection 2.5.b, section 2.10, and section 6.3 for further discussion.
[1712] *Ultramares Corp. v. Touche* [1931] 255 N.Y. 170. For more discussion about this case, see section 3.3.1.
[1713] For example, the Saudi Companies Act 2015 in article 96 has given every shareholder the right to discuss the assigned items in the assembly's agenda in addition to ask about them from the board of directors and the auditor. The same act in article 126-4 stipulates that the chairman of the board of directors has to give the shareholders among other regulatory authorities the financial statements, the board of directors' report and the auditor's report. Article 133 also gives the shareholders a supervisory rule on the companies account according to stipulated rules in the Companies Act and the company's by-laws, which means that they are the only ones who have a direct authority in connection with the auditor's report and the financial statements. Article 135 states clearly that an auditor has to announce his report at the general assembly, and the assembly if approved the board of directors' report and the financial statements without listening to the auditor's report, then its decision would be null and void. Lastly, article 136-1 does not permit the auditor to announce what has been known of the company's secrets arising from his work to the shareholders except in the general assemblies or to others, or then he could be removed as well and then to be asked for compensation. The Corporate Governance Rules 2017 has also affirmed the shareholders' rights to be the primary beneficiaries of the financial statements. For instance, article 12-6 has stated the competencies of the ordinary general assembly to approve the Company's financial statement. Moreover, article 14 gives the shareholders the right to obtain information related to the items of the General Assembly's agenda, particularly the reports of the Board and the external auditor, the financial statements and the audit committee's Report in order to enable them to make an informed decision in this regard. Lastly, article 80 stipulates "The Company shall assign the function of auditing its annual accounts to an independent and competent external auditor who possesses the necessary expertise and qualifications to prepare an objective and independent report to the Board and the shareholders, setting out whether the Company's financial statements clearly and impartially express the financial position of the Company and its performance in the significant areas."

Second, it is argued that the extension of auditor liability to unnamed shareholders is not, contrary to the suggestion of the court in *Ultramares*, tantamount to expanding the field so that it is similar to liability for fraud. For example, negligence can be made only by the auditor for not following the accounting standards in the annual financial statement. It also can be made via the administration and/or board in preparing the quarterly financial statements that may lead to material errors in the annual one. The joint responsibility would be on both the board of directors and the auditor if separately made some errors according to their specified tasks. In contrast, the fraud comes either from the management or from both the management and the auditor in all or in different stages. However, the Saudi law has specified, for instance, several criminal sanctions for those who were involved. The damage can be calculated based on the mathematical equation the researcher proposed or as held by the ACRSD in *Almojil*'s case for other cases. In addition, the CRSD and ACRSD have already developed ways of calculating damages in criminal cases such as market manipulation and insider trading that occur in the secondary market. The judgments have stated the right of private parties to claim their economic loss based on a specific criminal judgment (after notifying the CMA). Once a private party gets a final judgment for his interest, he then might be able to get his loss from the money already allocated at the CMA's fund of illegal gains or from the defendant (as stated in CML). It is still unclear yet if the plaintiff must be compensated from the illegal gain but it is believed this way is more sufficient than the latter. To illustrate this point, there are considerable discussions in Saudi Arabia criticising the Saudi Capital Market Authority on forfeiting the illegal gains to its own account, and then allow private parties to claim against defendants for their personal loss. Hence, it was suggested to allocate the illegal gain in a specific fund to be distributed directly to those investors who were damaged from a particular fraud or violation. This research is in the opinion that the class of persons who are civilly damaged are determined and their losses are known to the CRSD and ACRSD due to the fact that CMA accused a defendant based on his fraud or violation on specific dates for example as it is announced in the stock exchange, and then all affected transactions can be discovered from the exchange system.

Another related assumption with respect to combining a fraud from the management and an error from the auditor. This is the only case that the researcher believes that an auditor is not going to compensate ordinary shareholders, as the convicted officers and directors of the company will do. In this case, a fine with administrative sanctions can be imposed on the

auditor for not fulfilling his duty of care.[1714] In addition, there is a need to consider that even if an auditor follows the prevailing accounting standards and do not discover the fraud, then he would not be liable to compensate shareholders. However, administrative sanctions could be made which may also affect his insurance coverage at prospective audits. This clarification is vital as Judge Cardozo warned in *Ultramares* case that the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.[1715] It is also worth to affirm that the criminal misconducts which were done by the board of directors and the officers of a listed company must bear the consequences of their illegal actions towards shareholders on their own in this scenario without involving the auditor even if he has made a mistake, i.e. the criminal misconduct takes over the civil conduct. Shareholders would then be able to seek their compensation before the competent court or the quasi-judicial committee for their civil losses based on the illegal criminal misconduct that already have been judged in the criminal case.

Thus, though several judgments have referred to Judge Cardozo's statement, it is submitted that the class of damaged persons can be limited to ordinary shareholders in a specific time between the press release of the annual financial statement and the discovery of the negligence for specific amount based on the shareholders total loss in that period.

The court also considered the possible effects of an expanded liability theory to other similarly situated professions such as title companies and lawyers. Based on our analysis, every job has it is own duties and obligations so it is not acceptable to expand it to other professions. This conclusion is crucial to analyse as it might be argued that this thesis does not fully appreciate the development of the common law, which allows principles from one area to creep into the laws governing another. To emphasise, the Saudi legislator have singled out accountant's liability for audit failure to ordinary shareholders without the same danger of "creep", on the basis that the Sharia, and the market, requires selective treatment of auditors. In contrast, this area has been left to common law courts to decide without basing their judgments on any statutory rules, which have led to different understating in different times and also without extending the discussion on how the damages might be calculated to the listed company in a convincing way at minimum if they have excluded shareholders from being indemnified.

[1714] In section 2.9.1, the researcher highlights in brief the availability of administrative and criminal sanctions in the Saudi Companies Act 2015.
[1715] *Ultramares Corp. v. Touche* N.E. 441 (N.Y. 1931) 179-180.

With respect to the *Ultramares* court emphasis on the fact that a reasonable business person receiving a certificate without paying for it, and receiving it as one of many possible investors, one may look for more assurance outside the audit. This argument has no merit as already indicated the shareholders are the only one who pay for the auditing service based on their share ownership in a company. In addition, other possible investors mainly shareholders will then take the ownership of former shareholders despite the fact they have other tools to use to whether invest in a company or not. Accordingly, it can not be adequately connected to an error occurred from an auditor and negligence not discovered yet.

Finally, a scholar thinks that the audit can create a spill over effect, as information originally addressed to the shareholders can go to the benefit of creditors as well. This means that the company can seek to use the audit to reassure creditors and get funds, as is commonly observed in commercial practice.[1716] To answer this with justification, an auditor may declaim his liability to any class except shareholders. In addition, creditors can seek reassurance from the auditor himself so then their collected money from the same corporate after getting a final judgment or settlement with a liquidator will be the base on how much is not collected yet from the company and the auditor then pays the rest based on their contractual agreement regardless of the type of loan and if it is secured or not. Hence, there is no spill over to creditors.

In *Credit Alliance v. Arthur Andersen & Co.* case,[1717] the court has stated three prerequisites must be satisfied before auditors can be held liable for negligent misrepresentation to non-contractual third parties: (1) the auditor must have known that financial reports were to be used for a particular purpose; (2) the known party or parties were intended to be able to rely on those reports; and (3) there must have been some conduct linking the auditor to the relying party.

To put this case under the microscope, first we need to know that in 1978, the creditor company asked the Smith Company to provide its financial statements, after subjecting it to auditing by an external auditor as a condition to accept the acquisition of any additional financial credit in the future. This means that the auditor did not send the annual financial statements directly nor reaffirm it to a specific creditor or a group of creditors. In addition to that, the Smith company

[1716] Giudici (n259).
[1717] *Credit Alliance v. Arthur Andersen & Co.* 483 N.E.2d 110 (N.Y. 1985). For more discussion about the case, see section 3.3.2.

sent it for its own benefit and knowing it cannot affirm its correctness. In other words, the Smith company commissioned an external audit without any explicit approval and indication from the auditor of its special purpose or to be used by an intended recipient. Therefore, the Smith company's action did not make her liable in principle as the assumption of liability would be on the auditor conditioning he affirms the correctness of it. Moreover, in 1980, the Smith company declared its bankruptcy, and the creditor company litigated the auditor owing to negligence. The researcher observes that there was no direct contractual agreement between the auditor and the creditor, and in order to apply the contract law, the creditor needs to be identified as a main beneficiary third party. For the following reasons, the court was correct in its judgment with the three prerequisites must be satisfied before an auditor to be held liable for negligent misrepresentation to non-contractual third parties. The judgment can be extended to any third party's relationship with an auditor except shareholders. Hence, Saudi judges could benefit from these principles established and differentiate why it is not applicable to shareholders' relationship with an auditor.

The foreseen user approach was established in *Rusch Factors, Inc. v. Levin*,[1718] the *Rusch Factors* court held that an accountant would be liable for negligent financial misrepresentations which were relied upon by actually foreseen and limited classes of persons.[1719] This case represents another understanding of the relationship between third parties and an auditor. While the court in *Rusch* distinguishes *Ultramares* on the basis that the auditor in *Rusch* knew why he was being asked to certify the financial statements, the facts in *Ultramares* are difficult to distinguish – there the auditors also knew that the financial statements were to be presented to creditors. It could be argued that creditors are considered actually foreseen prior to the issuance of the annual financial statement and are reasonably foreseeable after the issuance of it. Further, creditors who are actually foreseen can extend their credit to a company conditioning that they get a reconfirmation from an auditor who issued the report. Their previous loans are not affected with the issuance of the financial statement as they already have secured their positions or relied on previous financial statement prepared by the same auditor or someone else. For new creditors who would like to offer credits, they then be able to be actually foreseen if agree with an auditor on relying on it. In contrast, shareholders whether they are actually foreseen or not reasonably foreseeable should not make any difference. Put it simply, shareholders trade their shares based on agreed prices on the exchange and in disregard to their investment status

[1718] *Rusch Factors, Inc. v. Levin* 284 F. Supp. 85 (D.C.R.I. 1968). For more discussion about the case, see section 3.4.
[1719] Ibid 93.

i.e. their ownership exist before the occurrence of the default in the financial statement. Hence, it is not acceptable for the court to extend the principle to potential shareholders by analogy as the positions of potential shareholders "who would acquire economic ownerships" and potential creditors are different as argued earlier from the Islamic point of view.

The Iowa Supreme Court applied the position expressed by the Restatement in *Ryan v. Kanne* [1720] where an accountant had prepared, but not audited, a financial statement. In rejecting the accountant's argument, the court contended that the liability of an accountant was dependent upon the undertaking of the duty rather than upon the rejection of dependability in the accountant's report. This may be true that an auditor undertakes that he or she fulfils the duty by applying the accounting standards, through issuing a post letter to a specific lender for example or by contract. However, this is not the case with existing shareholders or with the potential ones as they are swapping their positions in the secondary market. In other cases, such as raising capital, it is going to be limited to a specific group of shareholders and the law is clear about it. With respect to the point that the rejection of dependability in the accountant's report, the researcher thinks that no direct dependency could be established to creditors and that the presence of a disclaimer would be valid against them. In contrary, the same is not acceptable to shareholders as there is a contractual relationship that extends the financial statement to shareholders, by default, so that a disclaimer does not suffice.

To explain this point differently, it has been argued in this thesis that the involvement of the contractual agreement between an auditor and a listed company "who is being authorised by existing shareholders" to perform the annual audit, for the benefit of shareholders in general. Those existing shareholders have the right to sell their economic ownership at any time and more specifically in this scenario after performing the audit and before discovering the default in it via a restatement in the exchange or a regulatory action etc. Accordingly, and based on this assumption, the contractual agreement between the company and the auditor shifts to prospective shareholders, who bought their shares during the identified period only. For this reason, the presence of a disclaimer "or even without it" would not suffice against them unless there were a prior agreement has been made between the company and the auditor at the Ordinary General Assembly. This basic understanding comes originally from the example of a contractual agreement between two companies or between one company and an individual to

[1720] *Ryan v. Kanne* 170 N.W.2d 395 (Iowa 1969). For more discussion about the case, see section 3.4.

buy a company with all of its liabilities and obligations, and to conclude the transaction differently, prior approvals must be made from both parties.

Biakanja v. Irving[1721] was the first case to break away from the *Ultramares* decision. *Biakanja* considerably expanded third-party liability in negligence actions. Although the *Biakanja* court held that a balancing test is required when deciding the existence of third-party liability, other authorities have classified this case as one applying the Restatement (Second) of Torts § 552.[1722] Although the case did not involve an action against an auditor or public accountant, the rule of law set forth was later applied in public accounting cases.

The *Biakanja* court held that when determining if a defendant will be held liable to a third party not in privity, a question of policy arises and involves a balancing of factors. The factors that the court considered were:

1. The extent to which the transaction was planned to affect the plaintiff;
2. The foreseeability of harm to him;
3. The degree of certainty that the plaintiff experienced injury;
4. The closeness of the connection between the defendant's conduct and the injury suffered;
5. The moral blame attached to the defendant's conduct;
6. And the policy of preventing future harm.[1723]

Applying this test to our analysis concerning damaged shareholders, the service provided by an auditor cannot be treated as a transaction that affected third party not in privity. To put more stress on this point, the shareholders from an Islamic perspective are not considered third parties, thus, they could not be deprived from their direct rights against an auditor. For instance, a commercial transaction could be simply defined as "An interaction between two or more parties in which goods, services or something of value is exchanged for some type of remuneration."[1724] Hence, it could be argued that the audit agreement "transaction" are made between the auditor and the listed company in general. Moreover, this argument may also be

[1721] *Biakanja v. Irving* 320 P.2d 16 (Cal. 1958). For more discussion about the case, see section 3.4.
[1722] Julie Faussie, 'Limiting liability in public accounting suits: a desperate appeal from a beleaguered profession' (1994) 28 (3) 'Valparaiso University Law Review' 1079.
[1723] Ibid 19.
[1724] Business Dictionary, http://www.businessdictionary.com/definition/commercial-transaction.html, accessed 20 August 2019.

expanded to say that the audit service made by the auditor is solely for the purpose of assisting the company to fulfil a regulatory requirement.

Those argument might be true in theory and practice to some extent due to the fact this analysis is incomplete in respect of how a financial damage to a company from a faulty annual financial statement could be measured from the one hand. From the other hand, it has been illustrated in Chapter Two and this chapter that the Shariah does not distinguish between contract law and tort law in connection with the damaged property,[1725] which is represented in this case by the acquired shares. Hence, shareholders could benefit from their position as economic owners of the company "through their acquired shares" immediately to be indemnified from the auditor "and others if involved", in the case of misstatement in the annual financial statement either via personal or company action in Saudi Arabia. In the same vein and presumption, if a potential shareholder has acquired an ownership in a listed company post the default in the financial statement, then he would be able to ask for damages from selling his shares before the correction in the financial statement made public after obtaining a full judgment for instance. To conclude, the idea of considering shareholders as third parties not in privity from a common law standpoint must be rejected. Although, the first factor, which has been considered by the court must be understood differently to build a convincing and plausible interpretation from an Islamic point of view.

The foreseeability of harm to shareholders is clear, when the share price falls. However, this is not the case with creditors until they get a final judgment or get their money in full or on pro-rata from a liquidator. By no means, the researcher intends to disqualify creditors from claiming the act of negligence from an auditor or the board of directors. Due to the limited scope of this thesis, and in brief to illustrate on this point, secured creditors get their money from securities they agreed upon to hold from the company and if additional guarantees should be made from the auditor or/and from a substantial shareholder who personally accept. While this is not the case with non-secured creditors such as trade creditors who supply goods and services on credit and other creditors. But, they must make their own due diligence beforehand that consider the auditing failure risk among other risks found in any commercial transaction besides accepting their positions in the priority ladder as is. Other available options to mitigate this risk might come from having a contractual agreement with the auditor, or through using conventional

[1725] See section 2.5-b for a comprehensive discussion.

credit default insurance “swaps” -or other Shariah compliant instruments-, or by purchasing insurance products that cover commercial risks.

It should be noted in general that auditor failure does not lead to the bankruptcy of the audited company in contrast to accounting fraud in some cases aim to cover the very weak financial position. Hence, other litigation routes in criminal cases are available to get their money from those who are involved in a fraud personally. To conclude, the foreseeability of a creditor harm is not directly related to audit failure, and therefore, he cannot be treated in an equal position of a shareholder. The main issue therefore comes from the common law understanding of whom should be considered as third parties in essence with incomplete analysis, especially auditor liability cases referred to this judgment and most of the examined cases in this thesis.

The third criteria in connection with the degree of certainty that the plaintiff suffered injury can be also apply to shareholders and could be easily identified. In addition, there is a close connection between the auditor’s conduct and the injury suffered to them as they assign him based on their economic ownership through their company on the general assembly meeting to do the auditing. One may argue that the closeness of the connection is only that companies law requires the company to make the certified financial statements available to the shareholders. This argument might look partly true because it is logical to say that if the company pays for a service, then why it is required by the law to be available for shareholders only and excluding others who may also benefit from such as creditors, financial analysts, credit rating agency etc.

A moral blame attached to the auditor’s conduct could also be established by not fulfilling the contractual relationship assigned to him to follow the accounting standards. However, the blame must come with subsequent events that lead to pecuniary indemnification to those who are directly impacted by, and shareholders can ultimately fall under this category.

Regarding the policy of preventing future harm as the last factor in the balance test, common law courts still struggle to find plausible answers that minimize auditor’s default towards third parties and this thesis intends to fill the gap. To justify, If the thesis presumed the validity of including the shareholders with creditors among many others to be called “third parties” and be able to hold an auditor liable to them, then this liability cannot prevent future harm due to the impossibility of knowing how future harm could be prevented in civil cases, unlike criminal cases if sufficient sanctions were imposed with compensation. That is why this thesis reject the

above assumption. Another consideration from the Shariah point of view should be stressed out again is that there is no difference between the law of tort and the law of contract in terms of harms suffered to shareholders by a faulty financial statement arose from negligence. The reason for stating that here is to say that future harm could be mitigated in other annual audits of the same company or to other listed companies. Thus, this factor is implausible from a technical view to be accepted. In contrast, it could be broadly understood and not literally that mitigation is close to prevention so that shareholders of a listed company might benefit from the due diligence made on previous audits conducted with the same auditor especially those who "or their firms" were civilly liable before. Then, the future harm that might be prevented is to be connected with the concerned audit in question.

According to Yang, the majority of states use the rule adopted by the Restatement (Second) of Torts for liability to third parties for professional malpractice when the work was intended to influence and supply the information.[1726] In 2012, the American Law Institute further published Tentative No.1 of Restatement (Third) of Torts: Liability for Economic Harm §§1-6., specifically addressing liability for economic harm. This demonstrates that the rules for pure economic loss are important enough to use written statutes or rules.[1727] At May 21, 2018 and in the 95th Annual Meeting, members of the American Law Institute voted to approve Tentative Draft No. 3 of Restatement of the Law Third, Torts: Liability for Economic Harm, which marks the completion of this project. Discussion in this thesis focus on the Tentative Draft No.1, as no literature or materials even in the ALI website could be obtained. Although the proposed Restatement has not taken effect, it probably provides instrumental rules and policy arguments for those interested in negligent economic harm.[1728]

For negligent infliction of economic harm, Section 1 to Section 6 are particularly instrumental in which the Restatement clearly imposes no duty in general to avoid economic harm;[1729] explains what pure economic loss is,[1730] and regulates liability in the performance or negotiation of a contract[1731] in negligent misrepresentation[1732] and in negligent performance of

[1726] Yang, Wen-Hsuan, "Reconstructing the Taiwanese Rule on Pure Economic Loss: Establishing a General Standard for Recovery for Pure Economic Loss in Unintentional Torts" (2014). Theses and Dissertations. Paper 9. 32. For example: *Nycal Corp. v. KPMG Peat Marwick LLP.*,668 N.E.2d 1368 (1998); *Bily v. Arthur Young & Co.*, 834 P.2d 745 (1992); and *First Nat. Bank of Bluefield v. Crawford* 386 S.E.2d 310 (1989).
[1727] Ibid 35.
[1728] Ibid 35.
[1729] Tentative No.1 of Restatement (Third) of Torts: Liability for Economic Harm at §1.
[1730] Ibid. at §2.
[1731] Ibid. at §§3 and 4.
[1732] Ibid. at §5.

service.[1733] Sections 4 and 6 of the Restatement, which follow, are particularly important to this thesis.

In the proposed Restatement Rules for Recovery for Pure Economic Loss in Unintentional Torts, §4 titled: Professional Negligence Resulting in Economic Loss states "A professional is subject to liability in tort for economic loss caused by the negligent performance of an undertaking to serve a client." §6 titled: Negligent Performance of Services mentioned the following "(1) One who, in the course of his business, profession, or employment, or in any other transaction in which he has a pecuniary interest, performs a service for the benefit of others, is subject to liability for pecuniary loss caused to them by their reliance upon the service, if he fails to exercise reasonable care in performing it. (2) The liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit the actor performs the service; and (b) through reliance upon it in a transaction that the actor intends to influence. (3) A plaintiff's recovery under this Section is subject to the same rules of comparative responsibility that apply to other claims of negligence."

Broadly, duties of care for pure economic loss are only acknowledged in particular circumstances. Furthermore, limiting tort liability is especially powerful when parties are in privity of contract.[1734] Thus, a defendant is not liable in negligence for the plaintiff's pure economic loss in either a public nuisance case or a product liability case. In contrary, where a plaintiff suffers economic loss because of professional malpractice, courts in the United States apply three different rules — the near-privity rule, foreseeability test, and the Restatement approach.[1735]

The proposed tentative draft of Restatement (Third) of Torts: Liability for Economic Harm also covers pure economic loss suffered through professional malpractice.[1736] Under this standard, a professional is liable for a plaintiff's pecuniary loss suffered through his negligent performance of an undertaking to serve a client even if privity in contract exists between parties.[1737] When the professional is not in privity of contract with the victim – and unlike the

[1733] Ibid. at §6.
[1734] Comment a. to Section 3 in Restatement of the Law Third Torts: Liability for Economic Harm (Tentative Draft No.1, 2012). See also Restatment of Torts: Product Liability § 21 (1998).
[1735] Yang (1726) 34.
[1736] Tentative No.1 of Restatement (Third) of Torts: Liability for Economic Harm §§3-6.
[1737] Ibid. §4. The policy concern is that a client may not understand the professional's methods sufficient to negotiate a contract and that the community expects due care of the practitioner separated from contractual duties. Comment b. to Section 4 of the

Restatement (Second) of Torts – the proposed draft of the Restatement (Third) of Torts holds professionals liable in tort both for negligent misrepresentation and negligent performance of service. Similar to the rule in Restatement (Second) of Torts, the proposed Restatement (Third) of Torts limits the defendant's liability to third parties to whom the defendant meant to supply information or provide service either for the plaintiff's benefits or with the intent to influence the plaintiff's action.[1738]

Sharsky thinks that the Restatement (Third) Torts: Liability for Economic Harm provides some welcome doctrinal clarity with respect to foregrounding the existence of a contractual privity economic loss rule. However, considering that the project based on dual underlying justifications of preventing unlimited tort liability and of deference to contract, which are to be applied on a sliding scale, it does not address the "paradigm confusion" he has identified. Therefore, it will fall short of reshaping the entire economic loss rule field.[1739] To explain, first, it is essential to distinguish what he termed the "stranger paradigm" from the "consensual paradigm." The specter of the economic loss rule is raised in different categories of cases: products liability, contracting party, third party, and stranger. It should not be surprising that the economic loss rule plays out differently and has various consequences across these categories. The stranger paradigm begins with the "no duty" default premised in essence on unlimited liability concerns; the identification of a "special relationship" between the parties will, however, lead to imposition of a duty of care. The consensual paradigm starts from a very different premise, namely that there is a duty owed by the contracting (or quasi- contracting) parties. However, the key question is whether, and the extent to which, there is a public-policy imposed tort duty above and beyond any contractual duties.[1740]

In his opinion, "Paradigm confusion" has led scholars and courts to import the unlimited liability rationale, developed to limit tort law duties owed to strangers, into the commercial torts' realm, failing to recognize that the central question in the contracting party case is distinct: namely, is the duty recognised owed to another enforceable in tort as well as contract? At least, courts should clearly distinguish between the stranger paradigm and the consensual

proposed new draft. See also Comment f. to Section 4 in Restatement of the Law Third Torts: Liability for Economics Harm (Tentative Draft No.1, 2012) in which it explains: "Section 4 is an exception to Section 3."

[1738] As Justice Cardozo mentioned in *Ultramares v. Touche*, if liability [for negligence] sustains, a thoughtless slip or blunder, or the failure to detect a theft or forgery beneath the cover of deceptive entries may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.

[1739] Catherine M Sharkey, 'In Search of the Cheapest Cost Avoider: Another View of the Economic Loss Rule' (2017) 85 U Cin L Rev 1017, 153.

[1740] Ibid. 113.

paradigm, which, in turn should be understood to include products and contracting party cases. In each of these realms, the economic loss rule enforces a boundary between torts and contracts. However, an optimal approach goes beyond this determination of the applicable paradigm, and the associated hypothetical applicability or inapplicability of the economic loss rule. The cheapest cost avoider analysis offered in his article promises a more coherent and predictable economic loss rule doctrine and, in turn, a greater understanding of where the boundary between tort and contract is properly drawn.[1741]

After presenting relevant arguments in connection to the proposed Restatement (Third) of Torts, brief discussion is needed. First, even if the proposed draft of the Restatement (Third) of Torts holds professionals liable in tort both for negligent misrepresentation and negligent performance of service, the proposed Restatement limits the defendant's liability to third parties to whom the defendant meant to supply information or provide service either for the plaintiff's benefits or with the intent to influence the plaintiff's action. This is really crucial from the shareholders' position in common law countries as they are considered as third parties. Previous discussion of common law precedents showed the failure of identifying them as owners of such a company. Hence, the proposed Restatement is more likely will not change the common-law courts' previous position of auditor liability cases of a listed company in the U.S. Secondly, the stranger paradigm needs a "special relationship", which has to be connected to all ordinary shareholders of a company from the Shariah perspective broadly. In addition, special relationship with other third parties excluding ordinary shareholders must be established via contractual agreement between an auditor and specific third parties. This would lead to the discussion of the consensual paradigm that is established among contractual parties. To illustrate, it has been argued earlier that the contractual agreement between an auditor and a corporation is mainly done to benefit the shareholders as owners of the said company. Therefore, there is no specific public-policy that impose tort duty above and beyond any contractual duties. It has been explained that an auditor can not escape liability either in contract or tort law from Shariah perspective. Therefore, paradigm confusion will continue in common-law countries as existing boundaries between tort and contract are in place, while in Shariah there is no major difference to whom an auditor could be liable.

[1741] Ibid. 134.

In *Rosenblum Inc. vs. Adler*,[1742] the court expanded the understanding of the foreseeability concept. According to this concept, the auditor is responsible for normal professional negligence towards all persons the auditor predicts, to a reasonable degree, will use and depend on financial statements.

Rosenblum sold its project to the Giant Company in exchange for obtaining a share of its stocks relying on an unqualified auditors' report on the financial statements. After a short time, the Giant Company declared its bankruptcy, at which point the stocks became valueless. Rosenblum sued the auditor, claiming negligence, whereupon it was demonstrated that the client's management had manipulated the records to reveal assets that were not possessed by it or otherwise omitted the creditor's accounts from these records. The plaintiffs in *Rosenblum* claimed that Touche Ross had negligently audited Giant's fiscal years 1971 and 1972 financial statements.[1743]

To comment on the *Rosenblum* case, first, there is a need to say that there was a criminal act from the management of Giant Company in manipulating its records.[1744] This major point should have had led the discussion to examine if the management and the board of directors of Giant company are liable to third parties. Then, the interaction between the companies' management fraud and auditor negligence should have been assessed to determine what is the substantial action that affected on the financial statement. The discussion should also have been extended to seek answers to whom "the auditor or the management or both" they are liable and lastly how the damages should be calculated.

Second, the court did not identify whether there was an error from the auditor by not following the accounting standards. This move by the court could simply show that the auditor is not civilly liable if he has not discovered the fraud. In contrast, and in the assumption that the auditor discovered a fraud, then he would be criminally liable with the management if not being reported to the shareholders. Third, Rosenblum became a shareholder in Giant Company so that it could have sued the company's board of directors and officers who were responsible for the fraud in addition to the auditor who then is able to prove his innocence. Therefore, a

[1742] *Rosenblum v. Adler* 461 A.2d 138 (N.J. 1983). For more discussion about the case, see section 3.5.
[1743] Pacini & Sinason (n237) 15–66.
[1744] The Supreme Court judgment has stated that Giant had manipulated its books by falsely recording assets that it did not own and omitting substantial amounts of accounts payable so that the financial information that Touche had certified in the 1971 and 1972 statements was incorrect. The fraud was uncovered in the early months of 1973. The trial court denied defendants' motion to dismiss the plaintiffs' claims of fraud and negligence ascribable to the 1972 audit.

shareholder position based on his ownership should allow him personally or through his company to seek for compensation after determining the type of the case.

Fourth, the court has limited the users of the financial statements who have received such statements from the auditing firm directly to achieve a specific goal related with its works. There is no duty on an auditor by law to distribute a financial statement of a client or on behalf of him unless the auditor obliges himself by contract to make himself liable only for following the accounting standards with no responsibility about any fraud that comes from the management. Of course, an auditor must make certain tests to check about fraudulent transactions. Fifth, the court erred in not including stockholders who purchased stocks after the audit's preparation, or institutional investors or portfolio managers who did not obtain the financial statements from the client due to the fact the financial statements are made to them by law. In addition, once those investors or portfolio managers on behalf of their clients acquire a portion of shares in the company relying on these financial statements then they would be able to sue the company's board of directors and officers.

Sixth, the court has stated that an auditor would be able to obtain professional liability insurance. To answer this argument, the auditor liability insurance does not cover criminal acts and it is similar to D&Os insurance. Hence, the insurer would be then able to return to the insured for the paid defence cost by filing a lawsuit stating his unknowing of the criminal act connected with the case. Further, the court reasoned that because it did not have a well understanding of the relationship between shareholders and auditor so that the only way to cover the auditor is through limiting the users of the financial statement. This would be acceptable if the users are not shareholders or potential shareholders. As argued, it could be covered by auditor liability insurance if there is a clause in the insurance contract stating the right of an auditor to make such an agreement on a limited basis or to pay additional premium for certain number of financial statement users.

To conclude, the court judgment is not practical without considering the shareholders position as economic owners in detail so that the foreseeable users of audited financial statements, which are received, from a company pursuant to a proper business purpose must be rejected in contrary to other third parties including creditors who should prove their proper business purposes, and the latter case could be proved by a contractual agreement. In addition, a closer look to the creditors' position may give them the right to get compensated from the

management personally due to the management fraud and not from the auditor as he did not participate in it. Therefore, the court did not succeed to provide a solid and plausible answer to be relied on in other later cases.

Overall, American courts' different positions in relation to auditor liability cases towards third parties or even cases referred to them have led the major role on the development of case law. However, they did not reach comprehensive and acceptable levels of certainty. It could be also argued in general that these judgments were wrongly decided from Shariah perspective. Moreover, the U.S precedents' influence were extended to other examined jurisdictions' judgments to reach similar conclusion that in favour of auditors or by putting unacceptable criteria that may never be satisfied. Next, the law of England and major precedents in England jurisdiction will be critically examined.

7.3.2 The English Cases and the Suitability of its Principles in the Saudi Jurisdiction

In *Hedley Byrne & Co v Heller & Partners*,[1745] the House of Lords held that all persons who provide a statement owe a duty to any third person with whom a special relationship existed. Although the phrase "special relationship" had not been defined, the House of Lords held that special relationship existed because the defendant voluntarily assumed the responsibility of making accurate disclosures to the public.[1746]

The House of Lords ratified a legal principle stating that a person who has special skills, gives advice and information and knows that the information will be depended on must exercise due diligence towards the person who will depend on such, and so he would be responsible for any negligence or breach for this task but would be responsible for compensating the damage incurred by this person due to his negligence.

To comment on this case, it must be noted that it is not related to an auditor's negligence towards his client or third parties involved but it is related to two banks and one of them

[1745] *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* (1964) A.C. 465 (H.L.). For more discussion about the case, see section 4.2.
[1746] G Morris, 'The Liability of Professional Advisers: Caparo and After' (1991) Journal of Business Law 36 at 40.

provides a letter contain financial data concerned with the credit ability of its client. The principles established are vital to address.

In the context of this thesis, first, the special relation could be established between an auditor and his client and its shareholders as they are the real assignees of the auditing task to the auditor. The special relation of shareholders would be understood from the economic ownership position that solely allow them collectively to assign the auditor at the Ordinary General Meeting to audit their company. Without their authority, their company would not be able to be involved in this contractual agreement. Moreover, the auditing contract may expand to review the quarterly or biannual financial statements in addition to give an opinion on the annual one. However, the auditor liability would be mainly on the annual financial statement. This basic elucidation also brings to the attention the prospective shareholders' position, whom they have acquired their shares after the assigning of the auditing contract and before the release of the annual audit, or after the release of the annual audit and before the restatement of it, that allow them to be economically indemnified from those who are responsible about their wrongdoings. Therefore, the special relation between the company alone with the auditor is not practically acceptable in liability cases due to the impossibility of calculating damages, while this is not the case with shareholders. As argued earlier, existing and prospective shareholders buy and sell their shares with all their liabilities and obligations with all involved risks belong to their listed company.

Second, it is not acceptable to agree as the House of Lords held that special relationship existed because the defendant voluntarily assumed the responsibility of making accurate disclosures to the public.[1747] The meaning of public should be given a limited or guarded interpretation, whereby for example, an auditor in Saudi cannot be held liable to the public at large as he has a contractual relation with a specific entity so that what would be voluntary prior to contract will then be compulsory after the signing of it. Hence, the assumption of compulsory responsibility would be extended to a limited class within the company. Moreover, the meaning of voluntary responsibility of making accurate disclosures to the public is basically moral unless required by law such as regulatory organisations whom they have the authority to impose administrative sanctions or refer violations to the public prosecutor for criminal misconducts.

[1747] G Morris, 'The Liability of Professional Advisers: Caparo and After' (1991) Journal of Business Law 36 at 40.

Third, in Shariah, it has been seen that in some instances there is no difference between the tort and contract laws in terms of compensating the damaged party. In addition, it is accepted to say that a duty of care may arise from words as well as deeds; however, there is a duty of care for an auditor based on a contractual agreement. It must be noted that contractual agreements are enforceable in Shariah between parties except if prohibitions included. However, the researcher put more emphasis on discussing the Islamic law of tort to cover the subject to show that both laws could lead to the liability of auditors towards shareholders. Shareholders could choose which way is much more suitable to dispute or they can take an action based on both.[1748]

The case of *JEB Fasteners Ltd. vs. Marks, Bloom & Co.*[1749] is relevant to the thesis. In this case, the concept of the foreseeability was applied. The plaintiff (buyer) bought all stocks of a company relying on the auditor's report. Subsequently, it was demonstrated that the financial statements contained a huge amount of errors and the stocks possessed by the plaintiff were evaluated as being worth more than their real value. The auditor did not know when contracting with the client about auditing that there was a third party who wanted to possess stocks of the company. He later became aware of this particular third party and communications were made between the buyer and the auditor throughout the purchasing process.

The court held that "the accountants owed a duty of care to the plaintiffs. They knew that they would rely upon the accounts. However, in this case, the plaintiffs would have proceeded in any event, and so the negligence did not cause any of the damage suffered as long as the misrepresentation plays a real and substantial part, though not by itself as decisive part, in inducing the plaintiff to act, it is a cause of his loss and he relies on it, no matter how strong or how many are the other matters which play their part in inducing him to act ..."

This case represents one of the typical cases that the thesis seeks to address. First, this case indicates a special relation between a specific shareholder and an auditor. From the researcher's personal point of view, this transaction was made after the financial statement's release so that a duty of care was already established. Hence, no need for a shareholder to confirm the accurateness of the financial statement as other third parties should do. This point needs an additional clarification. The plaintiffs did not know before proceeding with the acquisition of

[1748] For example, the primary sources discussed at subsection 2.2.2 provide general rules that apply in the law of tort and the law of contract. See also section 2.7 for discussion on the liability of employer (principal) for the act of his employee (ajir).
[1749] *JEB Fasteners Ltd v. Marks Bloom &Co.* (1981) 3 All E.R. 289, aff'd, (1983) 1 All E.R. 583 (C.A.).

the company about the mistakes found in the financial statements[1750] even if they have had observations on it. Moreover, the acquisition of shares with their economic ownership would entitle the shareholder to transfer all obligations and liabilities of the acquired company to them. The financial statements have been issued during the negotiation period and were not restated before concluding the transaction so their influence would be obvious even if there are other criteria that assisted in taking the acquisition decision. Put it differently in today's business world, where a merger or an acquisition is planned to be proceeded with a listed company. Professional due diligence must be then made to be included depending on the particular case either in a shareholders' circular or prospectus "to increase the capital etc. and other than delisting from the exchange" as required by law to be approved by competent authorities first. Then the transaction would be completed after getting the shareholders' approval at the general assembly. In this case, those who became shareholders and relied on available documents provided earlier would be entitled to sue the auditor conditioning they have had encountered loss of value in their shares based on their existing ownerships. Even if they have sold some or all of their shares to other shareholders before the restatement, then, prospective shareholders are entitled too to be indemnified.

Second, shareholders even if they sue individually, the right of compensation could be established to all ordinary shareholders, depending on their variable losses i.e. the loss encountered to every shareholder based on his specific time of purchase and the restatement of the financial statement would give the court the ability to apply the same principle to other/prospective shareholders who also have the same right to get compensated. Third, what the court has stated regarding other factors that a shareholder relies on to take a position post the release of the financial statement and before knowing about the default has no merit because there is no way to justify someone's else negligence to excuse his liability.

[1750] *Stephenson LJ* at 589 [1983] 1 All ER 583 at (C.A.) has stated the following "To say, as the judge did (see [1981] 3 All ER 289 at 301), that the false picture represented by the defendants' accounts 'would certainly encourage him [the plaintiffs' director, Mr Bufton] to take over the company, and in that sense I think the plaintiffs relied on the accounts', with a reference to Mr Bufton's reservations about their accuracy and 'their limited influence' is not to deny them any influence, but only to accord them less influence than the high regard for Mr Godridge and Mr Wigg which the judge said 'influenced' Mr Bufton and his brother to take over the company (at 299). This is, to my mind, confirmed by the judge's attempted reconciliation (at 305) of his apparently inconsistent findings on the reliance and causation issues, 'that you can be influenced by something even though if you had not been influenced you would have acted in the same way'. I appreciate and accept the judge's finding that Mr Bufton was wrong in saying that he would not have purchased the company if the accounts had shown its true financial position and that in fact the plaintiffs would still have acted in exactly the same way and taken over the company. But that was because Mr Bufton and his brother were motivated by 'the two men, Mr Godridge and Mr Wigg' (at 305), not by the accounts to any substantial extent."

Caparo Industries Plc. v Dickman[1751] is one of the most famous verdicts in the history of auditor liability towards third parties. Hence, several cases referred to it as a landmark case to whether apply or to distinguish from. In this chapter, we will only provide critical analysis to this case as already been discussed extensively in Chapter Four.

In *Caparo,* the Court examined the statutory framework for accounts and audit under the 1985 Companies Act, and it decided that the purpose of statutory accounts is not to inform shareholders' investment decisions, and nor is it to inform the investment decisions of the wider public. The House of Lords acknowledged the absence of identified conditions, stating that the auditors in public shareholding companies were not responsible for negligence towards foreseen investors or current investors buying new stocks of the company depending on the obligatory auditing process.[1752] The general rule is that auditors owe their duties to the corporate body.

The court identified conditions that must be proven to apply. The claim in *Caparo* Industries failed because the third party, who relied on the accounts and suffered losses, did not prove the test of assumption of responsibility and consequent proximity, resulting in the auditors escaping liability.[1753]

To deliver a list of observations on this case, there is a need to say at the beginning that the case should have had more emphasis from a criminal perspective. Hence, the plaintiffs would have succeeded if the case were against the company's board of director and auditor to assess if an auditor had engaged in the fraud or not. To justify, the plaintiffs brought an action against the company's directors alleging fraud and against its auditors claiming that they were negligent in conducting the audit and making their report, which they were required to do within the terms of Sections 236 and 237 of the Companies Act 1985. Unfortunately, this case and other similar cases do not involve criminal prosecutions, hence, courts decide to ignore involving in lengthy discussion about the fraud and if specific legal rules in the criminal act cover this area. If this would not be the case, then the plaintiffs would have had relied on the outcomes of the criminal judgment to proceed with their civil cases.

[1751] *Caparo Industries plc v. Dickman* (1990) 1 All E.R. 568 (H.L.). For more discussion about the case, see section 4.3.
[1752] Pacini, Mary Martin & 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) 37 American Business Law Journal 171-236.
[1753] Matar (n220).

Second, the plaintiffs in *Caparo*'s case were the existing and potential shareholders so that they knew about the fraud after the discovery, thus, they already have acquired a stake of ownership in the company. Third, the auditor would have been accused for failing to take care if he did not apply the prevailing accounting standards despite the fact that he had discovered the fraud or not. Fourth, the court held that an auditor owed a duty of care to a company not to foreseen investors or current investors buying new stocks of the company depending on the obligatory auditing process. This analysis is incomplete, as the court did not extend the discussion to what extent an auditor owes a duty to the corporate body and how damage would be calculated. Thus, it cannot be assessed sufficiently unless the analysis connects with the shareholder ownership as argued by the researcher.

Fifth, I agree with Abugu's analysis on the *Caparo*'s case about disincentives the investing public face in relying on financial statements and auditing reports[1754] and with *Caparo*'s representative position.[1755] However, they did not extend the discussion to solve the issue from

[1754] Abugu (n405) 253-254, stated in his article the following:
"The decision in Caparo is a great disincentive to the investing public in relying on financial statements and auditing reports. In a typical situation where auditors have performed a lax audit, the accounts would not in fact give a true and fair view of the company's affairs when laid before the members with an unqualified report from the auditors. In such a situation, the company may, in certain circumstances, suffer loss as a consequence of such want of care. However, in most instances, the accounts will simply be incorrect by either overstating or understating the company's true results and value and the company itself will suffer no loss or damage. Loss will, however, be suffered by others, for example, by shareholders who sell shares at an undervalue or buy them at an overvalue. If the judgement is correct, an auditor is under no liability in respect of a careless audit unless it so happens that the company itself suffers loss. Such a situation is absurd. The decision is hypocritical and unrealistic. In reality, the annual report containing the financial statements of a company's performance as audited forms the bedrock of informed investment decisions by existing shareholders and prospective investors. For existing shareholders, it provides an analytical basis for the evaluation of the company and thereby influences the decision to sell or hold or even to make further purchases of the company's stock. For investment analysts, advisers and investors, it incorporates the most readily obtainable certified performance record of the company. Hence, it is only reasonable that it will be relied upon by professional advisers and ultimately in investment decisions. To limit the relevance of financial statements to its 'accountability role' for existing shareholders, as in Caparo, is a narrow conception of the effect of audited financial statement. Furthermore, it should be clear that auditors owe shareholders a duty of care in respect of the work of their audit and the opinions expressed in their report. This duty is inherent in the statutory duty to report to shareholders, which would otherwise be valueless and indeed deceptive. The decision appears to deny this duty of care where existing shareholders rely on the audited reports in making subsequent critical investment decisions of buying or selling the company's shares… It is further submitted that recognition of a duty owed to shareholders does not involve allowing shareholders to enforce the company's cause of action and does not constitute an exception to the rule that, in general, in an action to remedy a wrong done to a company, the only acceptable plaintiff is the company. The duty owed to shareholders is an independent and direct duty. And so should not be denied on this ground. If the need is to protect auditors, this can be better served by insurance indemnities or similar devices available for mitigating potential liabilities."

[1755] Leek argued "If the other requirements of a duty exist, public policy should only defeat that duty in rare cases where cogent reasons are plainly established. The ill consequences for which the auditors contend are not the consequences of a duty to a bidder, but of unlimited liability, which can only be remedied by legislation. If a duty is recognised, then in respect of any set of accounts the number of plaintiffs in a potential claim will be very limited. The amount of the claim will be the amount by which the shares drop in value when the true position is revealed. Liability cannot extend beyond the 'currency' of those accounts. There are cogent policy reasons in favour of a duty. It is in the interests both of the company and others that audited accounts should be and should be seen to be reliable. Without a duty such as that for which we contend over-optimistic accounts will normally not give rise to any liability. Further, it is in the interests of shareholders that bids should be made; and thus that a bidder has accounts on which he can rely and for which he has a remedy."; see also, James Leek, 'Liability of Auditors After Caparo Decision' (Presentation by the Chief Executive of Caparo Grow Ltd to the London Practioner Board, 17th April 1991) available at: http://cadbury.cjbs.archios.info/_media/files/CAD-03110.pdf, last visit August 1, 2019.

a different dimension, and here, the researcher provides further solutions. Sixth, it is not convincing to have different positions for shareholders, giving them some rights to sue an auditor in other type of claims like in a defective prospectus while no legal right to sue in the secondary market. I agree with the fact that an auditor has a duty towards an ordinary shareholder and this is in its essence a legislative issue and must be stated in the Company law and not to be left to the court to decide. Courts have failed to give convincing arguments on how an auditor is liable to the company itself and to what extent. Seventh, in Saudi Arabia, the law has stated clearly that shareholders among others are able to get indemnified as indicated in Chapter Two. Hence, this case does not represent a solid ground to be accepted in other jurisdictions.[1756]

The parties' relative exposure to risk may also help to explain the decision of the Supreme Court in *Steel v. NRAM Ltd*.[1757] In this case, the defendant solicitor gave misleading information to the claimant bank while acting for a third party, a client of hers, in relation to a proposed transaction with the bank. The bank relied on the incorrect information and subsequently suffered financial loss, in the form of a loss of security protecting its loan, which it tried to recoup from the defendant. The bank's claim failed. The point about this case is that the bank's reliance on the defendant's misstatement was not reasonable: it had the means and resources to have identified the error itself. Nor was there any assumption of responsibility on the part of the defendant. As a result, the risk of the transaction going wrong lay with the bank.[1758] As Lord Wilson put it: "a commercial lender about to implement an agreement with its borrower referable to its security does not act reasonably if it proceeds upon no more than a description of its terms put forward by or on behalf of the borrower".[1759]

In this recent Scottish verdict, another debate about the *Caparo* case was addressed to show how common law courts deal with the principle of duty of care in general. In *Steel and another v NRAM Limited*,[1760] the Supreme Court overruled the Inner House and first *confirmed Caparo*

[1756] For example, see the outcomes of hypothetical applications of Caparo in different jurisdictions. Ewoud Hondius, Professional Liability, pp.226-249, p.240 in M Bussani, and A Sebok. (Eds.). (*Comparative Tort Law*. (Cheltenham, UK: Edward Elgar Publishing 2015). doi: https://doi.org/10.4337/9781784718138.
[1757] [2018] UKSC 13.
[1758] Deakin, Simon. and Adams, Zoe. 'Establishing Liability in Principle: Duty of Care: Markesinis & Deakin's Tort Law (8th edn, 2019) Oxford University Press, 85.
[1759] [2018] UKSC 13 [38]. See also *Playboy Club London Ltd v. Banca Nazionale del Lavoro Spa* [2016] EWCA Civ. 457: there can be no assumption of responsibility if the defendant was totally unaware of the other party's existence, or of the purpose for which the statement was relied upon.
[1760] *Steel and another (Appellants) v NRAM Limited (formerly NRAM Plc) (Respondent)* [2018] UKSC 13.

Industries Plc. v Dickman had been incorrectly construed for many years. It was thought that case had endorsed a threefold test for establishing assumption of responsibility.

The Supreme Court in *NRAM* observed that in *Caparo* it was in fact the reasonableness of a representee's reliance that was crucial to the assumption of responsibility. The Court went on to reformulate the test by saying that, for the doctrine of assumption of responsibility to take place, the representee must establish in addition to the foreseeability leg of the test that:

(i) It was reasonable for him to have relied on the representation; and
(ii) the representor should reasonably have foreseen that he would do so.

The court observed "these ingredients of reasonable reliance and foreseeability are particularly relevant to a claim against a solicitor by an opposing party, because it is presumed to be inappropriate for a solicitor to assume such a responsibility towards the other side."[1761]

The court also acknowledged that, while this concept of assumption of responsibility was the basis of liability for careless misrepresentation, the concept might necessitate cautious incremental development in order to fit cases to which it does not readily apply. Therefore, this judgment endorses that the representor does not automatically presume responsibility for the accuracy of its statements in those conditions and that reasonableness will be a significant factor. The factual and commercial framework will be important when considering whether, in the full circumstances, it was reasonable for the third party to rely on the representation and whether it was reasonably foreseeable to the representor that the third party would do so.[1762]

Calvert et al. believe that the Supreme Court's observations on the *Caparo* decision have a potentially substantial influence on challenging cases where the limits of duties are being pushed.[1763] It will also have a substantial outcome on how claims for breach of duty under delict or tort are pled though it is dubious to drastically change the number of circumstances, which satisfy the test.

Purshouse believes that *Steel* is a landmark case on the law of pure economic loss and in its reaffirmation that the assumption of responsibility principle derived from *Hedley Byrne* is the benchmark of liability in negligent pure economic loss cases. In this respect, the case is

[1761] Ibid at paragraph 32.
[1762] Colette Finnieston, 'Supreme Court Decision: Assumption Of Responsibility' *Mondaq Business Briefing* (9 March 2018) Newspaper Article.
[1763] Alan Calvert, Alisdair Matheson and Cheryl Laird, '*NRAM v Steel*: the Death of Caparo?' (2018) Brodies LLP, 13 nhttps://brodies.com/binformed/legal-updates/nram-v-steel-the-death-of-caparo.

consistent with recent Supreme Court decisions such as *Robinson v Chief Constable of West Yorkshire Police* [2018] 2 WLR 595, that have critcise the use of a threefold Caparo test and the role of policy for determining the duty of care.[1764] In *Steel*, Lord Wilson emphasised that the "[m]ore important' aspect of *Caparo Industries plc v Dickman* [1990] 2 AC 605 for present purposes was its reassertion of "the need for a representee to establish that it was reasonable for him to have relied on the representation and that the representor should reasonably have foreseen that he would do so."[1765] Accordingly, the case is important in holding that reasonable reliance was "central to the concept of an assumption of responsibility."[1766] The wider question Purshouse has attempted to answer is: Could the issue in this case be reframed as one of causation?[1767] Lord Wilson thought so, stating that "the issue in the case might well have been cast in terms of whether [the defendants] were the cause of Northern Rock's loss rather than whether they owed a duty of care to it."[1768]

This case represents that *Caparo* does not succeed in its essence to be a solid base for future cases with respect to the duty of care in regard to an auditor. While this recent case is related to a solicitor's misrepresentation towards third party, it could be argued that it has a different analysis to establish the duty of care of a solicitor. In addition, further criteria that stated in this precedent should be seen from another dimension to state that shareholders already have achieved all criteria even the new ones stated in this judgment so that the indeterminate class issue could be diminished. In the researcher's opinion, the English courts would struggle to have a better understanding based on fair and just principles if it does not change its attitude towards shareholders and discuss their positions differently from other third parties. Hence, Saudi judges should be careful to read common law precedents and assess how principles are held. For instance, the auditor duty of care differs from the solicitor or doctor duties of care. In addition, to whom the duty of care is owed differs and depends on the type of third parties such as creditors and shareholders, a client of a solicitor, a client of a physician or a client of a bank etc. or a client like a company itself in addition to whom is connected with the client. Then, a new understanding would emerge and in contrast to existing confusing views held by courts,

[1764] Purshouse, C. (2019-09-01). *Steel v NRAM Ltd* [2018] 1 WLR 1190. In Essential Cases: Tort Law. Oxford: Oxford University Press. 3.
[1765] *Robinson v Chief Constable of West Yorkshire Police* [2018] 2 WLR 595 at [23].
[1766] Ibid at [35]). Some previous authorities had been less stringent and had interpreted this element of the *Hedley Byrne* principle in a way that is hard to justify (see e.g. *Smith v Eric S Bush* [1990] 1 AC 831).
[1767] Purshouse (n1765) 34.
[1768] *Robinson v Chief Constable of West Yorkshire Police* [2018] 2 WLR 595 at [17].

which may influence the wider legal community and then other countries would apply these principles as they are.

Robinson v Chief Constable of West Yorkshire Police,[1769] is another recent landmark case in the tort of negligence. According to Tofaris, it is unlike many of its predecessors because its status is not based on breaking new ground, but on charting the existing one with sufficient clarity. Moreover, Robinson does not bring about a significant change in the law, however, it supplies an authoritative guide to when does a duty of care arise?[1770]

Lord Reed set out six questions to be addressed,[1771] four of which were dependent on the answers to the first two, so there were two principal issues before the Supreme Court. First, whether the existence of a duty of care always depends on the application of the "*Caparo* test". Second, whether there is a general rule that the police are not under any duty of care when discharging their function of investigating and preventing crime.[1772]

Lord Reed commenced his judgment by disposing of the view that *Caparo* established a tripartite test.[1773] In so doing he reiterated a point made earlier by Lord Toulson in *Michael v Chief Constable of South Wales*.[1774] Lord Reed stated:

"that understanding of the case mistakes the whole point of *Caparo*, which was to repudiate the idea that there is a single test which can be applied in all cases in order to determine whether a duty exists, and instead to adopt an approach based, in the manner characteristic of the common law, on precedent, and on the development of the law incrementally and by analogy with existing authorities."[1775]

[1769] *Robinson v Chief Constable of West Yorkshire Police* [1] [2018] UKSC 4, [2018] 2 W.L.R. 595. Although the Supreme Court's decision was unanimous, the judges' reasoning was not. The majority approach is found in Lord Reed's judgment, with which Lady Hale and Lord Hodge agreed.

[1770] Tofaris, S. 2018, "Duty of Care in Negligence: A Return to Orthodoxy?", The Cambridge Law Journal, vol. 77, no. 3, pp. 454-457.

[1771] The Supreme Court was asked to consider six questions: (1) Does the existence of a duty of care always depend on the application of "the Caparo test" to the facts of the particular case? (2) Is there a general rule that the police are not under any duty of care when discharging their function of investigating and preventing crime? Or are the police generally under a duty of care to avoid causing reasonably foreseeable personal injuries, when such a duty would arise in accordance with ordinary principles of the law of negligence? If the latter is the position, does the law distinguish between acts and omissions: in particular, between causing injury, and protecting individuals from injury caused by the conduct of others? (3) If the latter is the position, is this an omissions case, or a case of a positive act? (4) Did the police officers owe a duty of care to Mrs Robinson? (5) If so, was the Court of Appeal entitled to overturn the Recorder's finding that the officers failed in that duty? (6) If there was a breach of a duty of care owed to Mrs Robinson, were her injuries caused by that breach? See PILA BULLETIN, UK Supreme Court clarifies the scope of the duty of care owed by police officers to members of the public, 14 February 2018, Available at: https://www.pila.ie/resources/bulletin/.

[1772] Cameron, Gordon. 2019, "Negligence and the duty of care; the demise of the *Caparo* test; and police immunity revisited: *Robinson v Chief Constable of West Yorkshire*", Edinburgh Law Review, 23(1), 82-88.

[1773] *Robinson v Chief Constable of West Yorkshire Police* [2018] UKSC 4, [2018] 2 W.L.R. 595 at para 21.

[1774] *Michael v Chief Constable of South Wales [2015] UKSC 2* para 106, after Robinson was heard in the Court of Appeal.

[1775] *Robinson v Chief Constable of West Yorkshire Police [2018] UKSC 4, [2018] 2 W.L.R. 595* at para 21.

Lord Reed then continued to place Lord Bridge's speech in *Caparo* in the context of the "retreat from *Anns*"[1776] and what has become known as the "incremental approach" concluding: "[i]t was that approach, and not a supposed tripartite test, which Lord Bridge then proceeded to apply to the facts before him."[1777]

If the "*Caparo* test" is not a test then it follows that the answer to the question, whether the existence of a duty of care always depends on the "*Caparo* test", must either be "no" or perhaps, "you are asking the wrong question". With the test gone the question becomes redirected towards the role of policy in determining duties. Lord Reed explained the recourse taken by the courts to policy as a consequence of the two-stage test in *Anns*, policy being the only available means of controlling the expansion of liability where foreseeability of harm and proximity gave rise to a prima facie case.[1778] He noted: "The need to have recourse to public policy for that purpose has been superseded by the return to orthodoxy in *Gorringe*."[1779]

Lord Reed continued:

"Where the existence or non-existence of a duty of care has been established, a consideration of justice and reasonableness forms part of the basis on which the law has arrived at the relevant principles. It is therefore unnecessary and inappropriate to reconsider whether the existence of a duty is fair, just and reasonable… Nor, a fortiori, can justice and reasonableness constitute a basis for discarding established principles and deciding each case according to what the court might regard as its broader merits. Such an approach would be a recipe for inconsistency and uncertainty…. It is normally only in a novel type of case, where established principles do not provide an answer, that the courts need to go beyond those principles in order to decide whether a duty of care should be recognised."[1780]

Thus, policy is most appropriately invoked as a consideration in novel circumstances, that is circumstances for which there is no precedent.[1781] Equally, policy may be invoked in inviting the Supreme Court to depart from a previous decision.[1782] The other ingredients of "the test", foreseeability of harm and proximity, remain arguable in every case as the circumstances permit since these are the established principles inherent in the question of duty.[1783] Tofaris

[1776] *Anns v Merton LBC [1978] AC 728.*
[1777] *Robinson v Chief Constable of West Yorkshire Police [2018] UKSC 4, [2018] 2 W.L.R. 595* at para 25.
[1778] Ibid at para 40.
[1779] Ibid, *Gorringe v Calderdale MBC* [2004] UKHL 15.
[1780] Ibid para 26. The words in parenthesis that have been omitted refer to the possibility of invoking policy in the Supreme Court as a ground for departing from an earlier decision. The final point is reiterated at para 42: "[W]here established principles do not provide a clear answer to the question whether a duty of care should be recognised in a novel situation, the court will have to consider whether its recognition would be just and reasonable." See also Lord Hughes, ibid para 100.
[1781] Cameron (n1773).
[1782] Ibid.
[1783] Ibid.

thinks that Lord Reed's analysis was not original, nor was it meant to be. Yet the fact that it proved necessary to undertake shows the level of confusion which persisted after *Caparo* and the importance of removing it.[1784] It is nonetheless still not entirely clear when a type of case is novel, as illustrated by the disagreement between Lord Reed, at [28], and Lord Mance, at [86]– [87], over whether or why *Smith v Ministry of Defence* [2013] UKSC 41, [2014] A.C. 52, was such a case.[1785] *Robinson* suggests that a novel situation is one which falls outside an established category of liability, or which cannot be decided by reference to established principles in the existing case law.[1786] In this respect, Lord Reed treated physical loss resulting foreseeably from positive conduct as constituting axiomatically an established category, irrespective of the precise factual circumstances.[1787]

Both *Robinson* and *Steel*[1788] were determined by employing principles resulting from established categories to the facts of the case. It was consequently pointless for the Court in either case to deal with the appropriate approach in novel cases where existing principles do not readily apply.[1789] Notwithstanding this, in both cases, both Lord Reed and Lord Wilson went on to consider the proper approach in such cases.[1790] Many courts and practitioners have regarded the decision of the House of Lords in *Caparo* as endorsing the three-stage test in novel cases.[1791] Both Lord Reed in *Robinson* and Lord Wilson in *Steel* pointed out that the House of Lords had done no such thing.[1792] Although their Lordships in *Caparo* had referred to the three-stage test in their speeches, they had also variously noted the restricted usefulness in practice of the three stage test and defined the search for a single formula as akin to pursuit of a will-o'-the-wisp.[1793]

Further, both Lord Reed and Lord Wilson observed that the House of Lords did not decide *Caparo* by applying the three-stage test.[1794] Rather, their Lordships in *Caparo* had applied an incremental approach, which highlighted the necessity for the law to develop novel categories of negligence incrementally and by analogy with established categories.[1795] Both Lord Reed in *Robinson* and Lord Wilson in *Steel* endorsed this incremental approach.[1796] Lord Reed in *Robinson* explained this approach in the following terms:

[1784] Tofaris (n1771) 454-457.
[1785] Ibid.
[1786] Ibid.
[1787] Ibid.
[1788] *Steel and another (Appellants) v NRAM Limited (formerly NRAM Plc) (Respondent)* [2018] UKSC 13.
[1789] Kevin Kee, 'Caparo is Dead, Long Live Caparo! English Supreme Court Decides Foundational Principles Regarding Duty of Care' (2018) available at: https://www.lipmankaras.com/2018/03/caparo-dead-long-live-caparo-english-supreme-court-decides-foundational-principles-regarding-duty-care/.
[1790] Ibid.
[1791] Ibid.
[1792] Ibid.
[1793] Ibid.
[1794] Ibid.
[1795] Ibid.
[1796] Ibid.

"In cases where the question whether a duty of care arises has not previously been decided, the courts will consider the closest analogies in the existing law, with a view to maintaining the coherence of the law and the avoidance of inappropriate distinctions. They will also weigh up the reasons for and against imposing liability, in order to decide whether the existence of a duty of care would be just and reasonable."[1797]

The *Robinson* as well as *NRAM* cases represent the latest developments in the area of tort law. Even though that both are not related to auditor liability, however, they will provide further influence on upcoming cases.[1798] This research has indicated clearly that such developments in England and other common law countries are going in the wrong direction. Not only *Caparo* that has presented the tripartite test of duty of care is wrong but also the incremental approach that was taken recently brings further complications. It is noted that an analysis should look first at the breach itself and whether it is criminal or civil.[1799] Then, an assessment of relevant facts should entail to whom the duty of care is owed. After that, a court should consider how the duty of care arises. Finally, after identifying the relevant connection between the tortfeasor "s", damaged investors "persons" and causation link, then the compensation amount would be easily determined. This thesis intends to provide a practical level of analysis that could be applied, and what it has been seen from common-law courts are merely theoretical aside from being plausible to apply in practice. Furthermore, *Caparo* test and even the incremental approach cannot be applied in novel cases as cases even in the same industry differ from profession to another so that moving the analysis from one case to another is misleading. To emphasise, civil law countries may provide clearer statutory rules in respect of tort breaches. However, it does not reach a straightforward outcome in relation to auditor civil liability in connection to negligent financial statements.[1800] Therefore, this thesis takes advantages from common and civil law to reach a better conclusion on how these types of cases should be held.

Last point has been addressed lately by Horsey and Rackley in regard of determining that a duty of care is owed as between parties in a particular context or in a particular category of

[1797] *Robinson v Chief Constable of West Yorkshire Police [2018] UKSC 4, [2018] 2 W.L.R. 595* at para 29.
[1798] See for example, *Playboy Club London Ltd v Banca Nazionale del Lavoro Sp* [2018] UKSC 43; [2018] 1 W.L.R. 4041; [2018] 7 WLUK 619; 179 Con. L.R. 17; [2018] P.N.L.R. 35; [2018] L.L.R. 657.
[1799] See, for example, *Assetco Plc v Grant Thornton UK Llp* [2019] EWHC 150 (Comm).
[1800] Hondius elaborated on the application of Caparo in five civil law countries that may reach different conclusions. In this hypothetical example, Donna audits the accounts of Caterpillar, Inc. inaccurately. Paul relies on these published documents to launch a takeover bid. This is successful, but Paul then discovers that the accounts overestimated the value of the company and that the price Paul paid per share was twice its actual value. In Austria, Paul has neither a claim in tort against Donna nor a claim based on a contract with effects to a third party. In England, following Caparo Industries, Paul has no claim against Donna. In France, Paul may recover against Donna if she is the statutory auditor of the company; but he may be denied recovery if she is a specially hired contract auditor. In Netherland, although no case law exists on this matter, it is thought possible to hold Donna liable. In Spain, there is no clear outcome of the case. Spanish scholars have different opinions and there are no Supreme Court decisions on the issue.
Ewoud Hondius, 'Professional Liability', pp.226-249, p.240 in M Bussani and A Sebok, (Eds.). *Comparative Tort Law*. (Cheltenham, UK: Edward Elgar Publishing. 2015) doi: https://doi.org/10.4337/9781784718138.

relationship, the determination that this is 'fair, just and reasonable' has already been made and the question does not need to be asked and answered again. Even where the precedents provide no conclusive answer as to whether a duty of care is owed, they may nonetheless provide more concrete guidance than we get from *Caparo*. So, for example, if the claimant suffers pure psychiatric injury, the courts will look to cases such as *Alcock v Chief Constable of South Yorkshire Police* [1992] and *Page v Smith* [1996], rather than *Caparo*, to answer the duty of care question. Similarly, in cases concerning pure economic loss, the courts have developed more concrete principles to help establish when duties of care are owed. Furthermore, where personal injuries, and possibly property damage, are concerned, it will generally be the case that foreseeability of such injury will suffice to establish a duty; in other words, the test set down in *Donoghue* will be used (although there are exceptions to this—see e.g. The Nicolas H). The point Horsey and Rackley are making is that where there is no clear precedent governing the case at hand, in contrast to the implication of the incremental by analogy approach, the courts do not—and should not—simply reject the claim without consideration of its merits. This discussion is crucial to refer, however, as argued in this thesis is that common law cases are not clear on whether the auditor duty of care should be connected to shareholders in particular and in addition if other principles of corporate law provide some assistance in this respect. Obviously, there is no answer exist thus far as long as the development of cases and statutes go in the wrong direction.[1801]

This thesis moves to analyse in brief related issues such as the relationship between the directors and the company and the rules of attribution to which extent can be connected to the topic under review in this thesis.

The Supreme Court in *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others [2015] UKSC 23, [2016] AC 1 (Jetivia)* unanimously dismissed the defendant's application holding that where a company has been the victim of wrongdoing by its directors, the wrongdoing cannot be attributed to the company as a defence to a claim brought against the directors in the company's name by its liquidators.[1802] A company has separate legal personality, but it can act only through its directors and agents. In most circumstances the acts and state of mind of a company's directors and agents can be attributed to the company by applying the rules of the law of agency; however, whether an act or state of mind is attributed to a company depends upon the context in which the question arises [41, 92, 181]. When the question of attribution arises in the context of an agency relationship, the nature of the principal's or other party's claim is highly material [87-91, 202].[1803]

[1801] Horsey and Rackley (n50), ch 3, Duty of care: basic principles.
[1802] For previous discussion about the case, see section 4.5.
[1803] *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others [2015] UKSC 23, [2016] AC 1 (Jetivia)* Lord Neuberger agreed with what Lord Mance said at paragraph 42:

In the context of this thesis, though a public company has a separate legal personality but that does not mean it is separate from its shareholders as owners. Therefore, shareholders share the risk attached to their company that involve in legitimate transactions to limited extent stated in relevant Companies law.

A public company through its agents "appointed by shareholders" directors and officers may involve in illegitimate transactions so the company may suffer loss from such actions. There are two scenarios: one is a public company that appoint some shareholders in the board of directors of the said company, and the second is not appointing shareholders as board members. In the first case, if there is fraud committed by some board members, we need to look at those involved. If some of them are shareholders, then they could be sued by the company "or its liquidator", shareholders for the benefit of all shareholders except those were involved. Other third-parties may claim their loss against those who committed the fraud. Once, they got a judgment, the money will be returned to the company and then all or some of the money "on a pro-rata basis" might be distributed. This means, collected money does not benefit only those who litigated but all third-parties who were damaged from such an illegal act. In the second scenario, where board members are not shareholders, the same analysis could be applied. The ill-gain benefits acquired by those board members will be returned back to the company at end.

Aside from the two scenarios drawn above, a fraud might be committed only by senior officers "not appointed in the board as executive" whether they are considered shareholders or not, then the same rules suggested could be applied. The researcher agrees with the principles held by the Supreme Court in *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others*. Similar analysis in the case of an auditor of a public company committed a fraud alone or with the assistance of board members. As stated by Lords Toulson and Hodge in this judgment, *Stone & Rolls* stands as authority for the point which it decided, namely that on the facts of that case no claim lay against the auditors, but nothing more. *Bilta* confirmed that the illegality principle considered in *Stone & Rolls* would not apply in circumstances involving public companies with innocent shareholders who took no part in or otherwise benefited from the unlawful act. It could be concluded that if an accounting fraud occurred in a public company, then attribution can not be attached to the company itself but only those who were involved

"Where the relevant rule consists in the duties owed by an officer to the company which he or she serves, then, whether such duties are statutory or common law, the acts, knowledge and states of mind of the company must necessarily be separated from those of its officer. The purpose of the rule itself means that the company cannot be identified with its officers. It is self-evidently impossible that the officer should be able to argue that the company either committed or knew about the breach of duty, simply because the officer committed or knew about it. This is so even though the officer is the directing mind and will of the company. The same clearly also applies even if the officer is also the sole shareholder of a company in or facing insolvency. Any other conclusion would ignore the separate legal identity of the company, empty the concept of duty of content and enable the company's affairs to be conducted in fraud of creditors." At para. 9 where Lord Neuberger says he agrees with Lord Mance's analysis at paras. 37-44 of his Judgment. fraud of creditors.

including those who are assigned to do specific job as an auditor. Therefore, compensation must benefit all shareholders except those who were involved in a fraud based on their positions as directors or officers in a company.

The Supreme Court of *Singularis Holdings Ltd (In Official Liquidation) (A Company Incorporated in the Cayman Islands) v Daiwa Capital Markets Europe Ltd* [2019] UKSC 50 upheld that the former investment bank and broker of Singularis, had breached the Quincecare duty of care, which establishes that a bank owes a duty to use reasonable skill and care in executing its customer's orders.[1804] As Lady Hale explained, "the precise purpose of that duty is to protect the Company against a misappropriation of funds, as occurred."[1805] On the question of attribution, the Supreme Court held that Mr Al Sanea's fraud should not be attributed to the company for the purposes of the *Quincecare* claim. The fundamental principle was that a properly incorporated company has an identity and legal personality separate from that of its shareholders and directors. The company has to act through the medium of real human beings but the acts of those persons are only treated as the acts and intentions of the company in circumstances specified by its constitution, or the ordinary rules of agency and vicarious liability, or other particular rules of law. Lady Hale stated that the Supreme Court had held unanimously in *Bilta v Nazir*[1806] that where a company had been the victim of wrongdoing by its directors, the wrongdoing of the directors cannot be attributed to the company as a defence to a claim brought against the directors - and their co-conspirators - by the company's liquidator for the loss suffered by the company as a result of the wrongdoing. Further, the key to any question of whether to attribute the knowledge of a fraudulent director to the company is always to be found in consideration of the context and purpose for which the attribution is relevant.

To conclude, the *Quincecare* duty by its nature will only arise and be breached in exceptional circumstances involving dishonest activity. As such, once breached, it seems the Court will take an ambiguous view of paradoxical attempts to escape liability by reason of that very activity - this would nullify the entire purpose of the *Quincecare* duty. Banks should be prudent that the *Quincecare* duty exists to preserve companies against dishonest activity by a person who is, as Lady Hale said, by definition a trusted agent of the company. Rosser et al. believe that this judgment is an additional step in the trend to put the burden firmly onto banks to guarantee the validity of their systems for detecting and acting on potential dishonest activity, even, and perhaps especially, by those so closely connected with their customer's genuine activities.[1807]

[1804] For previous discussion about the case, see section 4.5.
[1805] *Singularis Holdings Ltd (In Official Liquidation) v Daiwa Capital Markets Europe Ltd* [2019] UKSC 50 at at [35].
[1806] *Bilta (UK) Ltd v Nazir* (No 2) [2015] UKSC 23.
[1807] Rosser, Susan., McDonald, Ian. and Holden, Jeremy., UK: The UK Supreme Court Re-Visits Attribution Of Directors' Knowledge And The Illegality Defence Once More, Mondaq Business Briefing, November 13, 2019.

As the researcher agrees with the analysis of the Supreme Court in *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others*, similar agreement with the Supreme Court of *Singularis Holdings Ltd (In Official Liquidation) (A Company Incorporated in the Cayman Islands) v Daiwa Capital Markets Europe Ltd*. It is noteworthy to restate again that the issue in the context of this thesis in relation to auditor civil liability towards shareholders comes from the basic understanding of corporate legal personality separate from that of its shareholders. This understanding will not be helpful to identify damaged persons. Hence, it is illogical to categorise them as third parties. In addition, the relationship between the directors or the auditor of a listed company is merely agent/principle relationships for the benefit of the company and its shareholders. Therefore, the rules of attribution in civil or criminal acts must be connected to those who are involved. This thesis has explained in detail that the insured could be covered with relevant policy in case of a civil conduct. In contrary, wrongdoers of criminal misconducts can not. This means that no one could escape liability and this thesis has suggested the damaged persons whom should be compensated. This brief view should suffice to connect both cases as well as other pervious or potential cases to the discussion under review.

7.3.3 The Other Common Law Countries' Cases and the suitability of their principles in the Saudi jurisdiction

7.3.3.1 The Civil Liability of Auditors and their Connections with Shareholders Rights in Scotland

The case of *Royal Bank of Scotland v. Bannerman Johnstone Maclay*[1808] concerns being a lender and a shareholder in the same time to a listed parent company and its subsidiary in connection with the auditor negligence in an annual financial statement issued in favour of the parent company. The defendant relied on the *Caparo* judgment in addition to post *Caparo* case, *Galoo Ltd v. Bright Grahame Murray.*[1809] In that case, Glidewell L.J. said: "Mere foreseeability that a potential bidder may rely on the audited accounts does not impose on the auditor a duty of care to the bidder, but if the auditor is expressly made aware that a particular identified bidder will rely on the audited accounts or other statements provided by the auditor,

[1808] *Royal Bank of Scotland plc v Bannerman Johnstone Maclay (a Firm) and Others*: OHCS 23 Jul 2002, *Royal Bank of Scotland v. Bannerman Johnstone Maclay* (2003) P.N.L.R 6; (2005) B.C.C 235. For more discussion about the case, see section 4.7.1.
[1809] *Galoo Ltd v Bright Grahame Murray* [1994] 1 WLR 1360.

and intends that the bidder should so rely, the auditor will be under a duty of care to the bidder for the breach of which he may be liable."[1810]

Finley thinks that one of the outcomes of the *Bannerman* case was the potential exposure of auditors to litigation from third parties to whom they have not disclaimed liability. As a result, it became common to include a disclaimer of liability to third parties in the wording of the audit report. Furthermore, disclaimers may not entirely eliminate liability to third parties but they do reduce the scope for courts to assume liability falls upon them.[1811]

This case could be analysed from different legal grounds. First, the relationship between the bank as a shareholder of a listed company gives him or her the right to be possibly indemnified directly. On the other hand, during the time of conversion of being a shareholder instead of a lender, the duty of care cannot be established unless there is an agreement with the auditor. Then, if the lender (prior the conversion stage) got damaged from the defective financial statements, the calculation of damages would be obvious and based on the total loan amount or part of it. Second, a disclaimer in the annual financial statement could be valid between an auditor and all other third parties except shareholders. Hence, if a company has become insolvent and a lender still did not convert his ownership, he would then not be able to get indemnified from the auditor since he has no direct relationship with the auditor unless agreed by contract. This means that tort law does not play any important role to allocate the relationship between a lender and an auditor in comparison with contract law.

In a criminal misconduct scenario, there is no direct relationship between an auditor and a lender of a listed company so that the liability for the caused damaged in a financial statement should be investigated to assess if an auditor contributes to the fraud or not based on adhering on following the accounting standards. Otherwise, the full liability would be on the burden of board of director and officers of the listed company. Hence, the High court decision in *Barclays Bank plc v Grant Thornton UK LLP*,[1812] considered the enforceability of a disclaimer of liability within auditor reports against a third party despite the fact no need to state the enforceability of it. If there is a negligence only from the auditor's side then only a fine can be imposed by a regulator and not being distributed to damaged parties as a compensation. With

[1810] Ibid 1382.
[1811] Finley (n588).
[1812] *Barclays Bank Plc v Grant Thornton LLP [2015] EWHC 320 (Comm).* For more discussion about the case, see section 4.7.3.

respect to the reference to the nature of the parties involved, being two 'sophisticated commercial parties' who are both well versed in the usual limitations auditors impose on their responsibilities, it may be deemed important in judging whom would be considered as damaged persons depending on their experiences in trading or lending. For instance, in the context of this study, there is no difference between sophisticated ordinary shareholders such as institutional investors or portfolio managers and individual shareholders or between individual and institutional lenders.

7.3.3.2 The Civil Liability of Auditors and their Connections with Shareholders Rights in Canada

It is very interesting to add the Canadian law in the area of auditor's civil liability towards third parties as the Canadian Supreme Court recently has tried to further address landmark common law precedents to reach different conclusions in different times. In this section, an emphasis will be on the *Livent Inc. v. Deloitte & Touche*.[1813] First, this case represents an accounting fraud occurred from two main shareholders who also work as senior officers and board members at Livent. Hence, the Ontario's Superior Court of Justice convicted the of two counts of fraud and one count of forgery and the sentences imposed were reduced to five years' imprisonment for Drabinsky and four years' imprisonment for Gottlieb. Second, Deloitte partners were the subjects of proceedings before the Discipline Committee of the Institute of Chartered Accountants of Ontario. Three partners were disciplined for their actions relating to the audit of Livent's 1997 financial statements. The Court upheld the decision of the Discipline Committee as well. Third, as Livent was listed in the U.S beside Canada, the Livent's collapse generated a number of U.S. class actions brought by certain investors against Deloitte and other defendants under U.S. securities laws. These actions were settled. As part of the settlement, the U.S. judge supervising the class actions issued orders containing bar provisions and releases.[1814]

[1813] *Deloitte & Touche v. Livent Inc. (Receiver of)*, [2017] 2 SCR 855, 2017 SCC 63 (CanLII). For more discussion about the case, see section 5.3.3.

[1814] The settlements were embodied in orders of the United States District Court for the Southern District of New York. The terms of the orders were similar. These terms:

1. Approved the settlements as fair and reasonable and in the best interests of the class;
2. Discharged Deloitte and barred all future claims against it in, arising out of, or relating to, the actions;
3. Released Deloitte of all claims belonging to the representative plaintiffs and members of the classes;

Fourth, the plaintiff was the company itself through its receiver for the benefit of its stakeholders in general. This would be clear when Deloitte argued that Livent is not claiming for its own losses, but rather is advancing a proxy claim, indirectly, for losses sustained by its creditors and investors that will be recoverable in Livent's insolvency proceedings.[1815] The court of appeal has dismissed arguments Deloitte put them into consideration and stated that Livent incurred losses.[1816] Fifth, the court of appeal took into consideration the theory of damages formulated by experts occurred to Livent based on this equation: Loss (L) = Actual Liquidation Deficit (ALD) - Estimated Liquidation Deficit (ELD). Judges think that the quantum of the ELD is established by determining what the estimated loss on the sale of the assets would have been at the "Measurement Date". Namely, the date when (a) Deloitte breached its standard of care, (b) the fraud would have been discovered but for the breach, (c) if the fraud had been uncovered, Livent would have been unable to access the capital markets, and (d) this would, in turn, have led to a formal insolvency.

Sixth, the court of appeal thought that it would be important to understand the purposes of an audit in the context of a publicly traded company. In its analysis, it states: (1) Purposes of an Audit of a Publicly-Traded Company, (2) Articulating the Standard of Care, (3) The Standard of Care Framework: 1996-1998 by addressing the (a) Statutory and Regulatory Framework and

4. Released Deloitte of all claims by others arising out of the claims settled by the classes; and
5. Barred the classes or anyone claiming on their behalf from pursuing the settled claims, directly or indirectly, in any other forum.

[1815] For example, in its factum, Deloitte argues that:

1. The duty of care to an auditor's client does not extend "to assuming economic responsibility for losses experienced by those standing behind it";
2. The authorities "do not support imposing economic responsibility on auditors for losses beyond those actually suffered by the corporation";
3. It is a mistake to assume that an auditor's duty to its client "exists to the extent of all possible losses, however indeterminate, without regard to who exactly is experiencing those losses";
4. "Livent itself lost nothing because of its frauds";
5. The trial judge incorrectly assumed that "investor losses are recoverable so long as the company lends its name to an action to recover investor losses on behalf of the investors"; and
6. "[T]he trial judge … failed to apply these principles and granted an award of damages to Livent representing losses experienced not by it, but by its creditors.

[1816] At paragraph 57, the appeal court judge argued, "I reject Deloitte's submission that the losses were not Livent's losses. It impermissibly conflates damages sustained by the corporation with the distribution of those damages, once recovered, to creditors and other stakeholders, as part of the assets of the corporation, in the course of the proceeding under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 ("CCAA"). The two legal constructs are quite different, with different rationales and purposes. To conflate them is to disregard the long-recognized principle of corporate law that a corporation is a legal entity separate and apart from its shareholders and stakeholders, and that the corporation alone has the right to sue for wrongs done to it: *Hercules Managements Ltd. v. Ernst & Young* [1997] 2 S.C.R. 165, at para. 59."

b) The CICA Handbook[1817] to decide the Auditor's breach of standard of care by not paying attention to major red flags.[1818]

Seventh, the Supreme Court held Deloitte is only responsible for $40.4 million in damages, which was the portion specifically linked to the work on the 1997 financial statement audit.[1819] In addition, the ruling has confirmed that the indirect route can be used in such cases, but one commentator said it doesn't offer much help to shareholders because money recovered by bankrupt companies typically all goes to creditors.[1820]

After summarising the *Livent*'s case, the researcher could argue that this case was not successful in delivering fair and just verdict. First, the case should have been decided on a criminal basis and hold that executives who committed the fraud are liable to the company and its shareholders. This thesis does not investigate if the Canadian criminal law allows for payment of compensation to shareholders by convicted executives nor allow for payment of fines by a convicted person to the victim – in this case, by the auditor to the company. It is presumed that all criminal laws in common law and elsewhere that there are no specific rules in this respect. However, it could be understood that general rules of criminal laws could be applied to compensate damaged parties from wrongdoers.

[1817] Some of the standards from the CICA Handbook in effect at the relevant time according to the court of appeal judgments include: (i) The Objective of an Audit; (ii) Knowledge of the Client; (iii) Management's Good Faith and Professional Skepticism (iv) The Detection of Material Misstatements.

[1818] These red flags should have heightened Deloitte's awareness of the need to apply an objective attitude of professional skepticism, but apparently did not. By August/September 1997, the red flags were fully "aflutter" and included:

1. The fact that the audit environment for the 1996 audit had been classified as "high risk";
2. The 218 per cent variance in the 1996 audit between Livent's $22.9 million loss after amortization of the PPC and the projected net income of $20.6 million;
3. The frequent resort to unusual Revenue Transactions and the insistent inclusion of questionable revenues from those transactions in income;
4. The inconsistency in the Musicians' Pension Surplus Receivables from the 1995 audit to the 1996 audit;
5. Gottlieb's known deceit in failing to disclose Deloitte's reservations about including the gain from the Pantages Air Rights Agreement in Q2 1997 to the Audit Committee in August 1997;
6. Gottlieb's insistence that Deloitte change the composition of the audit team in order to make it more compatible with Livent's accounting strategies; and finally,
7. Gottlieb's constant resort to the severance-of-the-relationship trump card.

All of these factors supported the trial judge's finding that Deloitte had failed to meet its professional standard of care as of August/September 1997 or, at the latest, April 1998, and that Deloitte was therefore negligent.

[1819] Janet Mcfarland, 'Supreme Court Says Livent Auditors Liable But Sets Conditions' (2017) The Globe and Mail available at: https://www.theglobeandmail.com/report-on-business/supreme-court-says-livent-auditors-liable-but-sets-conditions/article37393018/.

[1820] Ibid.

Second, the auditor if convicted for breach of duty of care should have paid a fine to Livent, however, it must not be based on the proposed formula suggested in Chapter Two. Instead, it could be built on another formula based on a specific percentage of the total amount taken from the Livent's audit service, at this year, or divided on several connected years for instance in addition to the disciplinary action taken by the Discipline Committee of the Institute of Chartered Accountants of Ontario. This suggestion is to be applied narrowly i.e. where there is a fraud from the company and negligence from the auditor. This idea has been culminated from the literature and in conformity with countries' efforts in regard to using the proportionate liability system or setting a statutory compensation cap or contractual stipulations, as indicated in Chapter Seven in regard to calculating the cap. However, this thesis contends that prior suggestions cannot be applied as suggested by other scholars due to the fact neither the literature, court precedents or regulations distinguish between criminal and civil situations.

Third, as Livent was listed in two common law jurisdictions, the reach of settlement in the U.S should not have happened as it gives right to specific shareholders. In addition, this type of settlement is also a preferred way of avoiding proceeding in lengthy allegations as discussed in Chapter Three despite the fact all precedents were not successful in compensating third parties or even their corporations. Hence, this sort of settlement is not acceptable to other shareholders who also hold economic ownerships in the company. To justify, one may argue that US shareholders would not be then entitled to invoke the lengthy and costly courts procedures via reaching a settlement. Auditors may also not benefit from in order to protect their time, money and reputation by making a settlement in the US. This argument is not an effective mean to solve the issue for all damaged shareholders. For instance, what if some of the shareholders in Canada did the same with similar conditions stated in the settlement, would it then solve the whole issue of the criminal and civil cases? Also, what would be the situation of other shareholders if they wish to claim the same, are they then going to be ignored since they did not join the early settlement? It could be noticed in general that that common law courts avoid getting involved into lengthy discussions about the shareholders position in case of a settlement reached and the contradiction about the third parties "shareholders and creditors" positions in these types of court cases, where specific criteria must be met to claim damages. In addition, the US settlement would benefit mainly insurers and auditors' money to

pay little based on their own calculations or on discretionary calculations bases that proved to not be reliable.[1821]

Fourth, this ruling has confirmed that the indirect route can be used in such cases by taking a derivative action by shareholders on behalf of the company.[1822] In fact, this type of action does not offer much help to shareholders because money recovered by bankrupt companies typically goes to creditors who are protected by other legal codes and they would also be able to reach better settlements with respect to their debts unlike shareholders. Moreover, as noticed in this judgment, the compensation amount was disputed among the Supreme Court's members. This analysis would shed the light on the effectiveness of derivative action that entitles the shareholders to sue on behalf of their company as well as the company's action for its own benefit without connecting itself with its shareholders loss. The researcher is in the opinion that both actions are not sufficient means to determine the proper amount of compensation as argued generally in this thesis. Accordingly, the misunderstanding of common law judges led to unpracticable solutions.

Fifth, the Ontario Court of Appeal argued that Livent, brought this claim as distinct from its stakeholders, and the cause of action was for negligence in the performance of the auditor's duties, not negligent misrepresentation. This reason was put forward to differentiate this case instead of another out of court settlement reached from the class action taken in the U.S. Indeed, I agree that this type of cases concerns the negligence in the performance of the auditor's duties, not negligent misrepresentation due the fact that an auditor cannot be convicted by negligent misrepresentation in auditing the annual financial statements unlike the role of a receiver in a bankrupted company. This analysis would rather extend to a solicitor and client relationship. However, it is also hard to adjust the negligent misrepresentation principle to the solicitor relationship with third parties as in the case of *Steel and another v NRAM Limited*[1823] discussed earlier, unless a solicitor worked as a receiver.

[1821] For early discussion, see section 2.10.
[1822] This thesis has not discussed in detail the type of legal actions that can be taken by the company or its shareholders in common law countries due to the fact the relevant literature and precedents did not discuss their influence on compensating the company or its shareholders in case of default in the financial statements occurred by an auditor. A brief discussion can be found in section 2.10 in connection with available legal actions permitted by the Saudi Companies Act 2015 and the Resolutions of Securities Disputes Proceedings Regulations 2017 in comparison with derivative action permitted in the British Companies Act 2006.
[1823] *Steel and another (Appellants) v NRAM Limited (formerly NRAM Plc) (Respondent)* [2018] UKSC 13.

Lastly, this case represents a good example on how a common law precedent has tried to confirm that a company can be compensated from the auditor of the corporation. However, the discussion did not extend to those who were responsible about the fraud nor providing plausible explanation whether the formula of compensation can be applied in other cases especially if the company is still in operation and not bankrupted/insolvent yet. The cornerstone of the analysis must be based on fair procedures to identify how the negligence occurred, who are the damaged persons and how they would be compensated in all types of cases. There is no major difference between criminal and civil cases in terms of compensating the damaged shareholders, but the means might be different i.e. personal money in criminal case while another option comes from an insurer in the civil one.

Laing and Nickerson have shed light on the extent to which the *Livent* decision would affect the dynamics of the audit process in Canada. For example, whether it will affect the costs of audits, the terms on which they will be conducted, the diligence audit firms will need to perform before accepting a retainer or the ability of corporations, especially those with heightened risk profiles, to obtain audited financial statements are all open questions.[1824] It seems that this case will present several challenges to common law courts, who may refer to this case and either agree or hold opposing views.[1825] None of both directions would be fair for shareholders, therefore, the debate of auditor liability to the company or to its shareholders is going to be endless unless new understandings emerge within basic principles in company law. Concerning potential issues, audit firms would still benefit from previous position that favour them against shareholders as third parties or even with non-reliable compensation's measures provided by the Canadian Supreme Court in *Livent*. Thus, proximate calculations for conducting audits, which might be based on discretionary risks, would benefit the auditing industry to tackle baseless litigations from time to time. This would also deviate the discussion of auditor's liability and if it should be distinguished from criminal or civil cases.

In a very lengthy recent article, Howard and Kreaden of which were counsel for Livent at all three court levels have analyzed the lessons from the *Livent* decisions and in particular what they mean for auditors' liability (and perhaps the liability of other professionals) going forward. This article discussed extensively the majority and minority views contained in this judgment

[1824] Andrea Laing and Adam Nickerson, 'SCC Affirms Duty of Care but Reduces Auditor's Damages in Livent Decision' (2017) https://www.blakesbusinessclass.com/scc-affirms-duty-of-care-but-reduces-auditors-damages-in-livent-decision/, December 21, 2017.
[1825] *Asset Co v Grant Thornton UK LLP* [2019] EWHC 150 (Comm).

and why according to their opinions the majority were right in their understanding. Moreover, they not only summarised all surrounding issues identified in common law jurisdictions in respect of auditor liability and insurance coverage but also confirms that neither directions "held by majority or minority" would be convincing to solve raised issues fairly. Therefore, further debates will confirm that there are structural flaws in corporate, securities and tort law in Anglo-Saxon jurisdictions.[1826]

With respect to evidence investigated, the researcher believes that this case would be important for Saudi judges to analyse and take a different route as suggested in this thesis. For instance, a Saudi judge has to address the facts in a similar way, examine the evidence provided by disputed parties, address regulations in addition to accounting standards in this respect, discuss this case in connection with how the court has reached its decision differently beside other common law cases who put certain conditions to be met, put more emphasis on the shareholders position within the company from an Islamic point view, involve in detail about the criminal aspects if any first, and asses if it has to procced in this direction, and then civil law suits follow or a accepting the case as civil case directly, and last but not least discuss the general Islamic liability rules to reach a reasoned judgment that puts into consideration all involved parties without leaning to one party over another.

7.3.3.3 The Civil Liability of Auditors and Their Connections with Shareholders Rights in Australia

The focus of the analysis in this section would be centred on the *Bathurst Regional Council v Local Government Financial Services Pty Ltd*.[1827] Jagot J held that in designating a rating to the Constant Proportion Debt Obligation (CPDO) notes, S&P owed a duty of care to potential investors in those notes including the local council authorities. The Court concluded in its judgment that the councils proved that they suffered loss against LGFS, S&P and ABN AMRO, the damage being the amount each paid for the CPDO notes less than the amount they received on the cash-out of those notes. According to Kern, despite the fact the Australian Court did not

[1826] Howard and Kreaden (n547) 161-167.
[1827] *Bathurst Regional Council v. Local Government Financial Services Pty Ltd (No.5)* [2012] 1200.

specifically cite the *Caparo* Industries test, the court applied in substance a similar test for establishing the existence of a duty of care.[1828]

The Australian *Bathurst* case is an uncommon case where liability for financial loss was imposed on a bank and a credit ratings agency for losses experienced by professionals or sophisticated investors who have had relied on AAA ratings that were negligently issued by both the arranging bank and ratings agency in the wholesale securities market.[1829] The *Bathurst* case also demonstrates how another common law jurisdiction with very similar principles of negligence law can apply the traditional duty of care test as set forth in the *Caparo* Industries to show how a duty of care is created between the defendant rating agency and plaintiff investor.[1830]

This case extends the duty of care of a credit agency and the bank that asked for a rating on the CPDO notes to be delivered to sophisticated investors in the wholesale securities market in an inadequate way. First, a credit rating agency charges a bank or an agency to rate their products or creditworthiness so that there is a conflict of interest. Second, the rating agency has a contractual relationship with the bank or the issuer so that in case there is negligence in rating a specific product, then the bank or the issuer could ask for damages caused to it. However, it could be based on a specific amount of damages occurred to the reputation of the bank or the issuer. Third, those sophisticated investors invest in the CPDO notes which are types of credit derivative sold to those looking for exposure to credit risk will not get ownership in the bank itself. Instead, they put their money in a special purpose vehicle that issues debt notes in addition to investing in an index of debt securities commonly credit default swap indices. Hence, their ownership is limited to those specific notes and they can claim that they are entitled to specific amount of loss occurred due to rating from their bank. In fact, those investors should have agreed with the bank that these notes are worth minimum amount of money even if its priced in excess in the market so if there is a decrease in the price below this level, then they would be able to cash in their notes. This analysis cannot be shifted to shareholders as they have ownership in the company and their rights are connected to the company as a whole and not only to a separate entity.

[1828] Kern, (n471).
[1829] Ibid 14.
[1830] Ibid 14.

Fourth, there is an issue when a judge tries to apply principles of negligence law of duty of care test as set in other unrelated cases. Indeed, the duty of care tests should not be investigated before having full analysis to whom the duty of care is owed and how the damages would be calculated in addition to identify whether the contract or tort law will be applied. Therefore, the researcher does not see a clear and connected relationship between sophisticated investors in the debt market and credit rating agencies. Overall lessons from this case highlight the prevailed understanding among common law judges, who form general principles that creep from one area to another without clearly distinguishing the duty of care owed to a specific professional that has its own obligations and liabilities. Furthermore, this case shows how common law countries may move towards the wrong direction and other prospective cases may accept or reject the provided analyses in referred cases without being involved in deep analysis that address main issues suggested by the researcher in this thesis.

7.3.4 The Regulations and Statutory Requirements Related to Civil Liability of Auditors and their Connections with Shareholders Rights in Other Common Law Countries and their Suitability in Saudi Arabia

After analysing some of the main common law countries' precedents about auditor civil liability towards third parties and their suitability in the Saudi jurisdiction, in brief, the next section relates to concerned legislations. In general, there are five major sources of auditor's legal liability:

1. Client liability under common law, which has been discussed above and in Chapters Three and Four.
2. Securities legislation, such as provincial and territorial Securities Acts, which imposes liability on auditors who participate in the production of offering memoranda or prospectuses. In some provinces/territories, there is now statutory civil liability under securities laws for secondary market disclosures. The first part was discussed briefly to state that Saudi Arabia has similar regulations of common law countries. The second part was not discussed as not having a connection with compensating the client nor third parties.

3. Criminal liability of an auditor, which may result from federal or provincial laws if an auditor knowingly defrauds a third party through involvement with the financial statements. This case was not compared with Saudi Arabia, as criminal law is clear in this area and would have similar treatment with parties involved in an accounting fraud.
4. Fiduciary duty, where one party (auditor) must act in the best interests of another party. This duty through duty of care is explored to show that there might be a different treatment with respect to shareholders of a listed company, and
5. Auditor third party liability, which exists under tort law, and has been discussed above and in Chapters Three and Four.

The obvious issue in common law jurisdictions is the lack of codification in the area of auditor civil liability in the secondary market, while in Saudi Arabia the legal codes stated the liability of auditors toward the company and others including shareholders. This area is left to the Saudi courts to interpret and apply without providing detailed guidance on concerned laws and regulations on how they should be applied, despite their overall benefits to Saudi judges in delivering better holdings.

7.3 Conclusion

To conclude this theme, the researcher has focused on general principles to be analysed to show how common law principles were developed. The researcher finds that common law court judges are not able to state a general duty of care that apply in all cases in connection to auditor's liability. In addition, examined precedents fail to distinguish different professions' duties of care to their clients or third parties for example. The main issue arises from the lack of codification to state clearly that in addition to mixing the relationship between creditors and shareholders without further analysis. However, the case law tries to apply different tests to reach some conclusions to provide an insight to Saudi judges on how to hold a judgement. Finally, as there is no solid ground for the civil liability of auditors in common law countries, negative impacts have been witnessed in the professional insurance market. This is vital to be discussed as neither clear legal codes nor justified court precedents are in place. Consequently, this would lead to further hardship to a connected insurance market and then will not be able to play a vital role in protecting the auditing industry in a proper way. One may argue that there is a very common approach which is that liability will be imposed in cases where the recipient

was actually foreseen and the aims and purposes of the audit includes the reliance of the plaintiff on the content of the audit report. Thereafter, there are differences as to the levels of foreseeability and as to the basis for liability. The differences are of interest because they supply a variety of options to courts looking for guidance. These claims are good to be examined within common law jurisdictions but not to be transplanted to civil or Islamic jurisdictions.

Several points would conclude the overall arguments that this thesis attempts to answer in relation to auditor's civil liability towards shareholders. First, the duty of care is an important element to examine. It could be noticed that in general there is no dispute among examined jurisdictions that the auditor's duty of care focuses on providing clean financial statement after considering prevailed accounting standards. For instance, the Saudi Certified Public Accountants Regulations 1992 states that a "Certified Public Accountant shall be liable for damages … as a result of professional errors in the performance of his work…" In addition, the Shariah rules have indicated broadly about the duty of care of a professional, conditioning that he/she knows about the nature of his/her job and would be liable upon if he/she caused harm to someone else. Even though, there are no comparable legal provisions in common law countries, courts somehow discussed the auditor's duty of care with certain conditions that must be met after examining prevailed accounting standards in some instances and in other cases did not rely on them solely. Discussions of common law cases have also shown that some courts did not elaborate on examining the nature of fraud and its influence on later analysis and if it should be differed from the nature of negligence. Therefore, it could be argued that common law courts did not succeed in providing a clearer picture in this area.

The extent of the duty of care is another issue that has been investigated in this thesis. It should be noted that the administration with the board of directors of the joint stock company prepare the annual financial statement, and then it is verified by the auditor. By this, their duty of care to provide clear and free of errors' annual financial statement to shareholders is achieved. In addition, their duty extends to shareholders through a delegation given to work on their behalf as in case with the company's officers. While the duty of care, which is based on the contractual agreement with the auditor bring the responsibility of auditors to shareholders "whom agreed at the general assembly to assign the job to a specific auditor with their company" as primary beneficiaries of the annual report. Again, there is no difference between the law tort and the law of contract in determining the duty of care as the end aim is to compensate damaged shareholders either by the company action or by the shareholders' personal actions. In relation

to Saudi Laws, they have indicated that an auditor is asked for compensation if the damage occurs to the company, the shareholders or others. This text is not supported with additional criteria to examine how the auditor would be liable to them. The researcher has elaborated in detail about the liability of auditors to shareholders solely, and this would include their liability to the company as well. In relation to others, it could be understood that there must be contractual agreements with them to make the auditor liable. Moreover, this legal provision is general and includes all types of liability so that it could be interpreted differently according to the misconduct itself if it is criminal, civil, or administrative. Hence, it brings a flexibility in interpreting a relevant lawsuit. In shariah, the duty of care goes to direct damaged persons. In contrast, in examined common law countries, it is obvious to see that the extent of duty has been extended to include third parties with certain conditions, while keeping the liability of the auditor to the company but without further explanation and clear measures on how the damages could be measured.

The separation of shareholders from the company is another issue to be compared. In Saudi, the law has stated general provisions in relation to the separate legal entity of a listed company, and the shareholder position within the company. However, the liability of auditors to shareholders brings to the attention how relevant laws should be interpreted. Moreover, the CL 2015 has stated that a company is established by a contract of two, and it does not matter if parties have changed. In addition, the limited liability of the company and its shareholders before others are accepted by the law, but it cannot imply that they are separate from each other as they share the profit and loss in their business. From a Shariah perspective, the researcher does not see much difference between the position of a partner and a shareholder. Moreover, examined resolutions from well-known Islamic organisations have confirmed the positions of shareholders as owners of the company. Besides, they also indicated that a share represents a mutual portion of common assets of the company. In contrast, in England, other concepts were created by courts in respect to the separate legal entity, the position of shareholder, the meaning of share, which provide sharp contrast to the Saudi and Shariah perspectives. It could be understood that basic principles of conventional company law have influenced other complex issues. Therefore, a new understanding from regulators to codify concerned legislations should come to enable courts issue more convincing judgments that balance between the tortfeasor and damaged person as the end aim of litigation.

If the basic principles have been treated differently, then other technical issues in relation to

auditor civil liability should be solved. The thesis has elaborated in detail on the causation and foreseeability in concerned jurisdictions. It seems that there were different approaches "theories" as seen within the United States. In addition, those theories were implanted in other common law jurisdictions through court precedents. The overall assessment is that a third party cannot claim his loss unless there is a contractual agreement with an auditor, hence, his damage could then be covered. In relation to what damage has been caused to a company, common law courts were unable to bring clear measures in this respect. In contrast, in Saudi, there are no relevant cases to compare. However, general legal provisions and Shariah principles were investigated to show how courts should take a different approach as argued in this thesis.

Concerning one of the main aims of this study, which is related to how common law principles would help Saudi judges, this thesis has brought to the attention several judgments in relation to auditor civil liability to third parties in particular, and other precedents discussing surrounding areas. Those referred judgements developed within the last two hundred years bring to the surface valuable analysis and principles to be discussed. For instance, how common law courts discussed the separation of the company's legal entity from its shareholders? Moreover, the limited liability of a corporation is also important to discuss from an Islamic perspective in concerned lawsuits. In addition, the discussion of a company action and its connection to derivative action should be distinguished in Saudi courts to emphasise whether the raised lawsuit comes from a shareholder or his company. Then, the court would only consider his position as an owner or all shareholders' economic ownerships to determine the exact amount of damages. Another point concerns theories of liability developed by common law courts especially if arguments raised by defendants. Those theories should not be understood in general from a relevant case solely but also a Saudi judge should investigate in detail the facts of referred cases in a specific judgment as well as relevant facts in the case itself. This major step may help a judge to decide his case on a criminal or civil base and not be confused in his overall analysis. Finally, a comparison should be made between common law principles and Saudi statues, regulations and Shariah principles to reach fairer judgments. Lastly, Shariah rules are straight forward and Saudi laws must be interpreted according to such rules. Other than that, it may take several years to hear one case and may be unable to reach a solid judgment.

After analysing the common law cases in the context of their suitability in the Saudi

jurisdiction, it is crucial to shed light on the conventional insurance practices and principles related to professional liability insurance as they have been discussed extensively in the literature. In contrary, Takaful is still in its infancy stage and the literature does not yet touch this area and the current application of Takaful products is similar to the conventional ones. Here, the researcher tries to give an indication that Takaful products should adhere to Islamic principles in indemnifying third parties and particularly ordinary shareholders from negligence caused by an auditor. This might happen if there is clarity in the civil liability arena. Therefore, the next theme will discuss how effective civil liability rules could be synchronised with the insurance market.

7.5 Second Main Theme: How Conventional Insurance Principles and Practices in Professional Malpractice Can Benefit the Takaful Industry

7.5.1 Introduction:

The second theme is related to the insurance practices and principles in conventional and Takaful. The literature has indicated that there are different concepts in conventional and Takaful despite the fact there are similarities in few areas.[1831] In addition, the conventional insurance literature with respect to professional liability insurance is quite rich in comparison with Takaful where there is none. Hence, the use of conventional insurance is vital to evaluate how Islamic insurance principles are different in terms of applicable principles and products and more importantly in indemnifying shareholders as the end resort. It is worth noting that the system of liability and insurance are not connected in the conventional literature so that the literature is absolutely lost in terms of analysis and logic.

[1831] In contrast, according to Alhumoudi (n787) 181, the concept of insurance in Saudi Arabia is similar to the conventional insurance from the logic and the application. Alshamrani (n1030) also thinks that definitions in the implementing regulations with respect to the function of insurance, premium, insurance policy and the insurer confirm that the concept of cooperative insurance in Saudi Arabia is considered to be commercial insurance and not cooperative, because insurance companies in Saudi Arabia charge insurance premiums in exchange for their commitment to compensation. This makes the cooperative insurance commutative rather than cooperative, whereas the goal of cooperative insurance is solidarity and cooperation, managing takaful funds on behalf of the participants, and receiving a salary (wakala fee) for this service. Alshamrani also believes that it is of paramount importance to have an Islamic Insurance Act in Saudi Arabia as in Malaysia, and one, which takes the multiplicity of Islamic schools into account. For more discussion, see section 6.6; Abuzaid, Dina, Reform of the Doctrine of Utmost Good Faith: A Comparative Study between the UK and Saudi Arabia, University of Stirling, PhD Thesis, Brunel University, 2018, https://www.storre.stir.ac.uk/handle/1893/28038?mode=full#.XTt1Gy3L3RY, argues that there is no difference between Takaful and western insurance practises.

7.5.2 Related Subthemes

7.5.2.1 Literature Related to Professional Liability Products in Takaful and Conventional Insurance

The second part of this thesis focuses on the insurance dimension from the Islamic and conventional practices and principles. The discussion in Chapter Six started with Takaful model that adhere to Islamic teachings in comparison with conventional insurance. The researcher also shed some light on the legal structure of Takaful companies in addition to difficulties the industry face in Islamic "Fully Fledged such as Saudi or Muslim Majority such as Malaysia" and non-Islamic jurisdictions. The discussion also extended to legal issues that face the Takaful industry. The aim of this comprehensive review on Takaful business is to show that they are different in structure. The researcher found little literature with respect to professional liability insurance from the Takaful perspective, but only a few basic forms and information.[1832] In order to investigate the professional liability from an Islamic dimension, discussion shifted to examine conventional practices in this area in Chapter Seven. The investigation found that conventional insurance is not well connected with the civil liability system in common law countries. This is a crucial point to highlight as the researcher believes that if legal codes or solid precedents in the area of civil liability of auditor as examples are clear, then, the insurance market would play a better role in indemnifying damaged parties. The focus in this thesis is to synchronize the civil liability of the auditor to Takaful principles by providing plausible and logical arguments in this regard.

Takaful as explained earlier is based on the idea of shared responsibility, social solidarity, mutual cooperation or assistance, and brotherhood, and provides for mutual financial security and assistance to safeguard participants or members against a defined risk. The idea behind the mutual system then and today is to control risks that members commonly face through a structure that gives them control over decision making regarding different aspects of the

[1832] The researcher has received in 2015 a few professional liability insurance forms from Takaful practitioners to be compared with the conventional ones. He also found other forms in Takaful operators' websites in addition to basic information about the product in general or in particular about the auditor liability insurance. The researcher confirms that existing forms and information found are similar to forms and information in conventional insurance operators.

insurance company. People decided to group together by profession to collectively mitigate and control the common risks they face in their respective industries.[1833]

The Council of Senior Scholars in Saudi put conditions related to the cooperative nature that distinguish it from the conventional one.[1834]

There are two concepts that are not permissible in Takaful which are crucial to the thesis. First, the concept of Gharar according to Ibn Taymiya can be defined as "that whose consequences are unknown". His student Ibn Al-Qayyem defined it as "that which is undeliverable, whether it exists or not". The contemporary scholar Al-Zarqa defines "the forbidden gharar" as "a sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling". In the insurance context, gharar results from the contract being based on the occurrence of a contingent event carrying risk of loss.[1835]

The second forbidden concept in Takaful is Juhala. While one aspect of Gharar refers to risk arising out of doubt, uncertainty and indeterminacy, uncertainty per se or Juhala in transactions is also prohibited in Islam. In further jurisprudential analysis concerning uncertainty and the commercial insurance contract, Al-Qora Daghi has stated that uncertainty is influential in relation to financial indemnification contracts.[1836] According to the consensus of scholars, the most important forms of uncertainty are as follows:

e. Uncertainty in the Existence of Risk throughout the Insurance Process

f. Uncertainty in Obtaining Compensation

g. Uncertainty regarding the Amount of Compensation

h. Uncertainty regarding the Time of Payment of Insurance Amount (Compensation)

[1833] A Khorshid, *Islamic Insurance: A Modern Approach to Islamic Banking* (Routledge 2004).

[1834] The Council issued a rule Number. 5/10 that confirms the permission of cooperative insurance and forbids commercial insurance. The Council put the following regulations on the decision related to the insurance contract as follows:
1. Cooperative insurance is a donation contract aimed at cooperation for the removal of dangers and contribution to bear responsibility on the occurrence of disasters through financial contributions made by individuals to compensate a person(s) who sustains damage. The aim is not to realise profits but to "distribute" risks and cooperate on bearing damages.
2. Cooperative insurance is free of surplus and credit usury, so (financial) contributions should not be exploited in usury transactions.
3. Ignorance of subscribers on benefits of such transactions will not harm them because they are donors and no risk, fraud or gambling exists.
4. A group of subscribers in cooperative insurance company may invest the collective funds for the realisation of the objectives of the company.

[1835] Mahmoud A El-Gamal, 'An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence' (2001) 8(2) Islamic Economic Studies 33.

[1836] El Qora Daghi (n819).

Applying these two conditions in the context of auditor liability insurance, the conventional counterpart has the two forbidden elements. To clarify, Gharar is found in the selling of this product since the characteristics of the product are uncertain in practice nor on paper so that if an insurer would like to offer a protection to an auditor, then, this will involve a risky transaction. This analysis comes from the vagueness of civil liability rules in connection with auditing business in listed companies with no compensation to damaged persons or with the inability to pay a fair amount of compensation in common law countries.

Juhala is also found in conventional auditor liability insurance. For instance, there is uncertainty in the existence of risk throughout the insurance process, in obtaining compensation, in the amount of compensation, and in the time of payment of insurance amount.

In order to make Takaful auditor liability insurance conform with Islamic teachings, these two prohibitions ought to be avoided. First, if there are civil liability rules and legal codes connected to auditing business as in Saudi Arabia then the problem of risk is identified. Additionally, the researcher understands that Saudi Arabia is in the process of changing the accountancy law, however, this law cannot conflict with the Companies Law 2015 with respect to auditors' civil liability.[1837] It is proposed that an auditor would be limited to certain hours spent of auditing listed companies to ensure more accuracy as well as the limitation on a specific partner to audit specific amount of listed companies yearly. To take it from another perspective, a Takaful

[1837] In a circular from the Saudi Organization for Certified Public Accountants (SOCPA) to auditing firms work in Saudi Arabia dated 21/03/2018, the SOCPA asked them to give their comments on the proposed Accounting and Auditing Act. Available at: www.socpa.org.sa/getattachment/bd0593f0-b03d-403a-9b46-f44aabd06fad/128.aspx. On April 6, 2020, the Shura council in its session number 31 round 7, has started discussing the proposed Act. In particular, the council discussed the report of its finance committee regarding the draft of the accounting and auditing profession system. The proposed system aims to improve the performance of those associated with the accounting and auditing professions in the Kingdom. Available at: https://www.arabnews.com/node/1654391/saudi-arabia.
In particular, the proposal in article 15 states that an auditor has to allocate a specific percentage of the number of hours for each transaction he issued a report on it according to what is specified in the implementing regulation. Article 17 binds the auditor to review a certain number of listed companies according to what is stated in the implementing regulation. Article 18 states that an auditor is liable for damages that occurred to the client or others during his work. This article is similar to article 15 of the Certified Public Accountants Regulations 1992 in addition to confirm the auditor liability as stated in article 136 (1-2) of the Saudi Companies Act 2015. However, article 18 has never been interpreted and the thesis sheds lights on how it should be implemented by a competent court. Finally, article 37 gives the competent court to hear cases related to compensation and private rights that arise from or against an auditor. The proposed law in article 30 also gives a specific committee to hear disciplinary and administrative cases against the registered auditor as in point (c), which is related to the breach of accounting standards or corporate governance applicable in Saudi. The committee could impose further correctional measures against the auditor such as limiting the number of clients in less than a year and no more than two years as indicated in article 30. This legal step is good and will be welcomed from an insurer to price the professional liability product at this stage, and it is also helpful beside the number of listed companies that an auditor cannot exceed in a certain year. It is unclear yet what would be the competent court in criminal and civil cases with respect to the auditor's involvement. The competent court could impose criminal penalties as stated in article 33 to imprison the auditor no more than five years and/or fine does not exceed two million Saudi Riyals in case there is a fraud for example in relation to untrue data or hidden data that he has to show in any report, account, or document during his work and knowing its impact. In civil liability cases, the researcher provides an insight on it extensively in the thesis, and cases could be referred to the CRSD at this stage then to commercial courts once all relevant cases refer to them.

operator would then be able to price his product based on the number of audited companies that an auditor could audit as well as estimating the trades of a company in certain year by referring to previous three years for instance and assess if there is also a change in the capital of the listed company. This type of assessment could eliminate uncertainty.

Second, if there is an understanding on how damaged persons would be able to get indemnified then Juhala could be eliminated. Third, the amount of compensation is clearer through the formula suggested by the researcher to calculate the damages.[1838] Fourth, the time of compensation in the annual financial statement default should be after a final judgement as some evidence is needed from the exchange with respect to transactions made after the occurrence of the default and sale of shares, if any.

The literature provides explanations as to why managers choose auditors as insurance in preference to insurance companies. In particular, the insurance companies use the cost-benefit approach when deciding whether to enter a legal defence or to decide on an out of court settlement. However, both the auditors and the firms that are involved in litigation will consider the implications on their reputation and thus, with a similar common interest, they will ensure that they protect their reputations. This decision should not take place if there are clear civil liability rules, and instead, it should be based on the auditor's position of being negligent or not. Secondly, if investors suffer from losses because of a default occurred in an audited financial statement, the court is likely to hold the auditor responsible and to require him to bear the losses. An auditor's contribution to an investor's losses was viewed by the court as "socializing risk". As stated in Wallace, "… because he is responsible for business failures, the auditor in turn shifts this cost to clients through higher fees and then to society through higher prices and lower returns on investment."[1839] In fact, the researcher did not find enough judgments with respect to investors' losses in investigated common law countries. Moreover, shifting the cost to a client or to the society is not logical or suitable to the accounting industry as well as to the business community. Instead, the cost of auditing should be priced on plausible measures related to the objectives of a company, the complexity of transactions involved and the ability of the auditing firm to adhere with prevailing accounting standards.

[1838] See earlier discussion in section 2.10.
[1839] Wallace (n1110) 22.

The literature also indicated that the increases in liability insurance costs and limited availability of insurance coverage are two reasons that demonstrate the necessity for limiting third-party liability to accountants.[1840] These two reasons are not convincing since the civil liability system is vague and left to courts to decide while it is supposed to be codified to overcome these issues.

In support of the analysis, the predictability of the insured risk and the assessment of the potential size of damages are among the determinants of the insurability or not of audit firms; therefore, certainty regarding this assessment may lead to insurability. The issue of uninsurability for auditors in common law countries lie on: there is no sufficient record of successful claims against auditors that could provide guidance with respect to the insured risk and there is an ill-defined legal regime regarding the calculation of potential damages, which can always be subject to changes. Hence, uncertainty has resulted in problems regarding the coverage of auditors against potential claims. Our analysis on old and recent cases with respect to auditor civil liability towards third parties or even against company showed that no progress in prospective judgments would come to surface due to the fact the ill understanding of the damaged persons and the damaged properties (shares) at first place. Hence, our suggestions would be very significant to Takaful's insurers and insured persons to base their relationship, agree on optimal pricing and be in conformity with Islamic principles in sharing/distributing the risks instead of transferring the risk from the insurer to the insured person and then to society which is meaningless in its essence and logic and overshadowed with uncertainty about the contract itself.

Another issue is in connection with the auditor's liability insurance cover claims on a "discovery" basis not on the occurrence basis that was used in the past. This new coverage only extends to claims reported within policy effective dates, and occurrence dates are not considered. This causes a huge problem in professional liability insurance in the context of indemnifying shareholders in case of default in the financial statements, where occurrence during the insured year must be taken into consideration. This is also considered a fair treatment as the discovery of a default might take some time.[1841]

[1840] See section 6.3 for further discussion.
[1841] See section 6.3 for further discussion.

The litigation risk poses a high risk for auditors; however, cases tends to follow market bubbles and fluctuation. This litigation risk has effectively made large auditors uninsurable. This is why it is very important to price the auditor liability product.[1842] First, market bubbles and fluctuation depend on several factors, not intended to be discussed here. Hence, it is illogical to build a solid insurance market that change in pricing without any basis on risks involved/occurred in the insured business or profession. Second, litigation could have predicted results as the case with criminal cases so that it is illogical to compensate an auditor who involved in an accounting fraud for defence costs or to reach out of court settlement for example. Third, issues related to big auditing firms who are unable to be insured rely on the ambiguity of civil liability principles in common law countries. In addition, auditing firms regardless of their sizes should have separate professional liability insurance for their partners who are involved in auditing listed companies. Indeed, as we have stated earlier elsewhere that an auditor at partner level could engage in auditing in a certain number of listed companies every year. Hence, litigation risk during one working year is assumed to be expected. Of course, there are other types of businesses an auditor does for listed and non-listed companies in relation to non-auditing services, such as consultation. Hence, the liability of the auditor in non-auditing services that might be disputed could be measured depending on the average of previous three years that the audit firm assigned itself to a partner. Moreover, litigation risks in these cases could also be based on contractual agreement with clients. This would further enhance the insurer position to better price the litigation risk of a specific auditor. It seems unreasonable for insurers to price their products based on the litigation culture in a specific country and instead it should build them based on legal codes regulating specific business or in connection with it.

To support the novelty of our suggestions, we need to highlight in brief the current practice of the insurance industry in terms of deciding the proper premium that should be deducted from an auditor. Sevim and others have examined the litigation risk criteria that insurers use to price the auditor liability insurance.[1843] In their study, the litigation risk factors for accounting professional liability insurance were divided into two categories: customer-specific risk factors and firm-specific risk factors.

[1842] See section 6.3 for further discussion.
[1843] Şerafettin Sevim, Birol Yildiz and Nilüfer DalkiliÇ, 'Risk Assessment for Accounting Professional Liability Insurance' (2016) 24 (29) Sosyoekonomi 95.

The customer specific litigation risk factors comprised 9 variables: customer size, number of customers, sector of customers, financial challenges of customers, corruption of customers, free float of customers, income rate of customers, market value of customers and service duration. On the other hand, accountancy firm-specific litigation risk factors considered the following variables: size of the accountancy firm (number of employees, firm income), court case cycle, and quality of the accountancy firm.[1844]

Sevim and others concluded that insurance companies in Turkey have a simple insurance application form that does not evaluate many of the factors examined by insurance companies working internationally.[1845] Furthermore, after analysing the application forms of insurance companies in Turkey, it is seen that the company-specific risk factors are examined but the customer specific risk factors are not.

As referred to in the literature, the "liability" in professional liability insurance points to the fact that it protects the insurer against damage from his/her failure or negligence and that it covers court expenses if a customer sues.[1846] Any negligence in preparing financial statements or auditing could lead to a court case and compensation against a member of the accountancy profession.[1847] The current application of auditor's liability insurance in Takaful and conventional insurance are alike, focusing on paying out of court settlement and/or litigation expenses.

Moreover, in Sevim et al., they have analysed insurance forms in Turkey and relied on another earlier study that focused on other international insurers who analysed well-known insurers' forms.[1848] In practice, Saudi Arabian's Takaful companies (who have joint ownership with international insurers at some of them) for example provide professional liability products including auditor liability product. It is assumed that those Takaful companies in their assessment take similar approaches to conventional insurance companies stated above. One question should be asked here which is to what extent pricing of insurance premiums should be paid by auditors, and how is this connected to compensation of damaged investors, for

[1844] Ibid 95-96.
[1845] Ibid 110.
[1846] L.E Shapiro, 'Professional Liability Insurance' (2004) 46(10) *Ashrae Journal* 59.
[1847] Z Palmrose, 'Litigation and Independent Auditors: The Role of Business Failures and Management Fraud' (1987) 6(2) Auditing: A Journal of Practice & Theory 90.
[1848] Sevim et al. (n1844) 95-96.

example? In fact, insurance companies use the above criteria strategically to sell their products with either low or high premium or take the decision not to insure.

Another question should be asked if there was certainty in the auditor liability rules, would that then be a better pricing decision as well as better coverage? These questions pose big challenges that require adequate responses. In Saudi Arabia, there is no literature about auditor liability insurance or about professional liability products in general. In addition, there are no required mandatory provisions by regulators for auditors or directors and officers to be not insured nor required disclosure yet.[1849] There is only one disclosure according to the researcher's best of knowledge in relation to D&Os of a Saudi bank who are insured with its affiliated insurance company (which has two foreign international insurance companies among its big shareholders) i.e. related party transaction.[1850] This type of related transaction is considered the fourth transaction within the last four years consequently. What should be highlighted here is that there is no real competition at the moment between insurers to cover professionals as they are taking advantages from affiliated parties' transactions in connection with insurance coverage. Moreover, even though if a Takaful insurer takes a similar position of a conventional insurer, then would that be helpful to compensate damaged investors (via subrogation), for example in defaulted quarterly financial statement occurred by negligence acts from Directors and Officers of a listed company. It is helpful to make a proper assessment of liability provisions in addition to the stated criteria above to reach better decisions. Hence, it is doubtful that many Takaful companies that work in Saudi understand the meaning of legal risks as they might in contrast push for similar arguments with their insured persons such as auditors to avoid being liable to third parties as the case with shareholders or even how the damage done to a company should be calculated.

In a very recent interview, Alsaab and Altamimi have elaborated on the increasing demand for the D&Os liability insurance of listed companies within the last two years in Saudi, even though it has started since 2008 "two years after the major collapse of the Saudi Stock

[1849] The new Rules for Registering Auditors of Entities Subject to the Authority's Supervision issued by the CMA on 19/12/2018 in article 7.2.b mandate auditors to have adequate indemnity insurance for the risks of professional failures, available at: https://cma.org.sa/en/RulesRegulations/Regulations/Documents/Rules-Registering-Auditors-of-Entities-EN.pdf.

[1850] See MetLife AIG ANB Cooperative Insurance Company announcement re the renewal of insurance policy of a related party, available at: https://www.tadawul.com.sa/wps/portal/tadawul/home/announcement-details/!ut/p/z1/jZBNU4MwEIZ_iwfOu4mkRW80Q8VSUi0fQi5MUKcyQwKHVKf_3kjPUPe2M8_77jMLEiqQRn13J2W7waje7bVcNSLe8xgDmmAuthi-lge-SaOkSFbwNgGU8oA8-Lh_ehZrB4RxuS3ze0Qf5H_yODMh3s7LCVkymIClE8sNDGonuZ61oBSyv45QiEMheJRGIm9EkW6iI9SMUMZgB_LUD-31oV_Wjo8eemjVh_o5954zUMZwZaEic8D7oEdlLtlFt4NrCZAQyD4NjLqosHvRukkta_27Xy-j7sQ!/dz/d5/L0lJS2FZQSEhL3dMTUFBdFFBZ0VaZ1FBISEvNE5sR294QSEvWjZfTkhMQ0gwODJLMFRORjBBUVZPQ0JNRUtVSzYvNTU0MjQ!/.

Exchange". This demand came due to hiring foreign directors and officers in listed companies who ask for this type of coverage especially after two major corporate cases, so others follow. In addition, those directors and officers enable them to take more risks on concerned decisions without the fear of being litigated from shareholders and others and not pay from their personal pockets. One of the interviewees has mentioned that there were successful shareholders' claims to get compensated for D&O malpractice insurance but he could not elaborate in detail about their liability on misleading or neglected financial statements. Lastly, they emphasised the need to mandate this type of insurance as it is now considered non-mandatory despite the fact it is mentioned when filing a claim against them in the lawsuit application. In brief, this thesis brings more emphasis on the same application of Takaful products in comparison with conventional counterparts. Further, highlighting the issue of risk-taking in corporate decisions would lead to considering another discussion in connection with business judgment rules where there is a rich literature about as well as if those D&Os, for instance, have taken independent advice, which is outside of the scope of this thesis. Moreover, this thesis does not concern a group of shareholders but all shareholders. In addition, the first respected interviewee who works as a regional CEO of insurance company somehow has advertised this product to be sold in the market, while the respected lawyer brings a conventional understating about normal litigation risks faced by this category in Saudi Arabia based on prevailed laws. Further, the lawyer did not extend the discussion on how compensation would be determined fairly, whether it was based on contract law or tort law, and to whom the compensation would be received. Hence, it is expected from professionals, scholars and practitioners in Saudi "and elsewhere" to hold similar views unless new understanding emerges with a view to connect other related insurance products as well. Lastly, both referred to two court cases "*Almojel* and *Mobily*" involved either fraud or other types of criminal breaches such as insider trading so demands should not be broadly connected to criminal activities as the end aim of such coverage would be for unintentional negligence.[1851]

Several reports discussed the non-effectiveness of professional indemnity insurance and LLP status in limiting liability as the former might lead to the deep pockets syndrome while the

[1851] See: Increased demands in Saudi Arabia for D&Os insurance due to the increase of liability failure cases, CNBC Arabia, Interview with Naji Al-Tamimi and Saud Alsaab, 22-04-2019, Available at: https://www.cnbcarabia.com/program/25/episode/6255/التأمين%20على%20مسؤوليات%20وقرارات%20أعضاء%20مجلس%20إدارة%20الشركات%20أحدث%20المنتجات%20التأمينية%20في%20السعودية; See also Mohamed Alsaeed, 'An invitation to mandate corporates to get liability insurance' (Alriyadh, 19 December 2018) Available at: http://www.alriyadh.com/1726145. This article has invited CMA and SAMA to mandate D&Os due to conventional benefits provided.

latter does not protect the assets of the firm.[1852] Consequently, they claimed that there is an economic case for replacing joint and several liabilities with proportional liability and imposing a statutory cap on audit liability. In contrast, representatives of the insurance and investment communities, for example, stood in particularly strong opposition to the prospect of liability limitation. The essence of their concerns was the possibility that a fixed cap on auditor liability would lead to situations where litigants could not be fully compensated for their damages by auditors and would, therefore, pursue damages' claims against directors and officers of the audited company, with a subsequent pressure on insurance costs.

The researcher thinks that the issue called deep pockets syndrome[1853] is somewhat related to the effort of some shareholders to maximise their return on their lost investment if a corporate is insolvent. The issue comes from the auditing industry, as a firm would like to obtain his reputation and reduce the loss of litigation regardless of their legal position from the one hand. On the other hand, an insurer who provides any amount less than the agreed amount in the coverage for the insured person becomes easier instead of being sued with a final judgment. That being said, the main issue is the legal system which does not clarify how damaged parties or even their corporation are/is able to get indemnified through a company action or derivative action, so some investors use the class action to put some pressure on the insurer to pay any amount.

As for the replacing joint and several liability with proportional liability system as discussed extensively previously in Chapter Seven, it should be made clear that both systems should work well in case there are solid legal rules in the area of civil liability for auditors for the auditing of a business. To clarify, if an auditor is convicted for violating the accounting standards and hold that he is liable to pay a certain amount, then a judge cannot hold that he has to pay the full amount unless it is proved that no negligence occurred from the director and the officers of the listed company. The current situation in conventional practice appears erroneous, as this would lead to pressure on the directors and officers of the audited company, with a subsequent pressure on insurance costs. Both products should work in parallel. For instance, directors and officers who are involved in preparing a defaulted financial statement by negligence must be insured for those risks in the D&Os product. In addition, other members whether they are in the board of directors or were elected outside of the board to be in the auditing committee are

[1852] See earlier discussion in section 6.4.
[1853] See sections 4.9; 6.4 and 6.6 for further discussion.

also insured. Additionally, this product or other types also insure some departments. It is proposed that these products beside the auditor liability product could contribute to indemnify damaged persons if there are joint default from the companies' directors and officers and the auditor.

To conclude, the move taken by some common and civil law countries does not solve the main issues of: how an auditor could be liable, to whom duty of care is owed, and how damages are calculated. This better understating would help regulators form better rules and insurance business provide better services to their clients. The researcher thinks that Saudi Arabia would be a good example for applying the suggested auditor civil liability theory so that Takaful products would then be able to indemnify damaged persons. Indeed, according to the analysis, breach of accounting standards is uncommon so it would be then a profitable business to insure. However, in case of default, then the share of risks is distributed between the insurer and the insured person, and this outcome would suit Takaful products to be in conformity with Islamic principles.

In another part of the thesis,[1854] the literature suggested that different criteria can be used to calculate the cap: a) Setting a fixed, uniform sum that would apply in all cases; b) The type or size of company under audit; or c) The audit fee received by the auditor. Furthermore, with a given criterion for setting the cap, a method for applying the cap must be determined.[1855] The literature also shed light on the problem of calculating the risk-shifting component of PLI. If the risks of firm negligence and client insolvency are difficult for auditors to calculate, they are even more difficult for the auditors' insurers. Due to facing extraordinary uncertainty given their limited experience with the new relaxed privity rules and the leveraged balance sheets of many of today's corporations, underwriters will generally be cautious. Furthermore, they will try to err on the high side, especially in the large-stakes lawsuits.[1856]

The above attempts to limit auditor liability in western countries face several issues that are not easy to decide which method is preferable. First, the researcher thinks that from an Islamic

[1854] For earlier discussion, see section 6.4.
[1855] Nili Eyal, 'Setting a Statutory Cap on Auditors' Liability: What Method Should Be Used' (2013) 10(1) Rutgers Business Law Review 56-99 at 65-66.The options for applying the cap are as follows:
a) The cap is applied separately to each successful claim against the auditor; b) The cap is applied to all successful claims against the auditor in a calendar year, even if they are for different actions or omissions; or c) The cap is applied to all successful claims against the auditor that originate with the same action or omission. For this alternative, if one audit leads to several misrepresentations, the cap applies to each misrepresentation individually.
[1856] Leibman and Kelly (n623) 371

perspective, damages caused by an auditor fault cannot be limited by stating that in a legal code even if the intention of it is the public policy unless it could be well-justified. Second, damages from a default is considered as a private party injury so that it is up to the company's shareholders to decide to limit an auditor liability or not. Hence, a contract between the auditor and shareholders or an approval from them in the AGM should be requested. Third, if there are successful claims originated from the same action or omission caused by an auditor in a certain year, it raises an additional hurdle for an insurer to predict the range of potential claims numbers as well as the number of investors involved. Fourth, proportionate liability system already enforced in some countries is not tested yet to see who would then be able to get indemnified other than the company such as third parties including debtholders. Indeed, estimating the magnitude of audit failure is more uncertain when gauging the scope of claims which is difficult. This can occur due to limited information about the number, identity, or type of third-party shareholders or other investors who may assert claims.

This would pose an issue for the auditor to try understand the litigation risk that might arise and to whom the duty is owed unless it is specified in the contract. An insurer has to reach a middle ground with an auditor in connection to how a specific limit of the coverage should be left to auditing services for a specific client. Hence, there are great difficulties in general auditor liability insurance as they are not tailored to particular engagements and associated risks of audit failure, and financial statement insurance might help in this regard as it is designed for a specific client. However, the main issue comes in its origin from the lack of solid legal ground in common law courts or in the concerned statutes in other countries and not only on limiting the civil auditor liability to certain caps.

The issue of professional liability product in general is related to the coverage of third party claims instead of first party claims.[1857] In the context of our analysis, if an auditor made an error or an omission in the annual financial statements and caused damages to the company's shareholders, then, there is an immediate loss or damage of property or interest through devaluing the concerned share's' of every shareholder. It is also could be treated as risks of

[1857] According to Psaraki (n567), in first-party insurance there is an immediate loss or damage of property or interest, resulting in a loss that the insurer has to pay for. In third-party insurance, both the type of risk and the subject-matter of the contract are different. Namely, in third-party insurance there is no immediate loss or damage in property but rather the risk is identified as a situation in which the insured will have to make a payment or transfer a benefit owing to a claim against him. In this scenario, the insurer will have to pay the claims that the insured will become liable to pay. Within this framework, when the sum agreed to be received from the insurer is equal to the sum that the insured has to pay, the insured is adequately insured and no difficulty arises. However, when the sum to be received by the insured is less than the sum to be paid by him, a case of inadequate protection of the insured arises.

negligence identified in certain annual financial statement. Hence, by no means professional liability insurance could be treated as third party insurance since no risk comes from third parties such as shareholders and negligence only come from insured persons as the case with directors and officers who made mistakes in quarterly financial statements (in the form of coverage for securities violations related to inaccuracies in the statements) as expressed by Baker and Griffith or an auditor in the annual one. Then available compensations coverage should go to shareholders' pocket of, and depending on the percentage of participation in the error if it is related to the annual financial statements.[1858]

Baker and Griffith suggest that an accounting firm could agree by contract to provide a warranty that a particular financial statement does not contain material misrepresentations. The warranty could be drafted so that it provides protection that is equivalent to existing D&O insurance. The firm could obtain contractual liability insurance coverage from an insurer that would indemnify the firm for any warranty payments. From an underwriting perspective, this contractual liability insurance coverage would be similar to D&O insurance and thus could be offered by D&O insurance companies with relatively little change in their operations. This limited warranty would bring the monitoring and risk distribution functions closer together without the need for legal change.[1859]

To respond to their proposal in detail, first, if there is a contractual agreement between an auditor and an insurer, then it would be binding between them, however, to be effective it needs an additional approval from the OGA audited company. In addition, if there are any warranty payments to the company then on what basis such a settlement could be reached especially if it does not include the full amount of warranty? Moreover, there is a need if this suggestion is workable to have other products such as the D&O among the overall coverage. There is actually a major deficiency in this approach, which is the difficulty of connecting the impact of reputation loss for the company through the material misrepresentations.

[1858] Tom Baker and Sean J. Griffith, 'The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer' (2007) 95 GEO. L.J. 1795 at 1838.

[1859] Because the accounting firm would simply be providing a warranty of the audit, we do not believe that this warranty would violate the Sarbanes-Oxley prohibition on the provision of non-audit services. *See* 15 U.S.C. §78(j)-(l)(g) (2000 & Supp. 2004). The warranty would not contravene the three principles that the SEC has stated that it will use in defining non-audit services: "an auditor cannot (1) audit his or-her own work, (2) perform management functions, or (3) act as an advocate for the client." Strengthening the Commission's Requirements Regarding Auditor Independence, 67 Fed. Reg. 76,780, 76,783 (Dec. 13, 2002) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274).

Hypothetically, if A agrees to compensate B if an incident happened, then, on what basis the coverage would predict the expected damages. In Saudi, for example, car insurance coverage ultimately relies on compensating the loss of full body by a certain amount (diyah). If other things have happened to the injured person, then, the court will decide in principle the loss of benefit for the injured part in addition to other considerations might be taken as agreed between the insurer and insured person. Similar logic would be acceptable in case of auditor's negligence and caused damages to shareholders' shares, hence, there is something to be measured. As for the need to change the law, we have seen in Saudi Arabia that there is no need to change the law, while in common law countries, different judgments should be made until legal codes come into play to fill this gap. Finally, there might be a proposed agreement between the auditor and the listed company to limit their compensation to certain amount of money. However, it might be suggested to include a clause to state that shareholders have only the right to be indemnified if they accept to transfer their expected rights to other shareholders who would may come in place no matter if the corporate is insolvent or not. Of course, an auditor might bring his existing/potential professional liability/financial statement insurance that covers his liability to the AGM to be voted with the engagement letter. By this way, it could be acceptable to limit the auditor's liability. This understating comes from the essence of liability in tort and contract do not make an issue in this respect but more emphasis on identifying the damaged persons and their calculation of loss.

One of the benefits for providing financial statement insurance is related to the insurance carrier. Having extended coverage at a certain premium, the objective of the insurance carrier would be to minimise its claim losses. Accomplishing this objective as suggested is tantamount to minimising shareholder losses. Hence, the interest of the insurance carrier is aligned with the interests of shareholders. The researcher thinks that this analysis is right, as an insurer would then be able to limit his compensation to specific class who appointed him. In fact, it does not matter if an insurer suggests a specific auditor to audit the company's financial statements or it has been chosen from shareholders directly. However, an agreement of compensation value should be presented along with the engagement letter to be approved.

Another suggestion is attached to the occurrence-based policy in FSI. This is in fact logical from an insurance parlance, and it means FSI is retroactive coverage. There invariably will be a time lag between the event causing damages (a material financial misstatement) and their manifestation (revelation with value-destroying effects on securities).

As for the no action clause found in insurance policies restricting rights of third-party loss victims to recover directly from the insurer and requiring them instead to obtain judgments against the insured, this direction would weaken the utility of FSI. Particularly as a device to protect investors from issuer misconduct, manifested in its materially misstated financial statements that trigger FSI loss pay-outs. Hence, the FSI policies deemed to permit direct actions against FSI insurers by investors or their fiduciary representative. It might be better to have judgments against the insured. However, if one judgment has decided to compensate a shareholder or a group of shareholders, then others may initiate other actions relying on previous judgment(s) with different compensation amounts depending on their actual losses. Hence, there is no need to rely on an insurer own evaluation on calculating shareholder damage, which is quite difficult to make a fair distribution among damaged persons.

FSI would not alter the liability position of any other existing actors in the financial reporting process, including officers, directors, underwriters, and attorneys.[1860] In other words, financial statements are prepared in the first instance by management. Virtually every case of misleading financial statements involves complicity by officers and/or the board. For this reason, officers and directors would need to remain separately liable for their own misconduct. Furthermore, to forestall frivolous litigation, accountants' malpractice claims would need to be limited to suits by shareholders, not by management. To fill this gap, it is also suggested to have a tower of insurance coverage that assist damaged persons to get indemnification from the auditor or from the insurers directly and others as all of them are covered. In addition, it has to bear in mind that shareholders' corporate pay them to do specific tasks. Thus, limiting suits to shareholders in this type of claim is the right thing to accept and in conformity with Islamic principles.

[1860] Cunningham (n1235) 413.

7.6 Conclusion

This chapter discusses and analyses the extent common law principles in the area of auditor civil liability towards third parties and related discussion in covering audit failure. The purpose of discussion and analysis is to provide adequate solutions on how Saudi legal codes and Islamic principles should be interpreted. The rich literature gives the researcher the ability to reach unprecedented answers to be argued in later researches and papers. In addition, the researcher intends from this discussion to connect the civil liability principles to relevant insurance products. The discussion also extended to various issues that the researcher attempts to answer from an Islamic perspective. This thesis focuses on discussing the legal ground in Saudi and common law countries. Saudi Arabia has never dealt with this type of litigation before the courts. Furthermore, within the last 50 years, the former Saudi Companies Law 1965 and following legislations with respect to auditor civil liability towards the company and others were never interpreted. The thesis comes with various suggestions to activate concerned legal codes and how Takaful products could be able to indemnify damaged persons. Common law cases provide extensive debates that should be defeated in the Saudi courts if similar understanding arise especially from the big four auditing firms.

It has to be noted that technicalities of the auditing profession are not studied. However, in Saudi, the international accounting standards are applicable so the dependence on identifying the materiality of an error that comes from fraud or negligence is already covered. Moreover, the SOCPA in 2018 has issued a guide for auditing in Saudi Arabia. It is worth noting in chapter 7 of this guide, which is related to the evaluation of fraud risk, a misstatement could be created by fraud or error and the distinction between them is the intention. Auditors have to be cautious to fraud and must evaluate involved risks. The guide also states that the concept of being auditor as a watchdog is considered as lullaby for the auditor. Hence, the IFRS standard 240 indicates auditor responsibility in connection with fraud in the financial statement. This standard expands in its application based on standards 315 and 340 as related to the material misstatements occurred from fraud.

The researcher confirms that a judge needs to look at relevant standards and guidelines in connection to auditing to assess if he is liable for a misstatement. It is also suggested to investigate most fraud cases and ask if cases could arise too from errors as well. By this analysis, it could be easier to identify the fine line between them. Other rules with respect to

auditor civil liability is also present in the Saudi legislations; however, it would be an improved step to add certain criteria in implementing regulations. Finally, it has to be noted that the administration of the company is responsible for preparing the financial statement which includes the designing, implementing and keeping internal control to make it free from material statements that either occurred from fraud or error.

In the second theme of this thesis, insurance from Islamic and conventional perspectives were discussed. As the Saudi Cooperative Insurance Law 2003 is procedural, it needs to be changed to substantive law. However, discussion extended to relevant legal texts that would place the Takaful industry in a better position when pricing their products and in indemnifying damaged persons. Elsewhere, Takaful products are available in Islamic and non-Islamic jurisdictions; however, the vagueness of legislations in other countries poses great disincentives to Islamic principles. It is suggested that in order for it to move forward, it is best to disregard irrelevant precedents in common law countries, for example, and compensate damaged persons based on acceptable methods. Then, the concept of Profit-Loss Sharing is present between the insurer and the insured person so both of them will try their best to adhere to prevailing legal codes and standards to make a profit if any, as the principle intention is cooperation between involved parties.

Chapter 8: Conclusion

8.1 Conclusion of Chapters:

This thesis started out as an attempt to investigate the auditor civil liability towards third parties in investigated countries. The preview was broadened to examine the rule of insurance in providing efficient coverage to the auditor and indemnification to the injured investors as indicated in some concerned precedents and literature. The thesis has, therefore, tried to synchronise the civil liability rules with connected insurance products in order to make recommendations which will help to inform the process of reform of this area in Saudi Arabia.

As this chapter presents a conclusion of the research by presenting an overview of the major tenets, the study started with an introductory chapter that stated the main issue with relevant hypotheses. In addition, a general question had to be divided into sub-questions that this thesis seeks to answer. After that, Chapters Two to Four addressed the civil liability of auditors towards third parties in Saudi Arabia, the United States of America, England and other selected common law countries. These Chapters relied on existing legal codes and precedents.

In Chapters Five and Six, the discussion moved to insurance principles and products. Chapter Five addressed the current status of takaful and if it differs from conventional insurance in its structure. Chapter Six dealt with professional liability products which do not provide fair and just compensation. The key chapter in this thesis which is Chapter Seven, focused on analysing and discussing some concepts to provide a foundational ground to link the civil liability rules with insurance. This Chapter complements and concludes our consideration of the concerned two main themes that have been analysed in detail in order to connect them coherently, and to answer the question posed at the beginning of the thesis. The thesis aims to contribute to the continuing search for solutions that could be found in Islamic principles and legal codes applicable in Saudi. Therefore, the prime focus of this chapter is to present applicable and pertinent solutions for the identified major issues Here I will reiterate and draw together the arguments that I have made throughout this thesis. It was hoped to engineer a re-think of the usual perspective.

Taking a substantive view, each of the chapters has achieved the following:

Chapter Two mapped the landscapes of the main principles of the Islamic Law of Tort and their implications for auditor liability towards shareholders, and then investigated the current Saudi regulations with respect to auditor civil liability towards shareholders. It also noted that both, Islamic principles and Saudi statutes coupled with proposed legislation bring further clarity to applying relevant rules to auditor civil liability towards shareholders. Moreover, it highlighted the new direction that might be taken from the Saudi regulator in regards to the proposed Compensation Act that may enable the regulator to enact a law that is found in other civil law countries. The chapter also identified some conceptual similarities between Islamic and conventional, or Western, laws of tort, while highlighting some differences as to how the liability of professionals is determined and allocated: e.g. in cases of a direct or indirect cause of wrongdoing, as well as in the identification of who qualifies as injured persons.

To highlight major points examined in Chapter Two in the Islamic law of tort, the Shariah has regulations which ensure that damage shall be eliminated. The three elements of tort in Shariah "wrongdoing, harm, and causation" apply for all tort cases, regardless of the type of tort case or its time. In regard to the actionable harm, it must be on a property that is considered as a commodity such as ordinary shares of a listed company. It is necessary to establish the causal connection between the act of the auditor and the harm suffered by the shareholder for the existence of the right to claim damages. Moreover, an assessment of the auditor's action to determine if it is the direct or indirect cause of action ought to be done. The quantum of damages might then be measured based on parties' involvement in the defective annual financial statement other than an auditor such as directors and officers of a listed company. The strict liability in the Islamic law of tort in the context of this thesis is that the tortfeasor by direct cause will be held liable in all tort actions whether the element of transgression existed or not. One may contend that the auditor is responsible for verifying the annual financial statement and then be deemed liable for a misstatement in it and caused by a neglected act, if the person is the direct tortfeasor by not applying the prevailing accounting standards properly (IFRS in Saudi). In connection with the concept of vicarious liability in the Islamic Law of Tort, it is contended that senior officers and board members with executive roles are considered Ajir Kaass, while board members with non-executive roles and experts such as auditors are Ajir Mushtarak.

The Saudi legislation presents the second part of this chapter. Article 135 and Article 136 of the Saudi Companies Law 2015 contemplate the shareholders among others so that in case

there is a default in the financial statement caused by the auditor then the shareholders, independently of the company or through the company's legal action, would appear to be able to seek compensation. Article 15 of the Certified Public Accountants Regulations 1992 states that a Certified Public Accountant shall be liable for damages sustained by clients or other parties as a result of professional errors in the performance of his work. Article 82 of the Corporate Governance Rules 2017 highlighted the main duties of the External Auditor, and in particular stipulates that and the auditor shall be liable to compensate the Company, the shareholders, or third parties for the damages resulted from errors it commits in the course of its engagement. Article 5 and Article 12 articles of the CGR support the right of shareholders to be indemnified through personal, class, or company actions. Finally, the Capital Market Law (2003) mentioned in Article 55 the auditor among those who would be liable If a prospectus contains incorrect statements of material matters or omits material facts required to be stated in the prospectus.

The third part of this Chapter has focused on problems relating to whether Shareholders are able to get Indemnified from a Legal Perspective, with the aim of making recommendations which will contribute to the reforms in this area in Saudi Arabia. It started with the formula the researcher proposed in order to enable Saudi judges to calculate the damages incurred by shareholders in case of a default in the annual financial statement, a Saudi judge could make such calculations to compensate shareholders. The researcher has then examined the major U.S cases to show the development of dealing with compensation cases before courts and noted that most of the cases are settled before upholding judgments based on common econometric methods of calculating damages. In addition, referred cases are connected to criminal acts and not to accounting fraud at a minimum. Recently, the CML 2003 has been amended and stipulated new mechanisms re compensating damaged investors from illegal practices conducted in the stock market such as fraud in the financial statement of a prospectus, so there is still a gap in civil liability cases as argued in this thesis that needs to be filled.

The Chapter has examined as well conflicts of jurisdictions among Saudi courts arise in the case of default in the quarterly and annual financial statement, and envisaged which avenue shall hear a relevant dispute now and in the future either it has been raised through personal or class action, and why derivative action is not in place. Finally, the researcher presented a draft of the Compensation Law in line with Shariah principles that might be implemented in the future. However, some areas in relation to the thesis are examined to fill the gap by covering

other existing relevant statutes, regulations, and suggested mechanisms to compensate damaged investors. This law is in conformity with the discussion about the Shariah principles examined in Chapter Two of this thesis in regards to the law of tort as well as general principles that could apply too in the law of contract.

The main contributions of Chapter Two were: to establish and evaluate whether the arguments based on general Islamic principles and Saudi statutes are valid and plausible in measuring professional liability cases with respect to an auditor of a listed company, and to explore the possibility of indemnifying the shareholders or the company itself in case of financial statement error in from Islamic and legal perspectives.

Chapter Three has explored and examined the core case law and relevant statutes of auditor civil liability towards third parties in the US. The US courts have developed a variety of opinions and approaches and the law has developed at different paces, spanning the spectrum of contract privity through to foreseeability in negligence. The American courts developed four main legal rules or criteria for determining which third parties are due to a duty of care by the auditor with a care task, whereby they can sue the auditor for loss arising from the inaccuracy of financial statements resulting from the auditor's negligence. The four legal approaches are: a. the privity rule; b. the primary beneficiaries' rule (near privity rule); c. the foreseen user rule; and d. the reasonable foreseeability rule. These alternatives rested on shaky philosophical foundations created by respected judges according to the researcher's opinion. This will also lead to further debates for those who wish to challenge the work of these judges as this thesis does.

Prior to the extension of tort law, accounting suits were brought under the theory of contract law because of the existing contract between the auditor and the client. Hence, privity has been recognized as a necessary element in maintaining a suit in contract law.

The Known User approach has been established in *Ultramares Corp. v. Touche* by identifying a primary beneficiary to be the main receiver of the auditor reports so that the auditor was required to know the name of this beneficiary prior to the audit. It expanded the rule by extending the zone of the auditor's responsibility for negligence to include parties other than the client but limited that class to persons having a sufficiently proximate relationship. Judge Cardozo has stated his influential statement that the thesis attempts to answer by equalizing a negligence claim with a fraud claim "If liability for negligence exists…may expose accountants

to a liability in an indeterminate amount for an indeterminate time to an indeterminate class…" The Near Privity approach has been applied in *Credit Alliance vs. Arthur Anderson and Co.* with three prerequisites that must be satisfied before auditors can be detained liable for negligent misrepresentation to non-contractual third parties.

In *Rusch Factors, Inc. v. Levin*, the Restatement of Torts "Foreseen User Approach" has been invented by expanding the class of persons to whom the auditor owes a duty such as intended identifiable and unidentifiable beneficiaries. The exception for an auditor not being liable to them comes whenever there is no reason to believe the information would be made available to a third party, or if the information's use changes so as to increase audit risk materially. The Restatement Standard brings some problems in its applications as the courts are given a large amount of discretion to place more weight on some factors than on others. Thus, it creates an inconsistency in judgments due to the subjectivity of the application of the test as it does not require direct supplying of data by the auditor to the user, does not mention "linking conduct" or "shaping," and allows a plaintiff carrying out a "substantially similar transaction" as one contemplated by the auditor to bring suit.

The last standard developed in the U.S is the Foreseeable User approach in *Rosenblum Inc. vs. Adler*. The auditor is responsible for normal professional negligence "being able to purchase malpractice insurance" towards all persons the auditor predicts, to a reasonable degree, will use and depend on the financial statements, which are received from a company pursuant to a proper business purpose. However, the court indicated that the classification of recipients would be limited and would not include stockholders who purchased stock after the audit's preparation, or institutional investors or portfolio managers who did not obtain the financial statements from the client.

After exploring the main U.S case law coupled with other cases implemented these tests, the next section in Chapter Three briefed existing statutes relevant to the discussion. Both the 1933 SA and the 1934 SEA expanded auditors' liability to third parties beyond the boundary of the common law. However, the explored federal statutes were focused either on auditor liability for negligence that exists in connection with initial securities offerings that expose auditors to nominally strict liability, or actions involve secondary market trading that exposes auditors to liability under fraud theories if scienter is shown.

Chapter Four is considered one of the most vital chapters to this thesis as it shows most of the challenges relating to auditor civil liability towards third parties in England and selected common law countries that may have followed the English or US approaches. The first part has focused on English cases, scholars, and practitioners' points of view about previous and current applications of precedents in connection with auditor civil liability towards third parties, which have had a profound on the development of the law in other common law countries. The second part of Chapter Four aimed to introduce the auditor civil liability towards third parties within selected common law countries that may have followed the English or US approaches.

Chapter Four in its first part has explored English cases, scholars, and practitioners' points of view about previous and current applications of precedents in connection with auditor civil liability towards third parties, which have had a profound on the development of the law in other common law countries. It also briefed recent cases that are connected to other discussions under review in Chapter Seven. Until the beginning of the twentieth century, the third party had no right to sue the auditor for negligence even if the financial statements on which they depended on were the direct reason for the damages incurred.

It was also almost impossible to hold accountants and other gatekeepers liable for negligent misstatements in disclosure documents until 1964 through *Hedley Byrne & Co v Heller & Partners*. The House of Lords held that all persons who provide a statement owe a duty to any third person with whom a special relationship exists.

In subsequent years, the *Caparo* case signified a move back to a narrower understanding of the notion of stewardship. It returned the focus to the company as a corporate body rather than a collection of interests of individual shareholders and laid down stricter conditions under which a duty of care could be said to be owed by auditors. It is clear from *Caparo* that company auditors, in principle, owe their duties to the corporate body and not to outsiders. Other common law jurisdictions have reacted to *Caparo* by applying the traditional duty of care test set forth in it such as the Scottish *Bannerman* case and the Australian *Bathurst* case. The latter demonstrates how another common law jurisdiction with very similar principles of negligence law can apply the traditional duty of care test as set forth in the *Caparo Industries* to show how a duty of care is created between the defendant's rating agency and the plaintiff investors.

Various English decisions post-*Caparo* were surveyed. The limitations placed on the parameters of auditors' civil liability have continued in *Stone & Rolls v Moore Stephens*. It has shed light on crucial issues underpinning the company law that acquired more attention from respected common law courts. Those issues are the relationship between the directors and the company and the rules of attribution. Furthermore, it is noteworthy to examine to which extent can be connected to the topic under review in this thesis.

The UK Supreme Court considered the defence of ex turpi causa within the context of a directors' liability claim in *Jetivia SA v Bilta*. It confirmed that the illegality principle considered in *Stone & Rolls* would not apply in circumstances involving public companies with innocent shareholders who took no part in or otherwise benefited from the unlawful act. Following the confusion caused by *Stone & Rolls Ltd* and *Jetivia*, the Supreme Court in *Singularis v Daiwa* has reframed the analysis required. It makes clear that the answer to any question as to whether to attribute the knowledge and actions of a director to a company is always to be found in a consideration of the context and purpose for which the attribution is relevant. The ''directing mind'' analysis, and *Stone & Rolls* itself, ''can finally be laid to rest''. There is no step by step guide to when it will arise— each case, as it should, will depend on its facts and on an analysis of the policy reasons behind the relevant rules.

Under the British Companies Act 2006, an additional mechanism of protection against their clients has been guaranteed to auditors: the contractual limitation of their liability through liability limitation agreements (LLAs). The question that arises is whether the new protection layer available to auditors is disproportionately detrimental to the audit client's expectations from the audit.

The second part of Chapter Four aimed to introduce the auditor civil liability towards third parties within selected common law countries that may have followed the English or US approaches. It showed a convergence of opinions at least within the common law world on the liability of auditors towards shareholders in the secondary market, however, there remains variations in how they apply or interpret them. The secondary aim of this chapter was to examine recent developments in regulation in the same area. Many common law countries are moving towards proportionate liability systems instead of joint and several liability systems and are thus capping and limiting auditors' liability.

In Scotland, the judge in the *Bannerman* case decided that the non-existence of any disclaimer of liability to third parties was a major contributing factor to the duty of care owed to them. The defendants in *Bannerman* relied on *Caparo*, amongst other cases. The ICAEW promotes its use to manage the risk of liability to third parties, but this view is not shared by the Association of Chartered Certified Accountants, which recommends that work prepared per the required criteria does not require a comprehensive disclaimer.

In Canada, the Supreme Court of Canada in *Haig* adopted the broader "limited class test" as a basis for determining a duty of care. While in *Hercules Managements*, the court adopted the two-prong *Anns* test to determine whether an accountant or another professional owes a duty of care to a third party for negligent misstatement purposes. The case of *Livent* emphasized, where a novel purpose is claimed, the courts may not solely extrapolate from the duty recognized in *Hercules*. Rather, they must undertake a full duty of care analysis within the *Anns*/*Cooper* framework to conclude whether the plaintiff had a right to depend on the auditor's representation or services for that purpose. Moreover, even where a duty of care is recognized for a particular purpose, the plaintiff must still prove as a fact that it depended on the auditor's representation or services for their intended purpose. The majority's determination that the corporate identification doctrine should not be applied to the facts of this case places a high bar for its application in prospective cases of auditor negligence. While third-party claims may offer an alternative avenue of relief, their utility relies on the available resources of the fraudsters. Lastly, disclaimers of liability will no doubt receive renewed attention given the Court's description of auditing a large corporation as a "high-risk undertakin[g]" that can attract significant liability. In Australia, the *Evatt* case did not involve auditor liability to third parties but established the first legal test applied to decide when a professional owes a duty of care to a third party for negligent misinformation. Barwick CJ said that he had derived "assistance" from their Lordships in *Hedley Byrne*. In addition to the foreseeability of harm, his Honour referred to the need for a "special relationship" between the parties. In *Esanda*, many aspects of the *Esanda* ruling were consistent with the *Caparo* decision except that the *Esanda* court directed more attention to various policy factors that weigh on the scope of an accountant's duty to nonclients for negligence.

The discussion then extended to the regulations and statutory requirements related to civil liability of auditors in other common law countries. In Australia, the Professional Standards Act is in place in all States and Territories. It appears that the national system of statutory

capping introduced by the Australian parliament may be effective in limiting the liability of members of professional accounting bodies, concerning economic loss for damages arising from occupational and civil liabilities. The Australian Federal Parliament has amended the law of contribution to introduce proportionate liability to claims for economic loss under contract, tort, and statute. In Canada, there are five major sources of auditor's legal liability come from common law, securities legislation, in the production of offering memoranda or prospectuses or for secondary market disclosures, criminal liability of an auditor, which may result from federal or provincial laws through involvement with the financial statements, fiduciary duty, and auditor third party liability under tort law.

After exploring the principles of tort, statutes, and case law in Saudi and selected common-law countries in the area of auditor civil liability towards third parties and in particular, shareholders, the thesis moves to discuss the nature of Islamic insurance "Takaful" in comparison with conventional insurance in Chapter Five. This Chapter has assessed to what extent how it may play a better role in indemnifying damaged persons or the company, and if there is still a need to learn from conventional insurance practices and principles. In its first parts, the author surveyed its various meanings, manifestations, and historical development. It has been noticed the differing opinions of those who accept the practice of conventional insurance with those who either completely or partially reject it to distinguish it from Takaful practice through applying the four prohibited elements in Shariah in life and non-life insurance. Not only Takaful has been distinguished from conventional insurance but also differs from Protection and Indemnity Clubs in investment methods and the use of reinsurers facilities.

Several models Takaful Companies use in their legal structures. The Mudarabah Model represents a partnership, while the Wakala Model is considered a management contract. The hybrid model of the Wakala Mudarabah Model combines both principles of the two models. Another type called the Wakala Waqf Model is an extension of Wakala on the premise of the Waqf fund. The discussion shows the continuing effort and searches to find an optimal model that meets the Takaful industry expectation. The thesis has discussed the conceptual difference between the Saudi Cooperative model to Takaful insurance. The Re-Takaful is another matter that is limited in use due to impediments that it faces, so there is still a necessity to cooperate with conventional reinsurance. The legal issues and challenges that Takaful and Re-Takaful Businesses face were examined with a particular focus on Malaysia and Saudi besides other countries. The paid contributions to the policy-holders fund are based on donations is an issue

that not yet solved and if Takaful is considered as a donation contract. Indemnification made from a fund to which donations are made annually is also an issue. Questions are also raised regarding models of Takaful and conflict that comes from donation if it is not intended to be a profit-making and sharing relationship. Therefore, the tabarru fund cannot be mudarabah capital at the same time. It has been suggested that the Islamic insurance industry should be renovated by formulating business models that are intellectually and economically convincing.

The conflict of laws regulating Takaful in many parts of the world may be forced to follow regulations and implement practices that are not Shariah-compliant. The issue is that there is no principal Shariah board or body, which would ensure the uniformity of practices amongst the companies. The lack of uniformity of laws regulating Takaful is also a deterrent to ensuring that the same service is obtained worldwide. This issue is related to the absence of standardization of Takaful practices as the Takaful industry is relying heavily on the opinion of Shariah boards of operators, subject to any local regulatory constraints. It has been suggested to have an Islamic Insurance Act in Saudi Arabia as in Malaysia, and one, which takes the multiplicity of Islamic references into account. This idea has been as insufficient except substantial law that organizes Takaful and Re-Takaful operations are formed after considering relevant laws that cover specific areas as this thesis argues in general. Finally, this thesis has indicated clearly about the willingness of not solving existing issues that Takaful and Re-takaful face but to stress in general that the Takaful industry is connected to other laws that work in parallel as argued, and also to show that Takaful is different from conventional insurance in its essences and products to attract prospective policy-holders.

The final section in Chapter Five has focused on the development of Takaful since its appearance and opportunities arose. It indicated that several governmental and non-governmental initiatives were initiated. In Saudi, compulsory insurance in different sectors was introduced. This step may decrease legal cases that may arise before courts. It might be connected to the discussion of this thesis to assess how regulations interact with the insurance business as in the remit of this thesis Companies, Capital Market, and Accountant acts for auditor civil liability towards shareholders. The Saudi government has also adopted recently the Financial Sector Development Program to achieve the objectives for Vision 2030. For example, amending some articles on implementing regulations of the Law on Supervision of Cooperative Insurance Companies 2003 to improve the insurance industry to be compatible

with best practices worldwide as well as the Takaful business nature, and in addition to comply with the right application of Tawuni "or Takaful" insurance. Even though, there is clarity in imposing civil liability to an auditor in case there is negligence from a party and then being able to indemnify the damaged persons/company, the application of the rules needs to be interpreted from a practical point of views so that insurance can play a vital role. The introduction of debating points of comparable insurance law from, say the English legal system before the Insurance dispute resolution committees in Saudi will always be subject to the arguments, principles, and decisions relied upon being consistent with Shariah principles and the requirements for cooperative insurance in Saudi Arabia.

Chapter Six tackles some concerns surrounding the auditing industry from conventional insurance standpoints. In section two the position of common law courts and their assumptions about auditors' capacity to be indemnified by professional liability insurance is discussed. Courts have developed theories of liability or to be one of the important criteria in assessing the extent of liability. It started by indicating the importance of being insured from a court perspective so that compensation can be given to specific groups of identified users. The court in *Rosenblum* assumed that accountants could insure themselves against awards to reasonably foreseeable third parties due to negligence. Many courts view auditors to be in the best position to spread the costs of imposed liability by purchasing insurance. As the insurance industry is not in sync with courts, auditors have encountered increased difficulty in obtaining liability insurance. The High Court in *Esanda* outlined numerous policy factors to be weighed in judging whether an auditor owes a duty to a third party. One of them is the effect on the accountant's ability to obtain liability insurance.

This Chapter continued by illustrating in section three the issue of the unavailability of professional liability insurance for auditors because of the excessiveness of out of court settlements and lawsuits from third parties. In case of the availability of insurance, the increases in costs and expanded liability problems have caused auditors to considerably raise service costs. These two reasons demonstrate the necessity for limiting third-party liability to accountants.

Besides other reasons, the two Supreme Court decisions, *Tellabs* and *Janus* appear to have made a difference, according to the researchers, as they have effectively narrowed liability standards, requiring plaintiffs such as institutional investors to prove that auditors knew, or should have known, their clients' financial statements contained errors. These decisions

affected Rule 10b-5 litigation in different ways. Tellabs related to pleading standards, while Janus related to liability rules.

The decline in settlement value is likely driven by two factors. First, more cases are dismissed so settlement values mechanically decline. Second, the reduced settlements likely reflect the change in bargaining power. When plaintiffs are uncertain whether the case can proceed under the new requirements, it makes sense for them to be more likely to settle for a lower percentage of potential damages than to risk that the court will dismiss their claim. Moorthy et al. argued that the settlement process is driven by the uncertainty in the legal system. The uncertainty in class action cases has been driven both by uncertainty about pleading standards and uncertainty about the size of damage awards. Attorneys involved in out of court settlements believe that negotiating settlement amounts and terms are tailored to the defendant audit firm's ability to pay, which often depends on the nature and extent of the firm's insurance coverage.

It is believed that cases against auditors will likely continue as auditor litigation tends to follow market bubbles and fluctuation. This litigation risk has effectively made large auditors uninsurable. Auditors, as a result, now self-insured via "captives," or insurance firms owned by the global audit networks and funded with premiums paid by member firms. Numerous reports in connection to the ideal legal system of auditor and its associations with the availability of liability insurance were investigated in section four. The four key reasons of the professional indemnity insurance crisis came from a general lack of profit in the insurance market leading to a sharp fall in capacity for difficult risks; a cyclical hardening of the PLI market; increasing frequency of claims; and court decisions suggesting wider liabilities than previously estimated, yet leaving the legal position uncertain.

London Economics asserted that professional indemnity insurance and limited liability partnership were not operative in limiting liability as the former could lead to the deep pockets syndrome while the latter did not protect the assets of the firm. Among other changes obtained are replacing the joint and several liability concepts with proportionate liability. It engaged a statutory cap on auditor liability by contracting with the client. In Europe, the Final Report 2006 supports auditor liability limitations as an efficient device of risk protection in favor of the Big Four. It compares strict liability to negligence, joint and several liability to proportional liability, and discusses the extent of auditor liability, and liability insurance. The European Union officially has recommended adopting measures to limit auditor liability consistent with each state's legal system. Nevertheless, it proposed that auditor liability in the Member States

to change their current position by one of three methods: a cap on liability, proportionate liability, or limitation by contract.

The discussion has extended in section five to pinpoint the general insurance-based arguments and if the professional liability market heavily depends on the cyclicality through periods designated as either hard or soft markets in regard to auditor liability insurance. Cunningham contends that proposals to cap liability that are reinforced by arguments about a lack of insurance may be unable to respond to the dynamics of those markets. It could be appropriate to cultivate mechanisms that reduce insurance market volatility, if not strategies that would expand and sustain availability for all time. A consideration has then moved on to examine the association of conventional insurance with audit failure. There is also the inadequacy of professional indemnity insurance products. Enright and Jess explain that professional indemnity insurance is third-party insurance, differing from first-party insurance.

Another area of concern is related to auditing the financial statement and its relationship with insurance monitoring. For that reason, the most cost-effective way to bundle monitoring and risk distribution may involve a combination of accounting and insurance functions. One possible approach is the Financial Statements Insurance. An accounting firm could agree by contract to offer an assurance that a specific financial statement does not comprise material misrepresentations. The guarantee could be prepared so that it stipulates protection that is comparable to existing D&O insurance.

Further insights to explain the influence of joint and several liability systems in comparison to proportional liability systems and their connection with the availability of Auditor insurance were explored in section six. There are various rules to litigate the auditor and are considered from the aspect of insurance amount which the auditor needs to make available in favor of the plaintiff. It is assumed that every alternative system has a different effect on both the auditing quality and the investor’s decisions in terms of determining the volume of his investment. Advocates of modified strict liability believe the regime will create robust insurance and reinsurance markets. A modified strict liability regime would further reduce litigation, and possibly audit costs. Auditors would no longer have diligence-based defenses. The proportionate liability is crucial to control increasing insurance premiums, avoid insurance calamity, and thus ensure that defendant businesses and governments are able to continue to provide services to the community.

Methods for setting the appropriate level of a cap were suggested such as: connected to each successful claim against the auditor, or connected to all successful claims against the auditor in a calendar year, or connected to all successful claims against the auditor that originate with the same action or omission. However, calculating the risk-shifting element of professional liability insurance is problematic for auditors and their insurers to calculate.

Section seven deliberates on the audit failure and the professional liability product position from a conventional perspective. It is sought that the accounting profession can comprise the cost of their malpractice insurance in their billing rates so that allocating the cost of the risk of liability is crucial to avert misleading financial statements. In addition, as liability insurance rates are constructed on the pooling of risks, there would be a biased allocation of insurance costs with strict liability for accountants. Auditors purchase malpractice liability insurance to reinforce their exposure to such legal claims by using typical policies for definite time periods that are not tailored to specific engagements and accompanying risks of audit failure. This technique breaks the risk monitoring role from the risk distribution function so that auditors are in control of their insured activities with little or no oversight by insurers. A scholar believes that Error and Omission insurance as well as self-insurance programs are the existing models used to tackle liability for audit failure.

Chapter Six in its final section elaborates on reviewing the Financial Statement Insurance suggested by reputable western scholars that should deserve more consideration as a viable solution.

The FSI was presented to observe how this new product can be advantageous to the auditing industry as well as in compensating damaged persons. It might make a significant change in the principal-agent relationship. Distinctions with predominant insurance policies would enable the FSI to be efficient as policies must be occurrence-based and must be the primary insurance. The FSI would not change the liability position of any other remaining actors in the financial reporting process as financial statements are prepared in the first instance by management.

Premiums as a substantial element can be affected by stacking, circumstances where particular claims are shielded by overlapping insurance policies. Queries arise regarding which are primary and which cover only losses in excess of certain amounts or other coverage. Audit firms could keep on operating Self Insurance Programs but also commence on an FSI regime

by holding out their SIPs among those FSI insurers competing for issuer audit insurance work. FSI can offer a mechanism to create the functional equivalent of a damages cap for audit failure. This ground-breaking product associates the interest of the auditors with the interest of the insurance carrier, so it is likely to align the interest of the auditors, by extension, with the interests of shareholders. Moreover, the losses insured against, which comes from the declines in the valuation of companies resulting from omissions or misrepresentations in the financial statements, can be hedged in the capital markets with properly constructed derivatives.

Chapter Seven is considered the most important chapter that combine previous discussions surveyed in earlier chapters. Moreover, it provides further analysis and information in an attempt to answer the hypotheses stated in Chapter One. This chapter consists of two main themes designed to maintain a logical flow of information. It would be hard to discuss this chapter without understanding the two previous chapters, as this chapter is built on the conclusions of the five previous chapters put together. Here, the discussion is limited to elucidate further on some major points.

This research has faced chief multifaceted obstacles and overcomes to the extent that the work could send particular messages that serve hypotheses that arose in the first chapter. It is admitted that several debates from common and Islamic laws are not extensively studied as they can serve the main objectives of the thesis. Issues come from the interpretation, application, and distinction of common law cases that arrive at different conclusions. The law should not be too rigid in developing new rules that reflect societal changes, but there should be a preference for certainty. This is really to crucial to emphasize here and to show that it is impossible to direct the thesis to another direction. For instance, there is a rich literature about the history of the limited liability in the United Kingdom, and how *Salmon* case then has affirmed this concept.[1861] Another example is about examining the duty of care of multinational corporations for human rights violations relying on English tort case law.[1862] The latter work has tried to apply tests developed in British courts but it was not suitable to be explored in this thesis as they can not be compared with Islamic and Saudi laws. Therefore, this thesis not only brings academic debated for future research but also practical applications on how Saudi laws should be applied differently. Also, it is asserted that common-law countries should learn from

[1861] Dabor, Igho Lordson, 'Limited Liability: A Pathway for Corporate Recklessness?', (PhD Thesis, University of Wolverhampton 2016).
[1862] Nartey, E. 2018. 'Accountability Criteria and Remedies under Tort Law for Victims of Human Rights Abuses'. (PhD Thesis, University of East London).

other countries in order to enact proper laws in the area of research, in addition, to understand precedents differently.

Another obstacle is involving several scientific fields in this research. For example, the researcher is not a specialist in Islamic Law or the field of accounting. Nevertheless, the thesis intends to make a tentative analysis and give an indication about Shariah perspectives as it relates to auditor liability. Moreover, it is considered the first study to examine the Saudi liability system in comparison with common-law systems so that different case laws and principles are involved. Even though Saudi applies Islamic law, there are some conventional practices in Insurance and securities markets either stipulated in concerned statutes or driven by market players in insurance and auditing industries to mitigate the floodgate of claims. Hence, contrary views are not supported except in few legislations and Islamic principles in Saudi. The use of judicial precedents varies in compared countries in the degree of binding. Similar to civil-law countries, Saudi judges tend to enforce legal codes. Hence, taking benefits from case law must be subjected to Shariah rulings and interpreted relying on existing regulations.

The third subsection in section one has briefly stated particular objectives for this Chapter. It has considered the appropriateness of common law auditors' civil liability towards shareholders in Saudi Arabia. The discussion has expanded to conventional insurance practices and products and how they could be reformed and then applied in the Takaful industry. The third goal undertakes the issue of ambiguity within the liability system and insurance in common law countries, and then the discussion coins to harmonise the liability system of auditors with insurance from an Islamic perspective.

In the next subsection, the thesis advances these discussions and could not disregard key presumptions without giving them particular attention as complicated and advanced debates might not be understood. Risk sharing in the realm of the Islamic business environment is vital to point out either from corporate or insurance principles and services. Different types of shareholders and creditors in a public company, whom they are considered as third parties in the conventional business world are examined critically to distill which category would qualify to be considered as owners who benefits from statutory rights and obligations. Major influence on the notion of the separate legal entity that ought to not be detached from ordinary shareholders' positions in a listed company. Preferred shareholders are excluded from being indemnified unless they convert their ownership status as they have special incentives and do

not share equivalent risks and voting rights. Similar comprehension employs to creditors who may exchange their debts to equity and subsequently they could be deemed as ordinary shareholders.

In the first part of this subsection, the researcher shed light on the above issues in compared countries under study. In conventional Companies law, ordinary shareholders can take action through class action or personal actions only when the loss they seek to remedy is personal. When the loss is corporate, the company itself or through a shareholder may initiate an action on behalf of the corporate plaintiff by means of a derivative action. This subsection begins with examining the general concepts of legal personality and limited liability of a corporation and if it differs from a partnership in classical Islamic law and then Saudi legislations. The same principles are then reviewed from the common law perspective through English law and its principles as a model to the wider understanding of such applicable perceptions.

In classical Islamic law, these notions were comprehended differently from English law because the concept of a corporation had not yet emerged in those days and so jurists had no reason to describe its legal components. At the present time, the concept of a corporation has emerged. In regard to the Joint Stock Company, it has pronounced that every shareholder in the company possesses a mutual share of its assets and is calculated based on his equity ownership. It has elucidated that the subject matter of the share's sale contract is the common portion of the company's assets. In the Saudi law perspective, the Saudi law and Islamic Sharia law are not synonymous, and areas of conflict occur where they do not match. However, article 2 of the Companies Law 2015 has reaffirmed the Shariah understanding of the company. As a way of comparison to show the different understandings of a Company, in England, it is common to distinguish between Company and Partnership, while in Saudi there is no difference. In addition, the English Companies House has defined the company as "a legal entity with a separate identity from those who own or run it" and has been agreed in the Salomon case. The *Foss* rule even earlier than *Salomon* case has confirmed the separation of the company from its shareholders and decided the proper plaintiff by confirming that only the corporation can sue for wrongs done to it, not the shareholders.

The literature has indicated numerous rationales in justifying the reflective loss principle. In particular, a reduction in the value of shares does not constitute damage for the law's purposes as shares are merely a right to participate in a company and that right is unaffected when a company suffers a loss. One commentator believes that this rationale is undoubtedly highly

questionable because it comprises an excessively technical view of the concept of shares. Furthermore, this rationale cannot demonstrate why and when a defendant involves in a manner that incorrectly reduces the value of the claimant's shares, the damages are measured by reference to the degree to which the value of the shareholding has been diminished, therefore, this rationale can be dismissed.

The English case law has provided an exemption to the corporate separate personality through piercing the corporate veil. This principle gives the rights and liabilities of the company to be attributed to other natural or legal persons through a contract or statutory provisions. Nonetheless, in *Prest* and *Antonio Gramsci Shipping Corporation*, the courts have brought this concept into questions for the struggle of finding any principal principle for the rule and by holding that it does not firmly occur widely in practice.

The thesis has then reviewed the English CA 2006, and the reforms of the derivative claim. However, ratification of the directors' breach of duty by shareholders reveals an imperative role in defining whether permission should be granted by the court to hear a derivative claim. Recent studies conducted by Saudi scholars emphasized the need to reform the Saudi CL 2015 to include this type of claim. Therefore, the researcher concluded this point by pointing out the need for further examination and whether to be transplanted in Saudi.

A consideration of the raised subjects from Shariah and Saudi laws was presented in the following subsection. The preceding subsection has revealed the Shariah position in regard to the early understanding of companies and partnerships that confirm the indifference positions of partners in both types as well as contemporary Islamic jurists and Islamic institutions elaborated on the modern types of corporations. The Saudi CL 2015 has outlined the meaning of company and this definition agrees with Shariah principles in regard to a shareholder as a partner in a company. Consequently, the legal personality of a Joint Stock Company cannot be disconnected from the shareholder's position. In England, the *Salomon* case has confirmed this concept as well as other cases examined. The researcher does not accept the idea of sperate legal identity, especially that shareholders agree by law that their personal assets are not available to meet the company's debt. Concerning the derivative action from a common law perspective, the literature has constantly contended that the court in the Foss case has constructed its judgment on two primary principles of law, and one of them is the company's separate legal personality. Likewise, the "reflective loss" principle forbids a person other than the company to get any direct remedy for the harm to the company, even if that person has a

separate personal cause of action against the wrongdoer that is different from that of the company. It is remarkable to claim that suggestions to transplant the derivative action in the Saudi CL 2015 did not elaborate on why the Saudi regulator still retains the shareholders' personal action in this law. Additionally, various issues are not resolved by the derivative action and precisely how much the company would gain if succeeded.

After exploring these general principles, the thesis in the next section moves to examine if common law principles are appropriate to be useful in the Saudi perspective and if not, how should they be according to the researcher's opinion. In its first subsection, it has been justified why common-law countries' case law and regulations were selected. Scarce studies have compared the civil liability of auditors towards third parties in major common law countries with civil law countries. Commentators either underlined the main common-law theories to consider if a civil law country should adopt a fixed theory of liability, or criticized the common law countries' directions in this area by stressing the different civil law treatment of liability constructed on a legal code in their own country. As Saudi Arabia plans to form collective precedents in the commercial arena, it is in paramount importance to examine in detail how to benefit from other countries' case law and statutes. Other structural difficulties come as well from various understanding amongst Saudi judges and members of quasi-judicial committees of deducing related Shariah principles and legal codes and with the use of comparative jurisprudence endorsed lately. There is also an expected lengthy process for a shareholder to ensue his case to get indemnified as judgments must be made from different competent authorities. For instance, on 09 April 2020, Saudi has announced the enactment of the Commercial Courts Law. In chapter 2 of this law, it lists the type of disputes that fall into the competency of the Commercial Courts. Article 16 states that Commercial Courts are competent to hear claims and violations arising under the Companies Law 2015 as well as claims and violations arising under other commercial laws. It needs to supplement other arguments stated earlier with this new addition, as Companies and Auditing laws are considered commercial legislations concerning issues discussed in this thesis arise. However, it is not a crystal clear yet to assert that a plaintiff should proceed with his case before the Committee for the Resolutions of Securities Disputes as the damage occurs to his share as securities cases are under its jurisdiction. However, it has been argued earlier that it is suggested to proceed before one competent court after the removal of quasi-judicial committees established earlier for necessity purposes. Finally, it is not clear yet whether commercial court precedents and quasi-judicial committees' decisions will be used as a reference for judges and members of concerned

committees to rely on for future cases firmly or just for guidance. Given these expected difficulties a discussion of common law cases before a Saudi court/quasi-judicial committee has to underline the Islamic point of view to assess if those principles could be applied in Saudi Arabia.

This thesis has elaborated further for those who are less familiar with the common law system in a study largely centered on the development of legal principles and commercial practices in Saudi Arabia. There are mixed jurisdictions applying common law beside Shariah and the way comparative common law principles in Islamic jurisdictions is considered either binding as in the Malaysian civil courts or instructive as in the Saudi Arabian courts and quasi-judicial committees. It has been exemplified through the use of Urf to get benefit from common law cases. Moreover, the study of legal principles in and across mixed jurisdictions can offer deeper insights into the problems at stake, and the issue of pure economic loss was explored. A number of policy reasons were surveyed as to why common-law courts were hesitant to allow recovery of pure economic loss for negligence. This discussion was crucial to evaluate how common law principles are prevailing in the area of economic loss. Hence, it would be rational to be compared with Islamic jurisdiction.

This work has elaborated in detail on the subject to whom should be considered as a damaged person from an auditor's misconduct. It has selected the ordinary shareholders among other third parties as they belong to different categories and conflicting interests. Furthermore, allowing third parties to litigate the auditor ultimately exposes the auditor to arbitrary requirements, resulting in the paramount injury to the auditing profession. The duties of the external auditor to shareholders were then explored in the Saudi legal codes, and the concept of accountability is rooted in Shariah and legal codes.

The next section has reflected on particular arguments and materials in relation to auditor civil liability towards third parties in common law countries from Shariah and legal standpoints, as there are different approaches common law courts took in holding concerned judgments. In the first subsection, the U.S case law was approached to assess its principles' suitability in Saudi. There is no need to refer to specific precedents, and only will comment on the Tentative Draft No.1 of the Restatement of the Law Third, Torts: Liability for Economic Harm published by the American Law Institute. While the proposed Restatement has not taken effect, it perhaps offers pivotal rules and policy debates for those involved in negligent economic harm. In particular importance, Section 4 has given attention to professional malpractice. Under this

standard, a professional is liable for a plaintiff's pecuniary loss suffered through his negligent performance of an undertaking to assist a client whether there is privity in the contract between parties or not. In the latter case, and contrary to the Restatement (Second) of Torts, the proposed draft holds professionals liable in tort both for negligent misrepresentation and negligent performance of service. However, the proposed Restatement (Third) of Torts identical to the rule in Restatement (Second) of Torts, bounds the defendant's liability to third parties to whom the defendant intended to supply information or provide service either for the plaintiff's benefits or with the intent to influence the plaintiff's action. Arguments presented by the researcher stressed out the same position or conclusion that in favor of auditors the U.S courts may take in future cases that restrict shareholders unless identified. Hence, there is no progress provided in the area of research.

The following subsection has critically examined the English Case law and the Suitability of its Principles in Saudi. Particular attention was given to examine the incremental approach endorsed in *Robinson* and in *Steel*, as they constitute the newest developments in the area of tort law and will bring further authority on forthcoming cases. It has been debated that not only the *Caparo*'s tripartite test is incorrect but also the incremental approach that was taken recently carries further impediments. After presenting the fact of the two cases in Chapter Four, the researcher has then commented on related issues further clarified recently in *Jetivia* and *Singularis* and if they could be linked to the topic under review. In a similar fashion to the previous two subsections, the author has commented on other common law countries' cases and the suitability of their principles in the Saudi jurisdiction.

The thesis has then proceeded to briefly identify the five major sources of auditor's legal liability found in common law countries and their appropriateness in Saudi Arabia. It reaffirmed the lack of codification in the area of auditor civil liability in the secondary market in compared jurisdictions in contrary to existing Saudi laws, which clearly stipulated the liability of auditors toward the company and others including shareholders, and that is what the thesis is trying to show.

The last section was assigned to elaborate on the values Takaful companies may gain from conventional insurance principles and practices in professional negligence with an attempt to combine the discussion in Chapters Five and Six to synchronize liability rules with insurance principles and practices. It has been asserted again the importance of enacting legal codes or at least holding concrete precedents in the area of civil liability of auditor to enable the insurance

market to work in a transparent way starting from pricing relevant product and ended up with indemnifying damaged parties. Therefore, the principle focus of this section was to present applicable and measurable solutions to the risks involved.

In order to connect the discussion of auditor civil liability with auditor liability insurance, Chapter Seven has elaborated extensively on the potential impact of the proposed Accounting and Auditing Act that must work in parallel with the Companies Law 2015. This discussion was essential for pricing the concerned product centered on the number of audited companies to remove uncertainty. This idea is in contrast to the existing related product for determining the appropriate premium that should be deducted from an auditor. It has been argued that the litigation risk factors for accounting professional liability insurance do not adequately connect with proper civil liability rules. Concomitant to the stated reform, D&Os product would then be able to assist in indemnifying damaged shareholders if there are joint defaults from the companies' directors and officers and the auditor in preparing a defaulted financial statement. Consequently, in this situation the allocation of risks is distributed between the insurer and the insured person, and this conclusion would suit Takaful products to be in conformity with Islamic principles. Those insured will make their best to follow prevailing legal codes and standards to make a profit if any, as the chief intention is a cooperation between involved parties. In addition to the above products, the FSI was examined to assess if it could provide a viable and just solution to the issue under review. Therefore, the findings provide useful ways to deal with the issue of default in a financial statement and if insurance products are able to indemnify damaged investors and protect those who are insured in the same time.

This thesis has attempted to meet the challenges of producing an academic work of modest standards despite many challenges along the way. For instance, the thesis is not presented as having considered and answered exhaustively all questions and aspects on the liability of auditors, as a great discussion was linked to the criminal liability of auditors. Moreover, there was rich literature on the director's and officer's liability and relevant maladministration insurance. In addition to these specific problems, personal limitations in relation to the time frame and resources available to complete the doctoral stage e.g., the language barrier, and of the meta-challenges e.g., the confidential nature of insurance manuals dealing with related professional liability products may have affected the richness of the final conclusion. Despite of these challenges, it is believed that their effect would be in regards to the depth and not the content of the conclusions.

8.2 The Problem and Aims of the Thesis

The principal question that the thesis had set out to provide an answer to is; can Common Law principles regarding auditor civil liability towards shareholders assist in the development of the regulation of auditor civil liability towards shareholders in Saudi Arabia? The sub-questions have focused on relevant subjects that come from the main question. The aim of the thesis was to appraise and analyse the problems confronting judges when they are called to deliver a judgment in relation to auditor civil liability. In addition, to see if shareholders are able to get compensated via auditor or his insurer, if any in full or in partial, if there are other convicted defendants. This study was carried out qualitatively relying on primary and secondary sources. It was conducted using comparative analysis of different legal codes and precedents across Saudi Arabia for the first time and other common law countries. The discussion was further extended by descriptive and doctrinal methodologies as the end aim was to benefit Saudi Arabia with rich material found in common law literature and to take a different path that intends to achieve the general Shariah maxims through applying relevant Shariah principles and legal provisions. This research has revealed that there were significant discrepancies between the perceptions of common-law countries and Saudi with regards to auditor civil liability towards shareholders.

8.3 The Implications of the Analysis on the Problem

After discussing the aim of this thesis, subsequent questions were generated to problematize the objectives of the research. The main question comprises of two themes as discussed in the previous section. In order to answer such questions, some basic points need to be clarified and then linked together to give a logical sequence to understanding and then answering these questions.

After examining relevant precedents and legal codes in some common law countries, the thesis comes to the conclusion that examined precedents did not succeed in identifying the injured persons or at least how a damage may occur to a listed company. Judges of common law countries tried to change their analysis in relation to third parties' lawsuits against auditors

through shifting from contract law to tort law. There is no convincing nor unified principle of duty of care yet in place that balance the relationship between the auditor and damaged investors in relation to annual financial statements. It has been seen that claim in terms of flexibility of common law in comparison with civil law and Islamic law do not give an edge to be better. Indeed, common law judges are still lost because they are trying their best to protect the auditing industry from being convicted technically (putting impossible conditions that are unlikely to be met) without succeeding in identifying the damages occurring to specific properties belonging to specific stakeholders. Hence, from an Islamic perspective, the three components of liability in tort (wrong, damage and causation link) must be clear in order for a judge to issue a justified and fair verdict. This conclusion leads us to confirm that common law principles of auditor civil liability is not suitably applicable in Saudi.

As for the second part of the main question, we have seen some common law precedents that stated the ability of an auditor to be insured, therefore, it makes an auditor liable to identified third parties in a misstated annual financial statement. Moreover, the discussion linked to professional liability in conventional insurance is still traditional and entail the criteria of being insured as well as paying defence cost and out of court settlement if any. Furthermore, legal framework in most of examined common law countries do not allow the financial statement insurance to be an efficient tool that might be used to compensate damaged investors. On the other hand, despite the fact that Canada has legitimised this type of insurance and changed its liability system to be proportionate, it still faces great hinderance to indemnify damaged shareholders. This is noted as no legal codes are yet in place nor precedents so far, and the recent *Livent* case considered previously shifted the discussion to another direction.

Takaful (Cooperative Insurance) is still in its infancy stage in this area while there are much more developments in other areas. Hence, the application of Takaful professional liability products matches the conventional practice. The thesis also shows that the legal structure of Takaful company differs in many aspects from the conventional counterparts. This would lead us to put more emphasis on intended benefits of being insured so there is cooperation among policyholders to bear the loss that occurred to one of them, while the case in the conventional one may deprive damaged persons from being indemnified. Therefore, this research takes the position of the unsuitability of conventional insurance principles in Saudi Arabia. What would be helpful to say here is that Islamic insurance is built on Profit-Loss Sharing so that it has to differentiate itself in its essence and not only in the procedure as a rubber stamp.

Since auditor civil liability differs from one country to another, while Saudi Arabia does not yet have developed principles of auditor civil liability towards shareholders, in what way can Saudi Arabia benefit from other countries' experiences and practices to enhance its legal system? With regards to this first sub-question which is about the benefit that Saudi Arabia may acquire from common law countries' experiences and practices associated with auditor civil liability towards third parties to enhance its legal system, this question has been examined extensively. Despite the fact that there are drastic differences between examined countries and Saudi Arabia, it is hard to ignore the fact that common law courts have examined several liability cases in connection with auditor liability. In addition, the big four auditing firms have thousands of auditing services in those countries. The nature of litigation is quite advanced due to available legal tools used by law firms defending plaintiffs to maximise their economic benefits, in addition, big auditing firms have many internal legal counsellors and affiliated law firms who help them in defending their position for not being liable. Therefore, arguments by both parties of a lawsuit enrich the discussion in a specific case regardless of the final outcome that a court reaches in its judgment. Saudi Arabia would face similar arguments made by both parties, thus, the Saudi competent court/quasi-judicial committee must reach a different conclusion in its verdict based on Islamic principles and existing legal codes. Needless to say, that without the assistance of these common law precedents, it is quite hard for a Saudi judge to take a different position and a case may also take a long time to decide on justice and fair principles.

What is the extent and state of the law in this area in Islamic and non-Islamic jurisdictions? As this second sub-question is concerned with the extent of existing regulations in Islamic and non-Islamic jurisdictions in terms of minimising audit risk failure, this question has not been addressed systematically, however, it has been answered in separate chapters implicitly. To illustrate, examined law countries did not cover the liability of auditor's civil liability in the audited financial statements released in the secondary market in sharp contrast with the primary market (prospectus issuance) in their legal codes. It might be true that concerned regulators do not have the will to do that and leave the matter to courts to decide. Moreover, other regulations in connection to auditor's work in general are comprehensively covered in order to enhance the disclosure of a listed company, irrespective of the true and fair concepts that should be found in a financial statement. Hence, corporate governance rules play a crucial role in

protecting the corporate itself through taking several mandatory and voluntary procedures. The same understanding could be extended to corporate and securities laws. However, as the fact that liability of auditor towards a company or its shareholders is left to the court and given the lackadaisical attitude towards shareholders, we thus could conclude that no further improvement would be made unless legal rules in place state to what extent an auditor is liable and how damage should be calculated. It could be submitted the it is false to say that courts develop the common law incrementally and with circumspection.

In mixed jurisdictions, the thesis does not provide a full analysis due to the limited wordcount allocated to the thesis. However, it could be argued that Islamic countries with mixed legal systems such as common law, may reach a similar conclusion that common law countries achieved, because no legal codes state the liability of auditors towards a specific category of investors. Furthermore, concerned cases would be heard before civil law court's judges, and therefore it is most likely to reach similar conclusions. The mixed jurisdictions of Islamic law and civil law may reach similar or different conclusions depending on supremacy of Islamic law in such country. For Saudi Arabia as a fully-fledged Islamic country, our analysis shows that Saudi Arabia has a unique position because of their application of Shariah principles in addition to existing legal codes specifically in this area are compliant with the Shariah. Hence, audit failure might be minimised to the least extent if potential precedents partially or fully support our analysis using better justification than what has been assessed in common law countries.

Should third parties, particularly shareholders who suffer economic loss, be indemnified if an auditor is found civilly liable for errors in the audited financial statements in Saudi Arabia? This third sub-question is related to the eligibility of shareholders to be indemnified in case an auditor was found civilly liable in Saudi. This question does not need to be answered here in much detail as the whole thesis has given full support to the right of shareholders to get economically indemnified through their company's claim or via personal and class actions.

Do existing conventional professional liability insurance products play effective role in indemnifying third parties against auditor error in primary and secondary markets? The focus on the important role of conventional professional liability insurance in indemnifying third parties in the primary and secondary markets was considered in the fourth sub-question. The

discussion does not cover in detail the liability of auditors in the primary market. In general, professional liability products including D&Os and Auditor liability cover negligence that occurred in audited financial statements as stated in concerned regulations. Moreover, there is a specific product which is the prospectus insurance that generally covers errors and omissions found in any part of the prospectus unless intentionally stated. It could be also argued that financial statement insurance could be used in this regard. As known, there is no issue if there are limited class of investors that rely on information found in prospectuses. However, it is the opposite in the secondary market which the thesis has examined and concluded that legal codes need to be in place to encourage the insurance industry to do a better job than the existing position it takes through following market movements and irrelevant factors in finding measures of pricing the insurance products.

In what ways can Islamic professional liability insurance products provide an effective alternative to current conventional practices in the sphere of auditor civil liability for error in the audit of financial statements? This last sub-question focused on the existing and expected role of Takaful professional liability products in indemnifying third parties. If we presumed that there would be several cases in Saudi Arabia in future, then the insurance industry is likely to face prospective issues similar to the conventional ones. This may make a number of Takaful operators either remove available professional products from their lines or make them hesitant to insure those professionals especially in the corporate world. This understanding comes from the short experience of those operators, even if we accept that the Re-Takaful industry is still immature, so major reliance would be on conventional reinsurers. Those expected risks can be mitigated as argued in this thesis, especially existing and potential legal codes are in compliance with Shariah principles that support the indemnification of damaged persons. This is done without forgetting the fact that convicting an auditor who adheres to relevant standards is quite difficult to prove but not impossible. This would give investors in general the trust to invest in the secondary market with no fear from being unfairly compensated if negligence occurred in the annual financial statement. This understanding would be also convincing for an auditor to work in a better environment that support him in his unintentional failure in the annual financial statement work. A point that was not discussed in this thesis is in connection with the expected role of Takaful professional liability products if provided side by side with conventional counterparts, then, which one should an auditor purchase. I think it could be clear if Takaful is adequately presented even if there are no supporting precedents similar to the ones found in common law countries, so that an auditor would have the option to choose which

professional liability product is more suitable. While in the case if an option is given to a listed company or its shareholder in choosing the suitable financial statement insurance, then, it is believed that arguments made in this research support the indemnification of damaged persons whether from conventional or Islamic financial statement insurance as the end resort is alike but means and objectives are different. To this end, the thesis has tried to answer the above main question and subsequent-questions.

To conclude in brief some of the main issues and debates arose from the above questions this research attempts to tackle are the following: a- privity and non-privity of third parties to auditors, b- joint and several liability vs. proportionate liability, c- available litigation mechanisms, d- different treatments among insurance products "auditor vs. financial statement insurance", e- whether out of court settlements are fair or not, f- how the four common-law liability theories developed by courts in the U.S or principles in the U.K are inadequate, g- why should we redefine the philosophy of liability to distinguish between criminal and civil liability cases? h- how could we enact legislations that help the insurance industry to rely on when pricing existing and innovative products that meet the expectation and demand of insurers, insured persons, and third parties; i.e. to what extent should regulators respond to court decisions by changing or accepting relevant practices; i. why should shareholders understand their positions differently?; j. examining how common law principles be addressed in Saudi courts "via securities dispute resolution committees, then to insurance dispute resolution committees, and then prospective commercial courts.

8.4 Recommendations for Future Research

Matar has suggested three areas for future research not investigated yet.[1863] It is hoped that the researcher answered them satisfactorily and covered the insurance professional liability

[1863] Future researches suggested by Matar (n220) as follows:

1. Future research in civil legal liability rules should focus on the auditing standards regulating the auditing profession, and their effects on the auditing quality, and should also study whether users consider auditing standards as sufficient, in terms of judging auditor liability.

2. Also, additional research can be carried out in regard to the methods implemented by auditors striving to avoid liabilities towards their clients and third parties. The auditor can resort to some methods to avoid liability without losing clients; such methods can affect auditing quality and financial information, thus having grave effects on the investment level.

3. Future research should also focus on the comparative studies between different countries concerning legal rules and auditing quality, which may help to develop acceptable worldwide liability rules that can be harmonised with international investments across the world.

industry. As stated elsewhere, this research is a starting point for a modern profession to read into Islamic law and assess if existing regulations are in conformity with the main Islamic principles and teachings. Moreover, the civil liability of an auditor in case of negligence may lead to compensating the company and its shareholders. Hence, other researches should focus on the liability of directors and officers who are also involved in preparing quarterly financial statements. Other areas of research from a legal perspective in insurance should further extend the discussion about the role of Islamic insurance in other professions such as directors' and officers' liability product. It is also suggested to expand the research to the financial statement insurance. Other researches linked to accounting and insurance, should examine the theoretical background presented and test them empirically to see if they could be applied in practise, then, regulators would be able to take a further step to apply the law as is or with some modification. Lastly, other researches should also investigate how Takaful products could work in other jurisdictions whether Islamic or non-Islamic especially in professional liability products.

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