17 October 2002

Secretary
Trade Practices Act Review
C/- Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

## Review of the Trade Practices Act

### Overview

The Institute of Chartered Accountants in Australia (ICAA) and CPA Australia wish to bring to the attention of the Trade Practices Act Review Committee a matter of concern regarding the operation of the Trade Practices Act 1974 (the Act) as it affects the provision of professional services.

Our concern centres on the use of Section 52 of the Act and related matters in respect of Section 82. As you may be aware, actions for alleged breach of Section 52 of the Act (the provisions relating to misleading and deceptive conduct) have become increasingly routine against professionals service providers, including members of the accountancy profession, whenever professional negligence is alleged to have occurred.

Leaving aside the question of whether Section 52 is being used in ways that extend beyond the contemplation of the legislature when this Section was initially drafted (a point that arguably does warrant consideration), our submission is that the operation of the Act as it presently stands undermines State-based tort reform initiatives intended to provide professionals with relief from the effects of the present crisis in the professional indemnity insurance market.

Specifically, attempts by State legislatures to replace the law of joint and several liability between defendants by a system of proportionate liability will be thwarted unless Section 82 of the Act is similarly reformed to allow for proportionate liability to operate in respect of actions brought under the Act.

Additionally, the Act undermines the effectiveness of State-based legislation, such as the Professional Standards Acts in NSW and WA, that seeks to limit professional liability in exchange for certain guarantees of professional standards and conduct.

## Background

Section 52 of the Trade Practices Act makes it an offence to engage in conduct that is misleading or deceptive, or likely to mislead or deceive. Under Section 82, a person may recover damages for breach of Section 52 for "the amount of the loss or damage". In Henville v Walker (2001) 206 CLR 459, the High Court held that a person who suffers loss or damage as a result of misleading or deceptive conduct may recover the whole of that loss or damage, notwithstanding that the loss or damage could have been reduced by the exercise of reasonable care by the claimant. In other words, the doctrines of contributory negligence and the apportionment of damages should not be read into the construction of Section 82.

Professionals who are sued under the common law for negligence are now routinely also sued for breach of Section 52 of the Trade Practices Act.

## Consequences for the Accounting and Audit Professions

Many accountancy professionals practise in partnership or individually. Accordingly, they face unlimited liability for their negligent acts or omissions. This means that not only their business assets but also their personal assets are at risk should they be found legally liable for damages through an act of professional negligence. Under the Corporations Act, auditors and insolvency practitioners must be natural persons.

Over the past decade, individual claims against the profession have run into hundreds of millions and even billions of dollars. Most of these large claims have arisen as a result of audit work.

In recent years, the cost of obtaining insurance to cover professional liability has increased dramatically, whilst at the same time such insurance has become harder to obtain. For the large firms, commercial professional indemnity insurance is simply not available at the levels required.

Professional liability claims are escalating in many professions, though in Australia the liability problem for auditors is unique due to the sheer magnitude of the claims they are facing.

When a company fails, inevitably it is the auditor that is sued. The reason for this is simple - it is invariably the auditing firm that possesses the most obvious source of assets against which a plaintiff may recover, namely the professional indemnity insurance of the firm together with the personal assets of the partners.

Yet, virtually without exception the auditor will not have been the cause of the collapse. It will not have been the auditor who has made the decisions or devised the strategy that caused the company’s demise.

Under the law of joint and several liability, each person who is at fault and has contributed to the plaintiff's loss may be liable for the entire amount of the loss suffered. In practice this means that auditors are frequently sued for 100% of the damages suffered as other parties are often “men of straw”.

The result is that auditors' insurance is being asked to cover not only their own acts and omissions, but also those of other uninsured, under-insured or otherwise impecunious parties whose responsibility for the loss suffered is likely to be greater.

The very real threat posed by unlimited liability to the accountancy profession's long term survival has the most serious implications for the independent audit function, the financial reporting system, the capital markets and the well-being of business and the public generally.

However, unless reasonable limitation of liability for auditors is obtained, the ability of the profession to effectively perform its functions will be placed in jeopardy. Apart from the difficulties in attracting and retaining high quality professionals, exposure to unlimited liability is creating a risk-averse profession. This is resulting in a less than optimal level of information being provided in respect of audited entities at greater cost, to the detriment of investors and the business community generally. A key factor inhibiting the further development of auditing to provide greater levels of assurance is the fact that this would merely expose auditors to even greater potential liability.

**Solutions to the Liability Crisis**

Liability reform measures are needed, including the introduction of a system of proportionate liability, incorporation of auditing practices and a safety ceiling on professional liability.

These reform measures are complementary. Proportionate liability is premised on the principle that a party should be liable only for their own mistakes and not those of other unconnected parties as well. The purpose of a statutory ceiling on liability is to make risks more predictable and to contain the scale of these levels to insurable levels. Incorporation gives some solace to auditors that their personal assets and their families’ future will not be placed in jeopardy because of a mistake made by one of their partners (who, in a large firm, may be someone who lives and works in another country).

In the absence of such reforms, there is a very real prospect that commercial insurance for auditors will be unavailable in the future. Without insurance, there is little prospect of consumers recovering full damages. This is not in the public interest.

**Progress and Limitations of Past Reform Initiatives**

In 1994 and 1997, the NSW and Western Australian Governments passed their respective Professional Standards Acts. The Professional Standards legislation provides for professional liability to be limited in exchange for certain safeguards being met, namely

standards of ethical and professional conduct, risk management, complaints investigation, discipline, and maintenance of mandatory professional indemnity insurance. These safeguards are in the public interest as they act to reduce risk and improve professional standards. The ICAA along with CPA Australia and a number of other professional associations have had schemes operating in NSW for some time. In 2001 our scheme was renewed for a further five year period by the NSW Attorney General, the Hon Bob Debus MP. This is indicative of the success of the scheme and of the support it has within NSW. Our respective applications for a similar scheme in WA are presently before the Professional Standards Council for assessment.

The Professional Standards Acts were designed as a response to a developing liability and professional indemnity insurance "crisis". Its full potential has been inhibited because it has only local state operation within a national liability and insurance environment and because they can be circumvented if actions are brought under Federal legislation, including the Trade Practices Act. The restricted coverage of the legislation has limited the capacity of insurers, and professional service firms engaged nationally, to rely upon schemes to a satisfactory extent. These circumstances mean that consumers, professionals and insurers throughout Australia continue to be adversely affected.

In 1995, a major review of the law of joint and several liability conducted by Professor Jim Davis of the Australian National University sponsored by the Federal and NSW Governments (with the support of other members of the Standing Committee of Attorneys General) recommended:

- That the present joint and several liability of defendants in actions for negligence causing property damage or purely economic loss be replaced by liability which is proportionate to each defendant's degree of fault.
- That the liability for loss arising from misleading conduct in contravention of the Trade Practices Act, the Fair Trading Acts or the Corporations Law be proportionate to each defendant's degree of responsibility for that loss.

The accountancy bodies strongly supported the recommendations contained in the Davis Report.

In July 1996 the Federal and NSW Governments released for public comment the Draft Model Provisions to Implement the Recommendations of the Inquiry into the Law of Joint and Several Liability.

However, the momentum that was building around this reform initiative stalled, for a variety of reasons. Accordingly, proportionate liability was effectively dropped by the Standing Committee of Attorneys General in the late 1990s, despite warnings from the accountancy bodies that the next, inevitable downturn in the economic cycle will invariably see another wave of massive liability suits against professionals and a worsening position in the market for PI insurance.

**Current Initiatives**

Recent developments in the insurance market have proven these warnings correct and have once again brought issues associated with professional liability into the foreground.

Members in public practice are reporting massive increases in their professional indemnity insurance premiums this year of 200-1000% and beyond. At the same time, insurance cover is diminishing and for certain activities (including audit, insolvency and financial planning) it is unavailable or available only at prohibitive cost. Deductibles under policies are increasing at similar rates to the increase in premiums, and the terms on which insurance is being offered are increasingly restrictive and causing great uncertainty for practitioners.

The number of insurers prepared to offer professional indemnity insurance has dramatically contracted, from in excess of 30 to only 4 or 5, in the past couple of years.

Accordingly tort reform is presently on the agenda for all States and the Federal Government once again.

The ICAA and CPA Australia have welcomed the announcement contained in the CLERP 9 discussion paper released on 18 September 2002 that the Federal Government will seek the agreement of the States to introduce proportionate liability.

We support the Federal Government's stated view (as set out in the CLERP 9 discussion paper) that the market for audit services will be improved if the arbitrary consequences of the present rules relating to joint and several liability in relation to economic loss and property damage are reformed.

The CLERP 9 discussion paper states that this issue needs to be considered in a wider context than just the Corporations Act, recognising the central importance of the principle of joint and several liability in the general common law of negligence.

Clearly for reform to be effective, the effect of the Trade Practices Act also needs to be taken into account.

The NSW Government has taken an important step forward on this issue recently by releasing the Civil Liability Amendment (Personal Responsibility) Bill 2002. That Bill will introduce proportionate liability in civil cases in NSW (except in cases arising from personal injury). The accountancy bodies and the major firms strongly support this initiative by the NSW Government. We have commended this legislation for adoption by other State Governments.

**The Need for Reform of the Trade Practices Act**

As outlined above, action by the States to introduce proportionate liability will be ineffective unless the Federal Government takes similar action to amend the Trade Practices Act.

This means that attempts by State Governments to introduce proportionate liability between defendants through legislative amendments along the lines of the NSW Civil Liability Amendment (Personal Responsibility) Bill 2002 will likely be ineffective as a defendant will still be potentially liable for the full extent of any loss suffered by a plaintiff where the defendant is held to be in breach of Section 52 of the Trade Practices Act.

As Federal legislation overrides State legislation under the Constitution, unless action is taken to amend Federal legislation including the Trade Practices Act , the NSW legislation will be of little benefit to most professionals as in many legal proceedings, a plaintiff will have available several causes of action, including under the Trade Practices Act.

Amendment of the Trade Practices Act is now imperative to support the NSW Government's initiative to introduce proportionate liability in that State, which hopefully will be law before the end of this year, and to give effect to the Federal Government's statement of intent included in CLERP 9 to encourage other States and Territories to enact similar reform. Section 82 of the Trade Practices Act must be amended to ensure that a defendant's liability under Section 52 is limited to an amount that is no more than the proportion of the damage that the court considers just having regard to the extent of the defendant's responsibility for the damage or loss suffered.

The Act should also be amended so as not to interfere with State-based legislation, such as the Professional Standards Acts in NSW and WA, that seeks to limit professional liability in exchange for certain guarantees of professional standards and conduct.

**Conclusion**

This is an abbreviated version of the profession's case for liability reform. Further information is contained in the attached document on the profession's case for liability reform and the current crisis in the market for professional indemnity insurance.

The profession advocates the introduction of a system of proportionate liability and a safety ceiling on professional liability, a well as permitting auditors to incorporate.

These reform proposals are not evidence of auditors seeking to avoid the consequences of their mistakes. Proportionate liability is premised on the principle that a party should be liable only for their own mistakes and not those of others as well. The safety ceiling concept, as contained in the NSW and WA Professional Standards Acts, addresses the other root problem in this area, namely the unavailability of insurance and is intended to

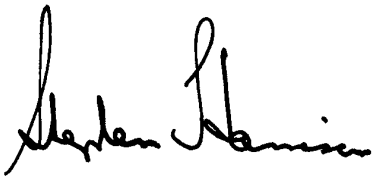
ensure that auditors can obtain adequate insurance to protect themselves and at the same time provide a reasonable level of protection to plaintiffs with legitimate claims.

A safety ceiling on liability makes risks more predictable and hence more insurable. In the absence of such reform, we can say with some confidence that if liability trends continue the way they are going, then there is a very real prospect that commercial insurance for certain areas of professional activity will be unavailable in the future.

Reforming the law of joint and several liability, by introducing proportionate liability for defendants in cases involving financial loss, is also needed. Proportionate liability, where defendants are liable only for the share of the damage they cause and for no more, removes the attraction of "deep pocket" defendants and the inherent risk of injustice to such defendants in paying for others' mistakes.

Momentum is building around these proposals within the community, as is support at both State and Federal Government levels. However, unless the Trade Practices Act is amended in a way that is consistent with law reform initiatives in the States and in other pieces of Federal law, such developments will be ineffective in delivering the intended improvements in the market for professional services and professional indemnity insurance.

Yours sincerely,



Stephen Harrison AO
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## MAKING ACCOUNTANTS INSURABLE

**OBJECTIVE**

The accounting profession is seeking reform of professional liability to ensure that auditors and accountants don't end up uninsurable.

**SOLUTION**

Without a three-pronged program of reform of professional liability, auditors and accountants will end up uninsurable.

The solution which ensures that auditors and accountants don't end up uninsurable, has three integral parts:

1. **Replace joint and several liability with proportionate liability (a wrongdoer should be liable only so far as their actual share of responsibility).**

2. **Introduce a "safety ceiling" on the liability of accountants for claims for damages, limited to say 10 times the amount of the fee up to a maximum of say $100m.**

3. **Allow audit firms to operate within limited liability corporate structures.**

All three reforms are required for a complete solution. The "safety ceiling" of 10 times audit fees to a maximum of $100m is the only measure which will immediately contain the spiralling rise in premiums, and improve the availability of indemnity insurance. Proportionate liability is necessary to support auditors in getting tougher with companies. Limited liability structures, in combination with the other two measures, will stop the brain-drain by reducing the threat to the personal assets of senior professionals.

## DELIVERING THE SOLUTION

Delivering the solution requires certain agreements between the Commonwealth and State/Territory Governments and appropriate provisions within State and Federal legislation, as follows:

1. **Proportionate Liability**
   - Commonwealth and States need to agree on introduction.
   - All States to introduce amendments to Civil Liability or similar legislation to provide for proportionate liability.
   - Commonwealth to make appropriate changes to the Trade Practices Act and Corporations Act.

2. **Safety Ceiling**
   - Commonwealth and States need to agree on appropriate ceiling.
   - Commonwealth to make appropriate changes to the Trade Practices Act.
   - States to introduce Professional Standards or equivalent legislation.

3. **Incorporation**

- Commonwealth to amend the Corporations Act 2001 to allow audit firms to operate within limited liability corporate structures.

## WHY REFORM IS NECESSARY

1. The current liability system is creating a market failure through a vicious cycle of spiralling premiums and shrinking cover.
   - **Over the last 12 months premiums for accountants have risen by between 125 and 1000 per cent and beyond.**
   - **For the major accounting firms, the average insurance cost per audit partner is well over $150,000 a year, while insurers at the same time are reducing insurance cover by tens of millions of dollars.**
   - **The risk exposure of auditors is simply beyond the reach of commercial insurance at any cost.**

2. Without auditors having compulsory professional indemnity insurance, consumers may not be able to make successful claims against them.
   - **Only two States (NSW & WA) have so far introduced the Professional Standards Legislation (PSL) which introduces the "safety ceiling" to protect all professionals and consumers.**
   - **For a complete solution, PSL must be adopted by all States and Territories, and be harmonised with Commonwealth laws.**

3. If uninsurable, auditors will be exposed to excessive risk if they are tougher on companies.
   - **CLERP 9 imposes a range of new responsibilities on auditors to make management more accountable.**
   - **Much of the onus for restoring confidence in capital markets is on auditors, but CLERP 9 proposals fail to fully create an environment where auditors can deliver this and still be insurable, or get adequate cover.**

4. The financial risks associated with unaffordable or unobtainable insurance coverage for accountants will discourage the best and the brightest from joining or staying with accountancy firms. This would result in a serious decline in the quality of accounting staff, with poorer corporate oversight and governance.
   - **Perversely, this will eventually promote more “Enrons”.**

5. Spiralling insurance premiums for accountants is threatening thousands of small to medium-size accounting firms, leading to a serious shortage of experienced auditors, a major escalation in the price of audit and accounting services for small to medium-size businesses, and the inability of small and new companies to secure a quality accounting firm.
   - **There are reports of accounting firms with up to 40 years experience being unable to obtain professional indemnity cover at all.**

6. Investors will not invest in areas of unquantifiable risk. Without comprehensive reform, insurance companies providing professional indemnity cover fall into this category.
   - **In the last six months, the number of active insurers for accountants has collapsed from 37 to five. As well, no Australian insurer will now provide cover for the four major accounting firms.**