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Commemorative paper

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A Comparative Study on Auditors' Negligent Liability

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Abstract

The auditor's responsibilities are likely to compete with those of the directors and auditors involved in the preparation of the financial statements of the company at issue. It is because the directors of the company at issue have incentives to commit illegal acts such as fraudulent accounting, while the auditor is tasked with deterring them. If the auditor intentionally or negligently fails to detect fraudulent accounting, the opposing actions of the two entities compete to the detriment of a third party, resulting in a joint and several liabilities. In general, the Korean civil law provides for joint and several liability in the case in order to protect victims heavily, as does the common law system. However, while joint and several liability has advantages in protecting victims, it can also lead to the unfairness among joint tortfeasors. In particular, it is not uncommon for an auditor who is negligent for a poor audit to compensate for the full amount of damages due to joint and several liabilities, even though

he or she may have been less liable than the company at issue with a greater incentive to commit fraud. It is because companies are often weakened after the litigations of accounting fraud.

There are several attempts to deal with the fairness issue, including proportionate liability, which has been adopted in Australia, the European Union, some states in the US, and Korea. Proportionate liability is a principle that seeks to protect the auditors by holding them severally liable, rather than jointly and severally, who are negligent in failing to amount to a perfect auditing. However, as the proportionate liability has its very nature of a split liability, it can still have negative effects, such as weakening victim protection and undermining audit quality. Because of these concerns, the UK has not adopted proportionate liability, but instead attempts to mitigate joint and several liabilities through the provisions of Company Act based on contractual relationships and general principles of Common law of torts such as limiting the scope of duty of care, which has been introduced in Caparo test etc. Both systems have their own advantages and disadvantages, and it will be up to each country's policy to decide which system to be pursed. However, in the position of a country with the proportionate liability, it is also worth considering how to limit the scope of protected third parties as a way to prevent the flood of litigations which is the main concerns of capital market regulators.
Keywords: Auditors’ Liability; Duty of Care; Joint and Several Liabilities; Proportionate Liability; Caparo Test

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I. Introduction

The purpose of an accounting audit is to protect stakeholders of a company and contribute to the sound management of the company by examining the truth of corporate accounting and expressing the auditor's opinion. The responsibility of an accounting auditor is likely to essentially compete with the responsibility of directors and auditors involved in preparing the financial statements of a company under investigation. This is because while directors and auditors of a company under investigation have an incentive to commit illegal acts such as false accounting, the role of an accounting auditor is to prevent such acts.

In general, our civil law stipulates that joint liability is assumed for the purpose of protecting the victim, and the common law of the Anglo-American legal system is the same. However, while joint liability has the advantage of protecting the victim, it can also result in ignoring the fairness among joint tortfeasors. Joint liability for joint tortfeasors focuses only on protecting the victim, regardless of whether the inducements of multiple tortfeasors conflict with each other. This is especially true in the case of joint liability between an accounting auditor and the directors and auditors of a company under investigation, because the interests of the two

parties are sharply opposed to each other. Of course, if an accounting auditor intentionally conducted a fraudulent audit, it would be the same as an ordinary joint tort, but since most cases of fraudulent audits are due to negligence, the issue of fairness inevitably arises.

In this regard, efforts have been made to ease the responsibility of accounting auditors. In Korea, the proportional liability introduced in the revision of the External Audit Act of 2017 is the result of such efforts. Korea has also accepted proportional liability, which was introduced through legislation and judgment by Australia in 2004, the European Union in 2008, and some states in the United States. Proportional liability is a concept that completely contradicts joint liability, as it ultimately recognizes the effect of divided debt. If proportional liability is introduced as a comprehensive principle for joint torts, it may result in giving up protection for victims, so a compromise is necessary. In particular, if proportional liability is applied, the liability for compensation of a company that has lost its ability to pay due to accounting fraud, etc., is divided with the liability of the accounting auditor, which makes it highly likely that full compensation for victims will be impossible. Therefore, divided liability should be applied exceptionally under strict conditions.

Due to concerns about the weakening of victim protection and the deterioration of accounting audits that may arise from proportional liability, the UK is showing a movement to limit joint liability in a different way. First, it uses a method of narrowly interpreting the scope of the auditor's duty of care to limit the liability itself. This method has the advantage of simultaneously eliminating the risk of male-oriented lawsuits caused by securities class actions, etc., since it can limit the claimant for compensation itself. In addition, it also recognizes the validity of the exemption clause for third parties or the liability limitation agreement between the parties to the agency contract, and uses the legal doctrine of limitation of liability under contract law. Of course, the UK method is not only relatively insufficient in terms of victim relief in that it limits the scope of victims in order to reduce the negative effects of joint liability, but also carries the risk of depriving a specific victim of his or her right to claim compensation.

There may be various legislative policy measures to ease the strictness of joint liability imposed on accounting auditors. Accordingly, this paper examines the legal principles of the External Audit Act, the Capital Market and Financial Investment Business Act (hereinafter referred to as the Capital Market Act), and the Civil Code in Korea, and compares them with the legal principles of the English company law and common law.

II. Liability for damages against Korean auditors

In Korea, the liability for damages of an accounting auditor is governed by the Capital Market Act, the External Audit Act, the Civil Act, etc. The External Audit Act and the Capital Market Act recognize joint liability in principle, but in cases where it is not intentional, joint liability is denied and proportional liability is recognized in order to limit the liability of an accounting

auditor. However, in order to prevent the side effects of proportional liability, joint liability is revived again if the victim is a beneficiary of basic livelihood protection. In addition, in order to prevent the weakening of victim protection that may occur due to proportional liability, even in cases where proportional liability is applied, if some tortfeasors do not have the ability to compensate, each party is responsible for additional damages up to 50% of their liability ratio. In addition, when a victim seeks compensation liability from an accounting auditor, the burden of proof is shifted so that the auditor does not have to prove a breach of duty of care.

1. Liability for damages of accounting auditors under the External Audit Act

1) Joint liability for joint illegal acts

(1) Types of illegal acts committed by accounting auditors and claimants for compensation

An accounting auditor's liability for damages arises when ① he or she neglects his or her duties and causes damage to the audited company (Article 31, Paragraph 1 of the External Audit Act), or ② he or she fails to record important matters or records them falsely, causing damage to a third party by relying on such matters (Article 31, Paragraph 2 of the External Audit Act). In the former case, the accounting auditor is liable for damages to the company in question, and in the latter case, he or she is liable for damages to the third party.

(2) Subject to joint liability under the External Audit Act

Joint liability is a liability in which joint tortfeasors jointly and severally bear the responsibility for compensation, and each tortfeasor is liable for the entire amount of damages, and if one of them compensates, the other tortfeasors are exempt from liability. [1] Joint liability can provide greater protection to victims because even if some of the joint debtors do not have assets to compensate, they can receive full compensation from the joint debtors who are able to do so.

The joint liability of external auditors is divided into joint liability among the certified public accountants in the audit team (Article 31, Paragraph 3 of the External Audit Act) and joint liability between the external auditor and the directors and auditors of the audited company (Article 31, Paragraph 4 of the External Audit Act). [2] Joint liability among the certified public accountants in the audit team is intended to regulate the liability of the audit team, which is a non-corporate organization in the form of a partnership, and is intended to recognize joint liability only for the certified public accountants who participated in the audit of the audited company. [3] Therefore, joint liability in this case should be distinguished from joint liability with the directors and auditors of the audited company. Joint liability with the directors and auditors of the audited company means that not only is the accounting auditor liable for

damages to the company or a third party, but if the directors and auditors of the company are also liable, the accounting auditor and the directors and auditors of the company are jointly liable for damages.
2) Proportional responsibility

(1) Contents of proportional liability

If the directors, auditors, and accounting auditors of the indicted company each bear liability for damages to the company or a third party, they shall be jointly and severally liable as joint tortfeasors. Considering that in most cases of accounting fraud, the company's assets are not enough to secure compensation, [4)] this joint and several liability effectively imposes compensation liability only on the accounting firm. Proportional liability is a special rule that seeks to protect accounting auditors by dividing the liability among joint tortfeasors in order to resolve the side effects of this joint and several liability. In other words, if the directors and auditors of the indicted company intentionally or negligently committed fraudulent accounting and the accounting auditor negligently failed to detect this, causing damage to others, the accounting auditor will not be jointly and severally liable but will be dividedly liable.

The proportional liability of external auditors is governed by the proviso to Article 31, Paragraph 4 of the External Audit Act. If a person liable for damages under joint liability is not at fault, he or she shall be liable for damages according to the liability ratio determined by the court based on the cause of attribution (proviso to Article 31, Paragraph 4 of the External Audit Act). However, there are certain restrictions on the division of debt under this proportional liability. If the income of the person claiming damages is below the amount of the National Basic Livelihood Security, the auditor and the directors and auditors of the relevant company shall be jointly liable for damages (proviso to Article 31, Paragraph 5 of the External Audit Act). In addition, if one of the persons liable for damages under the proportional liability does not have the ability to compensate and is unable to compensate part of the damages, he or she shall be liable for additional damages within the range of 50/100 of the respective liability ratio determined under the proviso to the same paragraph (proviso to Article 31, Paragraph 6 of the External Audit Act).

(2) Subject of proportional liability

Article 401 of the Commercial Act stipulates joint liability of directors, and Article 415 of the same Act applies this to auditors. As such, the provisions of the Commercial Act only stipulate joint liability for directors and auditors, and do not recognize proportional liability. On the other hand, the External Audit Act stipulates joint liability of the accounting auditor and the directors/auditors of the audited company as a principle, and exceptionally recognizes divided liability in cases where the person responsible for damages is not intentional. According to the text of the External Audit Act, the principle of joint liability presumes joint tortious acts between the accounting auditor and the directors/auditors of the audited

company, but it is silent about the subject of the exception to proportional liability. Therefore, the question is whether the subject of proportional liability under the External Audit Act should be limited to only between the accounting auditor and the directors/auditors, or whether divided liability should also be recognized between the directors/auditors. In my opinion, the External Audit Act is a special provision to protect accounting auditors as a regulation on accounting auditors, so an interpretation contrary to the provisions of the Commercial Act would be nothing more than an unfounded overinterpretation. [5)] In addition, since the structure of the statutory text recognizing proportional liability stipulates joint liability between accounting auditors and directors/auditors of a model company, and then stipulates proportional liability as an exception in the same clause, it would be impossible to expand the exception to joint liability to the joint acts of directors/auditors that are not related to accounting auditors. In other words, proportional liability would be recognized only between accounting auditors and directors/auditors of the audited company, and would not be recognized between directors and auditors of the audited company.

3) Shifting the burden of proof

In cases where the victim seeks compensation liability from the accounting auditor, the burden of proof is shifted so that it is not necessary to prove that the external auditor has breached the duty of care. If proportional liability is a step back from victim protection, then shifting the burden of proof is a special rule for victim protection. In other words, in order for an accounting auditor or a certified public accountant who participated in the audit to avoid compensation liability, it must be proven that he or she did not neglect his or her duties (Article 31, Paragraph 7 of the External Audit Act). However, there are exceptions where shifting the burden of proof is not recognized. In cases where a company, bank, insurance company, comprehensive financial company, mutual savings bank, etc. that has appointed an auditor claims compensation for damages, shifting the burden of proof is not recognized (Proviso of Article 31, Paragraph 7 of the External Audit Act). Since such persons are persons who can independently review the contents of the audit report, they are excluded from the special rule of shifting the burden of proof as a bona fide third party and thus have no practical benefit in protection.

2. Accounting auditor's liability for damages under the Capital Market Act

1) Types of illegal acts committed by accounting auditors under the Capital Market Act

(1) Illegal acts related to public notices

According to the Capital Market Act, accounting auditors are included in those responsible for issuing and disclosing securities reports, investment prospectuses, etc. (Article 125, Paragraph 1 of the Capital Market Act), and are also included in those responsible for making regular disclosures such as business reports, semi-annual reports, quarterly reports, and major matter reports (Article 162, Paragraph 1 of the Capital Market Act). An accounting auditor’s disclosure responsibility arises when the acquirer of securities (or the disposer in

the case of regular disclosures) suffers damages due to false descriptions or representations of important matters in disclosure documents, or failure to describe or represent important matters.

However, this responsibility is exempted if the auditor can prove that he could not have known this despite exercising due care, or if the acquirer of the securities (or the disposer in the case of regular disclosure) knew of the fact when making the acquisition offer. In this way, in order for the auditor to avoid liability for damages due to the disclosure act, he must prove that he was not negligent, so the burden of proof is shifted as in the External Audit Act (Article 125, Paragraph 1, Proviso, Article 162, Paragraph 1, Proviso of the Capital Market Act).
(2) Illegal acts related to accounting audits

If an accounting auditor of a trust company or collective investment company causes damage to the beneficiaries of the trust company (or investors in the case of collective investment) who used the accounting audit report due to false descriptions or representations of important matters or omissions of descriptions or representations of important matters in the accounting audit report as a result of the accounting audit, the auditor shall be liable for compensating the damage to the beneficiaries (Articles 115 and 241 of the Capital Market Act).

Just as an accounting auditor's liability for fraudulent or false disclosure is exempted if he or she proves that he or she was not negligent or if the other party was aware of it, an accounting auditor's liability for an accounting audit report on a trust company or collective investment company is also exempted if he or she proves that he or she was not negligent or if the other party was aware of it (Article 115, Paragraph 4, Article 241, Paragraph 4 of the Capital Market Act).
2) Scope of responsibility of the auditor

(1) Liability for compensation to a third party in good faith

The liability for damages to an innocent investor who relied on an audit report prepared by an accounting auditor is directly applied to the external auditor compensation law under the External Audit Act. In other words, the Capital Market Act applies joint liability, proportional liability, and shifting of the burden of proof in relation to damages when an innocent investor relies on an audit report attached to a business report, etc. and suffers damages (Article 170 of the Capital Market Act). Article 170 of the Capital Market Act is a provision that determines the relationship of responsibility between an accounting auditor and other responsible parties when damages arise due to false or fraudulent issuance or distribution disclosure acts as well as audit reports prepared for general accounting audits, etc. In addition, Article 170,

Paragraph 2 of the Capital Market Act allows for the estimation of the amount of damages, which is a special statutory liability provision that treats a tort liability as a contractual liability by estimating the amount of damages.
(2) Trust and collective investment

In addition to the public disclosure act, the specific provisions according to the form of financial investment business, such as the auditor of trust property (Article 115 of the Capital Market Act) and the auditor of collective investment (Article 241 of the Capital Market Act), also borrow the damage compensation law of the External Audit Act. That is, with regard to the auditor of trust property, it is stipulated that he/she shall be jointly liable to the beneficiaries with the directors and auditors of the trust company (Article 115 of the Capital Market Act), and with regard to collective investment, the auditor shall be jointly liable to the investors with the directors and auditors of the management company (Article 241 of the Capital Market Act). However, joint liability is denied in the absence of intent. In other words, if the person liable to compensate for damages does not have intent, he/she shall be liable to compensate for damages in accordance with the liability ratio determined by the court according to the cause of attribution (Article 115, Paragraph 2, Proviso, Article 241, Paragraph 2, Proviso of the Capital Market Act). However, in this proportional liability, if the claimant for damages is a person entitled to basic livelihood protection, joint liability is revived (Article 115, Paragraph 3, Article 241, Paragraph 3 of the Capital Market Act). In addition, Article 31 of the External Audit Act applies to provisions for increasing proportional liability or shifting the burden of proof in the event of nonperformance by some of those bearing proportional liability, obligations to take measures such as joint compensation funds or insurance subscriptions, and the exclusion period (Article 115, Paragraph 4, Article 241, Paragraph 4 of the Capital Market Act).
3. Liability of an accounting auditor for damages under civil law

1) Creditor relationship of multiple parties

When multiple parties are in debt, the debt can be divided into divisible and indivisible debts in terms of the method of performance. Divisible debt refers to debt whose performance can be divided among each debtor. The Civil Act stipulates that if there are multiple debtors, each debtor has equal rights and obligations unless there is a special expression of intent, thereby making divisible debt the principle for the creditor relationship among multiple parties (Article 408 of the Civil Act). Indivisible debt refers to debt whose performance cannot be divided. There are two types: one where the object of the performance is indivisible by nature, and the other where it is divisible by nature but becomes indivisible by the expression of intent of the parties. The latter is essentially no different from joint and several debts, but differs in that the absolute effect of a demand for performance, etc. is not recognized (Article 411 of the Civil Act).

2) Joint illegality of the acts of the accounting auditor and the directors and auditors of the prison company

Article 760, Paragraph 1 of the Civil Act stipulates that when several persons cause damage to another person through a joint tortious act, they are jointly liable for the damage. According to case law, in order for a joint tortious act to be established, each of the several acts must independently constitute a tortious act, and even if there is no joint awareness among the actors, each of the acts must be objectively related and jointly cause the damage. [6)]

There is no consensus on whether the fraudulent audit by the accounting auditor and the fraudulent financial statement preparation by the directors and auditors of the incarcerated company constitute joint illegal acts. There is also an opinion that the financial statement preparation by the directors and auditors of the incarcerated company and the audit by the accounting auditor are independent acts that cannot be considered a single act, and that the two actors have conflicting interests, so they cannot be considered joint acts. [7)] According to this opinion, although joint liability is recognized due to the provisions of the External Audit Act, it is argued that the two actors have conflicting interests in that the acts of the directors and auditors of the incarcerated company are intended for fraudulent accounting, while the acts of the accounting auditor are intended to detect and prevent such accounting, so they cannot essentially be joint acts.

However, according to case law, in order to be a joint act, conspiracy or even joint awareness is not necessary, and it is sufficient if the two acts are objectively related and joint. [8)] In other words, common intention or joint awareness of acts is not necessary between the actors for a joint tort to be established. And the meaning of two acts being related and joint means that, objectively speaking, the infringement of the victim's rights is jointly committed, and the act is recognized as a common cause of the damage. [9)] In other words, a related and joint act is merely an objective evaluation of the result of the infringement, and is a requirement unrelated to the purpose of the acts of the actors. No matter how different the purposes of the two actors are, if one infringement occurs as a result of the two acts, it becomes a joint tort. Therefore, regardless of legitimacy, if we follow case law, in the case of an accounting auditor's poor auditing, it becomes an independent tort due to the poor audit itself, but it is a joint tort because it is complexly related to the act of preparing poor financial statements by the directors and auditors of the company in question, causing damage.

2) Shifting the burden of proof

The issue of burden of proof needs to be divided into the burden of proof for intent and negligence and the burden of proof for causality. First, the burden of proof for intent and negligence can only be recognized in cases where the transfer of burden of proof is

specifically permitted, such as Article 31, Paragraph 7 of the External Audit Act and Article 170, Paragraph 1 of the Capital Market Act, so it is not recognized under civil law.

Next, regarding the burden of proof for causality, it is necessary to recall the meaning of joint liability. The reason why our civil law applies joint liability to joint tortious acts is to prevent each party from claiming responsibility as in the case of a divided debt relationship, so it is presumed that the damage was caused by the entire act of each joint tortfeasor. The Supreme Court case law also holds the same position, stating that "even if a case in which damage was caused by the concurrent acts of several people is insufficient to be considered a joint tortious act in the narrow sense of Article 760, Paragraph 1 of the Civil Act, joint liability presumes a causal relationship between each act and the occurrence of damage in accordance with the legislative policy considerations that seek to protect the victim by reducing the burden of proof. Therefore, in such cases, if an individual actor proves that there is no causal relationship between his or her act and the occurrence of damage, he or she is exempted from liability, and if he or she proves that part of the damage was not caused by his or her act, the liability for compensation is reduced to that extent." [10)] Therefore, in order for a joint tortfeasor to avoid joint liability under Article 760 of the Civil Act, he or she must actively prove that there is no causal relationship between his or her act and the damage.

In the case of the External Audit Act and the Capital Market Act, it is interpreted that the burden of proof of causation is shifted, just like in the civil law. In particular, the academic theory reflects the American Fraud-on-the-market Theory11 [)] and holds that the burden of proof is shifted because a joint tort of spreading fraudulent information is presumed to have a causal relationship between the act and the damage.12 [)]

3) Statute of limitations

According to the Civil Act, the right to claim compensation for damages resulting from an illegal act shall be extinguished by prescription if the victim does not exercise the right within three years from the date on which he/she becomes aware of the damage or the perpetrator, or if ten years have elapsed from the date on which the illegal act was committed (Article 766, Paragraphs 1 and 2 of the Civil Act). However, the External Audit Act stipulates that the accounting auditor's liability for damages shall be extinguished if the claimant does not exercise the right within one year from the date on which he/she becomes aware of the relevant facts or within eight years from the date on which the audit report was submitted (Article 31, Paragraph 9 of the External Audit Act). In addition, the Capital Market Act shall apply the statute of limitations stipulated in the External Audit Act (Article 170, Paragraph 1 of the Capital Market Act).

III. Liability of auditors for damages under English law

In the UK, the liability of an auditor can be broadly divided into criminal liability and civil liability. Criminal liability for the actions of an auditor can arise under the Companies Act 2006, and if an auditor knowingly or recklessly causes misunderstanding of particularly important matters or includes false or deceptive content in the annual report, he or she will be subject to criminal liability (Articles 495 and 507 of the Companies Act). The civil liability of an auditor can be divided into contractual liability and tort liability. Since liability arises between an auditor and a company according to a contract, shareholders can hold them liable for breach of contract according to the terms of the engagement letter. In broad terms, the liability of an auditor under the Companies Act can be seen as a specificization of contractual liability. In particular, the English company law presupposes that the liability of an auditor may arise due to general causes of liability such as negligence, breach of contract, breach of duty, and breach of trust, and only stipulates the principles and exceptions of the prohibition of indemnification and the reasons for limiting liability such as liability limitation agreements, but does not specifically stipulate the types or reasons for acts that give rise to liability. However, since a contractual relationship generally occurs between an auditor and a client company, it is difficult to govern legal relationships with third parties as contractual liability. Ultimately, relationships with third parties other than the counterparty to a contract are governed by liability for tort. In other words, if an auditor causes damage by breaching the duty of care to a third party, he or she will be liable for tort.

1. Responsibilities of an auditor under the Companies Act 2006

In the UK, unlike Korea, there is no special law such as the External Audit Act, and the company law regulates the responsibility of the auditor. Chapter 6 of the Companies Act 2006 stipulates the responsibility of the auditor, and consists of areas such as the invalidity of the disclaimer for the auditor and the agreement to limit liability (Articles 534 to 538A of the Companies Act). These provisions assume that the responsibility of the auditor mainly arises from the contractual relationship, and clearly state that the responsibility cannot be limited by contract, and that the responsibility can be limited only in exceptional cases with the approval of shareholders, etc. Of course, the company law does not deny liability for tort. Since the reason for the liability of the auditor is also stated as negligence, it should be considered that it envisages liability for tort as well as contractual liability. Since the tort liability for negligence under English common law cannot cover pure economic damage, [13)] the scope of liability under corporate law may be wider than the scope of liability under common law.

English company law does not provide for whether an auditor is directly liable to a third party who relies on the audit, other than when the auditor is liable to the company. However, there is a provision that when a company is liable to a third party, the person who owes a duty to the company for the execution of the matter is jointly liable with the company or another

person with a duty (Article 1187 of the Company Act). Nevertheless, the case where a company is liable to a third party who relied on the contents of the audit report itself is limited to cases where the company intentionally committed fraudulent accounting and disclosed it, so it is difficult to apply joint and several liability of the auditor under the Company Act broadly. [14)]

1) Cause of occurrence of auditor's responsibility

The liability of an accounting auditor arises when the rights of a company are infringed due to negligence, default, breach of duty, or breach of trust arising during the audit process (Article 532 of the Companies Act). Although the same article does not directly mention infringement of rights of a company in the text, considering that it is a provision under the title of prohibition of exemption clauses for accounting auditors, the same article should be understood as a provision presupposing responsibility for the company. In addition, it is interpreted that the rights of a company can be extended to various duties imposed on accounting auditors by law and the trust of the company arising during the audit process. The reason why negligence and breach of duty are mentioned as separate causes of liability is to distinguish the two, as breach of duty is only one element of negligence. In other words, it means that even a breach of duty that does not amount to negligence can cause liability for an accounting auditor, and a representative example of this would be the statutory duty of an accounting auditor.

2) Statutory duties of an accounting auditor

An accounting auditor must investigate whether the company has prepared and submitted accounting records, whether the accounting books and accounting records match, and whether the unlisted company's director compensation report and accounting records match, and present an opinion in the audit report. In addition, if appropriate accounting records do not exist or have not been submitted, if the accounting books and accounting records do not match, or if the unlisted company's director compensation report and accounting records do not match, the auditor has an obligation to state these facts in the report (Article 498, Paragraphs 1 and 2 of the Companies Act).

If an auditor fails to obtain information and explanations in accordance with the purpose of the audit based on his/her professional knowledge and conscience, he/she shall state such fact in the audit report (Article 498, Paragraph 3 of the Companies Act). If the requirements regarding the disclosure obligation of directors' benefits such as remuneration, pension, or retirement compensation (Enforcement Regulations under Article 412 of the Companies Act) are not complied with, or the requirements regarding information subject to the audit in the Director's Remuneration Report of listed companies (Enforcement Regulations under Article 421 of the Companies Act) are not complied with, the auditor shall state the necessary details to the greatest extent possible (Article 498, Paragraph 4 of the Companies Act).

Even if a company's director prepares accounting books in accordance with the regulatory system for small companies or follows the exemption provisions for small companies in preparing the director's report, if the auditor determines that the director's actions are improper, this fact must be stated in the accounting audit report (Article 498, Paragraph 5 of the Companies Act). If two or more persons are appointed as accounting auditors, it must be stated whether all of the appointed accounting auditors agree with the opinions in the report, and if any of them do not agree, their opinions and reasons must be stated (Article 498, Paragraph 6 of the Companies Act). If a company that is obliged to include documents regarding compliance with the Corporate Governance Code in the director's report for each fiscal year does not prepare them, the accounting auditor must confirm whether documents regarding compliance with the Corporate Governance Code have been prepared when preparing the annual accounting audit report, and if it is determined that there are no such documents, the auditor must state that fact in the accounting audit report (Article 498A of the Companies Act).

3) No Disclaimer

Any clause (meaning a company's articles of incorporation or individual contractual clause) that exempts all or part of the liability imposed on the company's accounting auditor in connection with negligence, breach of contract, breach of duty, dereliction of trust, etc. arising during the accounting audit process, or that compensates all or part of the liability imposed on the accounting auditor of the company or an affiliate (parent-subsidiary relationship or relationship between subsidiaries sharing the same parent company) is invalid unless the costs of a successful claim for damages are paid or there is an agreement to limit liability (Article 532 of the Companies Act).

Compensation for an accounting auditor who has obtained a favorable judgment or won a civil or criminal lawsuit is permitted despite the principle of nullity of exemption clauses (Article 533 of the Companies Act). Also, cases where the court provides relief for an accounting auditor's illegal actions on the grounds that they were honest and reasonable acts under Article 1157 are included in this exception.

4) Agreement on limitation of liability

Since 2008, the Companies Act has permitted liability limitation agreements (LLAs) between companies and auditors to reduce the risk of litigation regarding audits. A liability limitation agreement means including in the contract an upper limit on the amount of compensation that can be received from the auditor. In other words, a liability limitation agreement means an agreement that limits the liability of the company to the auditor arising from the auditor’s negligence, breach of contract, breach of duty, or breach of trust that occurs during the audit process. The nullity principle of an indemnity clause does not apply if the provisions of Section 535 (Conditions of Liability Limitation Agreement) and the enforcement regulations thereof of the Companies Act are complied with and the members of the company have

approved it in accordance with Section 536. A liability limitation agreement is valid within the scope of Section 537 (Effectiveness of Liability Limitation Agreement) of the Companies Act and is not subject to the Unfair Contract Terms Act 1977 (Section 534 of the Companies Act). [15] Since the agreement on limitation of liability applies only to acts or omissions that occurred during the accounting audit process within one fiscal year, the fiscal year to which the agreement applies must be specified (Article 535, Paragraph 1 of the Companies Act).

The Secretary of State for Business and Trade may establish specific rules that must be included or excluded in a liability limitation agreement (Section 535, Paragraph 2 of the Companies Act). Such mandatory provisions may be designated for the purpose of preventing anti-competitive effects (Section 535, Paragraph 3 of the Companies Act).

An agreement on limitation of liability requires the approval of the company's shareholders, but the general meeting of shareholders may approve it by resolving that approval is unnecessary before the agreement is concluded, approving the main agreement terms before the agreement is concluded, or approving it after the agreement is concluded (Article 536, Paragraphs 1, 2, and 3 of the Companies Act). The main agreement terms refer to the acts or omissions that are the subject of the agreement, the fiscal year to which the agreement applies, and the limitations on the liability of the accounting auditor (Article 536, Paragraph 4 of the Companies Act). Such approval may be withdrawn before the agreement is concluded, or before the start of the relevant fiscal year if the agreement has already been concluded (Article 536, Paragraph 5 of the Companies Act). Such withdrawal shall be effective even if the content of the agreement prohibits it.

An agreement to limit liability can only limit liability within a fair and reasonable scope, such as the statutory auditor’s liability, essential obligations under an audit contract, and professional standards expected of an auditor (Article 537, Paragraph 1 of the Companies Act). Even if an agreement is made in violation of this, any part that exceeds the scope shall be deemed invalid (Article 537, Paragraph 2 of the Companies Act). When determining a fair and reasonable scope, problems subsequent to the occurrence of the relevant damage or the possibility of compensation by other persons responsible for the same damage may not be taken into consideration (Article 537, Paragraph 3 of the Companies Act). A company that has entered into an agreement to limit liability must disclose the agreement (Article 538, Paragraph 1 of the Companies Act; Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreement) Regulations 2008).

There may be differences of opinion as to whether an agreement to limit liability to a third party is valid, but considering that the Royal Bank of Scotland v Bannerman Johnstone MacLay (2002) case ruled that a duty of care is owed to a third party because there was no exemption clause for third parties, it can be affirmed. [16]
5) Joint responsibility

A person who bears personal liability for the company's debts and other liabilities shall bear joint and several liability with the company and other liable persons (Article 1187 of the Companies Act). Directors and auditors who bear a duty of care to the company are included among those who bear liability to the company, and therefore bear joint and several liability. However, joint and several liability is not a liability that is naturally borne by an auditor, but is recognized only when the company bears liability because of their responsibility as a person related to the company's business, so the liability of an auditor to a third party who is not related to the company's liability should be distinguished.

2. Liability for torts based on common law negligence

1) Standards for attribution of duty of care in negligence

In order to pursue negligence under Anglo-American law, a duty of care must be attributed to the actor, and the damage must occur to the victim due to the actor's breach of that duty of care. Whether a duty of care can be attributed to the actor depends on whether it is reasonably foreseeable that the damage actually incurred to the victim will occur due to the actor's specific act. In other words, a duty of care arises only when a reasonable person could foresee that the act in question would cause the victim to suffer the same damage.

However, the scope of foresight of plaintiff and damage is bound to be interpreted differently depending on the judgment of each court, which inevitably leads to the problem that it is difficult to expect uniformity in the discovery of the duty of care. Of course, due to the accumulation of precedents, the determination of the presence or absence of a duty of care may not be an important issue in most cases due to the application of existing precedents. However, it cannot be ignored that it may be difficult to determine whether individual cases are identical or similar to existing precedents, and that the value of existing precedents will disappear when a completely new case arises in which there was no judgment on the existence or absence of a duty of care. [17)] For these reasons, the English courts have attempted to establish a unified framework for attributing the duty of care. As a result, two principles were derived that established consistent standards (General Principles) regarding the duty of care. First, the Neighbor test was established in 1932, but in 1990, the Caparo test overturned it and emerged as a new standard.

The neighbor principle was established in 1932 through the Donoghue case18) and was succeeded by Home Office v. Dorset Yacht Co. Ltd. case19) and Anns v. Merton LBC. case20) . According to the neighbor principle, ① if there is a close relationship between the tortfeasor and the victim that can impose a duty of care like neighbors (Relationship of Proximity or Neighborhood), it is judged that it is reasonably foreseeable that the tortfeasor's negligent act would result in damage to the victim (Reasonable Forsight of Victim and Harm). In addition, the Anns v. Merton LBC case requires ② additional review of whether there are reasons that can deny, limit or reduce the duty of care. [21)] There is a point to note in applying the neighbor principle, which is that there is an order in the application of the two

requirements. In other words, in cases where there is a close connection between the perpetrator and the victim, the principle is to assume a duty of care and then review the reasons for denial or limitation. [22)] This method of presupposing a duty of care in principle and reviewing the reasons for limitation for legal rationalization is problematic in that it has the potential to indiscriminately expand the attribution of the duty of care. For example, in the case of Junior Books Ltd v. Veitchi Co. Ltd. [23)] the neighbor principle was applied, but the tradition of not recognizing liability for tort for completely independent economic damages other than liability for damages under a contract was forgotten and liability for tort was recognized. [24)] It does not seem that this case broke the tradition in that all other cases do not recognize liability for tort for independent economic damages. Due to these problems, the neighbor principle was broken in the 1990 Caparo case, and the Caparo principle was established as the standard for attribution of the duty of care. [25)]

According to the Kapparo principle, in order to impose a duty of care, ① it must be reasonably foreseeable that the victim will suffer damage due to the tortfeasor's act, ② there must be sufficient proximity between the parties, and ③ the court must consider it fair, just, and reasonable to impose a duty of care. [26)]

2) Accounting auditor's liability for negligence towards third parties

Representative British cases on tort liability due to negligence include Caparo Industries Plc v Dickman (1990) and Royal Bank of Scotland vs Bannerman Johnstone MacLay (2002) . [27)] Both cases involved the tort liability for the negligence of an accounting auditor, but the judgments on the scope of the duty of care to a third party were different. In order to attribute a duty of care, all three conditions of the Caparo test must be met, and although the requirements of foreseeability and proximity of damage were met in both cases, the judgments on whether imposing a duty of care was fair, just, and reasonable were different. [28)]

(1) Caparo Industries Plc (Caparo) v Dickman (1990) case law

Plaintiff Caparo purchased stock in Fidelity Plc. on the basis of an accounting report prepared by the accounting firm Touche Ross (later merged into Deloitte & Touche). When Fidelity Plc. went bankrupt, Plaintiff brought a claim against Touche Ross for breach of duty of care to third-party investors. Plaintiff alleged that his decision to purchase stock was due to an inaccurate valuation prepared by Touche Ross, and that the accounting firm owed a duty of care to potential investors. The House of Lords, the final court, held that it was neither fair nor reasonable to impose a duty of care on the auditor, as the accounting report was intended to assist existing shareholders in exercising their rights, and that it was impossible for the auditor to know that the report would be used by unspecified potential investors such as Plaintiff.

(2) Royal Bank of Scotland (RBS) vs Bannerman Johnstone MacLay (Bannerman) (2002) precedent

The plaintiff, RBS, alleged that Bannerman, an accounting firm, failed to detect material fraudulent errors in the accounting of its client, APC Ltd., which resulted in its failure to deal with a default on an overdraft arrangement, which resulted in a loss of £13 million. The plaintiff claimed that the overdraft arrangement with APC, which it had approved, was based on Bannerman's audited financial statements, and therefore suffered loss as a result of the poor audit. This case differed from Caparo in that Bannerman, the accounting firm, could have been aware, through its examination of APC's Banking Facility Letter, that the accounting statements would be used as the basis for RBS's lending decision. Accordingly, the Court of Session in Scotland held that Bannerman owed a duty of care to RBS. Additionally, it was argued that the absence of a third-party indemnification clause in the contract between Bannerman and APC was a significant factor that prevented the duty of care from being denied.

3) Joint and Several Liability

If two or more tortfeasors cause separate damages to the victim through independent breaches of duty, each tortfeasor is liable only for the damages he or she caused. However, if two or more tortfeasors cause one indivisible damage to the victim through independent breaches of duty, the victim can claim compensation for all or some of the tortfeasors for his or her damages, and accordingly, the tortfeasors are liable jointly and severally. [29)] Joint torts that cause joint liability do not have to occur simultaneously because they only have to cause indivisible damages even if they occur independently. Joint liability has the advantage of providing particularly thick protection to the victim. For example, in the case of divided liability, there is a risk that some tortfeasors who are not financially capable will not be compensated, and even if all joint tortfeasors are financially capable, the victim may have to prove the causal relationship between each tortfeasor, which can be a complicated problem.

This joint liability requires an additional principle regarding the indemnity relationship of each tortfeasor. The traditional common law principle was that even if one joint tortfeasor compensated for all damages, he could not seek indemnity from another joint tortfeasor. However, currently, it is too harsh to deny indemnity, so an exception is recognized in cases where the act of harm itself is not clearly illegal and the tortfeasor claiming the right of indemnity is convinced that his act is legal, or in cases where the act of harm itself is clearly illegal but the person claiming the right of indemnity is liable to the other party. [30)]

4) Proportional Liability

From the perspective of the tortfeasor, joint liability demands more responsibility than the individual's share of the fault, and thus, certain professional organizations, such as accounting audit firms, have continued to argue against its application. In cases of personal

injury or other physical damage, it is necessary to provide strong protection to the victim through joint liability, but in cases of joint torts in professional areas, joint liability may lead to results that are not in line with justice. In particular, the reason why the liability of the accounting auditor is problematic is that when the finances of the company subject to the indictment have deteriorated, the victim's compensation claim is mainly directed to the accounting firm. This can lead to a vicious cycle where accounting costs increase and the client's accounting audit costs increase. In addition, because of the ability to secure the liability property, the accounting auditor, not the client company that is primarily responsible for the accounting fraud, ends up bearing the entire responsibility. As a result, there have been several attempts to ease the joint liability of the accounting auditor, and as a result, Australia, the European Union, and some states in the United States have introduced proportional liability for accounting auditors. In the UK, the Department of Trade and Industry's Judicial Committee conducted an inquiry into this issue in 1996 and concluded that the current joint liability was preferable to various forms of proportional liability. As a result, there is still controversy in the UK about whether to recognize proportional liability for auditors. [31)]

5) Disclaimers of Liability in Accounting Reports

In the UK, where proportional liability is not recognized, there is another attempt to alleviate the burden of accountability that is aggravated by the joint liability of the auditor. This is an attempt to prevent the expansion of liability by stating in the accounting report that there is no liability for a third party in addition to the agreement on limitation of liability recognized under the company law. Such disclaimer for third parties in the accounting report may be a unique disclaimer applicable in the UK, as it is influenced by the decision in Royal Bank of Scotland (RBS) vs Bannerman Johnstone MacLay (Bannerman) (2002). There is also criticism that the disclaimer, called the Bannerman clause, devalues the value of the accounting audit report. In other words, the disclaimer not only risks lowering the level of accounting auditing, but also has the effect of lowering the trust of third parties.

Ⅳ. Conclusion

Considering that the inherent duty of an accounting auditor is to ensure the truthfulness of accounting, it is natural under the principle of self-responsibility that he or she should be responsible for that duty. If the person in charge of uncovering the false records of a company under investigation fails to properly perform that duty by violating the duty of care, it is reasonable to assume responsibility for compensating the entire amount of damages, at least in terms of protecting the victim who trusted the accounting audit, in terms of external relations. If the corporate accounting documents were prepared due to the intention or negligence of the directors or auditors of the company under investigation, these persons should also be responsible for compensating the victim who suffered damages by relying on the corporate accounting documents for the entire amount of damages. In this way, when

one damage occurs due to two acts, that is, in the case of joint torts, it is a general principle that not only our law but also the Anglo-American law system applies joint liability to provide thick protection to the victim.

This joint liability leaves open the problem of internal settlement called the subrogation relationship, where the joint tortfeasor who has paid compensation can demand that the other tortfeasors who have escaped liability without compensation pay the same amount of responsibility as each other's share of fault. In this case where each person's responsibility is settled through the subrogation relationship, there is no room for the problem of equity. However, this is not the case in reality. In cases where the issue of fraudulent accounting becomes a problem and leads to litigation, the only one who can maintain the financial resources to fulfill the compensation responsibility is the accounting firm that conducted the audit, and the company that is actually being sued is likely to be in a situation where it has lost the ability to pay due to the fraudulent accounting. In the end, the problem of equity arises in that the entity that actually compensates for the entire damage due to joint liability is often the accounting firm, not the company in question.

There are several attempts to solve this problem of equity, and the representative policy of mitigating joint liability is proportional liability introduced by Australia, the European Union, some states in the United States, and Korea. Proportional liability is a principle that protects auditors by holding those who committed joint torts by negligence liable for joint liability, not joint liability. In Korea, the liability for damages of auditors is regulated by the Capital Markets Act, the External Audit Act, and the Civil Act. The External Audit Act and the Capital Markets Act recognize joint liability in principle, but in cases where there is no intent, they deny joint liability and recognize proportional liability in order to limit the liability of auditors. However, in order to prevent the side effects of proportional liability, joint liability is revived if the victim is a beneficiary of basic livelihood protection. In addition, in order to prevent the side effect of weakening victim protection that can be caused by proportional liability, even in cases where proportional liability is applied, if some tortfeasors do not have the ability to compensate, they are responsible for additional compensation of damages within 50% of their respective liability ratios. In addition, when the victim seeks compensation from the auditor, the auditor is required to prove that he or she did not breach the duty of care, thereby recognizing the shift in the burden of proof. Regarding whether the shift in the burden of proof can be extended to the proof of causality, our case law judges that, considering the legislative purpose of joint liability itself, the causal relationship between the act of the joint tortfeasor and the damage is naturally presumed. The doctrine and case law also consider that the causal relationship of the joint tort is presumed and the burden of proof is shifted in this regard according to the American fraud-on-the-market theory.

Since proportional liability is essentially a divided debt, it may have negative effects such as weakening victim protection or worsening auditing. Due to these concerns, instead of introducing proportional liability, the UK attempts to ease joint liability through the provisions

of corporate law based on contractual relationships and general principles of common law. In the UK, the discussion on the tort liability of an accounting auditor to a third party begins with the judgment of whether the accounting auditor owes a duty of care to a third party. According to the Caparo case, it is judged that a duty of care is owed to a third party, but the scope is limited. In other words, it is fair, just, and reasonable to impose a duty of care if it is possible to recognize that a third party will suffer damage due to its own breach of duty of care, but if it was not possible to recognize this, it is judged that a duty of care cannot be imposed. As a result, the Caparo case ruled that the auditor did not have a duty of care toward unspecified potential investors who suffered losses by relying on the audit report, because the auditor could not have been aware of those unspecified individuals in advance and prepared the audit report. On the other hand, according to the RBS case, if the auditor could have known that the client company had requested the audit report for the purpose of submitting it to a bank for loan review, the auditor could have recognized that the bank was a third party that needed to be protected, and thus negligence was acknowledged. In the case of the UK, the scope of third parties subject to the duty of care can vary depending on the individual case, so the side effects of the strictness of joint and several liability can be somewhat weakened. In addition, the UK also utilizes corporate law principles based on contract law, allowing liability to be limited by utilizing a disclaimer for third parties in the accounting report, and recognizing the effect of an agreement to limit liability between contracting parties. This British method may be criticized for not only providing relatively little relief to victims by limiting the scope of victims as a means of reducing the negative effects of joint liability, but also for carrying the risk of depriving certain victims of their right to claim compensation. However, since the court determines the scope of third parties in individual cases, it cannot be said that the risk of arbitrary judgment is seriously high.

There are advantages and disadvantages to both the method of introducing proportional liability and strictly judging its requirements, and the method of applying basic legal principles such as contract law and tort law to each case, so it is difficult to say that there is a superiority between the two, and it is a matter to be decided only by the legislative policy of each country. However, in our case of recognizing proportional liability, it is worth considering a method of limiting the scope of third parties who are protected, even for the purpose of preventing risks such as male-related lawsuits.

Notes

[*] We dedicate this thesis to commemorate the retirement of Professor Kim Hyo-shin and Professor Kim Yeon from the Law School of Kyungpook National University.

[1)] Joint and several obligations are distinguished as genuine joint and several obligations. Genuine joint and several obligations refer to cases where the obligation is jointly assumed with a subjective joint will, while insincere joint and several obligations are independent obligations since there is no subjective connection. The responsibility of the accounting

auditor is independent from that of the directors and auditors of the company in question, and there is no subjective joint will either, so strictly speaking, it corresponds to insincere joint and several obligations.

[2] According to the External Audit Act, accounting auditors are divided into accounting firms and audit teams. Certified public accountants who are not affiliated with a corporation must be members of the audit team to become accounting auditors (Article 2, Paragraph 7 of the External Audit Act).

[3] The legal nature of the audit team can be seen as a form of combination (Kwon Jae-yeol, “A Critical Review of External Auditors’ Liability for Damages,” Journal of Commercial Law Studies, Vol. 39, No. 4, Korean Commercial Law Association, 2021, p. 4).

[4] The person who bears joint liability with the accounting auditor is the director or auditor of the company in question, but in terms of actual ability to compensate, the victim's claim for compensation will be directed at the company through employer liability, not the director or auditor, and thus the company's liability property is at issue.

[5] Comrades: Choi Moon-hee, “Issues and Desirable Operation Methods of the Proportional Responsibility System for Accounting Auditors - Focusing on Critical Considerations and Improvement Tasks for the Revised External Audit Act -”, Justice, Vol. 144, Korean Law Academy, 2014, p. 267; Kwon Jae-yeol, the above paper, p. 20.

[6] Supreme Court Decision 96da46903, rendered on August 29, 1997.

[7] Lee Jun-seop, Proportional Liability System of External Auditors, Journal of Commercial Law, Vol. 33, No. 3, Korean Commercial Law Association, 2014, p. 80; There is also an opinion that the establishment of joint tort liability should be strictly enforced (Hong Seong-ju, “The Nature of the Subrogation Relationship in Unjust Joint Obligation: Supreme Court Decision 2003da24147, October 13, 2005,” Case Studies Vol. 19, Busan Case Studies Association, 2008, pp. 21-22).

[8] Supreme Court Decision 2005Da47014, 47021, 47038, pronounced on January 26, 2006.

[9] Supreme Court Decision 87DaKa2723, pronounced on May 23, 1989.

[10] Supreme Court Decision 2007da76306, rendered on April 10, 2008.

[11] The market fraud theory is a theory recognized through the case of Basic Inc. v Levinson, 485 US (1988) regarding securities fraud, which holds that since stock prices embody all important information, even fraudulent information (fraudulent statements) are reflected in the stock price. Our case law also adopts this market fraud theory, stating that general investors who invest in stocks should be regarded as believing the external auditor's report on the target company and using it as a judgment reference when trading stocks (Supreme

Court Decision 2014Da11895, April 29, 2020). This means that the occurrence of damage in the form of stock price fluctuations can be presumed to have occurred due to the spread of fraudulent information, which is consistent with the presumption that there is a causal relationship between the act of spreading fraudulent information and the damage in the form of stock price fluctuations.

[12] Kwon Jae-yeol, the above paper, p. 15.

[13] In order to limit the scope of liability for damages under English common law, it is traditional to recognize liability for damages only for direct and indirect damages resulting from a tort, and to deny liability for damages for pure economic damages that occur completely independently of the tort, recognizing that such damages are outside the scope of liability for damages.

[14] In light of the attitude of the English courts, which view the duty of care to third parties narrowly, it is difficult to see that a company is directly liable for compensation to a third party just because of the degree of negligence in the poor audit.

[15] However, in Scotland, some provisions of the Unfair Contract Terms Act apply.

[16] See infra note 27.

[17] Kit Barker, Peter Cane, Mark Lunney, & Francis Trindade, The Law of Torts in Australia, 5 th ed. Oxford University Press, 2012, p.457.

[18] Donoghue v Stevenson [1932] AC 562.

[19] Home Office v. Dorset Yacht Co. Ltd. [1970] AC 1004.

[20] Anns v. Merton LBC. [1978] AC 728.

[21] Ibid., at 751-752.

[22] James Goudkamp & Donal Nolan, Winfield & Jolowicz Tort, 20th ed . Thomson Reuter, Sweet & Maxwell, South Asian Edition, 2022, at 5-019, p. 85.

[23] Junior Books Ltd v. Veitchi Co. Ltd. [1983] 1 AC 520.

[24] James Goudkamp & Donal Nolan, supra note 19.

[25] Caparo Industries Plc v Dicman [1990] 2 AC 605.

[26] Lord Bridge in Caparo [1990] 2 AC 617.

[27] Royal Bank of Scotland (RBS) v Bannerman Johnstone MacLay (Bannerman) [2002] 205 SC 437.

[28] Vivienne Harpwood, Modern Tort Law, 7 th ed. Routledge-Cavendish, New York, 2009, pp.29-30.

[29] James Goudkamp & Donal Nolan, Winfield & Jolowicz Tort, 19th ed . Thomson Reuter, Sweet & Maxwell, London, 2014, at 22-001.

[30] James Goudkamp & Donal Nolan, op.cit., at 22-007.

[31] For a discussion of the introduction of proportional liability in the UK, see Tim Bush, Stella Fearnley, Shyam Sunder, Auditor Liability Reforms in the UK and the US: A Comparative Review, Proceeding at UK National Auditing Conference, 2007, pp.16-21.

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