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The Implications of Liability, Litigation, and Governance Structure for the Auditing Profession

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The collapse of Arthur Andersen haunts the auditing profession and the capital markets like the Ghost of Banquo. In 1990, the Laventhol & Horwath firm succumbed to the toll of failed audits and bankruptcy; but it is Arthur Andersen's death at the hands of the criminal process that has precipitated concern over the viability of the great auditing firms, leading to the formation of study groups such as this Advisory Committee. To be sure, concentration had reduced "the Big Eight" to "the Big Five" before the Arthur Andersen indictment, and the profession had already been heard to warn of the sapping effects of private litigation when the auditor was the last available deep pocket. The scandals leading to the enactment of Sarbanes-Oxley and the subjecting of the auditing profession to regulation by the Public Company Accounting Oversight Board ("PCAOB") transformed the discussion of liability, litigation and governance regimes for auditors. These issues now require analysis in a larger frame of reference – that is, what are the implications for the survival of the private audit function, the shape of the auditing profession and its capacity to serve the capital markets.[1]

Economic Implications: How They Ground in Liability

In October, 2006, the European Commission released their "Study on the Economic Impact of Auditors' Liability Regimes".[2] The EU Study focuses on the risk of loss of other audit firms, including one of "the Big-4 networks", posed by litigation liability.

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[1] The 103rd American Assembly, Columbia University has conducted a project in two sessions, "The Future of the Accounting Profession", November 13-15, 2003 (Leesburg, Virginia), and "The Future of the Accounting Profession: Auditor Concentration", May 23, 2005 (New York, NY) for which the author served as one of the reporters. A number of the themes and proposals discussed below were touched upon or discussed in one way or another by various participants in the course of those proceedings. The American Assembly does not take positions on issues, and the views expressed below are solely those of the author, who wishes to acknowledge the benefit of participating in those discussions. The author is a former General Counsel of the U.S. Securities and Exchange Commission (the "SEC" or the "Commission"), resident in the Washington, D.C. office of Baker Botts L.L.P.

[2] Prepared by London Economics, in association with Professor Rolf Evert for DC Internal Markets and Services, European Commission (citations herein are to the Summary, the "EU Study"). *See* http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf .

The EU Study highlights two contributing factors. First, major claims were found to be on the rise. In September 2005, one estimate presented outstanding claims against auditors brought in the U.S., where damages sought were $1 billion or more in the lawsuits directed primarily against the accounting firm and $10 billion or more where the audit client was sued and auditors were named as additional defendants. One cited study of securities class actions filed in the U.S. found an increase (in 2005) in the average settlement costs (over 2004) of 156% (to $71.1 million). Although the EU Study is concerned primarily with the fact that "the transnational claims of significant size against European firms are all claims filed in the U.S.",[3] the EU Study also considers the implications of that liability trend for the auditing profession globally. One "mega-claim" that cannot be settled for reasonable amounts, within the Firm's existing capital resources, and cannot be litigated without "betting the firm" constitutes the core threat, as seen by the profession and their counsel.

The second factor cited by the profession is the unavailability of insurance in the commercial market to cover these mega-claims. The EU Study found: (i) that over the period from 1981-1992, there were only two years in which underwriting auditor liability outside the U.S. was profitable; (ii) in the case of the U.S., in only one year was that line of business profitable; and (iii) in some years the loss-to-premium ratio exceeded 1,000%. For the largest firms, the EU Study notes, the vehicle of captive mutual companies has provided "a timing mechanism that smoothes the effect" of the more run-of-the-mill claims and settlement; but that few of the middle-tier firms and their affiliates can establish captives of a size to justify the cost.

This circumstance leaves the partners at risk. Here the EU Study estimates that sustained absorption of claims losses by partners in the range of 15%-20% of annual firm income would endanger most firms (including Big-4 networks). If the EU Study is correct, moreover,

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[3] Id. at 3.

that "tipping point" is not remote, when measured against the marked capitalization or turnover of audit clients in the U.K. for example.

These economic factors, adduced by the EU Study (and with a focus on the effect of their resident firms), lead the preparers (London Economics) to conclude that liability limitation may be the answer. Countries considering such legislation, to limit auditor liability by statute, evidently include Austria, Belgium, Germany, Greece and Slovenia.[4]

In this analysis, London Economics also notes that insurance for directors' and officers' liability is still available on the commercial market. The reason inheres in the nature of legal liability. For directors, the "fiduciary duty" was originally the most uncompromising known to the law – the prudent man in the management of his own affairs (care), and the duty to place the beneficiary's interest above his own (loyalty). For many good and valid reasons, the legal trustee managing the affairs of a legally incompetent minor did not translate in the case of directors overseeing the modern corporations or officers managing complex business. This led former SEC Commissioner Bevis Longstreth to pronounce the "prudent man rule" an anachronism, the courts of various states to articulate the standards of care and loyalty that may be expected, and state legislatures to enact "raincoat" provisions, exculpating directors from the consequences of error where their good faith remained intact.

With the auditing profession the current flowed the other way. The expectation for the audit was that it would detect fraud, the expectation for the auditors' report was that all the judgments were based on "auditable" facts and thus the report guaranteed (at least at the moment of the report) the health of the enterprise, thus the expectation for the firm was that their "association with" the numbers meant that all the numbers were right.

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[4] The U.K. is apparently considering permitting limitation by contract.

On the side of the audit firms, their voices are raised to protest that the public does not understand the limits of an audit, and that the expectations flowing from the report is a "brittle illusion". On the side of regulators, that is answered by pointing to the independence and credibility of the audit firm as the best hope for survival.

Small wonder, then, that we have a liability and litigation crisis in the audit profession. What can be done as a matter of legal reform that will factor the health of the profession without undermining investor protections?

Professionalism: The Roles of the SEC and PCAOB and Implications of Regulation for Liability

Undergirding the confidence the public can have in the audit report should be their confidence in the professionalism of the firm, which in turn comes to rest on the professionalism of its members. In assessing the relevance of private civil litigation for the health of the securities markets, it may be worth emphasis that the auditing profession is regulated. The authority the regulators exercise over professionals and their firms commands respect. Under SEC Rule 102(e), any person licensed to practice as an accountant may be suspended or disbarred from practicing before the Commission if found:

> (i) not to possess the requisite qualifications;
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> (ii) to be lacking in character or integrity or to have engaged in unethical or <u>improper professional conduct</u>; or
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> (iii) to have willfully violated or aided and abetted violation of the Federal securities laws (emphasis added).

In 1988, the Commission added a three-pronged test applicable to accountants and defining "improper professional conduct":

> (A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards (GAAP or GAAS); or

(B) Either of the following two types of <u>negligent</u> conduct:

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted; or

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.[5]

Prior to Sarbanes-Oxley and the establishment of the PCAOB, lingering questions about the scope of the Commission's authority to promulgate and enforce professional standards against auditors might have been raised in favor of permissive pleading, encouraging plaintiffs in the "mega-case" of private litigation, on the deterrence side of the debate. No more. For the accountant or firm who incurs an administrative bar, the sanction runs beyond public companies, to implicate state license to practice. In short, the federal regulation of quality and competence is now a completed fact, and the sanctions are a potential death-knell for a sanctioned auditor.

The only valid argument for allowing any civil litigation whatever against registered accounting firms, based on violation of professional standards, lies not in the core principal of deterrence, or of preventing audit failures, but in the ancillary policy of compensating investors. That policy implicates all of the considerations that led to enactment of the Private Securities Litigation Act of 1995, together with the experience of the courts in applying the PSLRA regime. Moreover, if the cost-benefit analysis of the EU Study suggests that the benefits of the "mega-claims" must be weighed against the risk to the capital markets of loss of one of the remaining Big-4 (rated as "far from nil" by the EU Study), then other structural and legal bulwarks against crushing liability that are now available to audit clients deserve to be

[5] In the Sarbanes-Oxley Act of 2002 (Section 602), Congress specifically inserted the text of this Rule as a new Sec. 4C of the Exchange Act. Sarbanes-Oxley (Section 105) also incorporated substantially these standards in authorizing the Public Company Accounting Oversight Board ("PCAOB") to conduct disciplinary proceedings and sanction registered public accounting firms.

considered for application to registered public accounting firms. Note here that we have an opportunity to leaven regulatory burden with benefit: if the accounting firms that audit public companies are subject to the quality control and professional standards of a federal regulatory regime, why should they not achieve a legal status with the ancillary benefit of protection from the mega-claims of private litigants which has not been historically possible? That protection may or may not be absolute. The registered accounting firm now has special duties imposed by Exchange Act sec. 10A to "report up the line" illegal acts discovered in the course of performing an audit; but those duties are accompanied by a statutory limitation of the liability of a registered accounting firm, precluding private litigants from asserting a violation.[6] How far we are prepared to go as a legal regime in acting on the approaches discussed herein should be gauged by the unique position of the profession as regulated by Sarbanes-Oxley, and the resemblance of the registered firms to public utilities, government-sponsored enterprises, or other entities performing unique services. This debate is not about "bailing out" an enterprise deemed "too big to fail"; rather, the issue is how to fence off litigation risk that may destabilize a major firm and an entire profession. The extent to which compensatory policies should be implemented in the face of enhanced regulation should guide the discussion.

<u>"Parmalat" and the Threat of Cross-Border, Vicarious Liability</u>

International networks of auditing firms and global alliances have for some time constituted the means by which the profession kept pace with the expanding horizons of their clienteles. These arrangements offered possibilities for global standard-setting, peer review, quality control and operating efficiencies. The <u>Parmalat</u> case,[7] coming before the U.S. courts

[6] Exchange Act, sec. 10A(c).

[7] <u>In re Parmalat Secs. Litig.</u>, 375 F.Supp. 2d. 278 (S.D.N.Y. 2005); <u>In re Parmalat Secs. Litig.</u>, <u>Bondi v. Grant Thornton Int'l</u>., 377 F.Supp. 2d. 390 (S.D. N.Y. 2005)

prior to the Supreme Court's Tellabs[8] decision, illustrates how the peculiarities of audit firm structure and governance can expose the profession to unusual risk.

In December 2003, the Italian diary company, Parmalat, filed for bankruptcy after widespread accounting irregularities were revealed. Investors sued the auditors, two Italian member firms of different international firms, and claimed against the international umbrella entities and the U.S. member firms, alleging both worldwide alliances were "united accounting firms." These allegations rested on agency and "alter ego" theories of partnership law. Motions to dismiss by the international umbrella firms and the U.S. member firms were denied, although only the Italian member firms served as Parmalat's outside auditors. Both international umbrellas and both U.S. firms must now defend.

The most unfortunate aspect of the Parmalat case centers on the ability of the plaintiff (in one case the Italian trustee) to turn against the international organization the very characteristics that provide utility and justification in terms of client service and investor protection.[9]

Litigation Reform: Regulatory Involvement: *Tellabs* and the Appellate Process

The denial of a motion to dismiss, as in Parmalat, has potentially serious consequences for the survival of an accounting firm facing the prospect of either settling for unreasonable amounts or risking trial. Although plaintiffs may appeal trial court decisions granting a motion to dismiss (as a final decision on the merits under 28 U.S.C. §1291), the defendant firm presently has no such right. This circumstance creates a litigation anomaly at a

[8] Tellabs, Inc. et al. v. Makor Issues & Rights, Ltd., et al., 551 U.S. ___ (2007).

[9] Plaintiffs in Parmalat invoked, as support for their vicarious liability theories of implied agency and "controlling person" liability under Exchange Act, section 20, the promulgation of professional standards, the internal firm cross-checking for quality control within the international firm, the formation of global practice groups within the firms to meet and provide additional training and continuing education for partners and associates – all part of the internal professional development of the firms.

time when the federal courts are revisiting the pleading standards enacted by Congress in the Public Securities Litigation Reform Act ("PSLRA").

The recent decision of the supreme Court in Tellabs illustrates the point. Justice Ginsberg, (writing for seven other justices), described the judicial purpose of the decision as follows:

> "Our task is to preserve a workable construction of the 'strong inference' standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims" (at 10)

One court went on to hold that an inference of scienter "must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent" (at 2), taking the complaint in its entirety "as well as other sources courts ordinarily examine" (at 11) when ruling on a motion to dismiss.

The importance of Tellabs lies in the Court's recognition that Congress' pleading standard establishes two requirements – pleadings with particularity *and* that the pled facts raise a strong inference of scienter, an inference not merely "plausible", but "at least as compelling as any opposing inference of non-fraudulent intent". Under this standard, it may be seriously questioned whether, in Parmalat, the denial of the international and U.S. firms' motion to dismiss was correct, and would have survived judicial review on appeal, had that been possible.

In considering a procedural reform to permit the defendant accounting firm to invoke stay of discovery and appeal of the denial of motion to dismiss, it is appropriate to ask why accounting firms are different from other litigants? Sarbanes-Oxley tells us they are: these international accounting firms are regulated professional organizations resembling public utilities. As such, the continuation of discovery may pose an unnecessary risk to continued audit service. Audit failures are very public, raising the question of why society needs the private litigant. Following Sarbanes-Oxley and creation of the PCAOB, resource constraints on the SEC would simply not seem to carry much weight in the discussion. The SEC has effectively leveraged its ability to discover audit failure with the PCAOB. The heightened conservatism that many audit clients see in their auditors, in response to Sarbanes-Oxley, suggests there is less need for the services of the private plaintiff to enhance audit quality.

The firms have argued that the SEC and PCAOB should be more active in appearing *amicus* before the courts to support the posting of reasonable appeal bonds in the mega-claim cases. That can be effected by Commission action (and does not require Congress to amend the Federal Rules of Civil Procedure) to facilitate appeal of meritless cases where the size of the appeal bond alone might threaten the existence of the firm (especially the mid-size firm).[10]

In a similar vein, as registered accounting firms are now federally-regulated under Sarbanes-Oxley, it is appropriate to question whether to continue a regime that permits assertion in State courts of private claims arising out of an audit failure, with "opt-out" class action plaintiffs pursuing their claims in those State courts. Since auditing standards under Sarbanes-Oxley are federally-mandated, should not most claims against registered accounting firms, arising in whole or in part from alleged violations of their professional standards, create exclusive jurisdiction in the federal district courts, without regard to diversity of the parties? As the professional standards of registered accountants is now a matter of federal law, why should the district courts of the United States have exclusive jurisdiction of violations of section 10(b)[11],

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[10] The firms have noted that the Supreme Court, in Pennzoil Co. v. Texaco, 481 U.S. 1 (1987) suggested that the scale of the bond might effect denial of due process.

[11] Exchange Act, sec. 27.

but not of federally-mandated professional standards applicable to registered accounts for which the violation may implicate section 10(b) and Rule 10b-5?

<u>The "Distressed Firm", Bankruptcy and "Merit" Regulation</u>

Of particular concern to the registered firms is their perceived inability to seek bankruptcy protection and survive, as audit clients do. Although now a highly-regulated profession, the registered firms do not achieve stability through regulation when the mega-case threatens a firm's existence. Sarbanes-Oxley created the PCAOB with many of the attributes of a "merit" regulator: indeed the first two chairman have come from a background of bank regulation, and the Board has recognized that its responsibilities and powers partake of merit regulations (quality assurance, confidentiality of certain of its findings). In this relationship, the registered firms may see a potential for enhanced PCAOB and SEC involvement to avert the failure of accounting firms.

It is an anecdotal but firmly held perception of the profession that no accounting firm has entered bankruptcy and emerged to continue its practice. The hard assets of the firm are not significant: the professionals and the clients are the lifeblood of the registered firm. With any anticipation of bankruptcy, these mobile assets are gone. The problem may be analyzed as one requiring a combination of legislative and regulatory innovation. However, the proposals being mulled by the profession may not be so far removed from the existing legal framework as might first appear.

<u>Bankruptcy Reform</u>: The Bankruptcy Code (11 U.S.C. §1129) contemplates the elimination of equity, unless preserved by consent of creditors. Here, miscalculation by plaintiff as judgment creditors is a real concern. Such creditors, whose claims arise out of or relate to violation of professional standards in serving the audit client, could be relegated to a separate

class of creditors, without ability to oppose reorganization under a court-approved plan offering a reasonable return on the claim over time, and without recourse to individual partners. The only showing required of the registered firm would be that the plaintiff creditors would receive under the plan more than expected in liquidation. An automatic stay against partners under Section 362 of the Code,[12] would also facilitate retention of partners.

Although perhaps radical on first blush, that approach is entirely consistent with the purpose of federal bankruptcy. The Code may be one of the most amended federal statutes – the Bankruptcy Code, along with the Internal Revenue Code and the Exchange Act, is part of a regime in which economic and social policy commingle and fine-tuning has often occurred. If the unavailability of practical relief under the current bankruptcy regime defeats an attempt to de-stabilize a major registered accounting firm through litigation, these changes should be considered seriously.

<u>The Regulatory Response to "Distress"</u>: The registered firms also fear the effect on loss of clients following entrance into bankruptcy reorganization. Here, it may be that (i) expansion of the emergency powers of the SEC, and (ii) regulatory activism to counter the threat of destruction of a registered firm, should be considered in light of historical precedent.

The emergency authority over the trading markets[13] was created following the 1987 Market Break, and utilized with effect by the SEC following the 9/11/01 terrorist attacks. The power to act by summary order, without compliance with the Administrative Procedure Act but subject to Presidential override, could be added to the SEC's authority to confront an emergency that threatened the ability of a registered accounting firm to continue to provide audit

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[12] 11 U.S.C. §362 now protects the debtor firm but not partners.

[13] Exchange Act, section 12(k).

services to issuers. All that would be required of the Commission would be a finding that an emergency existed and that the action undertaken was in the public interest and for the protection of investors.

Among the regulatory initiatives which some believe could stabilize a distressed firm, and avoid the "run on the bank" phenomenon are: (i) public statements by the SEC to assure registrant audit clients that notwithstanding an adverse verdict, the financial distress of the audit firm will not result in the agency's subjecting the registered firm's other audits to enhanced skepticism or review, (ii) regulatory recognition that additional time may be warranted for clients of a distressed firm to comply with financial reporting and filing requirements, and (iii) SEC assurances that exchanges should grant timely extensions of delisting deadlines to audit clients of the distressed firm in appropriate circumstances.

There is the additional view that registered firms consider the SEC and PCAOB well-positioned to discourage "client-poaching" during a period of distress for a registered firm. This would possibly be implemented by requiring a registrant changing auditors to demonstrate that the change was not related to a mega-verdict involving an audit affiliate in another jurisdiction unrelated to the registrant's audit – the Parmalat facts, for example.

At first blush, this all may seem quite alien to the way the regulators have related to the auditing profession. On the other hand, it can be fairly argued by the registered firms that these measures should properly be viewed as the alloy of awesome powers conferred by Sarbanes-Oxley, and part-and-parcel of the merit regulatory regime to which the registered firms are now subject. Whether the SEC or PCAOB would support such an expansion of authority or the expectations of how it would be exercised to stabilize a distressed registered firm, should not end the discussion. The SEC has gone so far as to require an undertaking against taking on new clients in the context of an enforcement order. The agency surely has (or can assemble) the resources to permit it to exercise responsibly (and responsively) a new and expanded role when the survival of private-sector auditing may be at stake.

Liability and Contract: As a rule, traditional negligent harm has not carried the private plaintiff as far in suing under the federal securities laws, compared with scienter-based actions under Exchange Act section 10(b). In these scienter-based actions, in addition to the reforms of the PSLRA, the Supreme Court has eliminated traditional aiding and abetting allegations in private civil litigation, in Central Bank, N.A. v. First Interstate Bank, N.A.[14] The anomaly is, however, that registered accounting firms remain liable under negligence theories, since they issue their report to clients for the public to read, under circumstances in which fraud may not be provable against the audit client.

For some time, auditors have worried that the public may not understand the limits on an auditor's ability to detect fraud.[15] Out of this has come refocused attention on the appropriateness of admitting into evidence in private litigation SEC "consent decrees" – administrative orders entered into without the respondent admitting or denying the facts as found by the Commission. The tendency of courts to admit the factual findings and conclusions of law into evidence under the public records exception to the hearsay rule[16], strike many as unnecessary and inappropriate: (i) unnecessary since the plaintiff should be able to plead a meritorious claim and achieve discovery without the "bootstrap" of admission of the SEC Order; and (ii) inappropriate since the Order is achieved as a settlement and not arrived at through adversarial proceeding before an impartial (non-party) fact-finder.

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[14] 911 U.S. 164 (1994).

[15] See, for example, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), in which the Court acknowledged the ability of an audit client, committed to concealment, to deceive the auditor and frustrate the audit.

[16] Option Resource Group v. Chambers Development Co., 967 F.Supp. 846 (W.D.Pa. 1966).

Whether the SEC would consider a rule urging on the courts this position, one cannot say. Whether such a rule should apply to registered accountants only, in light of their unique exposure to SEC discipline under Rule 102(e) would also be a question to consider.

Contract Limitations: Serious consideration could also be given to permitting some limitations of third-party claims against auditors by contract. Commentators have suggested that appropriate areas for (engagement) contract limitation on the liability standard on litigation process would include: (i) "forward-looking statements" which are included in GAAP financial statements and now excluded from the PSLRA safe harbor for forward-looking information, (ii) fencing off systems assurance reports, and (iii) designating venues where claims may be asserted, and (iv) contracting for choice of applicable law.[17]

Arbitration of claims under contract provisions has also received some attention. Here, SEC and PCAOB rulemaking could provide fairly detailed guidance over the qualifications and selection of arbitrators, the required elements of a written opinion, justification of any award, subsequent dissemination and use of opinions, and, of course, appealability to a regulatory authority and/or the courts.

The Business Model: Governance Implications

The threat of liability to the existence of the registered audit firm may be exacerbated by the partnership business model. Whether a formal corporate structure (with subsidiaries operating worldwide) would offer stability and protection, does not seem to have generated strong interest within the registered firms. To some extent, the fact that state licensing laws would have to be preempted by federal licensing seems less of a deterrent than pre-Sarbanes-Oxley. On the other hand, partnerships are run differently than corporations, however

[17] Richard I. Miller and Michael R. Young, "Financial Reporting and Risk Management in the 21st Century", Fordham Law Review, (April 1997), at 1987.

much their internal processes may appear "corporatized", and that may have created a conservatism in the willingness to explore new governance models.

Whether a worldwide, registered firm would be more resistant to de-stabilization by litigation should be the controlling question. The irony of Parmalat remains the imputation by pleading to the global umbrellas and U.S. affiliates of a degree of central control and governance authority they may have lacked. With the oversight of a board of directors constituted on the same basis of independence exhibited by audit clients, the registered firm might achieve some insulation from vicarious liability.[18] In addition to locating liability for departure from firm-mandated professional standards where the responsibility belongs, the governance model of an independent board may enhance the firm's credibility and provide access to capital at critical moments.

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[18] Higgenbotham v. Baxter International, No. 06-1312, (7th Cir., 2007), in which Judge Easterbrook's opinion, following Tellabs, affirms dismissal of the claims seeking to hold the parent vicariously liable for their Brazilian subsidiary based solely on the parent's knowledge of internal control issues at the subsidiary.