Auditors' Multi-Layered Liability Regime

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Abstract

The proposals to limit auditor liability, principally aimed at protecting the Big-4 from the risk of a catastrophic exposure to damages, are grounded on the assumption that auditors are generally over-deterred. The 2008 EC Commission Recommendation on auditor liability relies heavily on this assumption and the economic rationale that underpins it, which is entirely focused on liability towards investors and the US narrative concerning securities class actions. However, the case is much more complex. Any discussion about auditor liability must investigate the following questions: who the auditor's principals are; whether they are in a position to negotiate in order to design the optimal liability regime; whether and at what stage market failures prevent contractual negotiation; what kind of positive (or negative) interferences stem from multiple negotiations and a multi-layered liability regime; how such a multi-layered regime might be designed. This article covers these issues. It conducts a step-by-step analysis of each layer and considers the potential interactions amongst them. Its conclusion is that it is impossible to assess the optimal level of deterrence in multi-layered liability regimes of such complexity. From a wealth perspective, the case for a mandatory limitation of liability can be argued exclusively with regards to liability towards secondary market investors, albeit subject to numerous qualifications that the conventional wisdom too easily overlooks.

Keywords: auditor liability, audit litigation, accountant, multiple principals, liability caps, contract, mandatory rules, default rules, pure economic loss, floodgate argument, tort

JEL Classifications: D86, K22, K41, M42, M48

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INTRODUCTION

The accounting scandals of 2001-2003 raised serious questions about the role of auditors as the main gatekeepers of modern financial markets.[1] The idea that auditing firms had all the incentives to efficiently monitor their clients and denounce wrongdoings collapsed.[2] In the ensuing debate, many scholars claimed that deterrence in the form of civil liability had been reduced and had thereby been unable to prevent auditors from relaxing their expected professionalism and care.[3] However, the dissolution of Arthur Andersen which followed Enron's bankruptcy had in the meantime introduced a new ingredient to the otherwise traditional topic of auditor's liability.[4] The audit market was becoming increasingly concentrated with the 'Big Four' (Deloitte & Touche, Price Waterhouse Coopers, Ernst&Young, KPMG) auditing the majority of listed companies worldwide. Hence two new problems were surfacing. First, legal liability might put in danger one of the remaining networks.[5] Second, if the Big Four understand that they are "too big to fail", moral hazard arises.[6]

The 'Big Four' immediately started a new intense worldwide lobbying campaign demanding protection from legal liability,[7] on the premise that a catastrophic judgment against one of them could have meant the end to the

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[1] JOHN C. COFFEE JR., Gatekeepers: The Professions and Corporate Governance 103 ff. (Oxford Univ. Press. 2006).

[2] *See infra* notes 31-32 and accompanying text.

[3] JOHN C. COFFEE JR., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 Bus. Law. 1403, 1409-12 (2002).

[4] Cf. ROY CHANDLER & JOHN RICHARD EDWARDS, *Recurring Issues in Auditing: Back to the Future?*, 9 Accounting, Auditing & Accountability Journal 4, 20 (1996).

[5] For an attempt to analyze viability threats to Big Four auditing firms in relation to securities fraud class actions see ERIC L. TALLEY, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 Colum. L. Rev. 1641, 1673-93 (2006).

[6] LAWRENCE A. CUNNINGHAM, *Too Big To Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels*, see id. at 1698, 1698-99.

[7] The previous campaign had led to the passage of the Private Securities Litigation Reform Act ("PSLRA"): *see infra* notes 53 and 83 and accompanying text.

whole industry.[8] Auditors' calls did not go unheard. In the US, the discussion concerning securities class-actions was re-opened.[9] In the meantime, auditing firms were aggressively asking for arbitration clauses, damages exclusions, indemnity and hold-harmless provisions in their engagement contracts with American issuers[10] In the UK, auditors obtained a statutory right to limit their liability contractually under ss. 534-536 of the 2006 Companies Act.[11] At European Union level, the Commission recommended Member States to adopt liability caps in order to protect

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[8] *See supra* note 5.

[9] The core issue was that these powerful weapons could be fired at auditors, the traditional "deep-pocket" of financial scandals ending up in catastrophic insolvencies, all too easily. See Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, Report and Recommendations 28–31 (2007), available at http://www.uschamber.com/publications/reports/0703capmarketscomm.htm ("International observers increasingly cite the U.S. legal and regulatory environment as a critical factor discouraging companies and other market participants from accessing U.S. markets."); N.Y. City Econ. Dev. Corp., Sustaining New York's and the US's Global Financial Services Leadership 74–75 (2007), available at http://www.nyc.gov/html/om/pdf/ny_report_final.pdf, 74–75 (fear of litigation puts New York City at a disadvantage vis-a-vis London); Luigi Zingales et al., Interim Report of the Committee on Capital Markets Regulation, at x–xi (2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (citing liability risk as factor contributing to decrease in U.S. public equity market competitiveness); see also Comm. on Capital Mkts. Regulation, The Competitive Position of the U.S. Public Equity Market 1–5 (2007), available at http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf (providing additional data demonstrating loss of public equity market competitiveness). Cf. also JOHN C. COFFEE JR., *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534 (2006) (proposing different means to reform securities class actions so avoiding their circularity problem and increasing their deterrent value); AMANDA M. ROSE, *Reforming Securities Litigation Reform: Restructuring The Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 Colum. L. Rev. 1301 (2008) (proposing to grant the SEC the authority to screen, and approve or reject, Rule 10b-5 class action complaints before filing).

[10] Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Fed. Reg. 6847, 6847 (Feb. 9, 2006). The SEC contests indemnity provisions, holding that they impair independence: Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence, Frequently Asked Questions, Question 4 (issued December 13, 2004) (available at http://www.sec.gov/info/accountants/ocafaqaudind121304.htm).

[11] Under Section 534 (1) of the Act, auditors can limit their liability "in respect of any negligence, default, breach of duty or breach of trust, occurring in the course of an audit of accounts." The limitation cannot cover more than one financial year and it must be approved by a resolution of shareholders. Pursuant to Section 537, the liability limitations are not effective except to the extent they are "fair and reasonable" in the particular circumstances.

auditors,[12] following the results of an economic study ("Final Report") on the issue that it had commissioned.[13] The recommended limitation of liability for auditors would put the industry in a situation very similar to the few other industries that enjoy limited exposure to civil liability, like the shipping,[14] the airline,[15] and the nuclear industries.[16] The Commission's recommendation represented a great success for auditors, who had lobbied legislators for decades in order to get protection,[17] and a turning point in the regulation of the audit industry.

In the meantime, the "subprime" financial crisis exploded, momentarily shifting attention away from auditors.[18] However, the debate that has been raging since this new crisis has thrown new light on the issue of auditor liability. Amongst the new culprits are the rating agencies, which have so far escaped civil liability.[19] Many proposals suggest a re-regulation

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[12] Commission Recommendation, 5 June 2008, doc. No. C(2008)2274. This recommendation is a result of the 8th Company Law Directive (17 May 2006 Directive of the European Parliament and the European Council on the statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EC and 83/349/EEC), which reshaped statutory audit regulation in the light of the recent failure evidenced by the accounting scandals but, at the same time, asked the European Commission to report "on the impact of the current liability rules for carrying out statutory audits on the European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability" (Article 31 Directive 2006/43/CE).

[13] Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F): Final Report To EC-DG Internal Market and Services. pt. 1-332 (2006).

[14] See PATRICK GRIGGS & RICHARD WILLIAMS, *Limitation of Liability for Maritime Claims* (Lloyd's Shipping Law Library 3ed. 1998); MARK A. WHITE, *The 1851 Shipowners' Limitation of Liability Act: Should the Courts Deliver the Final Blow?*, 24 N. Ill. U. L. Rev. 821 (2004); CRAIG H. ALLEN, *Limitation of Liability*, 31 J. Mar. L. & Com. 263 (2000).

[15] See RANDI LYNNE RUBIN, *The Warsaw Convention: Capping the Value of Life?*, 12 Temp. Int'l & Comp. L.J. 189 (1998).

[16] On liability for nuclear damages see MICHAEL G. FAURE & TOM VANDEN BORRE, C*ompensating Nuclear Damage: A Comparative Economic Analysis of the U.S. and International Liability Schemes*, 33 Wm. & Mary Envtl. L. & Pol'y Rev. 219 (2008).

[17] In the US this lobbying effort had lead to the Private Securities Litigation Reform Act: *see infra* note 53.

[18] With the exception of the Madoff and Stanford affairs. On the former see ROSS D. FUERMAN, *Bernard Madoff and the Solo Auditor Red Flag*, 1 Journal of Forensic & Investigative Accounting 1 (2009).

[19] With arguments that recall many issues of the auditor liability's debate: "But at the same time that CRAs want to fend off more detailed regulation of their activities by emphasizing that their work is sound, they also want to fend off liability by presenting their work as a matter of opinion. While CRAs publicly state that their ratings are 'information,' on which they encourage investors to rely, in their interactions with regulators CRAs tend

of rating agencies that is based at long last on their exposure to civil sanctions.[20] Paradoxically, the Enron-era of financial scandals led to recommendations for a reduction in auditors' liability so as to protect the 4-incumbent dominated audit industry, whereas the Subprime Crisis is opening a discussion about increasing the exposure to civil liability of the 3-incumbent dominated credit rating industry. Curious reverse analogies do not stop here. The criticism of governments and regulators that left banks to become "too big to fail" has mounted in the wake of the subprime collapse. Observers point out that much of the size and complexity of many banks is designed to render their operations opaque to regulators, tax authorities and even shareholders.[21] The suggestion is to reduce bank size and complexity.[22] However, the parallel discussion concerning auditors never went in this direction. It actually focuses precisely on how to protect firms that are "too big, too interconnected, too complex and too international to fail".[23] These are times of great confusion.

How could the Big Four achieve so much, and just after one of the largest accounting crises in history? The economic analysis of auditor

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to argue that ratings are opinions rather than facts": CAROLINE M. BRADLEY, *Rhetoric and the Regulation of the Global Financial Markets in a Time of Crisis: The Regulation of Credit Ratings*, Transnational Law & Contemporary Problems, Forthcoming (2010).

[20] JOHN C. COFFEE, JR., *Enhancing Investor Protection and the Regulation of Securities Markets*, SSRN eLibrary, 66 (2009). ("At present, credit rating agencies face little liability and perform little verification. Rather, they state explicitly that they are assuming the accuracy of the issuer's representations. The only force that can feasibly induce them to conduct or obtain verification is the threat of securities law liability. Although that threat has been historically non-existent, it can be legislatively augmented"). See also FRANK PARTNOY, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U.L.Q. 619 (1999) (rating agencies should not simultaneously benefit from ratings-dependent regulation and be insulated from lawsuits alleging negligence or misrepresentation); FRANK PARTNOY, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors, April 2009, 14-16 (2009); JOHN P. HUNT, *Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 Colum. Bus. L. Rev. 109 (2009) (proposing that rating agencies either disclose the poor quality of the financial products they rate or disgorge profits derived from rating the products).

[21] See WILLEM BUITER, *How not to reform financial markets*, FT Maverecon page, July 9, 2009, at http://blogs.ft.com/maverecon/2009/07/how-not-to-reform-financial-markets/ (last visited February 1, 2010).

[22] PATRICK JENKINS & BROOKE MASTERS, *FSA's Turner backs living wills for banks*, Financial Times, September 2, 2009.

[23] See WILLEM BUITER, *Too big to fail is too big*, FT Maverecon page, June 24, 2009, at http://blogs.ft.com/maverecon/2009/06/too-big-to-fail-is-too-big (last visited February 1, 2010). Professor Buiter's quoted passage refers to banks. Needless to say, audit firms' complexity (*see infra* note 88) is a reflection of their clients' one.

liability helped in leading the discussion astray. Indeed, the assumption that auditor liability has to be reduced is founded on two arguments. The first claims that auditors must be protected and therefore that liability limitations, even though sub-optimal in a non-oligopolistic environment, can be optimal in an oligopolistic one that regulation wants to preserve or slowly transform into a more competitive setting.[24] I will not be dealing with this argument in this article. As I have mentioned, the conventional wisdom that the Big-4 are to be treated as a protected species is based on a reasoning that is considered totally unacceptable in other settings.

The second argument, however, is unrelated to concerns regarding audit market concentration. It asserts that auditors are over-deterred by current liability regimes applied around the world and, in particular, in the US and across Europe. Accordingly, it claims that auditor liability must be reduced because it is not optimally designed. The argument relies on the analysis of a single-layer optimum. The single-layer that calls for attention is liability to market investors, which are treated, at least *de facto*, as the only constituent served by auditors. The US securities class action narrative provides the foundation on which this limited economic understanding is based.

This approach is wrong. Things are in fact much more complex. Generally speaking, civil liability should induce auditors to invest in cost-effective measures designed to monitor managers and reduce the risk of misstatements in financial reports, thereby enabling auditors to offer, and charge for, the quality of care that shareholders, creditors, investors (as the case may be) are willing to pay for. When market failures are absent, the liability regime should be left in the hands of the parties concerned, since they have all the incentives needed to design their relationship and choose the sanctions to which to expose themselves. When market failures are well identified and civil liability is kept as a regulatory tool,[25] liability can be mandated (statutory liability), and therefore the onus is on the law to efficiently design the civil liability regime. Accordingly, any discussion about auditor liability must investigate who the parties concerned are, whether they are in a position to negotiate in order to design the optimal liability regime, whether and at what stage market failures prevent contractual negotiation, what kind of positive (or negative) interferences

[24] On the assumption that mainstream liability rules create barriers to entry in today's audit environment. *See infra* note 93 and accompanying text.

[25] Public regulation is another instrument to cope with market failures. Usually the legal system uses both private enforcers (through civil liability) and public ones (though regulation) to deal with market failures. A *locus classicus* on the topic is STEVEN SHAVELL, *Liability for Harm versus Regulation of Safety*, 13 J. Leg. Stud. 357 (1984).

stem from multiple negotiations and a multi-layered liability regime, and how this multi-layered regime should be eventually designed.

In this article I analyze auditor liability's multi-layered regimes. I deal with the different interests served by the auditors and consider the different legal strategies applicable to each layer. Then I illustrate some of the issues that have to be taken into consideration when designing an optimal multiple-layer regime and discuss the different policy options. In doing so, I make reference to some existent legal regimes and comment on them. My conclusion is that a generalized, uniform approach in favor of liability reduction has no grounds, at least at the current stage of our knowledge. The corollary of my reasoning is that the EC recommendation is bad policy.

The article proceeds as follows. Section I reviews audit litigation research and how the law and finance literature covers auditor liability issues. Section II investigates the economic analysis of audit liability regime on which the Final Report is built on. Section III covers auditor liability to the company. It also analyzes the main problems raised by a regime in which the company and the auditor can contract around auditor liability. Section IV deals with auditor liability to third parties under general private law doctrines and analyzes the floodgate argument, deemed a key concept in the law and economics literature concerning pure economic loss. Section V addresses prospectus audit liability and negotiated caps to auditor liability in this specific area. Section VI deals with auditor liability to secondary market investors, discussing and critiquing the "wealth transfer argument", probably the key reasoning employed in asserting that auditor liability over-deters. Section VII presents the problems that a multi-layered liability environment poses. Section VIII concludes.

I. THE ECONOMIC LITERATURE ON AUDIT LITIGATION

A. Introduction

There is a vast economic literature on audit litigation, proposing either adjustments to auditor liability regimes or evaluating the impact of amendments to these regimes. Interest in the subject started in the first half of the 1970s in the US,[26] as a result of some large American accounting scandals in the previous decade that generated a litigation explosion,[27] often

[26] See DOUGLAS W. HAWES, *Stockholder Appointment of Independent Auditors: A Proposal*, 74 Colum. L. Rev. 1, 2 (1974).

[27] See TED.J. FIFLIS, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 Vand. L. Rev. 31, 33 (1975).

described in catastrophic terms.[28] This explosion was also caused by the amendment to Rule 23 of the Federal Rules of Civil Procedure (FRCP), which opened up the road to modern securities class actions.[29] Two streams of literature arose in the wake of this litigation explosion: one qualitative, the other quantitative.

B. Qualitative studies

Qualitative (or conceptual) studies model *a priori* efficient liability regimes. The academic interest is focused on liability towards third parties. Probably the most influential study in the law literature is Professor Goldberg's, who firstly asserts that auditor tort liability to third parties is unnecessary, because third parties can purchase assurance from the auditor if they want to (through the company, which acts as an intermediary between the auditor and the market)[30] and, secondly, points out that reputation protection is a strong incentive for the auditor to take adequate care.[31] The accounting crisis of 2001-2003 showed that reputation alone is not sufficient.[32] Despite this crisis, many studies still argue that the effect of

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[28] NEWTON N. MINOW, *Accountants' Liability and the Litigation Explosion*, Journal of Accountancy 70 (1984).

[29] PAUL G. MAHONEY, *The Development of Securities Law in the United States*, 47 J. Acc. Res. 325, 333-339 (2009).

[30] VICTOR P. GOLDBERG, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. Legal Stud. 295, 301-7 (1988).

[31] Id. at 302-4.

[32] The role of reputation was grounded on the assumption that market incentives were strong enough to prevent auditors' lack of care or cooperation in fraud, since auditors share none of the gains of fraud or just a small fraction of them and are exposed to a large fraction of the risk in the form of reputation disruption. Judge Easterbrook famously exposed this position in *DiLeo v. Ernst & Young*, 901 F.2d 621, at 629. This assumption ignored the existence of agency problems within the audit firm, which incentived partners to put in danger the firm's reputation in order to pursue their own monetary incentives: see JOHN C. COFFEE JR., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269, 301-2 (2004). Moreover, the assumption ignored the fact that shareholders and investors cannot observe the audit quality, and that litigation is an incentive to investigate the audit process. For findings that audit quality is linked to litigation risk more than to pure reputation constraints see, in the accounting literature, INDER K. KHURANA & K K. RAMAN, *Litigation Risk and the Financial Reporting Credibility of Big 4 Versus Non-Big 4 Audits: Evidence from Anglo-American Countries*, 79 Acct. Rev. 473 (2004); CLIVE S. LENNOX, *Audit Quality and Auditor Size: An Evaluation of Reputation and Deep Pockets Hypotheses*, 26 J. Bus. Finance Acc. 779 (1999); RAMGOPAL VENKATARAMAN & JOSEPH P. WEBER, *Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings* 83 Acc. Rev. 1315 (2008); HO-YOUNG LEE et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the*

reputation on audit quality should at least be taken into account when modeling the auditor liability regime.[33] This argument could raise suspicions, as it should be applied to any defendant in a tort claim, not only to auditors. However, as I will show, liability towards secondary market investors might be sufficiently specific to make the argument partly useful in that restricted field.[34]

Other qualitative studies model the interplay between audit standards and auditor liability[35] or auditor wealth.[36] Many compare different liability rules[37] or joint and several liability regimes to proportionate liability regimes.[38] Also these studies are focused on tort liability to secondary market investors. Liability to the company is not covered, as the relationship between the company and the auditor is probably deemed to be a mainstream contract liability scenario that apparently does not offer sufficiently specific research issues. Liability to creditors is not an issue either, most likely because in the US legal scenario the auditor is generally not liable to banks and trade creditors.[39]

Cost of Equity Capital 48 Quarterly Journal of Finance and Accounting 85 (2009). *See* also *infra* note 54.

[33] *See* JOCHEN BIGUS, Auditors' Liability with Overcompensation and Reputation Losses 1 (2009) available at http://www.eale09 (last visited February 10, 2010). For empirical research on the role of reputation *see infra* note 54.

[34] *See infra* Section VI.

[35] Compare RONALD A. DYE, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 J. Pol. Econ. 887 (1993); RACHEL SCHWARTZ, *Auditors' Liability, Vague Due Care, and Auditing Standards*, 11 Rev. Quant. Finance Acc. 183 (1998); RALF EWERT, *Auditor Liability and the Precision of Auditing Standards*, 155 J. Inst. & Th. Econ. 181 (1999); JUAN JOSÉ GANUZA & FERNANDO GOMEZ, *Should We Trust the Gatekeepers?: Auditors' and Lawyers' Liability for Clients' Misconduct*, 27 Int. Rev. Law Econ. 96 (2007).

[36] RONALD A. DYE, *Incorporation and the Audit Market*, 19 J. Acc. Econ. 75 (1995) (analyzing AICPA 1992 decision to allow auditors to form general corporations and thereby shelter partners' wealth as an answer to the perceived 'crisis' in auditor liability).

[37] HANS-BERND SCHÄFER, *Efficient Third Party Liability of Auditors in Tort Law and in Contract Law*, Supr. Ct. Econ. Rev. 181 (2004).

[38] V. G. NARAYANAN, *An Analysis of Auditor Liability Rules*, 32 J. Acc. Res. (1994) (asserting that proportionate liability is better than joint and several liability with reference to 10b-5 class actions); FRANK GIGLER, *An Analysis of Auditor Liability Rules: Discussion*, 32 J. Acc. Res. (1994) (discussing Narayanan's paper). This is an issue that the Big 6 audit firms had raised in 1992 and that led to the PSLRA's amendment in 1995. *See* also *infra* note 83.

[39] *See infra* § IV.A.

C. Quantitative studies

The second stream concerns quantitative studies seeking to understand whether the US litigation crisis was really pending, and under what terms. These quantitative studies increased exponentially with the flood of litigation that followed the Savings & Loan debacle in the late 1980s, where auditors were accused of having contributed to the crisis with their lax approach.[40]

1. Pre-PSLRA Research

A large part of these studies analyzed predictors of audit litigation.[41] Amongst the investigated predictors, there are the client company's asset structure and characteristics,[42] the client's probability of bankruptcy,[43] auditor independence,[44] the audit client's probability of becoming the target of an acquisition,[45] auditor characteristics,[46] auditor resignation,[47] previous

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[40] See generally JAN S. BLAISING, *Note, Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis*, 25 Ind. L. Rev. 475 (1991); ROBERT TILLMAN & HENRY N. PONTELL, *Organizations and Fraud in the Savings and Loan Industry*, 73 Social Forces 1439 (1994); KITTY CALAVITA, et al., *The Savings and Loan Debacle, Financial Crime, and the State*, 23 Annual Review of Sociology 19 (1997); GEORGE A. AKERLOF & PAUL M. ROMER, *Looting: The Economic Underworld of Bankruptcy for Profit*, 2 Brookings Papers on Economic Activity 1, 23-36 (1993). For a thoughtful analysis of the Lincoln Savings and Loan's scam see MERLE ERICKSON, et al., *Why Do Audits Fail? Evidence from Lincoln Savings and Loan*, J. Acc. Res. 165 (2000).

[41] For a review see CLAIRE KAMM LATHAM & MARK LINVILLE, *A Review of the Literature in Audit Litigation*, 17 J. Acct. Literature 175 (1998).

[42] JAMIE PRATT & JAMES D. STICE, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Audit Fees*, 69 Acc. Rev. 639 (1994); KENT ST PIERRE & JAMES A. ANDERSON, *An Analysis of the Factors Associated with Lawsuits Against Public Accountants*, 59 Acc. Rev. 242 (1984).

[43] ZOE-VONNA PALMROSE, *Litigation and Independent Auditors: The Role of Business Failures and Management Fraud.*, 87 Auditing 90 (1987). This study showed that the allegation that the largest portion of failed companies were involved in audit litigation was false, that the most frequent resolution for business failures without management fraud was dismissal of the action against the auditor, that these dismissals were less reported in the financial press than damage payments made by the auditor to the plaintiff, and that the primary type of cases with large auditor payments were management fraud cases (101-102). Cf. also THOMAS LYS & ROSS L. WATTS, *Lawsuits against Auditors*, 32 J. Acc. Res. 65 (1994).

[44] LYS & WATTS, *supra* note 43.

[45] Id. at 70.

[46] ZOE-VONNA PALMROSE, *An Analysis of Auditor Litigation and Audit Service Quality*, 63 Acc. Rev. (1988).

[47] JAGAN KRISHNAN & JAYANTHI KRISHNAN, *Litigation Risk and Auditor Resignations*, 72 Acc. Rev. (1997).

Accounting and Auditing Enforcement Release (AAER) by the Securities and Exchange Commission (SEC),[48] the role of modified audit opinion.[49] It must be noted that this raft of studies refers to the US experience and generally aggregates all kind of lawsuits against auditors, without distinguishing the different legal scenarios.

Predictors are clearly not enough to assert that an audit litigation crisis is pending. In order to assess the issue, it must be understood whether the merits matter in audit litigation, or whether auditors are drawn into unwarranted litigation aimed at coercing settlements. In particular Professor Zoe-Vonna Palmrose, following Professor Alexander's path-breaking research,[50] has devoted a significant part of her research agenda to the issue, analyzing empirical evidence concerning trials of legal disputes involving independent auditors[51] and reviewing the empirical results reached by the literature, to show that the merits might not matter.[52]

2. *Post-PSLRA research*

Because of lobbying pressure exerted by auditing firms, the Private Securities Litigation Reform Act (PSLRA) modified the litigation scenario, thereby protecting the auditors from securities class litigation.[53] Many of the

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[48] ROSS D. FUERMAN, *Naming Auditor Defendants in Securities Class Actions*, 7 J. Legal Econ. 72 (1997). Fuerman's analysis also considers three other variables that he finds positively associated with the auditor being involved in civil litigation: the audited company bankruptcy within a year from the start of the litigation; plaintiff class period length; a culpable restatement of previously issued audited annual financial statements.

[49] JOSEPH V. CARCELLO & ZOE-VONNA PALMROSE, *Auditor Litigation and Modified Reporting on Bankrupt Clients*, 32 J. Acc. Res. 1 (1994).

[50] JANET COOPER ALEXANDER, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 1487 (1991). But cf. JOEL SELIGMAN, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"* 108 Harv. L. Rev. 438 (1994).

[51] ZOE-VONNA PALMROSE, *Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence*, 29 J. Acc. Res. (1991). *See* also MICHAEL L. ETTREDGE, *Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence: Discussion*, 29 J. Acc. Res. 186 (1991).

[52] ZOE-VONNA PALMROSE, *Audit Litigation Research: Do the Merits Matter? An Assessment and Directions for Future Research*, 16 Journal of Accounting and Public Policy 355 (1997).

[53] In 1991, in reaction to the litigation explosion that followed the Savings & Loan debacle (*see supra* note 40 and accompanying text), the (at the time) Big 6 and the American Institute of Certified Public Accountants ("AICPA") started their effort to reform securities class actions. This effort initially influenced courts' approach towards auditor liability, leading the Supreme Court to its seminal decision Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188-189 (1994), where the Court considered the

studies at the end of the 1990s analyzed the new landscape, predicting that audit quality would be unaffected because reputation is the key driver of audit quality.[54] Other studies, however, took a different view, showing that exposure to liability (the deep-pocket hypothesis) prevails over reputation as an incentive to take care.[55] A stream of empirical studies, both in economic and legal literature, has started to measure the impact of the PSLRA on stock prices,[56] the cost of equity,[57] nonnuisance claims.[58]

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arguments raised by the auditors' industry and decided not to attach private aiding and abetting liability to the 10b-5 cause of action: *see* DAVID L. GILBERTSON & STEVEN D. AVILA, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?*, 24 Iowa J. Corp. L. 681, 683 (1999). Following, the PSLRA was enacted, on the grounds of the intense lobbying activity of the audit industry: id., 682 nt. 6 (passage of the Private Securities Litigation Reform Act of 1995 was based on testimony similar to the accounting firms' Statement of Position); cf. also JOEL SELIGMAN, *Rethinking Private Securities Regulation*, 73 U. Cin. L. Rev. 95 (2004); JAMES D. COX, *Making Securities Class Actions Virtuous*, 39 Ariz. L. Rev. 497, 515-23 (1997). PSLRA introduced proportionate liability: *see infra* note 83. Some studies assert that the reform significantly benefited largest audit firms more than smallest ones: MARSHALL A. GEIGERA, et al., *Auditor Decision-Making in Different Litigation Environments: The Private Securities Litigation Reform Act, Audit Reports and Audit Firm Size*, 25 Journal of Accounting and Public Policy 332 (2006).

[54] SRIKANT DATAR & MICHAEL ALLES, *The Formation and Role of Reputation and Litigation in the Auditor-Manager Relationship*, 14 J. Acc., Aud. Finance 401 (1999); STEPHEN A. HILLEGEIST, *Financial Reporting and Auditing under Alternative Damage Apportionment Rules*, 74 Acc. Rev. 347 (1999). *See* also *infra* note 60.

[55] LENNOX, *supra* note 32; HO-YOUNG; LEE, et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital*, 48 Quart. J. Finance Acc. 85 (2009).

[56] Cf. D. KATHERINE SPIESS & PAULA A. TKAC, *The Private Securities Litigation Reform Act of 1995: The Stock Market Casts Its Vote*, 18 Managerial Dec. Econ. 545 (1997) (indicating that the market believed that PSLRA's potentially positive consequences outweighed its potentially negative consequences); MARILYN F. JOHNSON, et al., *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 Rev. Acc. Stud. 217 (2000) (shareholders generally benefit from PSLRA, although these benefits are mitigated when other mechanisms for curbing fraudulent activity are inadequate); ASHIQ ALI & SANJAY KALLAPUR, *Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events*, 76 Acct. Rev. 431 (2001) (additional analysis conducted beyond the ones followed in the previously mentioned research suggest that shareholders in four-high litigation-risk industries reacted negatively to the PSLRA).

[57] LEE, et al., *supra* note 32 (the PSRLA increased the cost of equity); JEFF P. BOONE, et al., *Litigation Reform, Accounting Discretion, and the Cost of Equity*, 5 J. Cont. Acc. Econ. 80 (2009) (the increase in the accounting discretion associated with the PSLRA increased the firm-specific equity risk premiums).

[58] STEPHEN J. CHOI, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L. Econ. & Org. 598 (2006) (PSRLA reduced nonnuisance claims); MICHAEL A. PERINO, *Did The Private Securities Litigation Reform Act Work?*, U. Ill. L. Rev. 913 (2003) (statistically significant evidence suggesting that the PSLRA improved

The 2001 accounting crisis started with the restatement season, which researchers immediately investigated.[59] After the crisis, the wind changed direction, and subsequent studies started to assume more openly than in the past that litigation exposure increases perceived audit quality.[60] As mentioned, prominent legal scholars stressed that the crisis had been caused by gatekeepers' reduced exposure to liability.[61]

D. Corporate Governance Indices

Both academics and investors' advisors have developed metrics for measuring the corporate governance quality of whole legal systems or single firms.

The Law & Finance literature does not pay too much attention to auditor liability rules. They are mentioned for the first time in 2006 in a much-quoted article concerning securities markets, but exclusively with reference to prospectus liability.[62] Following articles do not expand the view.[63] Those results are puzzling, for at least three reasons. First, because the large majority of the accounting literature deals with secondary market liability, more than with IPO settings.[64] Second, because the hypothesis of auditors' excessive liability was a mantra precisely in the legal and accounting literature of the 1990s, the years in which the Law & Finance literature started its investigations - which were to become immensely popular[65] and extensively critiqued.[66] Third, and more important, because

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overall case quality at least in the circuit that most strictly interprets the Reform Act's heightened pleading standard).

[59] ZOE-VONNA PALMROSE & SUSAN SCHOLZ, *Restated Financial Statements and Auditor Litigation*, SSRN eLibrary (2000); WILLIAM G. HENINGER, *The Association between Auditor Litigation and Abnormal Accruals*, 76 Acct. Rev. 111 (2001).

[60] *See supra* note 57. See also KHURANA & RAMAN, *supra* note 32; PAUL D. NEWMAN, et al., *The Role of Auditing in Investor Protection*, 80 Acct. Rev. 289 (2005); VENKATARAMAN & WEBER, *supra* note 32. *Contra*, CHEE KEUNG KEVIN LAM & YAW M. MENSAH, *Auditors' Decision-Making Under Going-Concern Uncertainties in Low Litigation-Risk Environments: Evidence from Hong Kong*, 25 Journal of Accounting and Public Policy 706 (2006); JOSEPH P. WEBER, et al., *Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG*, 46 J. Acc. Res. 941 (2008).

[61] *See supra* note 3.

[62] RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 J. Fin. 1, 7, 11 (2006).

[63] HOWELL E. JACKSON & MARK J. ROE, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. Fin. Econ. 207, 212 (2009).

[64] *See supra* Part I.B.

[65] RAFAEL LA PORTA, et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997); ANDREI SHLEIFER & ROBERT W. VISHNY, *A Survey of Corporate Governance*, 52 J. Fin. 737 (1997); RAFAEL LA PORTA, et al., *Law and Finance*, 106 J. Pol.

auditors are historically a key figure in monitoring managers,[67] empirical studies provide evidence that investors rely on auditors as fraud detection tools[68] and auditors follow fraud detection procedures under SAS 99 and ISA 240.[69] Thus, the total absence of any auditor liability indices is stunning. Equally puzzling is the most popular system of corporate governance predictors developed by commercial firms, namely the RiskMetrics's Corporate Governance Quotient (CGQ) system.[70] It considers shareholders' ratification of management's selection of auditors, but does not evaluate auditor liability.[71] Yet, as any litigator in this field knows well,

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Econ. 1113 (1998); RAFAEL LA PORTA, et al., *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999); RAFAEL LA PORTA, et al., *Investor Protection and Corporate Governance*, 58 J. Fin. Econ. 3 (2000); SIMON JOHNSON, et al., *Tunneling*, 90 Am. Econ. Rev. 22 (2000); ANDREI SHLEIFER & DANIEL WOLFENZON, *Investor Protection and Equity Markets*, 66 J. Fin. Econ. 3 (2002); SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, 88 J. Fin. Econ. 430 (2006); LA PORTA, et al, *supra* note 62.

[66] JOHN ARMOUR, et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, SSRN eLibrary (2008); SANJAI BHAGAT, et al., *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev. 1803 (2008); LUCIAN A. BEBCHUK & ASSAF HAMDANI, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263 (2009); SOPHIE COOLS, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, 30 Del. J. Corp. Law 697 (2005).

[67] *See infra* Part III.A.

[68] JOSEPH F. BRAZEL, et al., *Investor Perceptions About Financial Statement Fraud and Their Use of Red Flags*, SSRN eLibrary, 17 (2009).

[69] TINA D. CARPENTER, *Audit Team Brainstorming, Fraud Risk Identification, and Fraud Risk Assessment: Implications of SAS No. 99*, 82 Acc. Rev. 1119 (2007); T. JEFFREY WILKS & MARK F. ZIMBELMAN, *Decomposition of Fraud-Risk Assessments and Auditors' Sensitivity to Fraud Cues*, 21 Contemp. Acct. Res. 719 (2004); STEVEN M. GLOVER, et al., *A Test of Changes in Auditors Fraud-Related Planning Judgments since the Issuance of SAS No. 82*, 22 Auditing 237 (2003); MARIA KRAMBIA-KAPARDISM, *A Fraud Detection Model: A Must for Auditors*, 10 J. Fin. Reg. Compliance 266 (2002); CAROL A. KNAPP & MICHAEL C. KNAPP, *The Effects of Experience and Explicit Fraud Risk Assessment in Detecting Fraud with Analytical Procedures*, 26 Acc., Org. Soc. 25 (2001); ROBERT J. NIESCHWIETZ, et al., *Empirical Research on External Auditors' Detection of Financial Statement Fraud*, 19 J. Acc. Lit. 190 (2000); MARK F. ZIMBELMAN, *The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decision*, 35 (Supplement) J. Acc. Res. 75 (1997); KAREN V. PINCUS, *The Efficacy of a Red Flags Questionnaire for Assessing the Possibility of Fraud*, 14 Acc., Org. Soc. 153 (1989).

[70] RISKMETRICS GROUP, CORPORATE GOVERNANCE QUOTIENT, http://www.riskmetrics.com/cgq (last visited Feb. 23, 2010).

[71] RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, http://www.riskmetrics.com/sites/default/files/CGQ_Criteria_exUS.pdf ¶ 21, at 13 ("Shareholders should be permitted to ratify management's selection of auditors each year").

auditor's role and liability are core issues in *ex post* evaluation of the firm's corporate governance system.

E. Assessment

The research on audit litigation can be highly misleading. It is dominated by the US scenario[72] and investors' class actions against audit firms.[73] This has created a form of tunnel vision within the economic literature. The reported problem of the US scenario was that actions against auditors were (at least until 1995) too easily brought to coerce a settlement. However, this scenario had nothing specific concerning the auditor, except that in many cases the auditor was the "deep-pocket", as the company was bankrupt and the plaintiff's efforts were entirely addressed against the external auditor. In other words, excessive litigation against the auditor was treated by the accounting literature as a systemic problem of the pre-1995 American auditor liability regime instead of a part of the larger picture concerning securities class actions and distorted incentives in US private enforcement.[74]

The studies that go beyond the US border reach unclear results as to the role of litigation and civil liability.[75] Cross-country analyses have led to different results[76] and are spoiled by the usual, unreliable methods of

[72] Data concerning other markets are rare: for some examples see LAM & MENSAH, *supra* note 60; WEBER, et al., *supra* note 60.

[73] This is individually well known to many researchers. See for example DYE, *supra* note 36, at 78 (noting that, with reference to whether is it advisable to let auditors adopt the limited liability partnership, the European experience is not a useful benchmark for comparisons, as there are too many differences between the US and European countries' legal environments to make *ceteris paribus* arguments plausible).

[74] About which see for example ALEXANDER, *supra* note 50; JANET COOPER ALEXANDER, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487 (1996); PAUL G. MAHONEY, *Precaution Costs And The Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623 (1992); ELLIOTT J. WEISS & JOHN S. BECKERMAN, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053 (1995); PAUL G. MAHONEY, *The Exchange as Regulator*, 83 Virg. L. Rev. 1453 (1997); ADAM C. PRITCHARD, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925 (1999); STEPHEN J. CHOI, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465 (2004); CHOI, *supra* note 58; TOM BAKER & SEAN J. GRIFFITH, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 756 (2009).

[75] Cf. LAM & MENSAH *supra* note 60; WEBER, et al., *supra* note 60.

[76] Cf. J. FRANCIS & D. WANG, *The Joint Effect of Investor Protection and Big 4 Audits on Earnings Quality around the World*, 25 Contemp. Acct. Res. 157 (2008); JONG-

classifying jurisdictions that typify generalizations made in the Law & Finance literature.[77]

None of the leading articles in the economic analysis of the litigation crisis offer a clear background to auditor liability regimes. As to qualitative research, to the best of my knowledge there are no economic studies concerning auditor liability that deal with common agency models.[78] The problem of a multiple-layer optimum is substantially unaddressed in the literature. There are probably two reasons for this. First, the interaction of many liability layers is much more complex to be modeled; the best in vitro design of each single layer can be not the optimal solution when all the layers are merged together. Second, an analysis that does not concern exclusively liability to investors must also take into consideration the possibility that one or more liability layers are contractually designed. This adds further levels of complexity to the issue. If also second-best implications are taken into account, things become basically intractable.[79]

II. THE EC COMMISSION'S RECOMMENDATION

A. *Introduction*

The Final Report (FR)[80] supports auditor liability limitations as an efficient devise of risk protection in favor of the Big-4. The FR compares strict liability to negligence, joint and several liability (JSL) to proportional liability, the extent of auditor liability, and liability insurance. The FR

HAG CHOI, et al., *Audit Pricing, Legal Liability Regimes, and Big 4 Premiums: Theory and Cross-country Evidence.*, 25 Contemp. Acct. Res. 55 (2008).

[77] This critique of the L&F literature is contained in the articles mentioned at note 66.

[78] There is one paper I am aware of that deals with the common agency literature with reference to auditing, but it does not cover liability issues: see LAURA J. KORNISH & CAROLYN B. LEVINE, *Discipline with Common Agency: The Case of Audit and Nonaudit Services*, 79 Acc. Rev. 173 (2004). On common agency see B. DOUGLAS BERNHEIM & MICHAEL D. WHINSTON, *Common Agency*, 54 Econometrica 923 (1986).

[79] The theory of second best teaches that "if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable." R. G. LIPSEY & KELVIN LANCASTER, *The General Theory of Second Best*, 24 Rev. Econ. Stud., 11 (1956). On the normative impact of the theory cf. RICHARD S. MARKOVITS, *Second-Best Theory and Law & (and) Economics: An Introduction*, 73 Chi.-Kent L. Rev. 3 (1998); THOMAS S. ULEN, *Courts, Legislatures, and the General Theory of Second Best in Law and Economics*, 73 Chi.-Kent L. Rev. 189 (1998).

[80] *See supra* note 13.

recommends not to move to a regime of strict liability, proposes the adoption of a proportionate liability regime (PLR) for auditors, and finally it recommends a regime of limited liability through the adoption of liability caps or other similar devices. The comparison between a strict liability and a negligence regime is outside the scope of this article. Indeed, it has a limited positive interest, since a strict liability regime applied to a monitoring position raises many problematic issues and it is not envisaged by any jurisdiction I am aware of.[81] Therefore, I will focus my attention on the arguments which the FR follows to recommend a proportionate liability regime and other forms of liability limitations. These arguments are thoroughly articulated in Annex 6 to the FR, drafted by Professor Ewert.[82] The annex's author points out that his review of the economic literature and his subsequent conclusions are exclusively based on the analysis of the relationship between the auditor and market investors. Accordingly, the FR relies on a single-layer investigation.

B. Proportionate Liability Regime

A PLR was introduced in the US by the PSRLA as an instrument to limit auditors' exposure to investors class actions.[83] The event studies

[81] Cf. FR, *supra* note 13, at 142-43.

[82] FR, *supra* note 13, at 278-99.

[83] The legislative amendment was considered more as a measure to reduce the alleged over-enforcement of securities class actions than a move based on a clearly modeled theory of joint tortfeasors liability. In a literature that easily argues in favor of reputational incentives and market contracting, no word is given to explain how the right to contribution works in this context and why it has not been useful to make auditors active controllers of primary violators' wealth, considering that joint and several liability with contribution shares determined by fault is aimed at activating reciprocal controls over potential joint tortfeasors. I have not found any article addressing this issue in the auditor litigation literature, whether in law reviews or in accounting reviews. On some of the conceptual problems raised by joint and several liability see LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Sharing Damages Among Multiple Tortfeasors*, 98 Yale L.J. 831 (1989); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Apportioning Damages among Potentially Insolvent Actors*, 19 J. Leg. Stud. 617 (1990); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Settlement Under Joint and Several Liability*, 68 N.Y.U. L. Rev. 427 (1993); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Multidefendant Settlements Under Joint and Several Liability:The Problem of Insolvency*, 23 J. Leg. Stud. 517 (1994); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Multidefendant Settlements: The Impact of Joint and Several Liability*, 23 J. Leg. Stud. 41(1994); JOHN J. DONOHUE, *The Effect of Joint and several Liability on the Settlemente Rate. Matematical Symmetries and Metaissues about Rational Litigant Behavior. Comment on Kornhauser and Revesz*, 23 J. Leg. Stud. 543 (1994); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Evaluating the Effects of*

conducted tend to show that audit quality decreased.[84] However, audit quality is not an absolute measure, because it comes at a cost. Thus, a cost-benefit analysis is needed. The FR conducts it in two theoretical scenarios. The first one concerns the strategic interplay between auditors and investors in a PLR. According to Professor Ewert's analysis, a PLR may induce the auditor to take more care, as this would limit its liability if the managers, who are the primary violators, are insolvent. However, in a PLR, investors' suits are rarer. "A reduction in audit effort by moving from JSL to PL – concludes the author – might be beneficial if the efforts under JSL are too high, a situation that can clearly exist depending on the set of parameters."[85] This vague conclusion can hardly persuade one to abandon the well-tested institutional framework where JSL induces the watchdog to monitor the wealth of the primary violator, thereby substituting the wealth monitoring efforts of the protected parties, which usually face informational as well as collective action problems in doing so. Indeed, this traditional explanation of a JSL is totally neglected by the FR.

The second scenario considers the strategic interplay between the managers and the auditor.[86] The assumption is that if the auditor has a reduced liability exposure under a PLR, the manager has a higher liability exposure and therefore takes more care. However this assumption is based on shaky grounds. Under a JSLR the party who pays the whole damage has a right of contribution against the primary violator. Therefore, it is wrong to assume that the primary violator is less exposed to damages. Moreover, the damages suffered by investors are higher than managers' wealth and especially by sizeable managers' assets. When the assets are concealed, a PLR does not raise the managers' penalty (which is limited by the value of their sizeable assets), it simply shifts the risk of managers' insolvency on the investors. And under a PLR, auditors certainly have no incentives to monitor if and how managers conceal their assets.

Alternative Superfund Liability Rules, *in* Analyzing Superfund: Economics, Science, and Law (Richard L. Revesz & R. Stewart eds., RFF Press 1995); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, Joint and Several Liability § 2 (Peter Newman ed., Macmillan 1998); LEWIS A. KORNHAUSER & RICHARD L. REVESZ, Joint Tortfeasors (Boudewijn Bouckaert & Gerrit De Geest eds., Edward Elgar 2000).

[84] *See supra* notes 56-60.

[85] FR, *supra* note 13, at 289.

[86] FR, *supra* note 13, at 289-290.

C. Liability Caps

The FR is well aware that damage payments depends on sizeable assets, because this is one of the two arguments employed to argue in favor of liability caps. Professor Ewert argues that since investors pay for audit care, an excessive level of care can be detrimental and therefore that "restrictions on audit liability … may in fact be socially desirable."[87] This conclusion is supported, according to the analysis, by a study by Professor Dye concerning the effects of allowing auditors to limit their liability through incorporation.[88] In short, the FR's assumption is that through incorporation auditors "can reduce 'wealth at risk' to a socially optimal level."[89] There are three problems, however. First, the assumption relies on the capability of investors to monitor auditors' incorporated wealth and therefore to monitor the value of sizeable auditors' assets. Since a company's shareholders are not able to do that (otherwise they would directly monitor the company they invested in, instead of demanding audit services), it is difficult to believe that diffused investors who have to decide whether or not to invest into a company can do it better. An auditor's auditor would be needed. The problem would be therefore simply shifted from one level to the other. Second, prominent commentators have argued that incorporation, by reducing partners' incentives to monitor, is one of the reasons why audits became less reliable and the accounting crises exploded.[90] Thus, far from permitting a move of auditor deterrence's levels to the efficient frontier, incorporation reduced auditor incentives too much.[91] Third, the reasoning expressed by Professor Ewert must still

[87] FR, *supra* note 13, at 293.

[88] As a defensive measure against allegedly excessive exposure to liability risk following the S&L litigation explosion (*see supra* note 40 and accompanying text), lawyers and auditors in the US lobbied states' legislatures to be allowed to use the limited liability partnership. Texas started in 1991 and in a few years other states followed in mass: ROBERT W. HAMILTON, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. Colo. L. Rev. 1065 (1995). The main argument used to motivate the change was that, since audit firms had reached a huge dimension and complexity, it is was no longer feasible for partners to monitor each other.

[89] FR, *supra* note 13, at 293.

[90] JONATHAN R. MACEY & HILLARY A. SALE, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 Vill. L. Rev. 1167 (2003).

[91] But cf. FR, *supra* note 13, at 293, where it is also argued, with reference to auditors' incentives and earnings management, that "restrictions on accounting earnings management induce managers to employ more real earnings management which leads to a waste of real resources. From this viewpoint, higher audit quality may not unequivocally enhance the allocation of resources."

explain why liability limitation through asset sheltering granted by incorporation is not enough, and therefore why further protection from liability is needed.[92] This issue is not covered by Annex 6, which too quickly concludes in favor of auditor liability limitations.

D. Assessment

On the grounds of these vague conceptual arguments, the EC Commission has recommended liability limitations. The Recommendation, presented as an instrument to reduce barriers to entry in the international audit market,[93] is flawed. The main problem is that it does not only cover liability towards third parties and, in particular, secondary market investors, but it concerns any kind of liability. Note that prospectus liability and liability to the company was not investigated by the FR. Accordingly, the EC Commission simply expands the conclusions reached analyzing one layer (liability to secondary market investors) to all possible forms of liability. Moreover, it recommends limitations to liability to the company also in jurisdictions where shareholders, investors and other third parties are not entitled to sue the auditor, and thus where liability is already restricted as a matter of fact.

III. AUDITORS' LIABILITY TO THE COMPANY (REGIME 1)

Auditors serve different interests at the same time. The multi-layered analysis must begin with the interests of shareholders, who are the primary constituent, at least historically.[94]

[92] As I mentioned, liability limitation has been already applied to some specific industrial sectors, such as shipping, air transport, nuclear energy (*see supra* notes 14-16 and accompanying text). No research I am aware of seeks to compare these sectors to auditing.

[93] Even though the purpose of this article is not to evaluate whether auditor liability really is a barrier to entry, I would like to highlight the following passage of the FR: "Finally, audit liability risk and lack of liability insurance are viewed as a less serious barrier to entry by the middle-tier firms than by the Big-4 firms. This may reflect the fact that, in the absence of entry into the large company market segment, middle-tier firms have not yet had to address fully the issue of ensuring adequate liability insurance coverage for the liability that may arise out of statutory audits of large and very large companies. Indeed, in follow-up discussions with a number of the major middle-tier firms, some of these firms identified lack of insurance availability as a serious issue. When explicitly asked about the liability risk associated with the statutory audit of large companies, the issue of liability insurance was more clearly focused." FR, *supra* note 13, at 46. It seems that the FR's authors had somehow to convince middle-tier firms to be afraid of liability issues.

[94] The US literature stresses that the primary constituents are investors instead: *see, e.g.*, LAWRENCE A. CUNNINGHAM, *Securitizing Audit Failure Risk: An Alternative to Caps*

A. The Auditor as the Shareholders' Watchdog

Shareholders and partners need to monitor managers to be sure that no breach of contract occurs.[95] The auditor was used right from the very beginning of company history as a tool to control managerial opportunistic behavior.[96] The auditor looked for unauthorized expenses, embezzlements, and checked the accounting data prepared by the management.[97] In short, he was an inspector.[98] Initially, auditors were chosen among directors, assistants[99] or shareholders, which formed shareholders' committees.[100] Later on they became external professionals.[101]

The shareholders' watchdog role is typified by English law. The auditor was appointed by shareholders, who set its remuneration.[102] The

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on Damages, 49 William & Mary L. Rev. 711, 713 (2007). The reason is probably that external auditors are considered shareholders' watchdogs in cases of embezzlement only: *see infra* notes 108-115 and accompanying text.

[95] External auditors are part of a varied menu of corporate governance alternatives and complementarities: see, e.g., SADOK EL GHOUL, et al., *External versus Internal Monitoring: Do Western European Firms Rely More on Big Four Audits in the Absence of Multiple Large Shareholders and Families?*, SSRN eLibrary 1 (2009) (providing evidence that firms with multiple large shareholders whose presence brings valuable cross-monitoring are less apt to choose a Big Four auditor, and that family control and management is associated with lower demand for high-quality auditors).

[96] ROSS J. WATTS & JEROLD L. ZIMMERMAN, *Agency Problems, Auditing, and the Theory of the Firm*, 26 J. L. & Econ. 613 (1983).

[97] Accordingly, it has even been asserted that auditors are primarily engaged to inform management of inefficiencies and irregularities ('watchdog for the management' role): cf. WERNER F. EBKE, *In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Reponsibilities*, 79 Nw. U. L. Rev. 663, 674 (1984).

[98] COFFEE JR., *supra* note 1, at 110.

[99] WATTS & ZIMMERMAN, *supra* note 96, at 626-7.

[100] As Watts and Zimmerman observes, "when the U.K. Companies Act of 1844 required directors to keep accounts and required those accounts to be audited by persons other than the directors (or their clerks), Parliament was merely incorporating into the law a version of a practice that had existed for six hundred years." Id. at 626.

[101] See WATTS & ZIMMERMAN, *supra* note 96, at 628-633.

[102] The traditional English auditor's role of a watchdog appointed by the shareholders was followed by a series of legislation in England that, after the "railroad mania", started to mandate the audit. The lineage of companies acts commenced with the Joint Stock Companies Act of 1844 and led to the Companies Act of 1929, which required an auditor's report on the profits of the company of the last three years to be part of any prospectus used to sell shares, thereby introducing for the first time the prospectus audit into the history of securities regulation. Under the complex stream of companies law statutes, the auditor was always considered exclusively as an agent of the shareholders collectively. For analysis of the various companies acts from an audit perspective see SEAN M. O'CONNOR, *Be Careful What You Wish For: How Accountants and Congress Created*

auditor's role was to act antagonistically in regards of the directors, even though auditors were paid by the company.[103] This shareholders' watchdog role is still testified by the *Caparo* case,[104] in which the House of Lords decisively re-affirms that the auditor is an agent of the shareholders, not as investors but as persons who have delegated the day-to-day management of the company to the directors and who face a collective action problem in monitoring them, and thus charge the auditor to be a check upon directors.[105]

In the UK, the shareholders' watchdog role is still considered the only role that auditors have, with the sole exception of prospectus, where the auditor works in cooperation with the company and its management.[106] This is not so in other legal environments, where the perception is that the auditor serves multiple principals: the company, the investors, the general public.[107] However, in all legal environments is clear that the auditor is contractually bound to the company for the benefit of its shareholders. Accordingly, the auditor is liable to the company as the entity that unifies shareholders' interests. The first and most significant layer is not liability to investors, as economists wrongly believe; it is liability to the company.

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the Problem of Auditor Independence, 45 B.C. L. Rev. 741, 756-775 (2004). The shareholders' watchdog role remained relatively untouched by the appearance of the prospectus audit, which created a direct relationship between directors and auditors. The prospectus audit was covered by the Directors Liability Act 1890, which allowed directors to defend themselves against investor suits concerning prospectuses on the grounds that they – the directors – had in good faith relied on the expert reports of others.

As to the role of prospectus liability in muddling the auditor's role, *see infra* § V.A.

[103] In Caparo Industries plc v Dickman and others, [1990] 2 AC 605, Judge Bridge quotes the passage where Judge Vaughan Williams wrote in Re Kingston Cotton Mill Co [1896] 1 Ch 6 at 11: "No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them."

[104] *See supra* note 103.

[105] Lord Bridge of Harwich, quoting Judge Bingham in Bingham LJ in the Court of Appeal ([1989] 1 All ER 798 at 804. The shareholders of the company "have a collective interest in the company's proper management … indistinguishable from the interest of the company itself and any loss suffered by the shareholders … will be recouped by a claim against the auditor in the name of the company."

[106] *See infra* Part V.A.

[107] The US is a case in point. See O'CONNOR, *supra* note 102, at 824. The author has thoroughly investigated the history of auditors in the US between 1880 and 1934, comparing it to the UK experience. He points out that from the multiple roles taken by accountant ("the self-proclaimed 'authorized agents of publicity'": 690) came out an imbroglio, where external auditors are hired to perform a service on behalf of the client company, "with a host of implied duties to creditors, directors, and the 'investing public', not to mention a duty to shareholders and possibly even employees."

The requirements of auditor liability to the company are not uniform across countries. Indeed there are many issues where the law can have very different approaches. The first one is whether the auditor must be held liable for any damage that the undetected managers have caused to the company and that could have been prevented through the auditor's intervention. In the US the answer is negative. The auditor can successfully attribute knowledge of the fraud committed by its client's managers and employee to the client, even if the auditor did not conduct the audit in accordance with professional standards and was, therefore, negligent. Accordingly, the company has no claim against the auditor because the latter cannot be considered to have caused the damage when the wrongdoing was committed by or already known to the company's managers. The auditor and the company are *in pari delicto*.[108] In order to win the defense the client company must invoke the 'adverse interest defense,' asserting that the managers acted adversely to the principal, entirely for their own purposes, with the principal retaining no benefit from the managers' misconduct.[109]

In this way the requirements for ascertaining auditor liability becomes very narrow. Financial scandals teach that accounting manipulations serve multiple purposes.[110] Insiders misrepresent the company's financial reports both to enlarge the firm's activity range and dimension and to get private benefits from this.[111] Accounting manipulations increase the apparent firm performance and thereby managers' compensation packages and perks, whilst at the same time protecting managers against the risk of dismissal. They allow the use of the company's over-inflated shares to buy up other

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[108] *See, e.g.*, Hirsch v. Arthur Andersen, 72 F.3d 1085 (3d Cir. 1995); Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340 (3d Cir. 2001).

[109] *See* § 282 Restatement (Second) of Agency; Sharp v. KPMG 278 B.R. 28 (Bankr. E.D.N.Y. 2002).

[110] JEAN TIROLE, The Theory of Corporate Finance 20 (Princeton University Press. 2006).

[111] These arguments are known to US courts, but do not dent the strength of the imputation defense, at least in cases where third-parties different from the auditor are involved. "… (T)here is little doubt that in almost every situation where a corporate insider causes a corporation to engage in illegal acts so as to increase the corporation's actual or reported profitability, the insider will have personal interests that might arguably also be advanced if the illegal scheme succeeds. … Allowing corporations to sue co-conspirators whenever such an argument can be ginned up would give corporations a gaping exception from the *in pari delicto* doctrine, putting them on a different plane from actual human beings": In re American International Group, Inc., Consolidated Derivative Litigation, 976 A.2d 872, 892 (Ch. Del. 2009).

companies.[112] They help to get favorable loans, to comply with bank covenants concerning existing loans and, in the end, to keep afloat a firm that is sliding into insolvency. Since it is very difficult for accounting manipulations not to have a short term potentially positive impact on the company, in the US auditors can be considered, from a liability perspective, the shareholders' watchdogs exclusively in the purest cases of embezzlement.

In pari delicto defenses are sometimes conceptualized, with regards to auditor liability, as a corporate governance tool. They force shareholders to implement an adequate corporate governance system and, in particular, to choose a vigilant monitoring board where independent directors have a true role.[113] This approach assumes that independent directors are better positioned to ferret out corporate fraud than auditors[114] and that auditors generally should not take on their shoulders any liability for wrongdoings committed by the managers appointed by the shareholders.[115]

Other jurisdictions take a completely different approach. Italy is a case in point. The auditor is liable for any damage to the company that could have been prevented if the auditor had blown the whistle. The auditor is severally and jointly liable with the directors and can only recover from them (and from inside statutory auditors) pro quota the payment made to the

[112] For an example, see the facts analyzed in Cenco Incorporated v. Seidman & Seidman, 686 F.2d 449.

[113] This corporate governance view is adopted in *Cenco*, 686 F.2d at 456.

[114] But see on this point Judge Strine's eloquent critique in In re American International Group, Inc., Consolidated Derivative Litigation, 965 A.2d 763, 831 nt. 146 (Del. Ch. 2009): "Furthermore, audit firms are paid sizable fees for the thousands of hours their professionals spend on their duties at each issuer. ... The audit firm spends many more hours on the task than independent directors do, and are typically far better compensated. Notably, in corporate law, independent directors are entitled to rely in good faith on advice from the auditors that corporate books and records are accurate and GAAP-compliant and that corporate internal controls are adequate. *See 8 Del. C. § 141(e)* (protecting a director when she relies on "information, opinions, reports or statements" presented to her by someone she reasonably believes to have "professional or expert competence" in the matter). *Cenco* has this relationship backwards and assumes that as between independent directors and auditors, the former are better positioned to ferret out fraud. *Cenco*, 686 F.2d at 456. Doubtless both groups face challenges in doing so, and, likewise, both are positioned to reduce the risk of fraud in various ways, but I question the soundness of premising a legal rule on the belief that, in a simplistic binary choice, independent directors are better equipped to detect high-level fraud than a company's auditors. I also do not understand why what is, at most, an audit committee's negligence should totally bar the corporation's recovery against a professionally negligent agent."

[115] In Re Parmalat Securities Litigation, 2009 U.S. Dist. LEXIS 85523 (Parmalat officers did not abandon totally corporate interests, and therefore the *in pari delicto* defense applies).

company.[116] The *in pari delicto* defense is unknown to Italy. This severe approach is by no means shocking. It is theoretically in line with a modern and financially oriented view of the role of corporate information. Indeed, as a prominent author has pointed out,

> "when the managers make decisions that result in the corporation's violation of a disclosure rule, the corporation is the primary victim of the violation, just as it is the party hurt by a director or officer's breach of a fiduciary duty. This is because … disclosure's primary role is to improve corporate governance and to lower the corporation's cost of capital by increasing the expected level of liquidity. The corporation's shareholders are thus the persons ultimately damaged by the violation because poor management and reduced liquidity reduce the value of shares".[117]

These differences amongst jurisdictions can be explained by many factors. Differences in the corporate governance of companies certainly have a role.[118] History matters as well.[119] Finally, there can be few doubts

[116] A recent amendment to the auditor liability regime has not affected this rule: see Article 15 § 1 Decree-Law 27 January 2010 no. 39.

[117] MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. L. Rev. 237, 280 (2009).

[118] In Italy the agency problem lies in the relationship between the controlling shareholder (coalition) and minority shareholders: *see, e.g.*, LUCA ENRIQUES & PAOLO VOLPIN, *Corporate Governance Reforms in Continental Europe*, 21 J. Econ. Persp. 117 (2007). In the Italian landscape, the idea that managers can simply think of embezzling the company without driving the firm to expand its operations would be considered extremely naïve. The dimension of the company is crucial to enlarge the controlling shareholder's private benefits of control. Financial information is a key tool of corporate governance, as management's decisions can be constantly monitored by shareholders (MERRITT B. FOX, *supra* note 117, at 253-260). Thus, Italian law does not require that the agent has totally abandoned its principal's interest, since when siphoning off is present (at least, it is significantly present), any distinction between managers' (controlling shareholders') innocent interest for the company's success and managers' (controlling shareholders') self-interest is moot.

[119] Italian company law originally opted for the inside statutory auditors model ("collegio sindacale"), which can probably be considered an evolution of shareholders' committees. Inside statutory auditors were to be primarily seen, in the words of one of the major Italian commentators of those early times, "the permanent controllers of the directors, on behalf of the shareholders, who are not able to monitor them personally." CESARE VIVANTE, Trattato di diritto commerciale. Vol. II. Le società commerciali 277 (Vallardi. 1929). The idea that inside statutory auditors could escape liability on the grounds of some sort of imputation theory was unconceivable, because the inside statutory auditor committee was itself a body of the company. Later on, the law moved towards an outside auditors' model, which is now the default model for public companies and the mandatory one for listed companies. Under this model, companies have inside statutory

that the intensity of law enforcement has an influence in shaping the legal regime. In countries with low levels of law enforcement, legislators and interpreters are probably readier to adopt very severe rules, whereas in countries where law enforcement is very strong, they can be more prepared to relax substantive rules of liability.[120]

B. Contracting Around Auditor Liability to the Company

1. The Issue

Despite the differences among legal environments, it is undisputed that the relationship between the company and the auditor is a contractual one. In theory any difference among the jurisdictions would be less significant if the parties were left free to contract around the auditor liability regime and therefore expand or limit auditor liability or the scope of auditing. The issues previously discussed would appear "default rules." Accordingly, the most interesting question is why contracting over auditor liability is generally not admitted, with the exception of the new UK company law.[121] More generally, why is the whole field not left to the freedom of contract principle?

A first answer might be that many jurisdictions are afraid to reduce deterrence levels on auditors for the same reason they are afraid to leave the

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auditors to monitor management and outside auditors in charge of traditional audit tasks. When the system moved towards the outside auditor model, the shift was in no way viewed as a means of offering the outside auditor comparatively better treatment. The external auditor is not a company's body, but a mandatory external watchdog that fulfils identical needs with regards to financial reports. For a more detailed description of Italian law, which also lets companies adopt a German-like two tier structure or an Anglo-American one without inside auditors see GUIDO FERRARINI, et al., *Company Law Reform in Italy: Real Progress?*, 69 Rabels Zeitschrift 658 (2005).

[120] See GUIDO FERRARINI & PAOLO GIUDICI, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case in* After Enron 159 (John Armour & Joseph A. McCahery eds., Hart Publ. 2006) (analyzing the Italian situation of strong rules and lax private enforcement in the light of the Parmalat case).

[121] England now allows for limits to auditors' liability (*see supra* note 11 and accompanying text), but does not allow the adoption of clauses in the corporate constitutions limiting directors' liability. This represents a significant difference from Delaware General Corporation Law (and the laws of other states that followed Delaware on this path), whose Section 102(b)(7) permits corporations to limit or eliminate the liability of directors for all but intentional or self-serving conduct, but does not say anything about auditor liability: see BRIAN CHEFFINS & BERNARD BLACK, *Outside Director Liabilities Across Countries*, 84 Tex. L. Rev. 1385, 1406 (2006). Whether contractual limitations to auditors' liability are to be allowed is, however, the subject of current debate in the US: *see supra* note 10. In Italy both limitations and caps to auditors' or directors' liability are considered null and void.

company and its directors free to contract around director liability regimes.[122] The idea is that, at least *de facto*, directors and auditors serve not only shareholders, but other stakeholders as well. Therefore, the contract between the company and the auditor would have spillover effects on other constituents that rely on auditors' role. This answer reflects the correct assumption that auditors serve multiple principals and that deterrence through liability can be achieved only through a multi-layered approach.[123]

However, this unsophisticated 'common agency' explanation is not sufficient. Probably it does not explain why contracting over liability was not allowed prior to 2006 in the UK, where it was clear from the very beginning that the auditor acts exclusively as an agent of the company and therefore has no watchdog duties to third parties.[124] Accordingly, there must be also another explanation, confined to the pure shareholders' watchdog role.

2. Analysis: Shareholders' Collective Action Problem

The idea of an auditor acting as the shareholders' watchdog is difficult to put into practice in a large public company. The most obvious problem concerns the auditor's terms of engagement. In order to be a credible watchdog, the auditor should be elected, tenured and eventually dismissed by shareholders. However, the collective action problems that have induced shareholders to appoint auditors[125] affects also the appointment process: shareholders should spend time and resources in selecting the auditors and negotiating their engagement terms and price. It is difficult to find shareholders ready to provide this collective good.[126] In large, modern Anglo-American public companies shareholders are dispersed investors, rationally apathetic, ready to vote with management or with their feet.[127] The collective action problem that shareholders face is sorted out by the management itself, who selects the auditor on behalf of the company, negotiates the price and eventually tables the audit firm's name for the

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[122] With the exception of Delaware and the other states that followed it, allowing exculpation clauses: *see supra* note 121.

[123] *See infra* Part. VII.

[124] *See infra* notes 144-145 and accompanying text.

[125] *See supra* Part. III.A

[126] MANCUR OLSON, The Logic of Collective Action: Public Goods and the Theory of Groups 55 (Harvard University Press. 1965).

[127] See ANITA ANAND & NIAMH MOLONEY, *Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives*, 5 EBOR 223, 237 (2004).

shareholders to approve.[128] The experience of large modern companies has shown also in the UK that the parties to be monitored are inevitably the ones that decide the shareholders' watchdog selection (as well as its tenure and dismissal).[129]

In order to limit the shareholder collective action problem intermediate conduits (such as the audit committee) can be adopted.[130] But they are not fully reliable, because of well-known agency problems. This is certainly one of the reasons why all the terms and conditions of the contract are not left to free negotiation. But more important, negotiations of the contractual terms and, in particular, of liability issues could give room to an intergenerational problem.[131] New shareholders might enter into the company relying on the monitoring role of the auditors, whilst old shareholders having a controlling stake in the company would be able to modify *ex post* the engagement terms, for example by reducing the auditor's exposure to liability risk, in order to induce a lessening in the monitoring activity.[132] This is another facet of the latecomer terms' problem.[133]

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[128] In the US shareholders approval is not even required. On this longstanding issue see MELVIN ARON EISENBERG, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 Cal. L. Rev. 375, 424-26 (1975).

[129] ANAND – MOLONEY, *supra* note 127, at 240 ("Historically, the process by which auditors are appointed has been vulnerable to conflicts of interest: the auditors are appointed by shareholders and are responsible to them, but they are effectively hired and paid by management").

[130] The audit committee is the conduit under recent English practice, following the US experience: see ANAND – MOLONEY, *supra* note 127, at 240-242. In Italy the conduit is, with regard to listed companies, the inside statutory auditors' committee, which is the internal body of auditors that has been for a long time the substitute of Anglo-American external auditors and that now proposes to the general shareholder meeting the audit firm (even though in practice the managers still negotiate the fees with the audit firm to be proposed by the inside auditors). See Articles 13 and 19 Decree-Law 27 January 2010 no. 39.

[131] Intergenerational problems are contract problems, where a future generation cannot contract with the current generation about issues that will affect the former: see JOACHIM VON AMSBERG, *Excessive Environmental Risks: An Intergenerational Market Failure*, 39 Eur. Econ. Rev. 1447, 1448 (1995).

[132] Needless to say, controlling shareholders might have an interest in reducing the auditor's monitoring when they want to expropriate minority shareholders through the managers, in situations typically where the manager and the controlling shareholder are the same person or the members of the same family. The intergenerational problem would also become significant if the company and the auditor initially permitted to expand by agreement the scope of auditor liability (for example, by agreeing that the auditor is not allowed to invoke any *in pari delicto* defense) and later on returned to the default regime. Investors who decided to enter into the company in the meantime would be damaged.

[133] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, The Economic Structure of Corporate Law 32-34 (Harvard Univ. Press. 1991).

Standardization is therefore the other instrument used to reduce the collective action problem and the related intergenerational one. Engagement terms have been standardized with the help of auditor associations, making negotiations easier.[134] Since liability rules are at the core of the contractual relationship between the company and the audit firm, a mandatory approach to liability - equivalent to compulsory standardization[135] - expresses both a disbelief in the capacity of conduits not to be influenced by the executives that the auditors will monitor (or by the controlling shareholders that elect the board), and the need to curb the intergenerational problem. Common standards of care also facilitates the elaboration of common auditing procedures (for example, procedures of fraud detection) and thereby the training and monitoring of associates and partners, inducing positive network externalities.[136]

The intergenerational problems can become less significant in countries where shareholders are very homogeneous. This could explain why contracting over auditor liability has been recently allowed in the UK, where institutional investors are the prevalent shareholders of listed companies and the intergenerational problem is, accordingly, less worrying.[137] This also shows that the key features of the first layer largely depend on local conditions, discouraging any attempt to design in vitro the perfect regime of liability to the company.

IV. AUDITORS AND LIABILITY TO THIRD PARTIES UNDER GENERAL PRIVATE LAW DOCTRINES (REGIME 2)

A. Ultramares *Legacy*

1. Judge Cardozo's Decision

The audit can create a spillover effect, as information originally addressed to the shareholders can go to the benefit of creditors as well. This means that the company can seek to use the audit to reassure creditors and get funds, as is commonly observed in commercial practice. Is the auditor to

[134] *See, e.g.*, International Standards on Auditing (ISA) 210, concerning the terms of audit engagement.

[135] As a matter of fact, companies and auditors could also agree to expand the range of the latter's liability. However, this is never observed.

[136] This argument about positive network effects induced by mandatory liability is presented, with reference to medical liability, by JENNIFER ARLEN, *Contracting Out of Liability: Medical Malpractice and the Cost of Choice*, 158 U. Pa. L. Rev. 957, 989 (2009).

[137] *See supra* note 11.

be held liable if a creditor relies on its audit to finance the company? This is the classic *Ultramares* issue.[138] Judge Cardozo decided that the auditor was not liable for negligence towards Ultramares, whereas it would have been liable if fraudulent intent had been proved.[139] The auditor was not in privity with Ultramares, as the latter had not employed the former. "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."[140] Accordingly, a negligence claim would be equivalent to a fraud claim. As Judge Cardozo points out: "The extension, if made, will so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud."[141]

The *Ultramares* decision has influenced all the following history of Anglo-American law on the issue, and therefore the law and economics thinking about the subject-matter.[142] US State Courts or State legislation have developed and in many cases re-shaped the concepts analyzed by Judge Cardozo, adopting concepts like "near privity", "reasonable foreseeability" and similar, addressed at extending auditors' liability to cases in which it was perceived that the auditor knew or could have known that its audit was going to be used in order to induce a specified class of third parties to extend credit or invest in the company or in its shares.[143] In the UK, the House of Lords explicitly followed the *Ultramares* principles in

[138] Touche was the auditor of Stern, a firm that borrowed large sums of money from banks and other lenders to finance its operations. Touche knew that Stern exhibited the certified balance sheet to potential creditors, and prepared thirty-two certified copies with serial numbers as counterpart originals. However, Touche did not know to whom in particular Stern would show the certified balance sheet. Ultramares was a factor and financed Stern, but the balance sheet was false and Stern went bankrupt. Ultramares sued the auditor for negligence and fraud. See *Ultramares Corp. v. Touche* (1931) 255 N.Y. 170.

[139] Cardozo was too lenient on this point, according to GOLDBERG, *supra* note 30, at 296.

[140] *Ultramares*, *supra* note 138, at 179-180.

[141] Id., at 185.

[142] *See infra* note 148.

[143] For an overview of these concepts as applied by US courts see JAY M. FEINMAN, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 Fla St. U. L.Rev. 20, 34-48 (2003).

Caparo.[144] The House of Lords decided that the auditor owes a duty to the company and not to creditors or to any single shareholder who "as a purchaser of additional shares in reliance on the auditor's report, [he] stands in no different position from any other investing member of the public to whom the auditor owes no duty." This assertion takes into consideration the fact that the accounts and the audit become public at the Register, but did not comport any responsibility of auditors to the public at large.[145]

2. The Floodgate Argument

Why is the collective action interest of shareholders so well recognized, in particular by English courts,[146] while those of creditors (e.g. *Ultramares*) or investors (e.g. *Caparo*) are not, under common law? The key concept is privity, and behind privity lies one of the more catchy and quoted phrases in modern private law: Judge Cardozo's reference to exposition to "liability in an indeterminate amount for an indeterminate time to an indeterminate class".[147] This is the floodgate argument, which dominates any scientific discussion of pure economic loss.[148] The core idea

[144] *See supra* note 103. *Caparo* concerned a shareholder who, relying on the certified accounts of a listed company, launched a takeover on the company to later discover that the accounts were false. The shareholder sued the auditor.

[145] "What was surprising to company lawyer about *Caparo* was the narrow view taken by the court of the purposes Parliament had in mind when steadily expanding over the century the disclosure provisions of the Act and especially when requiring ever greater levels of public disclosure of financial reports rather than just their circulation to members and other current investors in the company": PAUL DAVIES, *Gower's Principles of Modern Company Law*, 554 (Sweet & Maxwell 6ed. 1997).

[146] *See supra* § III.A.

[147] *Ultramares*, *supra* note 138, at 179.

[148] *See, e.g.*, MARIO J. RIZZO, *A Theory of Economic Loss in the Law of Torts*, 11 J. Leg. Stud. 281 (1982); WILLIAM BISHOP, *Economic Loss in Tort*, 2 Oxford J. Legal Stud. 1 (1982); WILLIAM BISHOP, *Economic Loss: A Reply to Professor Rizzo*, 2 Oxford J. Legal Stud. 207 (1982); MARIO J. RIZZO, *The Economic Loss Problem. A Comment on Bishop*, 2 Oxford J. Legal Stud. 197 (1982); BRUCE CHAPMAN, *Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law*, 20 C.B.L.J. 180 (1992); JAN M. VAN DUNNÉ, *Liability for Pure Economic Loss: Rule Or Exception? A Comparatist's View of the Civil Law - Common Law Split on Compensation of Non-physical Damage in Tort Law*, 4 Eur. Rev. Priv. L. 397 (1999); JANE STAPLETON, *Comparative Economic Loss: Lessons From Case-Law-Focused "Middle Theory"*, 50 UCLA L. Rev. 531 (2002); MAURO BUSSANI, et al., *Liability for Pure Financial Loss in Europe: an Economic Restatement*, 51 Am. J. Comp. L. 113 (2003); FRANCESCO PARISI, *Liability for Pure Financial Loss: Revisiting the Economic Foundations of a Legal Doctrine*, *in* Pure Economic Loss in Europe 74 (Mario Bussani & Valentine Palmer Vernon eds., Cambridge Univ. 2003); GARY T. SCHWARTZ, *American Tort Law and the (Supposed) Economic Loss Rule, in* Pure Economic Loss in Europe 94 (Mario Bussani & Valentine Palmer Vernon eds., Cambridge Univ. 2003); FERNANDO GÓMEZ & JUAN ANTONIO RUIZ, *The Plural - and Misleading - Notion of*

is that if the auditor is liable towards any potential lender or investor approached by the company, he risks being exposed to unforeseeable costs in terms of liability, as in theory there is no limit to the capital a firm can demand and obtain from creditors or the market. By contrast, the auditor's potential exposition to risk for liability towards the company is limited, as it refers – one should assume[149] – to assets that managers can misappropriate. Accordingly, the floodgate argument is grounded in the problem of pricing the auditor's risk. The auditor cannot price its service, because it cannot know *ex ante* the liability risk to third parties he is going to face. It is very difficult for the company to credibly commit itself toward the auditor in order to sort out this problem, because once the information is provided (the audit), the company can use it freely, soliciting more and more potential investors to provide funds.[150]

Under the floodgate argument, it is up to investors to contract with auditors in order to buy protection.[151] Needless to say, investors could face coordination problems. When these problems become significant, securities law steps in and sorts them out by fiat.

Economic Loss in Tort: A Law and Economics Perspective, ZEuP 908 (2004); FRANCESCO PARISI, et al., *The Comparative Law and Economics of Pure Economic Loss*, 1 (2005); DAN B. DOBBS, *An Introduction to Non-Statutory Economic Loss Claims*, 48 Ariz. L. Rev. 713 (2006); HELMUT KOZIOL, *Recovery for Economic Loss in the European Union*, 48 Ariz. L. Rev. 871 (2006); GIUSEPPE DARI MATTIACCI & HANS-BERND SCHÄFER, *The Core of Pure Economic Loss*, 27 Int. Rev. L. Econ. 1 (2007).

[149] *See supra* notes 108-109 and accompanying text.

[150] The traditional policy basis of the floodgate argument is spelled out by the Supreme Court of Canada in *Hercules* [1997] 2 S.C.R. 165 quoting two law articles: BRIAN R. CHEFFINS, *Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow*, 18 C.B.L.J. 118, 125-127 (1991); IVAN F. IVANKOVICH, *Accountants and Third Party Liability - Back to the Future*, 23 Ottawa L. Rev. 505, 520-521 (1991). The arguments assert that liability to third parties would increase insurance and litigation costs, consequently reduce the audit service supply and increase the price paid by clients to incumbent auditing firms. These arguments are based on assumptions that remain very difficult to be empirically proved and are, therefore, unconvincing.

[151] It must be pointed out that unpredictability is not an issue with regards to management liability, because directors use the false accounts to misrepresent the company's situation and attract investments and credit, whereas the auditor does not know with precision whom the management is going to solicit. When the auditor should know that its attestation will reach a certain group of persons, the various doctrines I have already mentioned in previous note 143 and accompanying text might apply ("near-privity", "reasonable foreseeability" and the likes). Thus, both the manager and the auditor are shareholders' agents, but the former is in a very different situation from the latter because he knows what is he going to do with the false or negligently prepared statements, whereas the external auditor may have an idea but not a precise perception of the risk taken on.

3. The Floodgate Argument Is Not Universally Followed: The Case of Italy

The floodgate argument is not accepted in all countries. For instance, it is not known to Italian law, where auditors are liable to third parties. The reasons of this huge difference are probably many, but can be summarized under three different factors: the financial structure of companies, history, and law enforcement. As to finance, Italy has always been a country where the main financing channel for companies is in the form of banks and trade creditors. Creditors' protection has certainly been perceived to be more important than in Anglo-American jurisdictions, and the fact that financial statements were subject to publicity was easily considered evidence of their public value.[152] Accordingly, the Italian discussion has always been dominated by the need to extend directors' and statutory auditors' liability in order to individually protect creditors from reliance on false accounts.[153] As to history, the Italian auditors originally were inside statutory auditors, appointed by the controlling shareholder. Once it was decided that directors were to be made liable for damages incurred by creditors and investors who have relied on the financial statements prepared by them, it was difficult not to put inside statutory auditors in the same position. As insiders they could less persuasively state that they could not expect the financial statements to be used in order to induce creditors to fund the company and, more importantly, that they could not foresee this risk and perceive its monetary dimension.[154] This approach was passed on to external auditors, without too many distinctions between the two kinds of auditors and their position vis-à-vis the company.[155] As to law enforcement, in a country where creditors were perceived to have collective action problems and in the absence of class-action like mechanisms, a litigation crisis with following exposition to

[152] *Cf. supra* note 145 and accompanying text.

[153] *See* MARIO BUSSOLETTI, Le società di revisione 332 ff. (Giuffrè. 1985).

[154] Indeed, the 1942 Civil code stated at Article 2395 that directors are liable towards third parties. It said nothing about statutory auditors, but legal commentators started to assert that the rule was a general principle of our tort law (accordingly, the pure economic issue was totally bypassed) and that it should be applied by analogy to statutory auditors: see GIOVANNI DOMENICHINI, *Il collegio sindacale nelle società per azioni*, *in* Trattato di diritto privato 583 (Pietro Rescigno ed., Utet 1985). The 2003 amendment to the company law part of the Civil code has stated that statutory auditors (and external auditors) are liable towards third parties under Article 2395.

[155] *See supra* note 119. Recently enacted Article 15 Decree-Law 27 January 2010 no. 39 confirms the approach.

gigantic and unforeseeable liability was not to be considered a realistic risk.[156]

4. The Insolvency Scenario

In the jurisdictions where the floodgate argument governs auditor liability issues, the neat separation between the company as the aggregation of the shareholders' interest and creditors as third parties has to deal with the insolvency scenario. It is commonly asserted, in the law & economics parlance, that the residual claimants of an insolvent company are the creditors as a class.[157] Indeed, the insolvency liquidator usually claims money to third parties on behalf of the company but to the indirect benefit of creditors and not of shareholders, since equity is usually completely underwater in an insolvency scenario.[158] In other words, in an insolvency scenario the company's claims aggregates creditors' interests more than shareholders' ones; the distinction between the company and creditors as a class collapses.[159]

The recent English *Stone & Rolls* case has illuminated the issue.[160] Stone & Rolls (S&R) was under the complete control and effective ownership of Mr. Stojevic, who obtained from banks increasingly large amounts of money under letters of credit providing for deferred payment.

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[156] FERRARINI & GIUDICI, *supra* note 120, at 184 ff.; PAOLO GIUDICI, *Private Antitrust Law Enforcement in Italy*, 1 Comp. L. Rev. 61 (2004); PAOLO GIUDICI, *Representative Litigation in Italian Capital Markets: Italian Derivative Suits and (If Ever) Securities Class Actions*, 2-3 ECFR 246 (2009).

[157] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 133, at 69. ("When a firm is in distress, the shareholders' residual claim goes under water, and they lose the appropriate incentives to maximize on the margin. Other groups, such as preferred stockholders or creditors, then receive the benefits of new decisions and projects until their claims are satisfied. … voting rights flow to whichever group holds the residual claim"); N. Am. Catholic Educ. Programming Found. v. Gheewalla, No. 521, 2006, slip op. at 20 (Del. May 18, 2007) ("When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value"). *See* also *infra* note 159.

[158] *See supra* note 157.

[159] For this reason it is discussed whether when a company has become insolvent, the directors owe fiduciary duties to the creditors, the residual claimants of corporate assets being the constituency to which directors owe their allegiance. Cf. HENRY T.C. HU & JAY LAWRENCE WESTBROOK, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321, 1381-1396 (2007); DOUGLAS G. BAIRD & M. TODD HENDERSON, *Other's People Money*, 60 Stan. L. Rev. 1309 (2008); STEPHEN M. BAINBRIDGE, *Much Ado about Little - Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. Bus. & Tech. L. 335 (2007); LARRY E. RIBSTEIN & KELLI A. ALCES, *Directors' Duties in Failing Firms*, 1 J. Bus. & Tech. L. 529 (2007); SIMONE M. SEPE, *Directors' Duties to Creditors and the Debt Contract*, 1 J. Bus. & Tech. L. 553 (2007).

[160] Moore Stephens v Stone Rolls Limited (in liquidation) [2009] UKHL 39.

The banks thought they were financing commodity trades, but the documents were forgeries. S&R got the money without waiting for the expiry of the deferred periods by assigning or forfeiting the letters of credit. The funds were then partly siphoned off to third parties related to Mr. Stojevic, or partly used to manage a Ponzi-scheme against the same banks, to get access to larger and larger letter of credits. At a certain point the scheme ceased, and the banks were left with unsecured and substantial losses. The company's liquidator sued the auditor.

The auditor raised the English version of the American *in pari delicto* defense. The auditor won the case because S&R was a one-man company. Accordingly, the three Lords who decided in favor of MS saw no shareholders to protect, and the argument that the "very thing" that auditors have to do is to monitor management and report fraud was not seen as persuasive in the absence of innocent shareholders to be protected.[161] More important to the discussion of the present paragraph, the three Lords that formed the majority were particularly worried to go against *Caparo*[162] by introducing a hidden creditors' action against the auditor through the liquidator's claim.[163] In fact, the action's proceeds would have been used to repay the defrauded banks, as the company's loss (the money siphoned off) was the creditor's loss.[164] This was not the main argument the Lords used to dismiss the liquidator's claim.[165] However, it introduces further elements of

[161] Moreover, one Lord did not even consider fraud detection as the "very thing" that auditors are expected to do: "The detection of fraud is only a small part of the total statutory and common law duties owed by auditors, and the discovery that an apparently respectable and prosperous company is carrying on activities that are wholly fraudulent must be a very rare occurrence": Lord Walker, at ¶193.

[162] *See supra* note 103.

[163] I have strong sympathy for Lord Mance's observation that "within the majority speeches, although their reasoning differs, there can be found … an inversion of the decision in Caparo – whereby the denial to creditors in that case of recovery against auditors because the company would have its own claim is deployed to deny the company's claim against auditors because this would indirectly benefit the company's creditors": *Stone & Rolls*, at ¶ 207.

[164] Lord Phillips, *Stone & Rolls*, at ¶ 5: "The final reason of common sense that predisposed me against this claim was one which would not, unlike the other two, occur to the man in the street but might occur to a student with knowledge of the principles of the law of negligence. Looking at the realities, this claim is brought for the benefit of banks defrauded by S&R on the ground that Moore Stephens should have prevented S&R from perpetrating the frauds. Why, if this is a legitimate objective, should the banks not have a direct cause of action in negligence against Moore Stephens?"

[165] The House of Lords could escape from this swamp thanks to the fact that the audited client was a one-man company, thereby applying the imputation defense and rejecting the adverse selection exception. Whether the auditor has to be held liable where

complexity. If it is true, the consequences are that when the company were not in a position to distribute the proceeds to the shareholders the auditor would be free from any liability whatsoever. This result would be clearly absurd, as it would encourage the auditor to help the managers or the controlling shareholder in spoiling the company up to the last cent.[166] If it does not hold true, however, the separation between shareholders and creditors as a class is not as monolithic as it may appear at first sight[167] Indeed, the company also aggregates the interest of the creditors as an undistinguished class, at least from the moment in time where an insolvency procedure has to start. For this reason, the law of some countries asserts that the company's claims are conducted also in the interest of creditors as residual claimants of the company's estate.[168] This also means that creditors as a class have no right to start derivative actions against the directors and the auditor, as the action can only be brought by the liquidator. By contrast, the liquidator cannot pursue creditors' individual claims, which have to be singularly advanced by any creditor against the directors and the auditor.

5. The "Wrongfully-Incurred Unpayable Debt" Quagmire

Up to now, bankruptcy law has not been part of the analysis, at least explicitly. However, auditor liability to the company is also influenced by bankruptcy law. More precisely, is the auditor liable for the wrongfully-incurred unpayable debt that the company assumed before being subject to insolvency liquidation? The accusation would be that if the auditor had picked up the material misstatements in the company's financial reporting, the company's operation would have been somehow stopped and it would

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the company is not entirely a one-man company is the intricate problem that the House of Lords has left us with following *Stone & Rolls*.

[166] Note that the issue is completely different from a discussion on whether or not the auditor has a duty toward creditors as such. It is undisputed under the English and US systems that the answer is negative. The issue is exclusively whether the company is entitled to recover damages that would not have been suffered if the auditor had done its job with care, when the proceeds go first to the benefit of creditors because there is a liquidation procedure to be applied. Note as well that a positive answer would also imply that the action is vested with the insolvency liquidator.

[167] As Judge Scott points out in *Stone & Rolls*, at ¶ 119, there is "a difference between a cause of action in negligence brought by a solvent company and a similar cause of action brought by an insolvent company. In the former case any damages recovered will benefit the shareholders; in the latter case the damages will benefit the creditors." The real issue is therefore whether an auditor must be held liable to the company "for failure to pick up a fraudulent scheme rendering it increasingly insolvent," as Lord Mance writes at ¶ 268.

[168] This is the case of Italian law, where it is discussed whether the liquidator is entitled to sue any party whatsoever on behalf of creditors as a class or directors and auditors only.

not have taken further debt. Is it within the scope of auditing to stop a company from sliding into insolvency and still expand its liabilities?

The answer depends on the function that each jurisdiction attributes to the financial statement. When the loss of the subscribed capital has legal implications, as it is the case under Article 17 of the Second Directive in Europe (where a shareholder meeting must be called when the company has suffered a serious loss of legal capital), it might be questioned whether these implications stem to benefit creditors as well. In the case of a positive answer, the auditor's negligence might lead to liability for the company's losses that could have been prevented if the balance sheet had shown the capital loss in time. When the legal system also adopts a "recapitalize or liquidate rule,"[169] there is little doubt that the auditor can be held liable for not having prevented the shareholders from protecting creditors by recapitalizing the company or stopping its operations to avoid further losses.[170]

Further on, the auditor's position depends on whether or not managers have a duty to file for insolvency proceedings at a certain point in time or to act in order to protect creditors' claims, and therefore whether or not they face liability for prolonging the life of an insolvent company.[171]

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169 LORENZO STANGHELLINI, *Directors' Duties and the Optimal Timing of Insolvency: A Reassessment of the "Recapitalize or Liquidate" Rule*, forthcoming, 2010.

170 The Italian system adopts a "recapitalize or liquidate" rule under which the directors have a duty to detect net assets unbalances and call a shareholder meeting when more than one third of the capital has been lost, or either liquidate or call shareholders to recapitalize when the whole capital has been lost. *See* LORENZO STANGHELLINI, *supra* note 169. It is assumed that creditors can observe this through the publication of the company's financial statements. If directors evade their duty by means of misstatements in the financial reporting, the insolvency liquidator steps in the shoes of the company and its residual claimants (the creditors as an undistinguished class) and brings a claim against the directors and the auditors asserting that, through the misreporting, the company prolonged its life and deepened its debt, when managers should have promptly initiated an insolvency procedure. On the European system of legal capital protection, *see* Legal Capital in Europe (Marcus Lutter ed., De Gruyter 2006) and the articles published on volume 7 of EBOR 2006.

171 In the US this is the realm of the much discussed 'deepening insolvency doctrine': cf. J.B. HEATON, *Deepening Insolvency*, 30 Iowa J. Corp. L. 465 (2005); SABIN WILLETT, *The Shallows of Deepening Insolvency*, 60 Bus. Law. 549 (2005); TAERA K. FRANKLIN, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J. L. & Bus. 435 (2006). Vice Chancellor Leo Strine held that "Delaware law does not recognize [deepening insolvency] as a cause of action, because catchy though the term may be, it does not express a coherent concept." Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 174 (Del. Ch. 2006). The Delaware Supreme Court affirmed Vice Chancellor Strine's decision in Trenwick America Litigation Trust v. Billet, No. 495, 2006 (Del. Aug. 14, 2007).

Indeed, the significant point in time will be presumably signaled by the financial reports and therefore monitored by the auditor, which will be held liable for not having properly exercised his professional care in reviewing the company's accounts. In other words, if the directors have to protect the company's creditors when the financial indicators reach a certain level (which could be mandated by a specific rule or a generic standard), the auditor takes liability in the case the financial statements were not properly reviewed.

V. AUDITORS AND INVESTORS IN PRIMARY CAPITAL MARKETS (REGIME 3)

A. In IPOs, Auditors are Reputational Intermediaries Needed by the Issuer

The idea embraced by *Ultramares* that auditors are in privity with the company and have no relationship with unknown third parties is not suited to the real workings of capital markets. When the company taps the financial markets, it is trying to convince a general class of investors to put money in the firm, in the form of equity, debt or any equity-like or bond-like hybrid as the case may be. The company is usually also promising these investors that through listing it will create conditions for them to resell the financial instruments that they are going to underwrite or purchase. The usual asymmetric relationship between the company and its investors applies, but here it is amplified by an evident collective action problem. Diffused investors are not singularly going to instruct an auditor to investigate the company's accounts. While in an *Ultramares* situation the company might expect the creditor to ask for a due diligence review by a specifically appointed auditor, in an IPO situation there is no way anybody could expect the solicited, anonymous investors to instruct an auditor. Accordingly, it is clear that it is the company that has to instruct the auditor to the benefit of solicited investors. The idea that the auditor is working for the shareholders as an antagonist controller of managers is out of place in a public offering scenario, as the managers are asking third parties for money on behalf of the company (the shareholders) and using the auditor as a reputational intermediary.[172] The corollary is that the director can even rely

[172] The *locus classicus* is RONALD J. GILSON & REINIER H. KRAAKMAN, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 618-621 (1984). See also STEPHEN J.

on the auditor with regards to the accounting data that the latter examines and certifies:[173] the auditor becomes somebody the director can trust when the company's accounts are considered. Since the audit can have an internal value at least as a director's defense, it can be confused with an internal audit.[174]

The muddling of the auditor's role is rooted in the prospectus audit. Indeed, in an IPO scenario the privity concept collapses, because the investors are precisely the beneficiaries of the prospectus audit. The law considered this situation starting with the UK Companies Act 1929, mandating the company auditor's certification of the company's profit and loss statement for the last three years to be included in any prospectus used to sell shares.[175] This statute was the template of today's most famous example in this field, Section 11 of the Securities Exchange Act.[176] It has been recognized since its adoption that this rule was addressed to sorting out the 'privity problem' and its likes.[177]

B. Prospectus Auditing and Why the Floodgate Argument Is No Longer an Issue

Why is exposition to unpredictable liability no longer an issue in this setting? Curious as it may seem, I have never found this obvious question posed in the literature. If the floodgate argument is reconceptualized as a problem of pricing risk, the answer can only lie in the mechanism followed by companies to tap the market, which puts auditors in a position to know *ex ante* how much capital the company is going to request and therefore to

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CHOI, *Market Lessons for Gatekeepers*, 92 Nw. U.L. Rev. 916, 924 (1998), who uses the term "certification intermediaries" instead.

[173] *See supra* note 102.

[174] Cf. SEAN M. O'CONNOR, *Strengthening Auditor Independence by Reducing the Need for It: Reestablishing Audits as Control and Premium Signaling Mechanisms*, SSRN eLibrary 1, 8 (2006).

[175] For a review of English legislation see O'CONNOR, *Be Careful What You Wish For, supra* note 102, at 760-773.

[176] In this situation the auditor is no more an agent of the shareholders, but a professional rendering services to a client: id. at 824.

[177] WILLIAM O. DOUGLAS & GEORGE F. BATES, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 198 (1933) ("To say the least the Act goes as far in protection of purchasers of securities as plaintiff in *Ultramares Corp. v. Touche* unsuccessfully urged the New York Courts of Appeal to go in the protection of a creditor") [footnotes omitted]; HARRY SCHULMAN, *Civil Liability and the Securities Act*, 43 Yale L.J. 227, 249 (1933) ("The most striking innovation is, of course, that dispensing with any requirement of privity").

establish the risk involved by the audit activity.[178] Moreover, the registration requirements allow the auditor to read the prospectus and know how much money the company is going to ask the market for. The auditor is liable because he has given his consent to the mention of his name and work in the prospectus, accorded because the auditor knew what was going on, because he read the registration statement and knew how much money the client was seeking to raise.[179] Moreover, Sect. 11 (g) mildly caps liability to the price at which the security was offered to the public. Liability is joint and several in this setting, contrary to secondary market liability, which in the US is proportionate.[180]

1. Why Were Voluntary Liability Caps Not the Norm? Incomplete Audit Contract as an Efficient Strategy both for the Issuer and the Auditor

If the company bargains on behalf of the investors, the company could negotiate specific terms in the audit contract and might for instance agree a liability cap. However, in no jurisdiction are the company and the auditors left free to negotiate the latter's liability regime to investors. Here there is no agency problem at work, as the negotiation comes before the investment made by the investors, and investors could refuse to give money to a company that has negotiated unpalatable terms with its own auditor. Why is liability limitation not an issue in this scenario as well?

One answer might be that securities law does not allow liability limitations, as the auditor role is perceived as a public one, whose liability cannot be subject to negotiation of any kind to keep the *in terrorem* effect

[178] PAOLO GIUDICI, La responsabilità civile nel diritto dei mercati finanziari 363-65 (Giuffrè. 2008).

[179] This is crystal clear under the Securities Act Section 11(a)(4), according to which persons liable include "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him." The same holds true under s90 and s150 of the UK Financial and Services Markets Act 2000.

[180] *See supra* note 83. Under Italian law the role of the registration requirements in overcoming the floodgate argument is not visible, but this is simply because the floodgate argument is not a real issue there: *see supra* Part IV.A.3. Therefore, the Italian equivalent of Sect. 11 does not even mention that in order to be held liable the auditor must have given his consent to the insertion of the audit in the prospectus, and there is no cap to liability. Article 94.8 CFSA.

that public policy deems necessary.[181] However, a modern analysis of the issue cannot entirely rely on this quick response. The law mandated prospectus audits that were probably already used in the market.[182] If this is true, the question turns on to why voluntary prospectus audits did not contain any qualification with regards to auditor liability before the law stepped in and mandated them.

The most likely answer is that explicit liability limitation is no option from a marketing perspective for an issuer who wants to solicit investors, because no issuer would dare to tap the market offering a prospectus audit in which the auditor does not put all his liability at stake. The engagement of an auditor is a bonding cost and the auditor's reputation and liability is what makes the bond credible.[183] Limited liability would reduce the bond's value and thereby the firm's capability to tap a competitive market where other firms offer the auditor's full liability. Since the law was unclear on whether auditors were liable to investors, an equilibrium between the issuer and the auditor could be reached by not promising anything in favor of solicited investors, leaving the auditor's liability issue in a limbo.[184] In marketing activities the consortium could use the auditor as a reputational intermediary and a bonding mechanism, thereby offering evidence that the accounts could be relied on. In litigation, the auditor could deny liability invoking the privity doctrine. In this scenario the parties could rationally decide to leave the contract incomplete as to auditor liability, in order to leave the issue to the court. The reason was that in mass litigation the plaintiffs are dispersed, and singularly face incentives to litigate that are no match in comparison to the defendant's.[185] Accordingly, no significant litigation was to be expected; and in the rare cases where there was litigation, if the court denied the auditor's liability, the court was to be blamed, not the auditor.[186] In order to

[181] The *in terrorem* effect of the 1933 Act is stressed both by DOUGLAS & BATES, *supra* note 177, at 173; SCHULMAN, *supra* note 177, at 227.

[182] See GEORGE J. BENSTON, *The Value of the SEC's Accounting Disclosure Requirements*, 44 Acct. Rev. 515, 520 (1969).

[183] *See supra* note 172.

[184] COFFEE JR., *supra* note 1, at 113 observes, on the grounds of a different line of reasoning, that "some evidence suggests that … illusory bonding was prevalent in the U.S. market during the early 20th century".

[185] The class action mechanism creates economies of scale: see, e.g., CHARLES SILVER, *Class Actions - Representative Proceedings*, in Encyclopedia of Law and Economics, vol. V, The Economics of Crime and Litigation 194, 202 (Bouckaert & De Geest eds., 1999).

[186] In the US before 1966 there was no significant litigation of the issue. The introduction of the class action reshaped this quiet scenario: MAHONEY, *supra* note 29, at 333.

avoid these problems, the law stepped in and mandated prospectus audit liability.[187]

2. Why Can't the Company and the Auditor Contract Around Prospectus Liability? A Multi-Layer Hyphothesis

This reconstruction leaves open the question of why modern securities law seems to be so rigid in ruling prospectus liability. Why not allow liability limitation agreements now that the law is more settled on auditor liability issues? It might be that in financial markets, standardization is required to reduce transaction costs, thereby making self-tailored liability unpalatable[188] due to the excessive demands on investors, who need to be able to make cross-comparisons among issuers.[189] However, it is very difficult to assess whether or not standardization's needs are really that compelling. Accordingly, it would also be possible to imagine a system of contracted limited liability, in which the issuer states in the prospectus if and how the auditors' liability is limited. The problem, standardization apart, is that this system would impact on the regime concerning liability to secondary market investors (if any). It is not imaginable to have limited liability in the primary market and unlimited liability in the secondary one, as this would create incentives not to undersign or purchase newly issued shares, pushing investors to buy them in the aftermarket instead. Thus, the design of prospectus liability goes hand-in-hand with that of liability to secondary market investors.

VI. AUDITOR'S LIABILITY IN SECONDARY MARKETS (REGIME 4)

On the topic of how to regulate auditor's liability to secondary market investors we find striking differences among legal systems. The US scenario is the most famous, as it is the one where securities class actions are mainly

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[187] The apparently irrational scenario depicted in this paragraph, where investors leave the auditor liability issue open, is not particularly peculiar. The explosion of litigation concerning the now disappeared auction rate securities (ARS) market is one of the many examples where investors did not 'stress test' contractual clauses. See Aline van Duyn & Joanna Chung, *Auction rate securities facing tough scrutiny*, Financial Times, October 23, 2009, available at http://www.ft.com/cms/s/0/64bb7e50-bf6c-11de-a696-00144feab49a.html (last visited March 10, 2010)

[188] A proposal for self-tailored liability is advanced in CHOI, *supra* note 172, at 951-58.

[189] Cf. ZOHAR GOSHEN & GIDEON PARCHOMOVSKY, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711, 737-48 (2006).

used, and it is thoroughly analyzed by the economic literature.[190] Liability was originally implied under Rule 10b-5.[191] The plaintiff must show that the defendant acted with scienter in order to succeed.[192] It is much discussed what scienter is. It is more than a negligence standard, and probably less than a desire to cause harm.[193] A special pleading rule requires plaintiffs to plead with particularity facts giving rise to a strong inference of fraud, therefore reducing the access to pre-trial discovery.[194] With regards to auditors, probably the most significant specific protection against liability is the Supreme Court decision in *Central Bank* not to attach private aiding and abetting liability to the 10b-5 cause of action.[195] The decision was taken in 1994, at the apex of the debate concerning the need to reduce auditor liability.[196] The Court's reasoning is clearly influenced by this debate. The second specific protection is offered by proportionate liability, introduced in 1995 with the PSLRA in substitution of joint and several liability.[197] The aggregate impact of these requirements has been a visible reduction of civil deterrence on the auditor, which is among the reported causes of the accounting crisis of 2001.[198]

Under other jurisdictions, like the UK, negligent auditors are not liable towards secondary market investors, unless special circumstances exist.[199]

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[190] *See supra* part I.

[191] *Kardon v. National Gypsum Co*., 73 F. Supp. 798 (E.D. Pa. 1947).

[192] The Supreme Court in *Ernst & Ernst v. Hochfelder* held that plaintiffs must prove the defendants acted with "scienter - [the] intent to deceive, manipulate or defraud." Hochfelder, 425 U.S. 185, 197 (1976).

[193] In *Hochfelder* the Supreme Court left open the question of whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5. Even though federal courts have generally concluded that recklessness constitutes scienter, it is pointed out that "[C]ourts have been less than precise in defining what exactly constitutes a reckless misrepresentation": KEVIN R. JOHNSON, *Liability for Reckless Misrepresentations and Omissions under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. Cin. L. Rev. 667, 674 (1991).

[194] See HILLARY A. SALE, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on "33 and "34 Act Claims*, 76 Wash. U. L.Q. 537 (1998).

[195] *See supra* note 53.

[196] *See supra* note 53 and accompanying text.

[197] *See supra* note 83 and accompanying text.

[198] *See supra* note 3.

[199] Outside prospectus liability, no statutory liability for inaccurate statements was in place before 2006. *Caparo* excludes common law negligence liability towards third parties, unless the defendant knows that some investors are going to rely on the statement. *See supra*, note 103. The adoption of the Transparency Directive in 2004 forced the Government to introduce a statutory liability of issuers to investors for untrue or misleading statements in all periodic disclosures made to the market, through new Section 90A of the

By contrast, under others jurisdictions, like Italy, negligent auditors are always liable towards investors in connection with financial misstatements that they might have identified, whether investors undersigned or bought newly issued shares or purchased shares in the secondary market.[200] Other jurisdictions cap auditor liability.[201] In short, this is the area where we find the most significant variability in approaches, and this needs some explanations.

A. Law & Economics Analysis

The economic analysis concerning auditor liability to the company is straightforward. The differences among countries are significant but subtle. The economic analysis of auditor liability to creditors is straightforward as well, and the differences can be briefly explained on the grounds of the perception any single jurisdiction has about creditors' collective action problems. The economic analysis of auditor liability to primary market investors is the most straightforward. Indeed, differences among countries are not particularly significant. With regards to liability to secondary market investors, instead, economic analysis is far from being straightforward. The mainstream is focused on the pure wealth argument, but it relies on a strong

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Financial Services and Markets Act 2000, introduced by the Companies Act 2006. Liability concerns issuers only, and exclusively for fraudulent misstatements. On this issue see PAUL DAVIES, Davies Review of Issuer Liability - Liability for misstatements to the market: A discussion paper by Professor Paul Davies QC 24-25 (2007). An amendment of Section 90A PAUL DAVIES, Davies Review of Issuer Liability: Final Report (2007) is currently under discussion. Under its terms, liability will be extended, covering a broader range of disclosure. But the general framework will not be affected. For a discussion see EILIS FERRAN, *Are US/Style Investor Suits Coming to the UK?*, 9 J. Corp. L. Stud. 315, 318-330 (2009).

[200] In the past the adoption of a gross negligence standard was proposed (MASSIMO SANTARONI, La responsabilità del revisore 218 (Giuffrè. 1984), on the assumption that the auditor is offering its services to market investors for free. This thesis did not meet the consensus of scholars and courts, which opted for the application of general principles of tort or contract law, which do not distinguish between negligence and willful conduct. In the Italian literature the key topic has been whether tort or contract law are to be applied to auditor liability, and whether liability stemmed from specific rules or was grounded on general principles of law: see, e.g., MARIO BUSSOLETTI, Le società di revisione 231 ff. (Giuffrè. 1985); EUGENIO BARCELLONA, Responsabilità da informazione al mercato: il caso dei revisori legali dei conti 236 ff. (Giappichelli. 2003). See also GAETANO PRESTI, *La responsabilità dei revisori*, I Banca borsa 160 (2007).

[201] For a review, see Questionnaire on the Legal Systems of Civil Liability of Statutory Auditors in European Union: Update of the study carried out on behalf of the Commission by Thieffry & Associates in 2001 http://ec.europa.eu/internal_market/auditing/docs/liability/consultation_annex1_en.pdf (last visited March 10, 2010).

assumption (investors diversification) and a 'single layer' analysis that oversimplifies the problems.

1. In Favor of No Liability Whatsoever (Except Intentional Misrepresentation): the Pure "Wealth Transfer" Argument

The idea that secondary market investors should not have any action against the negligent or grossly negligent auditor relies on the following line of reasoning.[202] The auditor's misstatement causes one investor to buy and another investor to sell. When the misstatement is corrected, the former investor discovers that he has purchased at a price higher than the one he would have chosen, whereas the latter investor discovers that he was lucky, because he sold the shares before the information about the true situation was disclosed. In this situation there is no social loss as there is no wealth destruction (equivalent to social loss). What you see is, allegedly, a mere transfer of wealth. If the auditor were asked to compensate the purchaser for the damages he suffered, the auditor should also be able to get the money back from the seller, who gained because of good luck and not because of some special merits. If the auditor cannot get the money back, the compensation is unrelated to the social cost (which is, by assumption, zero) and the liability system does not work properly: it over-deters wrongdoers, and auditors end up taking too much care.[203] From a "hypothetical bargain" approach,[204] investors cannot be interested in the company buying protection for them by asking the auditor to take liability (or the law to impose it), because they hold diversified portfolios and can with equal probabilities be on the buy side or on the sell side.[205] The reasoning is thereby grounded on two premises. The first one is that the wealth transfer is insignificant from a social perspective, as it does not cause any direct

[202] The reasoning was presented, in connection with secondary markets, by FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 639-644 (1985) (revised and reprinted in Easterbrook & Fischel, *supra* note 133, ch. 12). The two authors pointed out, however, that their argument was not equivalent to hold that the optimal damages in the aftermarket are zero because losses and gains net out (at 641). The reasoning is further developed by MAHONEY, *Precaution Costs And The Law of Fraud in Impersonal Markets*, *supra* note 74, at 627-635, and by DONALD C. LANGEVOORT, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 646-648 (1996).

[203] See, e.g., DARI MATTIACCI & SCHÄFER, *supra* note 148, at 22.

[204] See DAVID CHARNY, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815 (1991); IAN AYRES & ROBERT GERTNER, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 89-90 (1989). Ayres and Gertner use the expression "would have wanted" theory.

[205] DARI MATTIACCI & SCHÄFER, *supra* note 148, at 22.

misdirection of capital to the issuer and therefore has no implications for real investment.[206] The second one is that secondary market investors in the aggregate do not care about (socially expensive) liability based means of protection against wealth transfers, because they can protect themselves through (socially cheap) diversification.[207]

2. *In Favor of Liability*

Even a diversified investor would like to be on the winning side of any transaction. Accordingly, precaution (guarding) costs are incurred by any investor, whether he is diversified or not.[208] Thus, there is no transfer of wealth that is really "pure" in terms of social effects. Precaution costs are a social cost of misreporting in secondary markets. Accordingly, damages to secondary market investors can be a socially beneficial instrument to deter misreporting. However, it is true that there is no direct correlation between damages suffered by investors on the wrong side and precaution costs.[209]

If the assumption of purely diversified portfolios is relaxed, things change.[210] Undiversified investors can still equally be on one side or the other, but their risk increases. Risk-adverse investors do not want to take all this risk on their shoulders, and demand protection. Therefore, companies need to buy protection in the form of auditor's liability. Indeed, this is what we see in very large block transactions, where the buyer usually asks for a due diligence review in which an auditor is involved and a company's

[206] From a different viewpoint, as far as primary market investors are concerned the company benefits from its misstatements, by gaining at the expense of the unaware investor, whereas with reference to secondary market investors the company does not get any money and therefore faces less powerful incentives to misstate information. Accordingly it is argued that, in terms of the need for deterrence, the second situation can be addressed differently, taking also into consideration that, because of the class action mechanism, there is a serious risk of over-deterrence. See DONALD C. LANGEVOORT, *supra note* 202, at 657-662 (proposing a threshold to civil sanctions).

[207] The underlying assumption is therefore that primary market investors can only be on the buy side, and want protection, whereas secondary market investors do not care, because they do not know where they will be.

[208] EASTERBROOK – FISCHEL, *supra* note 202, at 641.

[209] EASTERBROOK – FISCHEL, *supra* note 202, at 641-642. For an extended analysis see MAHONEY, *supra* note 74 (who points out that compensating liquidity traders who do not face precaution costs overcharges the offender, thereby arguing against the FOTM theory).

[210] For a strong critique of the wealth transfer argument and its assumptions concerning the importance of diversification see THOMAS A. DUBBS, *A Scotch Verdict on "Circularity" and Other Issues*, Wisc. L. Rev. 455 (2009).

balance sheet at the time of the transaction is drafted.[211] When undiversified buyers of blocks are active in the market, it might be convenient for sellers to offer them a continual service of reliable audit services, where the auditor assumes liability to secondary market investors. In fact, the company is already paying the auditor and thus the cost of offering auditor liability can be affordable, especially when the absence of effective representative litigation limits the true exposition of auditor to the blockholders only. For the same reasons mentioned with reference to contractual arrangements between the company and the auditor, however, contractual liability is no option here, because of intergenerational problems: the issuer should negotiate with the auditor a liability regime to aftermarket investors that can never be renegotiated to the benefit or damage of any successive generation. Liability by fiat (if any) has to step in.

Apart from the portfolio diversification issues, the wealth transfer payment argument does not consider the links between primary and secondary markets. Let me go back to the primary market. The assumption is that the company wants to reassure the investor and therefore finds an auditor who acts as a gatekeeper. If the primary market investor is potentially interested in reselling the shares – and this is certainly so if the shares are sold in the course of an initial public offering aimed at listing the company, for listing aims at creating liquidity[212] – he may want the company to employ an auditor to the benefit of potential buyers also in the future, if and when he decides to sell the shares. Moreover, the first investor will want to be sure that the auditor's responsibilities to third parties (if any) are fixed at least until the moment he enters the secondary market to sell his shares. Needless to say, the second investor might wish the same, and so on, as nobody wants to buy a financial instrument that will negatively modify its rights and entitlements when in his hands.

Is this wish reality in modern financial markets? The fact that in private transactions concerning large share purchases buyers ask for an audit of the company's records in order to ascertain the firm's value might also be related to this wish, independently from the level of diversification. More important, empirical studies show that, in secondary markets, disclosure of information and, in particular, earning announcements and financial data boosts trade volumes.[213] Disclosure generates liquidity.[214] Accordingly, it is

[211] Many Italian cases concern this scenario: *see, e.g.*, Tribunale di Milano, 18 June 1992, Giur. It. 1993, I, 2, 1.

[212] *See infra* note 214.

[213] The mechanism is investigated in the model proposed by OLIVER KIM & ROBERT E. VERRECCHIA, *Pre-Announcement and Event-Period Private Information*, 24 J. Acc.

reasonable to assume that an investor in the primary market who is potentially interested to sell his shares in the secondary market would require a future audit and some form of reliable assurance that the audit performed will be accurate as this will offer a boosted platform for liquidating his investment.[215] This assurance concerns liquidity, and reduces the "wedge" between demand and offer of securities.[216] Add to this that negligent audit will influence the prices of future primary market emissions of the same security,[217] as well as the market for corporate control.[218] Finally, consider that the value inflation of a security traded on secondary markets affects the alternative investment offered on the primary market and thereby project choice in the society,[219] and it appears that some form of liability to secondary market investors might be needed to impose socially desirable care on the auditor.

The problem is therefore to establish what is the appropriate level of liability needed. An author has recently and thoroughly suggested that the differentiation between primary and secondary market investors is

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Econ. 395 (1997), and empirically tested, for instance, by OLE-KRISTIAN HOPE, et al., *Geographic Earnings Disclosure and Trading Volume*, 28 J. Acc. Pub. Pol. 167 (2009).

[214] ROBERT E. VERRECCHIA, *Essays on Disclosure*, 32 J. Acct. & Econ. 97 (2001); LUZ HAIL & CHRISTIAN LEUZ, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. Acc. Res. 485 (2006) (firms from countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms have a significantly lower cost of capital); WARREN BAILEY, et al., *The Economic Consequences of Increased Disclosure: Evidence from International Cross-Listings*, 81 J. Fin. Econ. 175 (2006) (absolute return and volume reactions to earnings announcements typically increase significantly once a company cross-lists in the U.S., supporting the hypothesis that it is the individual firm's disclosure environment to explain the increase); RICHARD LAMBERT, et al., *Accounting Information, Disclosure, and the Cost of Capital*, 45 J. Acc. Res. 385 (2007) (the quality of accounting information can influence the cost of capital); R.K. ATIASE & L.S. BAMBER, *Trading Volume Reactions to Annual Accounting Earnings Announcements*, 17 J. Acc. Econ. (1994). See more in general CHRISTIAN LEUZ & PETER WYSOCKI, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research*, SSRN eLibrary 2008 (survey of the theoretical and empirical literature on the economic consequences of financial reporting and disclosure regulation).

[215] "Whichever reason motivates a potential buyer, if she anticipates a low level of liquidity in the secondary market at whatever time she might wish to sell in the future, the share she is considering purchasing is worth less to her. Her anticipation of a high bid/ask spread at the time that she sells means that she anticipates a lower sale price. As a result, she will not be willing to pay as much to purchase the shares today": FOX, *supra* note 117, at 267.

[216] Id. at 267.

[217] CHAPMAN, *supra* note 148, at 196-197.

[218] Id. at 196-197.

[219] FOX, *supra* note 117, at 268.

completely misplaced, since “disclosure has substantially equal social value whether or not the firm is selling equity at the time.”[220] Accordingly, “civil liability should be structured to give corporate decision makers equally strong incentives for disclosure regulation whether or not the firm is publicly offering equity at the time”.[221] Other authors consider the wealth transfer rationale to be partly convincing, and propose some form of deterrence-based civil remedies[222] or other instruments of private enforcement reduction.[223] Thus, the topic becomes a matter of measure, which is very much influenced by the specific characteristics of each jurisdiction, and more particularly by the level of investors’ diversification, the role of the security-information industry[224] and press,[225] the importance attributed by the audit network to reputation in the jurisdiction,[226] plus the local efficiency of public and private enforcement. Moreover, the civil sanctions to which the auditor is exposed from other constituents (the company, the creditors as a mass or singularly, primary market investors) are to be considered as well, because the auditor operates in a multilayered liability regime. Thus, the mentioned differences amongst countries in the treatment of liability to secondary market investors in general and auditor liability in particular can be explained in the light of all these factors.

VII. MULTI-LAYERED ANALYSIS

The layer-by-layer analysis conducted in previous paragraphs shows that at least two regimes, namely liability to the company and prospectus liability, are usually present. At least one jurisdiction is experimenting the limitation of auditor liability to the company, which can be agreed on by the shareholders meeting. The single-layer analysis has also shown that contracting over liability to the company can raise significant

[220] Id. at 260-264.

[221] Id. at 269.

[222] See LANGEVOORT, *supra* note 202, at 657-662. *Contra* HARVEY J. GOLDSCHMID, *Capping Securities Fraud Damages: An Unwise Proposal in an Imperfect World*, 38 Ariz. L. Rev. 665 (1996).

[223] In the US context, Paul Mahoney proposes the abandonment of the FOTM theory: MAHONEY, *Precaution Costs And The Law of Fraud in Impersonal Markets*, *supra* note 74.

[224] EASTERBROOK-FISCHEL, *supra* note 202, at 641.

[225] On the role of the business press as an information intermediary see BRIAN J. BUSHEE, et al., *The Role of the Business Press as an Information Intermediary*, 48 J. Acc. Res. 1 (2010). Cf. also ALEXANDER DYCK, et al., *Who Blows the Whistle on Corporate Fraud?*, SSRN eLibrary (2008).

[226] *See supra* notes 31-33 and accompanying text.

intergenerational (latecomer) problems, and that contracting over liability to primary market investors could create information problems, even though it is difficult to assess their magnitude and therefore the real value of standardization. As to liability to secondary market investors, there are arguments in favor of its containment, but the measure depends on the conditions of each local capital market.

The next step is to understand how these layers interact.

A. Interactions between Regimes 1 and 3

Limitation of liability to the company can diminish the level of care that the auditor takes when its service concerns public offerings. Indeed, the main content of the audit activity does not change. The auditor could be exposed both to liability to the company and to the primary market investors if the company's financial reports are misstated. In other words, the audit is an activity that can generate exposition to two different damage claims: company's claims and prospectus liability claims. Deterrence at one level influences deterrence at the other. If liability to the company is reduced by agreement, the auditor can be induced to diminish the general level of care with an impact also over primary market investors. Accordingly, the company's and the auditor's ability to contract over the latter's liability to the former may have a negative impact over primary market investors, notwithstanding the fact that contracting over liability to those investors is not allowed. In short, alterations to the liability to the company regime may produce a negative externality. It was mentioned that an argument against contracting over directors' and auditors' liability is that it would reduce deterrence, whereas in this area liability must preserve its strong deterrent effect.[227] The reasoning simply reflects the intuition that in a multi-layered regime the limitation of liability at one layer's level can produce spillover effects.

B. Interactions between Regimes 1 and 4

A reduction in auditor liability to the company can have negative spillover effects over liability to secondary market investors as well, if liability to those investors is recognized. This can offer a further explanation to the reason why the UK was the first jurisdiction to allow contracting over auditor liability. In the UK, investors' claims against the auditor are not allowed. Therefore, this second spillover effect is not present.

[227] *See supra* note 122 and accompanying text.

When contractual limitations of liability to the company are allowed, shareholders should not find easy ways to circumvent the company's agreement by suing the auditor as market investors, otherwise the cap on liability to the company can lead to an increase of direct claims of investors against the auditor and therefore generate the double-recovery issue mentioned in following paragraph. Accordingly, countries where hurdles to direct investors' claims are not easy to establish may have an interest in keeping a non negotiable (mandatory) regime of audit liability to the company.

C. Double Recovery (Overlaps of Regimes 1 and Regimes 3 or 4)

If recovery is granted to investors (either those on primary or secondary markets), a hidden problem emerges: double recovery, in case there is an action both by the company and the investors. The double recovery issue arises in cases where the investors who have purchased the corporate securities claim damages for the difference between what they paid and the true market value of the securities, and this difference is wholly or in part due to assets looted by managers or assets burned by the firm without any previous reported information. In these cases, both the investors and the company could claim damages that could be related to the same event.[228] The prototypical case of a double-recovery scenario is offered by *Cenco*.[229]

[228] Consider this example. The company possessed a cash reserve that managers or controlling shareholders have siphoned off. The financial statements mention the reserve among the company's assets. Let me assume that they represent 50 per cent of the company's equity. The company issues new shares. When the looting is discovered, the company's shares halve their value. The company can claim the money lost, whereas investors can claim the excessive price paid to buy the newly issued shares. If the company recovers the money and the new shareholders have not sold their shares, any damage is restored. If investors have disposed of their shares, they might be entitled to claim damages independently from what the company gets back. If investors recover their "investment" damage and the company its "asset" damage, there is double recovery.

[229] Cenco Incorporated v. Seidman & Seidman, 686 F.2d 449; 1982 U.S. App. LEXIS 20664; Fed. Sec. L. Rep. (CCH) P98,615 (7th Cir. 1982). Cenco Incorporated management had orchestrated in a massive fraud. The fraud involved the inflating of inventories, which enlarged the apparent value of the company. The inflated shares were used to buy other companies. Cenco was also able to borrow funds at cheaper rates and to present inflated claims for inventory lost or destroyed to its insurers. Investors who had bought Cenco shares at inflated prices or who sold or held the shares at a loss after the fraud's discovery sued the company and the auditors and got a settlement. Cenco sued the auditors on the assumption that managers had not been properly monitored. In a famous opinion, Judge Posner dismissed Cenco's claim also on the grounds of the perverse double-

Double-recovery is a significant problem once an auditor's liability to primary markets investors is admitted, and more so if also auditor's liability for misstatements to secondary market investors is acknowledged. A solution to avoid double recovery would be to use procedural mechanisms that oblige both the company and the investors to have their cases discussed before the same court; additionally, the court may dismiss the claims of investors who still hold financial instruments of the company, for the part of their damages that will be indirectly restored through payment from the auditor to the company.

D. Interactions between Regime 1 and 2

The existence of liability to creditors adds a further degree of complexity to the issue. First, it influences the approach to liability to the company. As the *Stone & Rolls* case shows,[230] if liability to creditors is totally denied, the problem arises of how to treat the claim of the insolvent company. In fact the proceeds of the claim go to the benefit of creditors as a unified class of residual claimants. The legal framework concerning legal capital rules, directors' duties to creditors, or duties to file for insolvency affects this scenario. Second, it is not always easy to distinguish, in an insolvency scenario, liability to the company representing creditors as a class of residual claimants and liability to single creditors.

E. Interactions between Regimes 3 and 4

As to the relation between regime 3 and regime 4, it seems clear that if contracting over prospectus liability were permitted, liability to secondary

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recovery effect that a judgment in favor of the company would have benefited shareholders who had kept the shares and had received money from the settlement. This is the significant part of the opinion: "The people who bought during the fraud period and either sold at a loss or continue to hold at a loss are the plaintiffs in the recently settled class action in which both Cenco and Seidman were defendants. Seidman has already paid $ 3.5 million to them. Those who continue to own stock in Cenco (as distinct from those who sold at a loss) would receive additional compensation if Cenco prevailed in this action against Seidman. This is not to say they would be overcompensated; but it seems odd that the same shareholders should be able to recover damages from Seidman twice for the same wrong - once directly and once, in this suit, indirectly. Finally, the shareholders who bought after the fraud was unmasked lost nothing. The unmasking of the fraud caused the price of Cenco's stock to be bid down to reflect not only the true value of its inventories but also any anticipated injury to the company as a result of the fraud. Because of shareholder turnover, there is always a potential mismatch between the recovery of damages by a corporation and the compensation of the shareholders actually injured by the wrong for which the damages were awarded. It is simply a more dramatic mismatch in this case than usual" (at 455).

[230] *See supra* Part IV.A.4.

market investors should be necessarily capped or eliminated. The reason is obvious. Should liability to primary market investors be limited, investors would have a strong incentive to purchase securities in the secondary market to take benefit of the highest potential claim against the auditor. In order to sell its securities, accordingly, the company should discount its offering and lure the first generation of investors.[231] Again, the liability regime adopted at one level would display its effects at another level, interfering with any attempt to design an optimal single-layer liability regime at the affected level.

To the best of my knowledge there are no legal regimes that treat secondary markets investors better than those on primary markets. Usually the opposite is true. The differentiation creates, however, complexity problems. Any legal regime that treats differently purchasers who undersigned or bought in the primary market from purchasers in the secondary market must be able to make a distinction between them. This is the difficult task that US courts have to manage ("tracing requirement").[232]

VIII. CONCLUSION

It is basically impossible to assert *a priori* what the adequate level of deterrence is in a complex multi-layered liability regime, and more so when liability can be contracted around at one or more levels. The analysis has shown that the auditor liability case is much more difficult than the mainstream economic literature suggests. At least three different liability regimes come to the surface. A fourth is present in some countries. They are strictly interconnected. Each one presents its own peculiarities, which cannot be considered in a vacuum, but must be assessed by considering the whole system of rules governing auditor liability in each country. If bankruptcy law, corporate governance, capital markets law, civil procedure peculiarities concerning each single jurisdiction are added to the picture, any idea that the issue can be easily and uniformly managed vanishes.

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[231] It would be rather curious if, to offer an example, an issuer could arrange for its auditor's liability to be capped at 5 million Euro in an IPO and the auditor's liability to investors who buy the shares in the secondary market were not limited in some way. Investors would have incentives to buy the securities in the secondary market and no rational investor would underwrite the shares in the primary market, unless the company offers them at discount. Accordingly, limitation caps in primary markets are conditioned by limitation caps in secondary markets.

[232] *See* HILLARY A. SALE, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 Wash. L. Rev. 429 (2000).

If one considers the three main regimes (liability to the company, to solicited primary market investors, to secondary market investors), a clear case for mandatory limitation of liability can be held in the last regime only. The UK does not have any liability toward secondary market investors, unless willful conduct is proven. This is 'real life' hard evidence that negligence liability in this field is not essential. In the US, liability is *de facto* limited as well by the *scienter* requirement, proportionate liability, and the non application of common law tort rules concerning aiding and abetting. Other countries adopt liability caps in this area: Germany is the most notable example. However, the reduction or abolition of liability towards secondary market investors has to consider that information, especially reliable information concerning financial statements, creates liquidity. For countries with capital market liquidity problems the introduction of liability caps could be highly detrimental, especially if the audit network perceives that its global brand's reputation is not at risk and therefore reputation effects are totally or significantly lost. Moreover, this move would create complexity in the liability system, as investors who are in a similar position would be treated differently whether they have undersigned or purchased newly issued financial instruments from the company (the consortium) or from other market participants.

Mandatory limitation of auditor liability to the company would go to the core of the auditing function and require an answer to the question of why mandatory audits are required. There are no reasoned arguments in the economic literature and in the law and economics literature in favor of the introduction of mandatory caps to this form of contractual liability. A different assessment concerns contractually negotiated agreements to expand or restrict auditor liability to the company, following the UK example. They can be allowed if there is no significant fear of intergenerational problems amongst investors and substantial negative spillover into the other layers of liability. Moreover, the shareholders should not find any easy way to circumvent the company's agreement by suing the auditor as market investors, for in this case the cap on liability to the company would create large incentives to individual shareholder claims.

As to liability to primary market investors, there are no economic arguments in favor of a mandatory cap to liability in this area either. Apart from the needs of standardized financial instruments by market investors, however, no further argument could be advanced against tailor-made liability regimes where the auditor reduces its liability exposures up to a certain limit. Needless to say, this limit must be consistent with the one eventually adopted with reference to liability towards secondary market investors, otherwise an incentive not to undersign or purchase new shares would be created.

From the standpoint of this analysis, the fear of an imminent catastrophe in the audit field should simply induce countries to fine-tune liability to secondary market investors and, eventually, to accept contractually negotiated and fully transparent agreements between the company and the auditor, aimed at modifying the default liability regime towards the company and primary markets investors. No argument can sustain a cap by fiat in regimes 1 (liability to the company) and 3 (liability to primary market investors). If a catastrophic liability were to draw a Big-4 audit network into the abyss, the only solution would be to eliminate mandatory audits and leave companies, shareholders and investors to look for alternative solutions or, keeping mandatory audits, ignore the issue and let market forces put pressure on companies to simplify their international operations, thereby opening the market to small and medium-sized audit companies.

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