European Business Organization Law Review 13: 501-555

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doi:10.1017/S1566752912000353

Auditors' Multi-Layered Liability Regime

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https://doi.org/10.1017/S1566752912000353 Published online by Cambridge University Press

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Abstract

The European Commission's Recommendation of 2008 on auditor liability relies heavily on the assumption that auditors are over-deterred. The economic rationale that underpins this assumption is entirely focused on liability towards investors and the US narrative concerning securities class actions. This approach oversimplifies the issue, because it does not consider why auditors really exist and what the different interests served by them are. Accordingly, it neglects that auditors' liability is multidimensional. This article analyses auditor liability's multi-layered regimes. It investigates who the auditor's principals are; whether the auditor and those principals 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; and how such a multi-layered regime might be designed. In doing so, the article makes reference to some existent legal regimes and comments on them. However, its analysis is functional, not comparative. The article argues that the auditor liability case is much more com-

https://doi.org/10.1017/S1566752912000353 Published online by Cambridge University Press

plex than the economic and the law & economics literatures suggest, and concludes that a generalised, uniform, worldwide approach in favour of liability reduction has no scientific grounds, at least at the current stage of our knowledge.

Keywords: gatekeepers, corporate governance, auditors, audit litigation, multiple principals, contract, liability.

1. 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 liability.[4] The audit market was becoming increasingly concentrated, with the 'Big Four' (Deloitte & Touche, Price Waterhouse Coopers, Ernst&Young, and 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 realise 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 of the whole industry.[8] Auditors' calls did not go unheard. In the US, the discussion concerning securities

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[1] John C. Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006), at p. 103 et seq.

[2] See *infra* nn. 32-33 and accompanying text.

[3] John C. Coffee Jr, 'Understanding Enron: "It's About the Gatekeepers, Stupid"', 57 *Business Lawyer* (2002) p. 1403, at pp. 1409-1412.

[4] Cf. Roy Chandler and John Richard Edwards, 'Recurring Issues in Auditing: Back to the Future?', 9 *Accounting, Auditing & Accountability Journal* (1996) p. 4, at p. 20.

[5] For an attempt to analyse 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 *Columbia Law Review* (2006) p. 1641, at pp. 1673-1693.

[6] Lawrence A. Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels', see ibid., p. 1698, at pp. 1698-1699.

[7] The previous campaign had led to the passage of the Private Securities Litigation Reform Act (PSLRA): see *infra* nn. 54 and 84 and accompanying text.

[8] See *supra* n. 5.

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class actions was re-opened.[9] In the meantime, auditing firms were aggressively asking for arbitration clauses, damages exclusions, and 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, in 2008, the Commission recommended Member States to adopt liability caps in order to protect auditors,[12] following the results of an economic study (Final Report) that it had

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[9] The core issue was that these powerful weapons could all too easily be fired at auditors, the traditional 'deep pocket' of financial scandals ending up in catastrophic insolvencies. See Commission on the Regulation of U.S. Capital Markets in the 21st Century, *Report and Recommendations* (2007), at pp. 28-31, 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.'); New York City Economic Development Corporation, *Sustaining New York's and the US's Global Financial Services Leadership* (2007), available at: <http://www.nyc.gov/html/om/pdf/ny_report_final.pdf>, at pp. 74-75 (fear of litigation puts New York City at a disadvantage vis-à-vis London); Luigi Zingales, et al., *Interim Report of the Committee on Capital Markets Regulation* (2006), at pp. x-xi, available at: <http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf> (citing liability risk as a factor contributing to the decrease in US public equity market competitiveness); see also Committee on Capital Markets Regulation, *The Competitive Position of the U.S. Public Equity Market* (2007), at pp. 1-5, 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 *Columbia Law Review* (2006) p. 1534 (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 *Columbia Law Review* (2008) p. 1301 (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. p. 6847 (9 February 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 13 December 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 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.

[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

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commissioned on the issue.[13] The recommended limitation of liability for auditors would put the industry in a situation very similar to that of the few other industries that enjoy limited exposure to civil liability, such as the shipping,[14] airline[15] and 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, shifting attention away from auditors, at least momentarily.[18] 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]

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insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability' (Article 31, Directive 2006/43/EC).

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

[14] See Patrick Griggs and Richard Williams, *Limitation of Liability for Maritime Claims*, 3 edn. (Lloyd's Shipping Law Library 1998); Mark A. White, 'The 1851 Shipowners' Limitation of Liability Act: Should the Courts Deliver the Final Blow?', 24 *Northern Illinois University Law Review* (2004) p. 821; Craig H. Allen, 'Limitation of Liability', 31 *Journal of Maritime Law and Commerce* (2000) p. 263. The recent oil disaster in the Gulf of Mexico has once again raised the issue of liability limitation, this time with reference to leaks from offshore oil rigs and to liability caps available, under certain conditions, both to offshore facilities' operators and to rigs' owners. In the US, oil pollution is currently governed by the Oil Pollution Act (OPA), enacted in 1990 after the Exxon Valdez disaster in order to streamline US oil pollution law and increase exposure to liability in this field: see Antonio J. Rodriguez and Paul A.C. Jaffe, 'The Oil Pollution Act of 1990', 15 *Tulane Maritime Law Journal* (1990) p. 1; Michael Faure and Wang Hui, 'Economic Analysis of Compensation for Oil Pollution Damage', 37 *Journal of Maritime Law and Commerce* (2006) p. 179. Under OPA, BP, which operated the Deepwater Horizon rig, might attempt to limit its exposure to $75 million, unless gross negligence is proven. Accordingly, there have been many proposals to repeal the liability caps both from OPA and the Shipowners' Liability Act of 1851. See, e.g., the draft text of the Clean Energy Jobs and Oil Company Accountability Act, Sections 102 and 502, available at: <http//:democrats.senate.gov/pdfs/The_Clean_Energy_Jobs_and_Oil_Company_Accountability_Act_of_2010.pdf> (last visited 18 May 2012).

[15] See Randi Lynne Rubin, 'The Warsaw Convention: Capping the Value of Life?', 12 *Temple International and Comparative Law Journal* (1998) p. 189.

[16] On liability for nuclear damages, see Michael G. Faure and Tom Vanden Borre, 'Compensating Nuclear Damage: A Comparative Economic Analysis of the U.S. and International Liability Schemes', 33 *William and Mary Environmental Law and Policy Review* (2008) p. 219; Michael Trebilcock and Ralph A. Winter, 'The Economics of Nuclear Accident Law', 15 *International Review of Law and Economics* (1997) p. 215.

[17] In the US, this lobbying effort had led to the Private Securities Litigation Reform Act: see *infra* n. 54.

[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* (2009) p. 1.

[19] With arguments that recall many issues of the auditor liability debate: 'But at the same time that CRAs want to fend off more detailed regulation of their activities by emphasizing that

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Many proposals suggest a re-regulation 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 has opened a discussion about increasing the exposure to civil liability of the 3-incumbent-dominated credit rating industry.[21]

Despite the shift of attention towards rating agencies, hedge funds and banks, auditors have recently returned to the spotlight. This has probably been more the case in Europe, where a lot of attention has been paid to the fact that audit firms had given clean opinions to banks revealing huge losses on positions held on and off-balance sheet in the 2007-2009 period.[22] The European Commission launched

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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 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' (2009), available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1466277>.

[20] John C. Coffee, Jr, 'Enhancing Investor Protection and the Regulation of Securities Markets' (2009), available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1372194>, at p. 66 ('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 *Washington University Law Quarterly* (1999) p. 619 (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* (2009), available at: <http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf>, at pp. 14-16; John P. Hunt, 'Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement', *Columbia Business Law Review* (2009) p. 109 (proposing that rating agencies either disclose the poor quality of the financial products they rate or disgorge profits derived from rating the products).

[21] Curious reverse analogies do not stop here. The criticism of governments and regulators that banks have been left to become 'too big to fail' has mounted in the wake of the subprime collapse. Observers have pointed 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. The suggestion is to reduce bank size and complexity. However, the parallel discussion concerning auditors' liability has never gone in this direction. It actually focuses precisely on how to protect firms that are too big, complex and international to fail. Needless to say, audit firms' complexity (see *infra* n. 89) is a reflection of their clients' complexity.

[22] Cláudio Flores, 'New Trends in Auditor Liability', 12 *European Business Organization Law Review* (2011) p. 415, at pp. 417-419; House of Lords, *Auditors: Market Concentration and Their Role – Economic Affairs Committee*, available at: <http://www.publications.parliament.uk>. Walter Doralt and Andreas Fleckner, et al., 'Max Planck Institute Working Group on Auditor Independence – Comments on the European Commission Green Paper: Audit Policy – Lessons

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public consultations, at the end of which it proposed new regulation on the quality of audits of public-interest entities and a directive to enhance the single market for statutory audits.[23] Apparently, the issue of auditors' liability lost its momentum in the ensuing discussion. However, the 2008 Commission Recommendation on liability caps is still there, and this is an issue that comes and goes but never disappears. Accordingly, one has to understand how the Big Four could achieve so much, especially just after one of the largest accounting crises in history.

My answer is that the economic analysis of auditor 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 deal with this argument in this article. As I have mentioned, the conventional wisdom that the Big Four are to be treated as a protected species is based on a reasoning that is considered totally unacceptable in other settings, and the latest proposed European audit reforms provide for regulatory mechanisms that are intended to open up the top end of the audit market.[25]

The second argument, however, is unrelated to concerns regarding audit market concentration and has not been addressed by the 2011 new regulatory proposals of the European Commission. 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, who are treated by the economic literature, at least *de facto*, as the only constituent

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from the Crisis', 59 *Rivista della Società* (2011) p. 485. In the US, the discussion is currently mainly focused on the Public Company Accounting Oversight Board (PCAOB) and its powers of inspection: see PCAOB, 'Testimony Concerning the Role of the Accounting Profession in Preventing Another Financial Crisis' (2011), available at: <http://pcaobus.org/News/Speech/Pages/default.aspx>; Clive Lennox and Jeffrey Pittman, 'Auditing the Auditors: Evidence on the Recent Reforms to the External Monitoring of Audit Firms', 49 *Journal of Accounting and Economics* (2010) p. 84.

[23] Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities, 30 November 2011, and Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, 30 November 2011 (both available at: <http://ec.europa.eu/internal_market/auditing/reform/index_en.htm>). See Walter Doralt and Andreas Fleckner, et al., 'Auditor Independence at the Crossroads – Regulation and Incentives', 13 *European Business Organization Law Review* (2012) p. 89.

[24] On the assumption that mainstream liability rules create barriers to entry in today's audit environment. See *infra* n. 94 and accompanying text.

[25] See European Commission, Reform of the Audit Market – Frequently Asked Questions, § 4, available at: <http://ec.europa.eu/internal_market/auditing/reform/index_en.htm>.

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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 for which shareholders, creditors and investors (as the case may be) are willing to pay. 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,[26] liability can be mandated (statutory liability), and therefore the onus to efficiently design the civil liability regime is on the law. 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 stem from multiple negotiations and a multi-layered liability regime, and how this multi-layered regime should possibly be designed.

This is, to the best of my knowledge, the first article in the international literature on auditor liability that offers a comprehensive analysis and discussion of auditor liability's multi-layered regimes. I deal with the different interests served by auditors and consider the different legal strategies applicable to each layer. I then 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. In particular, I consider the US legal regime, which is the reference point for economists and lawyer-economists who write on liability issues and influence policy. I also consider the UK system, which is often mentioned by European specialists in law & economics, and the Italian system, which is very different from those of the US and the UK regarding many issues of auditor liability. However, my analysis is functional, not comparative. I argue that the auditor liability case is much more complex than the economic and the law & economics literatures suggest and conclude that a generalised, uniform worldwide approach in favour of liability reduction has no scientific grounds, at least at the current stage of our knowledge. The corollary of my reasoning is that the 2008 EC Recommendation is bad policy and must be forgotten.

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[26] Public regulation is another instrument to cope with market failures. Usually, the legal system uses both private enforcers (through civil liability) and public ones (through regulation) to deal with market failures. A *locus classicus* on the topic is Steven Shavell, 'Liability for Harm versus Regulation of Safety', 13 *Journal of Legal Studies* (1984) p. 357.

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The article proceeds as follows. Section 2 reviews audit litigation research and how the law and finance literature covers auditor liability issues. My purpose is to show how the economic literature has been entirely focused on a single layer and a single perspective: liability to investors from the perspective of US law. Section 3 investigates the economic analysis of the audit liability regime on which the 2008 EC Recommendation is built, and shows that it is totally flawed. From section 4 onwards, I develop my multi-layered functional analysis. I proceed sequentially. Section 4 covers auditor liability to the company. It also analyses the main problems raised by a regime in which the company and the auditor can contract around auditor liability. Section 5 deals with auditor liability to third parties under general private law doctrines and analyses the floodgate argument, deemed a key concept in the law and economics literature on pure economic loss. Section 6 addresses prospectus audit liability and negotiated caps on auditor liability in this specific area. Section 7 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 8 presents the problems that a multi-layered liability environment poses. Section 9 concludes.

2. THE ECONOMIC LITERATURE ON AUDIT LITIGATION

2.1 **Introduction**

There is a vast economic literature on audit litigation, either proposing 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,[27] as a result of some large American accounting scandals in the previous decade that generated a litigation explosion,[28] often described in catastrophic terms.[29] 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.[30] Two streams of literature arose in the wake of this litigation explosion: one qualitative, the other quantitative.

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[27] See Douglas W. Hawes, 'Stockholder Appointment of Independent Auditors: A Proposal', 74 *Columbia Law Review* (1974) p. 1, at p. 2.

[28] See Ted. J. Fiflis, 'Current Problems of Accountants' Responsibilities to Third Parties', 28 *Vanderbilt Law Review* (1975) p. 31, at p. 33.

[29] Newton N. Minow, 'Accountants' Liability and the Litigation Explosion', *Journal of Accountancy* (1984) p. 70.

[30] Paul G. Mahoney, 'The Development of Securities Law in the United States', 47 *Journal of Accounting Research* (2009) p. 325, at pp. 333-339.

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2.2 Qualitative studies

Qualitative (or conceptual) studies model *a priori* efficient liability regimes. The academic interest is focused on liability towards third parties. The most influential study in the law literature is probably that of Professor Goldberg, 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)[31] and, secondly, points out that reputation protection is a strong incentive for the auditor to take adequate care.[32] The accounting crisis of 2001-2003 showed that reputation alone is not sufficient.[33] Despite this crisis, many studies still argue that the effect of reputation on audit quality should at least be taken into account when modelling the auditor liability regime.[34] 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.[35]

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[31] Victor P. Goldberg, 'Accountable Accountants: Is Third-Party Liability Necessary?', 17 *Journal of Legal Studies* (1988) p. 295, at pp. 301-307.

[32] Ibid., at pp. 302-304.

[33] 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 (or just a small fraction) of the gains of fraud 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 incentivised partners to put the firm's reputation in danger 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 Law Review* (2004) p. 269, at pp. 301-302. 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 and K.K. Raman, 'Litigation Risk and the Financial Reporting Credibility of Big 4 Versus Non-Big 4 Audits: Evidence from Anglo-American Countries', 79 *Accounting Review* 473 (2004); Clive S. Lennox, 'Audit Quality and Auditor Size: An Evaluation of Reputation and Deep Pockets Hypotheses', 26 *Journal of Business Finance and Accounting* (1999) p. 779; Ramgopal Venkataraman and Joseph P. Weber, 'Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings', 83 *Accounting Review* (2008) p. 1315; Ho-Young Lee, et al., 'The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital', 48 *Quarterly Journal of Finance and Accounting* (2009) p. 85. See also *infra* n. 55.

[34] See Jochen Bigus, 'Auditors' Liability with Overcompensation and Reputation Losses', 33 *OR Spectrum* (2011) p. 287. For empirical research on the role of reputation, see *infra* n. 55.

[35] See *infra* section 7.

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Other qualitative studies model the interplay between audit standards and auditor liability[36] or auditor wealth.[37] Many compare different liability rules[38] or joint and several liability regimes to proportionate liability regimes.[39] These studies are also 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 one that economists and lawyer-economists take as a reference point in the international literature) the auditor is generally not liable to banks and trade creditors.[40]

2.3 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.[41]

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[36] Compare Ronald A. Dye, 'Auditing Standards, Legal Liability, and Auditor Wealth', 101 *Journal of Political Economy* (1993) p. 887; Rachel Schwartz, 'Auditors' Liability, Vague Due Care, and Auditing Standards', 11 *Review of Quantitative Finance and Accounting* (1998) p. 183; Ralf Ewert, 'Auditor Liability and the Precision of Auditing Standards', 155 *Journal of Institutional and Theoretical Economics* (1999) p. 181; Juan José Ganuza and Fernando Gomez, 'Should We Trust the Gatekeepers?: Auditors' and Lawyers' Liability for Clients' Misconduct', 27 *International Review of Law and Economics* (2007) p. 96.

[37] Ronald A. Dye, 'Incorporation and the Audit Market', 19 *Journal of Accounting and Economics* (1995) p. 75 (analysing the American Institute of Certified Public Accountants' (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).

[38] Hans-Bernd Schäfer, 'Efficient Third Party Liability of Auditors in Tort Law and in Contract Law', *Supreme Court Economic Review* (2004) p. 181.

[39] V.G. Narayanan, 'An Analysis of Auditor Liability Rules', 32 *Journal of Accounting Research* (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 *Journal of Accounting Research* (1994) (discussing Narayanan's paper). This is an issue that the Big 6 audit firms raised in 1992 and that led to the PSLRA's amendment in 1995. See also *infra* n. 84.

[40] See *infra* section 5.1.

[41] See, generally, Jan S. Blaising, 'Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis', 25 *Indiana Law Review* (1991) p. 475; Robert Tillman and Henry N. Pontell, 'Organizations and Fraud in the Savings and Loan Industry', 73 *Social Forces* (1994) p. 1439; Kitty Calavita, et al., 'The Savings and Loan Debacle, Financial Crime, and the State', 23 *Annual Review of Sociology* (1997) p. 19; George A. Akerlof and Paul M. Romer, 'Looting: The Economic Underworld of Bankruptcy for Profit', *Brookings Papers on Economic Activity* (1993) p. 1, at pp. 23-36. For a thoughtful analysis of the Lincoln Savings and Loan's scam, see Merle

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2.3.1 *Pre-PSLRA research*

A large part of these studies analysed predictors of audit litigation.[42] Amongst the investigated predictors are the client company's asset structure and characteristics,[43] the client's probability of bankruptcy,[44] auditor independence,[45] the audit client's probability of becoming the target of an acquisition,[46] auditor characteristics,[47] auditor resignation,[48] previous Accounting and Auditing Enforcement Release (AAER) by the Securities and Exchange Commission (SEC),[49] and the role of modified audit opinions.[50] It must be noted once again that this raft of studies refers to the US experience. They generally aggregate all kinds 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

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Erickson, et al., 'Why Do Audits Fail? Evidence from Lincoln Savings and Loan', 38 *Journal of Accounting Research* (2000) p. 165.

42 For a review, see Claire Kamm Latham and Mark Linville, 'A Review of the Literature in Audit Litigation', 17 *Journal of Accounting Literature* (1998) p. 175.

43 Jamie Pratt and James D. Stice, 'The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Audit Fees', 69 *Accounting Review* (1994) p. 639; Kent St Pierre and James A. Anderson, 'An Analysis of the Factors Associated with Lawsuits Against Public Accountants', 59 *Accounting Review* (1984) p. 242.

44 Zoe-Vonna Palmrose, 'Litigation and Independent Auditors: The Role of Business Failures and Management Fraud', 87 *Auditing* (1987) p. 90. 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 types of cases with large auditor payments were management fraud cases (at pp. 101-102). Cf. also Thomas Lys and Ross L. Watts, 'Lawsuits Against Auditors', 32 *Journal of Accounting Research* (1994) p. 65.

45 Lys and Watts, *supra* n. 44.

46 Ibid., at p. 70.

47 Zoe-Vonna Palmrose, 'An Analysis of Auditor Litigation and Audit Service Quality', 63 *Accounting Review* (1988).

48 Jagan Krishnan and Jayanthi Krishnan, 'Litigation Risk and Auditor Resignations', 72 *Accounting Review* (1997).

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

50 Joseph V. Carcello and Zoe-Vonna Palmrose, 'Auditor Litigation and Modified Reporting on Bankrupt Clients', 32 *Journal of Accounting Research* (1994) p. 1.

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Professor Alexander's path-breaking research,[51] has devoted a significant part of her research agenda to the issue, analysing empirical evidence concerning trials of legal disputes involving independent auditors[52] and reviewing the empirical results reached by the literature, to show that the merits might not matter in US litigation.[53]

2.3.2 *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.[54] Many of the studies at the end of the 1990s analysed the new landscape, predicting that audit quality would be unaffected because reputation is the key driver of audit quality.[55] Other studies, however, took a different view, showing that exposure to liability (the deep-pocket

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[51] Janet Cooper Alexander, 'Do the Merits Matter? A Study of Settlements in Securities Class Actions', 43 *Stanford Law Review* (1991) p. 1487. 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 *Harvard Law Review* (1994) p. 438.

[52] Zoe-Vonna Palmrose, 'Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence', 29 *Journal of Accounting Research* (1991) p. 149. See also Michael L. Ettredge, 'Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence: Discussion', 29 *Journal of Accounting Research* (1991) p. 186.

[53] Zoe-Vonna Palmrose, 'Audit Litigation Research: Do the Merits Matter? An Assessment and Directions for Future Research', 16 *Journal of Accounting and Public Policy* (1997) p. 355.

[54] In 1991, in reaction to the litigation explosion that followed the Savings & Loan debacle (see *supra* n. 41 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 in *Central Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164, 188-189 (1994), where the Court considered the 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 and Steven D. Avila, 'The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?', 24 *Iowa Journal of Corporate Law* (1999) p. 681, at p. 683. Subsequently, the PSLRA was enacted, on the grounds of the intense lobbying activity of the audit industry: ibid., at p. 682, note 6 (the 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 *University of Cincinnati Law Review* (2004) p. 95; James D. Cox, 'Making Securities Class Actions Virtuous', 39 *Arizona Law Review* (1997) p. 497, at pp. 515-523. The PSLRA introduced proportionate liability: see *infra* n. 84. Some studies assert that the reform significantly benefited the largest audit firms more than the 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* (2006) p. 332.

[55] Srikant Datar and Michael Alles, 'The Formation and Role of Reputation and Litigation in the Auditor-Manager Relationship', 14 *Journal of Accounting, Auditing and Finance* (1999) p. 401; Stephen A. Hillegeist, 'Financial Reporting and Auditing under Alternative Damage Apportionment Rules', 74 *Accounting Review* (1999) p. 347. See also *infra* n. 61.

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hypothesis) prevails over reputation as an incentive to take care.[56] A stream of empirical studies, both in economic and legal literature, has started to measure the impact of the PSLRA on stock prices,[57] the cost of equity,[58] and non-nuisance claims.[59]

The 2001 accounting crisis started with the restatement season, which researchers immediately investigated.[60] 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.[61] As mentioned, prominent legal scholars stressed that the crisis had been caused by gatekeepers' reduced exposure to liability.[62]

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[56] Lennox, *supra* n. 33; Ho-Young Lee, et al., 'The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital', 48 *Quarterly Journal of Finance and Accounting* (2009) p. 85.

[57] Cf. D. Katherine Spiess and Paula A. Tkac, 'The Private Securities Litigation Reform Act of 1995: The Stock Market Casts Its Vote', 18 *Managerial and Decision Economics* (1997) p. 545 (indicating that the market believed that the PSLRA's potentially positive consequences outweighed its potentially negative effects); Marilyn F. Johnson, et al., 'Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995', 5 *Review of Accounting Studies* (2000) p. 217 (shareholders generally benefit from the PSLRA, although these benefits are mitigated when other mechanisms for curbing fraudulent activity are inadequate); Ashiq Ali and Sanjay Kallapur, 'Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events', 76 *Accounting Review* (2001) p. 431 (additional analysis conducted beyond the analyses referred to in the previously mentioned research suggests that shareholders in four high-litigation-risk industries reacted negatively to the PSLRA).

[58] Lee, et al., *supra* n. 33 (the PSLRA increased the cost of equity); Jeff P. Boone, et al., 'Litigation Reform, Accounting Discretion, and the Cost of Equity', 5 *Journal of Contemporary Accounting and Economics* (2009) p. 80 (the increase in the accounting discretion associated with the PSLRA increased the firm-specific equity risk premiums).

[59] Stephen J. Choi, 'Do the Merits Matter Less After the Private Securities Litigation Reform Act?', 23 *Journal of Law, Economics and Organization* (2006) p. 598 (the PSLRA reduced non-nuisance claims); Michael A. Perino, 'Did the Private Securities Litigation Reform Act Work?', *University of Illinois Law Review* (2003) p. 913 (statistically significant evidence suggesting that the PSLRA improved overall case quality at least in the Ninth Circuit, the one that most strictly interprets the Reform Act's heightened pleading standard).

[60] Zoe-Vonna Palmrose and Susan Scholz, 'Restated Financial Statements and Auditor Litigation' (2000), available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=248455>; William G. Heninger, 'The Association Between Auditor Litigation and Abnormal Accruals', 76 *Accounting Review* (2001) p. 111.

[61] See *supra* n. 58. See also Khurana and Raman, *supra* n. 33; Paul D. Newman, et al., 'The Role of Auditing in Investor Protection', 80 *Accounting Review* (2005) p. 289; Venkataraman and Weber, *supra* n. 33. *Contra*, Chee Keung Kevin Lam and 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* (2006) p. 706; Joseph P. Weber, et al., 'Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG', 46 *Journal of Accounting Research* (2008) p. 941.

[62] See *supra* n. 3.

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2.4 Corporate governance indices

Both academics and investors' advisers 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.[63] Articles that followed do not expand the view.[64] This is 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.[65] 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[66] and extensively critiqued.[67] Third, and more importantly, since auditors are historically key figures in monitoring managers,[68] empirical studies provide evidence that investors rely on auditors as fraud detection tools[69] and auditors follow fraud detection procedures under SAS 99 and ISA 240.[70] Thus, the total absence of any auditor liability indices is stunning.

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[63] Rafael La Porta, et al., 'What Works in Securities Laws?', 61 *Journal of Finance* (2006) p. 1, at pp. 7 and 11.

[64] Howell E. Jackson and Mark J. Roe, 'Public and Private Enforcement of Securities Laws: Resource-Based Evidence', 93 *Journal of Financial Economics* (2009) p. 207, at p. 212.

[65] See *supra* section 2.2.

[66] Rafael La Porta, et al., 'Legal Determinants of External Finance', 52 *Journal of Finance* (1997) p. 1131; Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance', 52 *Journal of Finance* (1997) p. 737; Rafael La Porta, et al., 'Law and Finance', 106 *Journal of Political Economy* (1998) p. 1113; Rafael La Porta, et al., 'Corporate Ownership Around the World', 54 *Journal of Finance* (1999) p. 471; Rafael La Porta, et al., 'Investor Protection and Corporate Governance', 58 *Journal of Financial Economics* (2000) p. 3; Simon Johnson, et al., 'Tunneling', 90 *American Economic Review* (2000) p. 22; Andrei Shleifer and Daniel Wolfenzon, 'Investor Protection and Equity Markets', 66 *Journal of Financial Economics* (2002) p. 3; Simeon Djankov, et al., 'The Law and Economics of Self-Dealing', 88 *Journal of Financial Economics* (2006) p. 430; La Porta, et al, *supra* n. 63.

[67] John Armour, et al., 'Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis', 6 *Journal of Empirical Legal Studies* (2009) p. 343; Sanjai Bhagat, et al., 'The Promise and Peril of Corporate Governance Indices', 108 *Columbia Law Review* (2008) p. 1803; Lucian A. Bebchuk and Assaf Hamdani, 'The Elusive Quest for Global Governance Standards', 157 *University of Pennsylvania Law Review* (2009) p. 1263; Sophie Cools, 'The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers', 30 *Delaware Journal of Corporate Law* (2005) p. 697.

[68] See *infra* section 4.1.

[69] Joseph F. Brazel, et al., 'Investor Perceptions About Financial Statement Fraud and Their Use of Red Flags' (2009), available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1460820>, at p. 17.

[70] Tina D. Carpenter, 'Audit Team Brainstorming, Fraud Risk Identification, and Fraud Risk Assessment: Implications of SAS No. 99', 82 *Accounting Review* (2007) p. 1119; T. Jeffrey Wilks and Mark F. Zimbelman, 'Decomposition of Fraud-Risk Assessments and Auditors' Sensitivity to

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Equally puzzling is the most popular system of corporate governance predictors developed by commercial firms, namely RiskMetrics' Corporate Governance Quotient (CGQ) system.[71] It considers shareholders' ratification of management's selection of auditors, but does not evaluate auditor liability.[72] Yet, as any litigator in this field well knows, auditors' role and liability are core issues in the *ex post* evaluation of the firm's corporate governance system.

2.5 **Assessment**

The research on audit litigation can be highly misleading. It is dominated by the US scenario in general[73] and investors' class actions against audit firms in particular.[74] This has created a form of tunnel vision within the economic literature. The reported problem of the US scenario was that investors' actions against auditors were (at least until 1995) too easily brought to coerce a settlement. However, this scenario had nothing specific about 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 as part of the larger

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Fraud Cues', 21 *Contemporary Accounting Research* (2004) p. 719; Steven M. Glover, et al., 'A Test of Changes in Auditors' Fraud-Related Planning Judgments Since the Issuance of SAS No. 82', 22 *Auditing* (2003) p. 237; Maria Krambia-Kapardism, 'A Fraud Detection Model: A Must for Auditors', 10 *Journal of Financial Regulation and Compliance* (2002) p. 266; Carol A. Knapp and Michael C. Knapp, 'The Effects of Experience and Explicit Fraud Risk Assessment in Detecting Fraud with Analytical Procedures', 26 *Accounting, Organizations and Society* (2001) p. 25; Robert J. Nieschwietz, et al., 'Empirical Research on External Auditors' Detection of Financial Statement Fraud', 19 *Journal of Accounting Literature* (2000) p. 190; Mark F. Zimbelman, 'The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions', 35 *Journal of Accounting Research* (Supplement) (1997) p. 75; Karen V. Pincus, 'The Efficacy of a Red Flags Questionnaire for Assessing the Possibility of Fraud', 14 *Accounting, Organizations and Society* (1989) p. 153.

[71] Riskmetrics Group, Corporate Governance Quotient, available at: <http://www.riskmetrics.com/cgq> (last visited 23 February 2010).

[72] Riskmetrics, Non-U.S. Indicator Definitions, available at: <http://www.riskmetrics.com/sites/default/files/CGQ_Criteria_exUS.pdf>, para. 21, at p. 13 ('Shareholders should be permitted to ratify management's selection of auditors each year').

[73] Data concerning other markets are rare: for some examples, see Lam and Mensah, *supra* n. 61; Weber, et al., *supra* n. 61.

[74] This is well known to many researchers. See, for example, Dye, *supra* n. 37, at p. 78 (noting that, with reference to whether is it advisable to let auditors adopt 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).

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picture concerning securities class actions and distorted incentives in US private enforcement.[75]

The few international studies that go beyond the US border arrive at unclear results as to the role of litigation and civil liability.[76] Cross-country analyses have led to different results[77] and are spoiled by the usual, unreliable methods of classifying jurisdictions that typify generalisations made in the law & finance literature.[78]

None of the leading articles in the economic analysis of the litigation crisis offer a clear understanding of 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.[79] The problem of a multiple-layer optimum is substantially unaddressed in the literature. There are probably two reasons for this. First, modelling the interaction of many liability layers is much more complex; the best *in vitro* design of each single layer might be not the optimal solution when all the layers are merged together. Second, an analysis that does not exclusively concern 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.[80]

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[75] Regarding which see, for example, Alexander, *supra* n. 51; Janet Cooper Alexander, 'Rethinking Damages in Securities Class Actions', 48 *Stanford Law Review* (1996) p. 1487; Paul G. Mahoney, 'Precaution Costs and the Law of Fraud in Impersonal Markets', 78 *Virginia Law Review* (1992) p. 623; Elliott J. Weiss and John S. Beckerman, 'Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions', 104 *Yale Law Journal* (1995) p. 2053; Paul G. Mahoney, 'The Exchange as Regulator', 83 *Virginia Law Review* (1997) p. 1453; Adam C. Pritchard, 'Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers', 85 *Virginia Law Review* (1999) p. 925; Stephen J. Choi, 'The Evidence on Securities Class Actions', 57 *Vanderbilt Law Review* (2004) p. 1465; Choi, *supra* n. 59; Tom Baker and Sean J. Griffith, 'How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements', 157 *University of Pennsylvania Law Review* (2009) p. 756.

[76] Cf. Lam and Mensah, *supra* n. 61; Weber, et al., *supra* n. 61.

[77] Cf. J. Francis and D. Wang, 'The Joint Effect of Investor Protection and Big 4 Audits on Earnings Quality around the World', 25 *Contemporary Accounting Research* (2008) p. 157; Jong-Hag Choi, et al., 'Audit Pricing, Legal Liability Regimes, and Big 4 Premiums: Theory and Cross-country Evidence', 25 *Contemporary Accounting Research* (2008) p. 55.

[78] This critique of the L&F literature is contained in the articles mentioned *supra* n. 67.

[79] 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 and Carolyn B. Levine, 'Discipline with Common Agency: The Case of Audit and Nonaudit Services', 79 *Accounting Review* (2004) p. 173. On common agency, see B. Douglas Bernheim and Michael D. Whinston, 'Common Agency', 54 *Econometrica* (1986) p. 923.

[80] 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 and Kelvin Lancaster, 'The General Theory of Second Best', 24 *Review of Economic Studies* (1956)

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3. The European Commission's Recommendation

3.1 Introduction

The Final Report (FR)[81] supports auditor liability limitations as an efficient device of risk protection in favour of the Big Four. It compares strict liability to negligence, joint and several liability (JSL) to proportional liability, and discusses the extent of auditor liability, and liability insurance. The FR recommends not to move to a regime of strict liability, proposes the adoption of a proportionate liability regime (PLR) for auditors, and, finally, 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 is not envisaged by any jurisdiction I am aware of.[82] 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.[83] The 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.

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p. 11. On the normative impact of the theory, cf. Richard S. Markovits, 'Second-Best Theory and Law & Economics: An Introduction', 73 *Chicago-Kent Law Review* (1998) p. 3; Thomas S. Ulen, 'Courts, Legislatures, and the General Theory of Second Best in Law and Economics', 73 *Chicago-Kent Law Review* (1998) p. 189.

[81] See *supra* n. 13.

[82] Cf. Final Report to EC-DG Internal Market and Services, *supra* n. 13, at pp. 142-143. Probably the most significant issue concerns the incentives to take optimal precautions when multiple monitoring parties (directors, auditors, lawyers, etc.) are involved: see Andrew Tuch, 'Multiple Gatekeepers', 96 *Virginia Law Review* (2010) p. 1583, who analyses the topic with reference to gatekeepers' liability towards market investors. Strict liability regimes with liability caps aimed at reducing gatekeepers' exposure have been advocated, in the US, by Frank Partnoy, 'Corporate Accountability: Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime', 79 *Washington University Law Quarterly* (2001) p. 491; *idem*, 'Strict Liability for Gatekeepers: A Reply to Professor Coffee', 84 *Boston University Law Review* (2004) p. 365 (proposing strict liability for gatekeepers for material misstatements or omissions in offering documents, contractually limited to a minimum percentage of the issuer's ultimate liability), and John C. Coffee Jr, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', 84 *Boston University Law Review* (2004) p. 301; *idem*, 'Partnoy's Complaint: A Response', 84 *Boston University Law Review* (2004) p. 377 (advocating strict liability for gatekeepers with a ceiling based on a multiple of the revenues from the client and independent of the latter's liability).

[83] Final Report to EC-DG Internal Market and Services, *supra* n. 13, at pp. 278-299.

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3.2 **Proportionate liability regime**

A PLR was introduced in the US by the PSLRA as an instrument to limit auditors' exposure to investors' class actions when the gatekeeper has no conscious awareness of the statement's falsity.[84] The event studies conducted tend to show that audit quality decreased.[85] However, audit quality is not an absolute measure, because it comes at a cost. Thus, a cost-benefit analysis is needed. The FR conducts this analysis 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 his 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' con-

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[84] Under the PSLRA, the defendants who acted knowingly are jointly and severally liable, whereas those who did not are liable for their proportionate share, and recklessness is explicitly excluded from the definition of knowing misconduct: see Donald C. Langevoort, 'Reform of Joint and Several Liability under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects', 51 *Business Lawyer* (1996) p. 1157, at pp. 1162-1166. The legislative amendment was considered as a measure to reduce the over-enforcement of securities class actions rather than as a move based on a clearly modelled theory of joint tortfeasors' liability (*idem*, at pp. 1158-1162). In a literature that easily argues in favour 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. In a very interesting recent article, Andrew Tuch analyses multiple gatekeepers' interactions and risk-shifting arrangements in the context of registration statements, but the study does not cover the interaction between gatekeepers and firm managers: cf. Tuch, *supra* n. 82, at pp. 1645-1657. On some of the conceptual problems raised by joint and several liability, see Lewis A. Kornhauser and Richard L. Revesz, 'Sharing Damages Among Multiple Tortfeasors', 98 *Yale Law Journal* (1989) p. 831; Lewis A. Kornhauser and Richard L. Revesz, 'Apportioning Damages Among Potentially Insolvent Actors', 19 *Journal of Legal Studies* (1990) p. 617; Lewis A. Kornhauser and Richard L. Revesz, 'Settlement Under Joint and Several Liability', 68 *New York University Law Review* (1993) p. 427; Lewis A. Kornhauser and Richard L. Revesz, 'Multidefendant Settlements Under Joint and Several Liability:The Problem of Insolvency', 23 *Journal of Legal Studies* (1994) p. 517; Lewis A. Kornhauser and Richard L. Revesz, 'Multidefendant Settlements: The Impact of Joint and Several Liability', 23 *Journal of Legal Studies* (1994) p. 41; John J. Donohue, 'The Effect of Joint and Several Liability on the Settlement Rate. Mathematical Symmetries and Metaissues about Rational Litigant Behavior. Comment on Kornhauser and Revesz', 23 *Journal of Legal Studies* (1994) p. 543; Lewis A. Kornhauser and Richard L. Revesz, 'Joint and Several Liability', in Peter Newman, ed., *The New Palgrave Dictionary of Economics and the Law II* (Macmillan 1998) p. 371; Lewis A. Kornhauser and Richard L. Revesz, 'Joint Tortfeasors', in Boudewijn Bouckaert and Gerrit De Geest, eds., *Encyclopedia of Law and Economics, Volume II. Civil Law and Economics* (Edward Elgar 2000) p. 625.

[85] See *supra* nn. 57-61.

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cludes 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.'[86] 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 JSL is totally neglected by the FR.

The second scenario considers the strategic interplay between the managers and the auditor.[87] 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 JSL regime, 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' sizeable 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 to the investors. And under a PLR, auditors certainly have no incentives to monitor if and how managers conceal their assets.

3.3 **Liability caps**

The FR is well aware that damage payments depend on sizeable assets, because this is one of the two arguments employed to argue in favour of liability caps. Professor Ewert argues that since investors pay for audit care, an excessive level of care can be detrimental, and he therefore states that 'restrictions on audit liability … may in fact be socially desirable'.[88] 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.[89] In short, the FR's assumption is that through incorporation, auditors 'can reduce "wealth at risk" to a socially optimal level'.[90] There are three problems, however. First, the assumption relies on the capability of investors to monitor auditors' incorporated wealth and therefore the value of size-

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[86] Final Report to EC-DG Internal Market and Services, *supra* n. 13, at p. 289.

[87] Ibid., at pp. 289-290.

[88] Ibid., at p. 293.

[89] As a defensive measure against allegedly excessive exposure to liability risk following the S&L litigation explosion (see *supra* n. 41 and accompanying text), lawyers and auditors in the US lobbied states' legislatures to be allowed to use limited liability partnership. Texas started in 1991 and within a few years other states followed *en masse*: Robert W. Hamilton, 'Registered Limited Liability Partnerships: Present at the Birth (Nearly)', 66 *University of Colorado Law Review* (1995) p. 1065. The main argument used to motivate the change was that, since audit firms had reached huge dimensions and complexity, it is was no longer feasible for partners to monitor each other.

[90] Final Report to EC-DG Internal Market and Services, *supra* n. 13, at p. 293.

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able auditors' assets. Since a company's shareholders are not able to do this (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 in a company can do it better. An auditor's auditor would be needed. The problem would therefore simply be 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.[91] Thus, far from permitting a move of auditor deterrence's levels to the efficient frontier, incorporation reduced auditor incentives too much.[92] Third, the reasoning expressed by Professor Ewert must still explain why liability limitation through asset sheltering granted by incorporation is not enough, and therefore why further protection from liability is needed.[93] This issue is not covered by Annex 6, which too quickly concludes in favour of auditor liability limitations.

3.4 **Assessment**

On the grounds of these vague conceptual arguments, the European Commission has recommended liability limitations. The Recommendation, presented as an instrument to reduce barriers to entry in the international audit market,[94] is flawed. The main problem is that it not only covers liability towards third parties and, in

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[91] Jonathan R. Macey and Hillary A. Sale, 'Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry', 48 *Villanova Law Review* (2003) p. 1167.

[92] But cf. Final Report to EC-DG Internal Market and Services, *supra* n. 13, at p. 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'.

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

[94] 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 Final Report: 'Finally, audit liability risk and lack of liability insurance are viewed as a less serious barrier to entry by the middle-tier firms than by the Big 4 firms. This may reflect the fact that, in the absence of entry into the large company market segment, middle-tier firms have not yet had to address fully the issue of ensuring adequate liability insurance coverage for the liability that may arise out of statutory audits of large and very large companies. Indeed, in follow-up discussions with a number of the major middle-tier firms, some of these firms identified lack of insurance availability as a serious issue. When explicitly asked about the liability risk associated with the statutory audit of large companies, the issue of liability insurance was more clearly focused', Final Report to EC-DG Internal Market and Services, *supra* n. 13, at p. 46. It seems that the FR's authors had somehow to convince middle-tier firms to be afraid of liability issues.

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particular, secondary market investors, but concerns any kind of liability. Note that prospectus liability and liability to the company were not investigated by the FR. Accordingly, the Commission simply expands the conclusions reached by analysing one layer (liability to secondary market investors) to all possible forms of liability.[95] Moreover, it recommends limitations to liability to the company also in jurisdictions where shareholders, investors and other third parties are not entitled to sue the auditor, and where liability is thus already restricted.

4. 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.[96]

4.1 **The auditor as the shareholders' watchdog**

4.1.1 *History and the English experience*

Shareholders and partners need to monitor managers to be sure that no breach of contract occurs.[97] The auditor was used right from the very beginning of company history as a tool to control opportunistic managerial behaviour.[98] He looked for unauthorised expenses, embezzlements, and checked the accounting data prepared

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[95] See also Walter Doralt and Alexander Hellgardt, et al., 'Auditors' Liability and Its Impact on the European Financial Markets', 67 *Cambridge Law Journal* (2008) p. 62, who observe that the impact on the European capital markets of limiting auditor liability can be comprehensible only when liability to all the potential claimants (company, shareholders, third parties) is taken into account.

[96] 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 on Damages', 49 *William and Mary Law Review* (2007) p. 711, at p. 713. The reason is probably that external auditors are considered shareholders' watchdogs in cases of embezzlement only: see *infra* nn. 110-117 and accompanying text.

[97] 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?' (2012), available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1373808> (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).

[98] Ross J. Watts and Jerold L. Zimmerman, 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence', 26 *Journal of Law and Economics* (1983) p. 613.

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by the management.[99] In short, he was an inspector.[100] Initially, auditors were chosen from among directors, assistants[101] or shareholders, which formed shareholders' committees.[102] Later, they became external professionals.[103]

The shareholders' watchdog role is typified by English law. The auditor was appointed by shareholders, who set his remuneration.[104] The auditor's role was to act antagonistically in regard to the directors, even though auditors were paid by the company.[105] This shareholders' watchdog role is still testified by the *Caparo* case,[106] 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

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[99] 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 *Northwestern University Law Review* (1984) p. 663, at p. 674.

[100] Coffee Jr, *supra* n. 1, at p. 110.

[101] Watts and Zimmerman, *supra* n. 98, at pp. 626-627.

[102] As Watts and Zimmerman observe, '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', ibid., at p. 626.

The historical development of the audit profession in Germany is very different and has been mentioned in order to explain the reason why in Germany, since 1931, auditors' liability to the company is capped: Miles Gietzmann and Reiner Quick, 'Capping Auditor Liability: The German Experience', 23 *Accounting, Organizations and Society* (1998) p. 81.

[103] See Watts and Zimmerman, *supra* n. 98, at pp. 628-633.

[104] 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 an 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 the Problem of Auditor Independence', 45 *Boston College Law Review* (2004) p. 741, at pp. 756-775. 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* section 6.1.

[105] 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.'

[106] See *supra* n. 105.

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problem in monitoring them, and thus charge the auditor to be a check upon the directors.[107]

In England, the shareholders' watchdog role is still considered the only role that auditors have (with the sole exception of prospectus auditing, where the auditor works in cooperation with the company and its management).[108] This is not so in other legal environments, where the perception is that the auditor serves multiple principals: the company, the investors and the general public.[109] However, in all legal environments it 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.

4.1.2 *The auditor's role and liability to the company: the US and* in pari delicto *defences*

The requirements of auditor liability to the company are not uniform across countries. Indeed, there are many issues where the law can take very different approaches. The most significant 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 his client's managers and employees 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*.[110] In order to win the defence, the

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[107] 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'.

[108] See *infra* section 6.1.

[109] The US is a case in point. See O'Connor, *supra* n. 104, at p. 824. The author has thoroughly investigated the history of auditors in the US between 1880 and 1934, comparing it with the English experience. He points out that from the multiple roles assumed by the accountant ('the self-proclaimed "authorized agents of publicity": at p. 790) an imbroglio resulted, where external auditors were hired to perform a service on behalf of the client company, 'with a host of implied duties to creditors, directors, and the "investing public", not to mention a duty to shareholders and possibly even employees' (at p. 824).

[110] 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).

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client company must invoke the 'adverse interest defence', asserting that the managers acted adversely to the principal, entirely for their own purposes, with the principal retaining no benefit from the managers' misconduct.[111]

In this way the requirements for ascertaining auditor liability become very narrow. Financial scandals teach us that accounting manipulations serve multiple purposes.[112] Insiders misrepresent the company's financial reports both to enlarge the firm's activity range and dimension and to derive private benefits from this.[113] Accounting manipulations increase 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 companies.[114] They help to get favourable 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 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 defences are sometimes conceptualised, with regard to auditor liability, as a corporate governance tool. They force shareholders to implement an adequate corporate governance system and, in particular, to select a vigilant monitoring board where independent directors have a true role.[115] This approach assumes that independent directors are better positioned to ferret out corporate fraud than auditors[116] and that auditors generally should not take any liability for wrongdoings committed by the managers appointed by the shareholders.[117]

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

[112] Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006), at p. 20.

[113] These arguments are known to US courts but do not dent the strength of the imputation defence, 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).

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

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

[116] 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

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4.1.3 *Jurisdictions where the* in pari delicto *defence is unknown: Italy*

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 company.[118] The *in pari delicto* defence 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.[119]

These differences amongst jurisdictions can be explained by many factors. Differences in the corporate governance of companies certainly play a role.[120] History

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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.'

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

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

[119] Merritt B. Fox, 'Civil Liability and Mandatory Disclosure', 109 *Columbia Law Review* (2009) p. 237, at p. 280.

[120] In Italy, the agency problem lies in the relationship between the controlling shareholder (coalition) and minority shareholders: see, e.g., Luca Enriques and Paolo Volpin, 'Corporate Governance Reforms in Continental Europe', 21 *Journal of Economic Perspectives* (2007) p. 117. In the Italian landscape, the idea that managers can simply think of embezzling the company's funds 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

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matters as well.[121] Finally, there can be few doubts 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 more ready to adopt very severe rules, whereas in countries where law enforcement is very strong, they may be more prepared to relax substantive rules of liability.[122]

4.2 Contracting around auditor liability to the company

4.2.1 *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 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 to be 'default rules'. Accordingly, the most interesting question is why contracting

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control. Financial information is a key tool of corporate governance, as management's decisions can be constantly monitored by shareholders (Fox, *supra* n. 119, at pp. 253-260). Thus, Italian law does not require that the agent has totally abandoned its principal's interest, because when funds (at least significant funds) have been siphoned off, any distinction between managers' (controlling shareholders') innocent interest in the company's success and managers' (controlling shareholders') self-interest is moot.

[121] 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, as '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* (Vallardi 1929), at p. 277. The idea that inside statutory auditors could escape liability on the grounds of some sort of imputation theory was unconceivable, because the inside statutory audit committee was itself a body of the company. Later, the law moved towards an outside auditors model, which is now the default model for public companies and the mandatory model for listed companies. Under this model, companies have inside statutory 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 a comparatively better treatment. The external auditor is not a company's body, but a mandatory external watchdog that fulfils identical needs with regard 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* (2005) p. 658.

[122] See Guido Ferrarini and Paolo Giudici, 'Financial Scandals and the Role of Private Enforcement: The Parmalat Case', in John Armour and Joseph A. McCahery, eds., *After Enron* (Hart Publishing 2006) p. 159 (analysing the Italian situation of strong rules and lax private enforcement in the light of the Parmalat case).

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over auditor liability is generally not admitted, except under UK company law.[123] More generally, why is the whole field not left to the freedom of contract principle?

4.2.2 *Common agency explanation for not admitting contracting around*

A first answer might be that many jurisdictions are afraid to reduce deterrence levels in regard to auditors for the same reason they are afraid to leave the company and its directors free to contract around director liability regimes.[124] 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 spill-over effects on other constituents that rely on the 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.[125]

However, this unsophisticated 'common agency' explanation is not sufficient. 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 (at least in England) that the auditor acts exclusively as an agent of the company and therefore has no watchdog duties to third parties.[126] Accordingly, there must also be another explanation, confined to the pure shareholders' watchdog role.

4.2.3 *Shareholders' collective action problem as an explanation to standardisation of engagement terms and liability exposure*

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, if necessary, dismissed by shareholders. However, the collec-

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[123] The UK now allows for limits to auditors' liability (see *supra* n. 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 and Bernard Black, 'Outside Director Liabilities Across Countries', 84 *Texas Law Review* (2006) p. 1385, at p. 1406. Whether contractual limitations to auditors' liability are to be allowed is, however, the subject of current debate in the US: see *supra* n. 10. In Italy, both limitations and caps to auditors' or directors' liability are considered null and void.

[124] With the exception of Delaware and the other states that followed it, allowing exculpation clauses: see *supra* n. 123.

[125] See *infra* section 8.

[126] See *infra* nn. 146-147 and accompanying text.

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tive action problems that have induced shareholders to appoint auditors[127] affect 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.[128] In large, modern Anglo-American public companies shareholders are dispersed investors, rationally apathetic, ready to vote with management or with their feet.[129] The collective action problem that shareholders face is sorted out by the management itself, which selects the auditor on behalf of the company, negotiates the price and eventually tables the audit firm's name for the shareholders to approve.[130] 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' selection of the watchdog (as well as its tenure and dismissal).[131]

In order to limit the shareholders' collective action problem, intermediate conduits (such as the audit committee) can be adopted.[132] 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 importantly, negotiation of the contractual terms and, in particular, of liability issues could give room to an intergenerational problem.[133] New shareholders might enter 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

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[127] See *supra* section 4.1.

[128] Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Harvard University Press 1965), at p. 55.

[129] See Anita Anand and Niamh Moloney, 'Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives', 5 *European Business Organization Law Review* (2004) p. 223, at p. 237.

[130] 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 *California Law Review* (1975) p. 375, at pp. 424-426.

[131] Anand and Moloney, *supra* n. 129, at p. 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').

[132] The audit committee is the conduit under recent UK practice, following the US experience: see Anand and Moloney, *supra* n. 129, at pp. 240-242. In Italy, the conduit, with regard to listed companies, is the inside statutory auditors committee, which is the internal body of auditors that, for a long time, has been the substitute of Anglo-American external auditors and that now proposes the audit firm to the general shareholders' meeting (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 of 27 January 2010, no. 39.

[133] 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 *European Economic Review* (1995) p. 1447, at p. 1448.

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risk, in order to induce a lessening in the monitoring activity.[134] This is another facet of the latecomer terms problem.[135]

Standardisation is therefore the other instrument used to reduce the collective action problem and the related intergenerational one. Engagement terms have been standardised with the help of auditor associations, making negotiations easier.[136] 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 standardisation[137] – 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 facilitate 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.[138]

The intergenerational problems can become less significant in countries where shareholders are very homogeneous. This could explain why contracting over auditor liability has recently been allowed in the UK, where institutional investors are the prevalent shareholders of listed companies and the intergenerational problem is, accordingly, less worrying.[139] This also shows that the key features of the

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[134] 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, typically in situations where the manager and the controlling shareholder are the same person or members of the same family. The intergenerational problem would also become significant if the company and the auditor initially permitted, by agreement, expansion of the scope of auditor liability (for example, by agreeing that the auditor is not allowed to invoke any *in pari delicto* defence) and later returned to the default regime. Investors who decided to enter the company in the meantime would be damaged.

[135] See Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991), at pp. 32-34.

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

[137] As a matter of fact, companies and auditors could also agree to expand the range of the latter's liability. However, this is not known to have ever happened.

[138] 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 *University of Pennsylvania Law Review* (2009) p. 957, at p. 989. In a recent article it has been argued that when firms compete for (scarce) managerial talent with other companies, the choice of governance in one firm is affected by the governance quality of its competitors, because companies with poorer governance pay managers more and are therefore more attractive to them, inducing a general under-investment in corporate governance and increase in managers' compensation: Viral V. Acharya and Paolo Volpin, 'Corporate Governance Externalities', 14 *Review of Finance* (2010) p. 1. Should this hypothesis be confirmed by empirical studies, standardised audit liability might also be explained as a form of regulation aimed at alleviating the governance externality problem.

[139] See *supra* n. 11.

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first layer largely depend on local conditions, discouraging any attempt to design *in vitro* the perfect regime of liability to the company.

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

5.1 ***Ultramares* legacy**

5.1.1 *Judge Cardozo's decision*

The audit can create a spill-over effect, as information originally addressed to the shareholders can go to the benefit of creditors as well. This means that the company can seek to use the audit to reassure creditors and get funds, as is commonly observed in commercial practice. Is the auditor to be held liable if a creditor relies on his audit to finance the company? This is the classic *Ultramares* issue.[140] Judge Cardozo decided that the auditor was not liable for negligence towards Ultramares, whereas he would have been liable if fraudulent intent had been proven.[141] 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.[142]

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.'[143]

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[140] 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 factoring firm 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.

[141] Cardozo was too lenient on this point, according to Goldberg, *supra* n. 31, at p. 296.

[142] *Ultramares*, *supra* n. 140, at pp. 179-180.

[143] *Idem*, at p. 185.

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The *Ultramares* decision has influenced all the subsequent history of Anglo-American law on the issue and therefore the law and economics thinking about the subject.[144] US state courts or state legislation have developed and in many cases re-shaped the concepts analysed 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 his audit would be used to induce a specified class of third parties to extend credit or invest in the company or in its shares.[145] In the UK, the House of Lords explicitly followed the *Ultramares* principles in *Caparo*.[146] It decided that the auditor owes a duty to the company and not to creditors or to any single shareholder who 'as a purchaser of additional shares in reliance on the auditor's report, … stands in no different position from any other investing member of the public to whom the auditor owes no duty'. This assertion takes into consideration the fact that the accounts and the audit become public at the Register, but do not entail any responsibility of auditors to the public at large.[147]

5.1.2 *The floodgate argument*

Why is the collective action interest of shareholders so well recognised, in particular by English courts,[148] 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 more quoted phrases in modern private law: Judge Cardozo's reference to exposure to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class'.[149] This is the floodgate argument, which dominates any scientific discussion of pure economic loss.[150] The core idea is

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144 See *infra* n. 150.

145 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 *Florida State University Law Review* (2003) p. 20, at pp. 34-48.

146 See *supra* n. 105. *Caparo* concerned a shareholder who, relying on the certified accounts of a listed company, launched a takeover of the company to later discover that the accounts were false. The shareholder sued the auditor.

147 'What was surprising to company lawyers 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*, 6th edn. (Sweet & Maxwell 1997) p. 554.

148 See *supra* section 4.1.

149 *Ultramares*, *supra* n. 140, at p. 179.

150 See, e.g., Mario J. Rizzo, 'A Theory of Economic Loss in the Law of Torts', 11 *Journal of Legal Studies* (1982) p. 281; William Bishop, 'Economic Loss in Tort', 2 *Oxford Journal of Legal Studies* (1982) p. 1; William Bishop, 'Economic Loss: A Reply to Professor Rizzo', 2 *Oxford Journal of Legal Studies* (1982) p. 207; Mario J. Rizzo, 'The Economic Loss Problem. A

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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 exposure to the risk of liability towards the company is limited, as it refers – one should assume[151] – 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 he 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.[152]

Under the floodgate argument, it is up to investors to contract with auditors in order to buy protection.[153] Needless to say, investors could face coordination prob-

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Comment on Bishop', 2 *Oxford Journal of Legal Studies* (1982) p. 197; Bruce Chapman, 'Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law', 20 *Canadian Business Law Journal* (1992) p. 180; Jan M. Van Dunné, 'Liability for Pure Economic Loss: Rule Or Exception? A Comparatist's View of the Civil Law – Common Law Split on Compensation of Non-physical Damage in Tort Law', 4 *European Review of Private Law* (1999) p. 397; Jane Stapleton, 'Comparative Economic Loss: Lessons from Case-Law-Focused "Middle Theory"', 50 UCLA Law Review (2002) p. 531; Mauro Bussani, et al., 'Liability for Pure Financial Loss in Europe: An Economic Restatement', 51 *American Journal of Comparative Law* (2003) p. 113; Francesco Parisi, 'Liability for Pure Financial Loss: Revisiting the Economic Foundations of a Legal Doctrine', in Mario Bussani and Valentine Palmer Vernon, eds., *Pure Economic Loss in Europe* (Cambridge University 2003), at p. 74; Gary T. Schwartz, 'American Tort Law and the (Supposed) Economic Loss Rule', in Bussani and Palmer Vernon, eds., ibid., p. 94; Fernando Gómez and Juan Antonio Ruiz, 'The Plural – and Misleading – Notion of Economic Loss in Tort: A Law and Economics Perspective', 4 *Zeitshrift für Europäisches Privatrecht* (2004) p. 908; Francesco Parisi, et al., 'The Comparative Law and Economics of Pure Economic Loss', 27 *International Review of Law & Economics* (2007) p. 29; Dan B. Dobbs, 'An Introduction to Non-statutory Economic Loss Claims', 48 *Arizona Law Review* (2006) p. 713; Helmut Koziol, 'Recovery for Economic Loss in the European Union', 48 *Arizona Law Review* (2006) p. 871; Giuseppe Dari Mattiacci and Hans-Bernd Schäfer, 'The Core of Pure Economic Loss', 27 *International Review of Law and Economics* (2007) p. 1.

[151] See *supra* nn. 110-111 and accompanying text.

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

[153] It must be pointed out that unpredictability is not an issue that concerns management liability, because directors use the false accounts to misrepresent the company's situation and

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lems. When these problems become significant, securities law steps in and sorts them out by fiat.

5.1.3 *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 in Italian law, where auditors are liable to third parties. The reasons of this huge difference are probably many, but can be summarised 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 are subject to publicity is easily considered evidence of their public value.[154] 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.[155] As to history, Italian auditors were originally 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 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.[156] This approach was passed on to external auditors, without too many distinctions between the two kinds of auditors and their position vis-

attract investments and credit, whereas the auditor does not know with precision whom the management is going to solicit. When the auditor knows that his attestation will reach a certain group of persons, the various doctrines I have already mentioned *supra* n. 145 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.

154 Cf. *supra* n. 147 and accompanying text.

155 See Mario Bussoletti, *Le società di revisione* (Giuffrè 1985), at p. 332 et seq.

156 Indeed, the 1942 Civil Code stated, in 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 Italian 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 Pietro Rescigno, ed., *Trattato di diritto privato* (Utet 1985), at p. 583. The 2003 amendment to the company law part of the Civil Code states that statutory auditors (and external auditors) are liable towards third parties under Article 2395.

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à-vis the company.[157] As to law enforcement, in a country where creditors have always been perceived to have collective action problems and in the absence of class action-like mechanisms, a litigation crisis with subsequent exposure to gigantic and unforeseeable liability has never been considered a realistic risk.[158]

5.1.4 *The problem of distinguishing the company (the shareholders) and the creditors in an 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' interests and creditors as third parties is subject to the insolvency scenario. It is commonly asserted, in law & economics parlance, that the residual claimants of an insolvent company are the creditors as a class.[159] Indeed, the insolvency liquidator usually claims money from third parties on behalf of the company but to the indirect benefit of the creditors and not of the shareholders, since equity is usually completely underwater in an insolvency scenario.[160] In other words, in an insolvency scenario, the company's claims aggregate creditors' interests more than those of shareholders; the distinction between the company and creditors as a class collapses, raising complex problems.[161]

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[157] See *supra* n. 121. Recently enacted Article 15, Decree Law of 27 January 2010, no. 39, confirms the approach.

[158] Ferrarini and Giudici, *supra* n. 122, at p. 184 et seq.; Paolo Giudici, 'Private Antitrust Law Enforcement in Italy', 1 *Competition Law Review* (2004) p. 61; Paolo Giudici, 'Representative Litigation in Italian Capital Markets: Italian Derivative Suits and (If Ever) Securities Class Actions', 6 *European Company and Finance Law Review* (2009) p. 246. A peculiar class-action mechanism has recently been introduced in Italy (Article 49, Law of 23 July 2009, no. 99, which amends Article 140-*bis* Legislative Decree of 6 September 2005, no. 206) but it does not cover torts. Its impact on capital markets law is analysed in Paolo Giudici, 'L'azione di classe e la responsabilità civile nel diritto dei mercati finanziari', in Atti del Convegno di studio, Courmayeur, 1-2 October 2010, *Class action: il nuovo volto della tutela collettiva in Italia* (Giuffrè 2011) p. 191.

[159] See, e.g., Easterbrook and Fischel, *supra* n. 135, at p. 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'); *North American Catholic Educational Programming Foundation* 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* n. 161.

[160] See *supra* n. 159.

[161] 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 and Jay Lawrence Westbrook, 'Abolition of the Corporate Duty to Creditors', 107 *Columbia Law Review* (2007) p. 1321, at pp. 1381-1396; Douglas G. Baird and M. Todd Henderson, 'Other People's Money', 60

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The recent English *Moore Stephens* case has illuminated the issue.[162] 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. The banks thought they were financing commodity trades, but the documents were forgeries. S&R obtained 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 letters 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* defence. The auditor won the case because S&R was a one-man company. Accordingly, the three Lords who decided in favour of Moore Stephens 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.[163] More important to the discussion of the present section, the three Lords that formed the majority were particularly worried to go against *Caparo*[164] by introducing a hidden creditors' action against the auditor through the liquidator's claim.[165] 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.[166] This was not the main argument the Lords used to dismiss the liquidator's

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Stanford Law Review (2008) p. 1309; Stephen M. Bainbridge, 'Much Ado About Little – Directors' Fiduciary Duties in the Vicinity of Insolvency', 1 *Journal of Business and Technology Law* (2007) p. 335; Larry E. Ribstein and Kelli A. Alces, 'Directors' Duties in Failing Firms', 1 *Journal of Business and Technology Law* (2007) p. 529; Simone M. Sepe, 'Directors' Duties to Creditors and the Debt Contract', 1 *Journal of Business and Technology Law* (2007) p. 553.

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

[163] 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, ibid., at para. 193.

[164] See *supra* n. 105.

[165] 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': *Moore Stephens*, at para. 207.

[166] Lord Phillips, *Moore Stephens*, at para. 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

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claim.[167] However, it introduces further elements of complexity. If it is true, the consequence is that if 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 plunder the company up to the last cent.[168] If it does not hold true, however, the separation between shareholders and creditors as a class is not as monolithic as may appear at first sight.[169] Indeed, the company also aggregates the interests 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.[170] 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.

5.1.5 *The 'wrongfully incurred unpayable debt' quagmire*

Up to now, bankruptcy law has not been part, at least not explicitly, of the analysis in the literature on auditor liability. However, auditor liability to the company is

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frauds. Why, if this is a legitimate objective, should the banks not have a direct cause of action in negligence against Moore Stephens?'

167 The House of Lords could escape from this quagmire thanks to the fact that the audited client was a one-man company, thereby applying the imputation defence and rejecting the adverse selection exception. Whether the auditor has to be held liable where the company is not entirely a one-man company is the intricate problem that the House of Lords has left us with following *Moore Stephens*.

168 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 his 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.

169 As Judge Scott points out in *Moore Stephens*, at para. 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 para. 268.

170 This is the case of the law in Italy, 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. Article 15, Decree Law of 27 January 2010, no. 39, has recently changed the law. It is discussed whether it has removed the liquidator's entitlement to pursue the claims of creditors as a class against the outside auditor: see Paolo Giudici, 'La responsabilità civile del revisore legale', *Le Società (speciali)* (2010) p. 33. See also *infra* n. 172.

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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 stopped somehow and would not have taken out further debt. Is it within the scope of auditing to stop a company from sliding into insolvency and from further expanding the client's 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 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 stand 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 has a 'recapitalise or liquidate rule',[171] the auditor might be held liable by the company's creditors for not having alerted the shareholders to the need to recapitalise the company or stop its operations to avoid further losses.[172]

Furthermore, 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.[173] Indeed, the significant point in time will

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[171] See Lorenzo Stanghellini, 'Directors' Duties and the Optimal Timing of Insolvency: A Reassessment of the "Recapitalize or Liquidate" Rule', in Paolo Benazzo, Mario Cera and Sergio Patriarca, *Il diritto delle società oggi – Innovazioni e persistenze* (Utet 2011) p. 731.

[172] The Italian system applies a 'recapitalise 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 on shareholders to recapitalise when the whole capital has been lost. See Stanghellini, *supra* n. 171. It is assumed that creditors can find this out from 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, asserting that, through the misreporting, the company prolonged its life and deepened its debt, when managers should have promptly initiated an insolvency procedure. This action can be brought against inside auditors as well. Under the new regime established by Article 15, Decree Law of 27 January 2010, no. 39, it can apparently no longer be brought against the outside auditor on behalf of creditors as a class. Accordingly, the liquidator can now only pursue the company's right of action against the outside auditor.

On the European system of legal capital protection, see Marcus Lutter, ed., *Legal Capital in Europe* (De Gruyter 2006) and the articles published in volume 7 of the European Business Organization Law Review 2006.

[173] In the US, this is the realm of the much discussed 'deepening insolvency doctrine': cf. J.B. Heaton, 'Deepening Insolvency', 30 *Iowa Journal of Corporation Law* (2005) p. 465; Sabin Willett, 'The Shallows of Deepening Insolvency', 60 *Business Lawyer* (2005) p. 549; Taera K.

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presumably be signalled by the financial reports and therefore monitored by the auditor, who will be held liable for not having properly exercised 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 for not properly reviewing the financial statements.

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

6.1 The role of auditors in IPOs: reputational intermediaries

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 will not singularly 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 the 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 are using the auditor as a reputational intermediary.[174] The corollary is that the director can even rely on the auditor with

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Franklin, 'Deepening Insolvency: What It Is and Why It Should Prevail', 2 *New York University Journal of Law and Business* (2006) p. 435. 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 America Litigation 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).

[174] The *locus classicus* is Ronald J. Gilson and Reinier H. Kraakman, 'The Mechanisms of Market Efficiency', 70 *Virginia Law Review* (1984) p. 549, at pp. 618-621. See also Stephen J. Choi, 'Market Lessons for Gatekeepers', 92 *Northwestern University Law Review* (1998) p. 916, at p. 924, who uses the term 'certification intermediaries' instead.

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regard to the accounting data that the latter examines and certifies:[175] 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 defence, it can be confused with an internal audit.[176]

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.[177] This statute was the template of today's most famous example in this field, Section 11 of the US Securities Exchange Act.[178] It has been recognised since its adoption that this rule was meant to sort out the 'privity problem' and its likes.[179]

6.2 **Prospectus auditing**

6.2.1 *Why the floodgate argument is not an issue in prospectus auditing*

Why is exposure to unpredictable liability no longer an issue in this setting? Curious as it may seem, I have never seen this obvious question posed in the literature. If the floodgate argument is reconceptualised 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 establish the risk involved in the audit activity.[180] Moreover, the registration requirements allow the auditor to read the prospectus and know how much money the company will ask on the market. The auditor is liable as he has given his consent to having his name and work mentioned in the prospectus. Accordingly, the auditor understood what was going on, since he read the

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[175] See *supra* n. 104.

[176] Cf. Sean M. O'Connor, 'Strengthening Auditor Independence by Reducing the Need for It: Reestablishing Audits as Control and Premium Signaling Mechanisms', 81 *Washington Law Review* (2006) p. 525, at pp. 532-533.

[177] For a review of English legislation, see O'Connor, *supra* n. 104, at pp. 760-773.

[178] In this situation the auditor is no longer an agent of the shareholders, but a professional rendering services to a client: *idem*, at p. 824.

[179] William O. Douglas and George F. Bates, 'The Federal Securities Act of 1933', 43 *Yale Law Journal* (1933) p. 171, at p. 198 ('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 Shulman, 'Civil Liability and the Securities Act', 43 *Yale Law Journal* (1933) p. 227, at p. 249 ('The most striking innovation is, of course, that dispensing with any requirement of privity').

[180] Paolo Giudici, *La responsabilità civile nel diritto dei mercati finanziari* (Giuffrè 2008), at pp. 363-365.

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registration statement and knew how much money the client was seeking to raise.[181] Moreover, Section 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 when the defendant acted without knowledge.[182]

6.2.2 *Why were voluntary liability caps not the norm in prospectus liability? The incomplete audit contract as an efficient strategy for both the issuer and the auditor*

I have argued that the privity concept and the floodgate argument do not hold in an IPO scenario, where the company addresses the prospectus audit to the solicited investors. Indeed, prospectus audits were already used in the market before the law mandated them.[183] Then the question turns to why prospectus audits did not contain voluntary clauses governing auditor liability to solicited investors.[184] The answer to this question might help us to understand why, today, no legal system (at least, none that I am aware of) allows the company and the auditor to contract around auditor liability to primary market investors.[185]

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[181] This is crystal clear under 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.

Shelf registration, however, has changed this environment, since large, established and thickly traded issuers can incorporate by reference into their registration statements the information contained in their 10-K, 10-Q and 8-K filings, thus changing, at least *de facto*, the due diligence procedure, and merging the primary and secondary market context: cf. Merritt B. Fox, 'Shelf Registration, Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis', 70 *Virginia Law Review* (1984) p. 1005; Fox, *supra* n. 119, at p. 243, note 11; Donald C. Langevoort, 'Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment', 63 *Law & Contemporary Problems* (2000) p. 45.

[182] See *supra* n. 84. 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* section 5.1.3. Therefore, the Italian equivalent of Sec. 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.

[183] See George J. Benston, 'The Value of the SEC's Accounting Disclosure Requirements', 44 *Accounting Review* (1969) p. 515, at p. 520.

[184] Note that here there would be no collective action problem of the type mentioned above in section 4.2, 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.

[185] See *infra* section 6.2.3.

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I suspect that voluntary contractual mechanisms concerning auditor liability to solicited investors did not develop in the market because explicit liability limitation would, from a marketing perspective, not be an option for an issuer who wants to solicit investors. Probably 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.[186] Limited liability would reduce the bond's value and thereby the firm's capability to tap a competitive market where other firms offer full auditor liability. Since the common law at the time was unclear on whether auditors were liable to investors, however, an equilibrium between the issuer and the auditor could be reached by not promising anything in favour of solicited investors, leaving the auditor liability issue in limbo. In marketing activities, the consortium could use the auditor as a reputational intermediary and an illusory bonding mechanism, thereby offering evidence that the accounts could be relied on.[187] 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 compared with those of the defendant.[188] Accordingly, no significant litigation was to be expected; and in the rare cases where there was litigation, if the court denied auditor liability, the court was to be blamed, not the auditor.[189] In order to avoid these ambiguity problems, the law stepped in and mandated prospectus audit liability.[190]

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[186] See *supra* n. 174.

[187] Coffee Jr, *supra* n. 1, at p. 113, observes, following a different line of reasoning, that 'some evidence suggests that … illusory bonding was prevalent in the U.S. market during the early 20th century'. Andrew Tuch considers the impact of legal uncertainty in risk-shifting arrangements between underwriters and auditors or lawyers in relation to registration statements: Tuch, *supra* n. 82, at pp. 1650-1651.

[188] The class action mechanism creates economies of scale: see, e.g., Charles Silver, 'Class Actions – Representative Proceedings', in Boudewijn Bouckaert and Gerrit De Geest, eds., *Encyclopedia of Law and Economics, Volume V. The Economics of Crime and Litigation* (Edward Elgar 1999) p. 194, at p. 202.

[189] In the US, before 1966, there was no significant litigation on the issue. The introduction of the class action reshaped this quiet scenario: Mahoney, *supra* n. 30, at p. 333.

[190] The apparently irrational scenario depicted in this section, 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 and Joanna Chung, 'Auction Rate Securities Facing Tough Scrutiny', *Financial Times*, 23 October 2009, available at: <http://www.ft.com/cms/s/0/64bb7e50-bf6c-11de-a696-00144feab49a.html> (last visited 28 May 2012).

https://doi.org/10.1017/S1566752912000353 Published online by Cambridge University Press

6.2.3 *Why can't the company and the auditor contract around prospectus liability? A multi-layer hypothesis*

This reconstruction leaves open the question of why modern securities law seems to be so rigid in ruling prospectus liability. A system of contracted liability, in which the issuer states in the prospectus if and how the auditors' liability is limited, is not theoretically unthinkable.[191] Why not allow liability limitation agreements now that the law is more settled on auditor liability issues?[192] A typical answer is that in financial markets standardisation is required in order to reduce transaction costs, thereby making self-tailored liability unpalatable due to the excessive demands on investors, who need to be able to make cross-comparisons among issuers.[193] However, it is very difficult to assess whether or not standardisation needs are really that compelling.

The real problem, standardisation apart, is that a system of contracted limited liability 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, to whom we have to turn our attention.

7. AUDITORS' LIABILITY IN SECONDARY MARKETS (REGIME 4)

On the topic of how to regulate auditors' liability to secondary market investors we find striking differences among legal systems. The US scenario is the most famous, as it is there where securities class actions are mainly brought, and it has been thoroughly analysed by the economic literature.[194] Liability was originally implied under Rule 10b-5.[195] The plaintiff must show that the defendant acted with *scienter* in order to succeed.[196] The meaning of *scienter* has been much discussed. It is more

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[191] A proposal for self-tailored liability is advanced in Choi, *supra* n. 174, at pp. 951-58. The author does not mention any legal system where such a system has been adopted.

[192] As I mentioned, there is no legal system I am aware of that allows the company and the auditor to contract around auditor liability to primary market investors.

[193] Cf., Zohar Goshen and Gideon Parchomovsky, 'The Essential Role of Securities Regulation', 55 *Duke Law Journal* (2006) p. 711, at pp. 737-748.

[194] See *supra* section 2.

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

[196] 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).

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than a negligence standard, and probably less than a desire to cause harm.[197] A special pleading rule requires plaintiffs to plead with particularity facts giving rise to a strong inference of fraud, therefore reducing access to pre-trial discovery.[198] With regard to auditors, probably the most significant specific protection against liability is the Supreme Court's decision in *Central Bank* not to attach private aiding and abetting liability to the 10b-5 cause of action.[199] The decision was taken in 1994, at the apex of the debate concerning the need to reduce auditor liability.[200] The Court's reasoning was 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.[201] The aggregate impact of these requirements has been a visible reduction of deterrence, which is among the reported causes of the accounting crisis of 2001.[202]

Under other jurisdictions, like the UK, negligent auditors are not liable towards secondary market investors, unless special circumstances exist.[203] By contrast, under other jurisdictions, like Italy, negligent auditors are always liable towards

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197 In *Hochfelder*, the Supreme Court left open the question of whether reckless behaviour 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 *University of Cincinnati Law Review* (1991) p. 667, at p. 674.

198 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 *Washington University Law Quarterly* (1998) p. 537.

199 See *supra* n. 54.

200 See *supra* n. 54 and accompanying text.

201 See *supra* n. 84 and accompanying text.

202 See *supra* n. 3.

203 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* n. 105. 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 Financial Services and Markets Act 2000, introduced by the Companies Act 2006. Liability concerned issuers only, and exclusively for fraudulent misstatements. In 2006, the Treasury invited Professor Paul Davies to conduct a review of the liability of issuers in respect of damage or loss suffered as a consequence of inaccurate, false or misleading information disclosed by issuers or their managements to the market or of failure to disclose relevant information: see Paul Davies, *Davies Review of Issuer Liability – Liability for Misstatements to the Market: A Discussion Paper by Professor Paul Davies QC* (2007), available at: <http://www.treasurers.org/node/3258>; for a discussion, see also Eilis Ferran, 'Are US/Style Investor Suits Coming to the UK?', 9 *Journal of Corporate Law Studies* (2009) p. 315, at pp. 318-330. Following the Davies Review, the Section 90A liability regime for information published by public companies through the Regulatory Information Service was significantly widened on 1 October 2010.

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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.[204] Other jurisdictions cap auditor liability.[205] In short, this is the area where we find the most significant variability in approaches, which requires some explanations.

7.1 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 among the legal systems 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 unequivocal. Indeed, the differences among countries are not particularly significant. With regard to liability to secondary market investors, however, economic analysis is far from plain. The mainstream is focused on the pure wealth argument but relies on a strong assumption (investors' diversification) and a 'single layer' analysis that oversimplifies the problems.

7.1.1 *In favour of no liability whatsoever (except in the case of 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 concerning securities fraud.[206] The auditor's misstatement causes one investor to

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[204] In the past, the adoption of a gross negligence standard was proposed (Massimo Santaroni, *La responsabilità del revisore* (Giuffrè 1984), at p. 218), on the assumption that the auditor is offering his 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* (Giuffrè 1985), at p. 231 et seq.; Eugenio Barcellona, *Responsabilità da informazione al mercato: il caso dei revisori legali dei conti* (Giappichelli 2003), at p. 236 et seq.; Grazia Monia Buta, *La responsabilità nella revisione obbligatoria delle s.p.a.* (Giappichelli 2006), at p. 148 et seq. See also Gaetano Presti, 'La responsabilità dei revisori', I *Banca borsa* (2007) p. 160.

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

[206] The reasoning was presented, in connection with secondary markets, by Frank H. Easterbrook and Daniel R. Fischel, 'Optimal Damages in Securities Cases', 52 *University of*

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buy and another one 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, by assumption, is zero) and the liability system does not work properly: it over-deters wrongdoers, and auditors end up taking too much care.[207] From a 'hypothetical bargain' perspective,[208] 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.[209] 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 misdirection of capital to the issuer and therefore has no implications for real investment.[210] The second one is that secondary market investors in the aggregate do not care about (socially expensive) liability-based means of protection

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Chicago Law Review (1985) p. 611, at pp. 639-644 (revised and reprinted in Easterbrook and Fischel, *supra* n. 135, ch. 12). The two authors pointed out, however, that their argument was not equivalent to holding that the optimal damages in the aftermarket are zero because losses and gains net out (at p. 641). The reasoning is further developed by Mahoney, 'Precaution Costs and the Law of Fraud in Impersonal Markets', *supra* n. 75, at pp. 627-635, and by Donald C. Langevoort, 'Capping Damages for Open-Market Securities Fraud', 38 *Arizona Law Review* (1996) p. 639, at pp. 646-648. Any understanding of the US literature cannot be divorced from the peculiar effects produced by the fraud-on-the-market theory on securities litigation: see *infra* n. 231.

[207] See, e.g., Dari Mattiacci and Schäfer, *supra* n. 150, at p. 22.

[208] See David Charny, 'Hypothetical Bargains: The Normative Structure of Contract Interpretation', 89 *Michigan Law Review* (1991) p. 1815; Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules', 99 *Yale Law Journal* (1989) p. 87, at pp. 89-90. Ayres and Gertner use the expression 'would have wanted' theory.

[209] Dari Mattiacci and Schäfer, *supra* n. 150, at p. 22.

[210] 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 receive 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 Langevoort, *supra* n. 206, at pp. 657-662 (proposing a threshold to civil sanctions).

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against wealth transfers, because they can protect themselves through (socially cheap) diversification.[211]

7.1.2 *In favour 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.[212] 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.[213]

If the assumption of purely diversified portfolios is relaxed, things change.[214] 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 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 balance sheet at the time the transaction is drafted.[215] 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 exposure of the 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 towards 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.

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[211] 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.

[212] Easterbrook and Fischel, *supra* n. 206, at p. 641.

[213] Ibid., at pp. 641-642. For an extended analysis, see Mahoney, *supra* n. 75 (who points out that compensating liquidity traders who do not face precaution costs overcharges the offender, thereby arguing against the fraud-on-the-market theory).

[214] 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', *Wisconsin Law Review* (2009) p. 455.

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

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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 find an auditor who acts as a gatekeeper. If the primary market investor is potentially interested in reselling the shares – and this is certainly the case if the shares are sold in the course of an initial public offering aimed at listing the company, for listing aims at creating liquidity[216] – 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 no one wants to buy a financial instrument that will negatively modify one's rights and entitlements when in one's 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 of the level of diversification. More importantly, empirical studies show that, in secondary markets, disclosure of information and, in particular, of earning announcements and financial data boosts trade volumes.[217] Disclosure generates liquidity.[218] Accordingly, it is reasonable to assume that an investor in the

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[216] See *infra* n. 218.

[217] The mechanism is investigated in the model proposed by Oliver Kim and Robert E. Verrecchia, 'Pre-Announcement and Event-Period Private Information', 24 *Journal of Accounting and Economics* (1997) p. 395, and empirically tested, for instance, by Ole-Kristian Hope, et al., 'Geographic Earnings Disclosure and Trading Volume', 28 *Journal of Accounting and Public Policy* (2009) p. 167.

[218] Robert E. Verrecchia, 'Essays on Disclosure', 32 *Journal of Accounting and Economics* (2001) p. 97; Luz Hail and Christian Leuz, 'International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?', 44 *Journal of Accounting Research* (2006) p. 485 (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 *Journal of Financial Economics* (2006) p. 175 (absolute return and volume reactions to earnings announcements typically increase significantly once a company cross-lists in the US, supporting the hypothesis that it is the individual firm's disclosure environment that explains the increase); Richard Lambert, et al., 'Accounting Information, Disclosure, and the Cost of Capital', 45 *Journal of Accounting Research* (2007) p. 385 (the quality of accounting information can influence the cost of capital); R.K. Atiase and L.S. Bamber, 'Trading Volume Reactions to Annual Accounting Earnings Announcements', 17 *Journal of Accounting and Economics* (1994) p. 309. See more in general, Christian Leuz and Peter Wysocki, 'Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research' (2008), available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105398> (survey of the theoretical and empirical literature on the economic consequences of financial reporting and disclosure regulation).

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primary market who is potentially interested in selling 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.[219] This assurance concerns liquidity and reduces the 'wedge' between demand and offer of securities.[220] Add to this that a negligent audit will influence the prices of future primary market emissions of the same security,[221] as well as the market for corporate control.[222] Finally, consider that the value inflation of a security traded on secondary markets affects the alternative investment offered on the primary market and thereby the choice of investment projects across society,[223] 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 the appropriate level of liability needed. Recently, Professor Fox has suggested that the differentiation between primary and secondary market investors is completely misplaced, since 'disclosure has substantially equal social value whether or not the firm is selling equity at the time'.[224] 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'.[225] Other authors consider the wealth transfer rationale to be partly convincing and propose some form of deterrence-based civil remedies[226] or other instruments for private enforcement reduction.[227] 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[228] and press,[229] the

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219 '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* n. 119, at p. 267.

220 *Idem*, at p. 267.

221 Chapman, *supra* n. 150, at pp. 196-197.

222 *Idem*, at pp. 196-197.

223 Fox, *supra* n. 119, at p. 268.

224 *Idem*, at pp. 260-264.

225 *Idem*, at p. 269.

226 See Langevoort, *supra* n. 206, at pp. 657-662. *Contra*: Harvey J. Goldschmid, 'Capping Securities Fraud Damages: An Unwise Proposal in an Imperfect World', 38 *Arizona Law Review* (1996) p. 665.

227 In the US context, Paul Mahoney proposes abandoning the fraud-on-the-market theory: Mahoney, 'Precaution Costs and the Law of Fraud in Impersonal Markets', *supra* n. 75.

228 Easterbrook and Fischel, *supra* n. 206, at p. 641.

229 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 *Journal of Accounting Research* (2010) p. 1. Cf. also Alexander Dyck, et al., 'Who Blows the Whistle on Corporate Fraud?', 65 *Journal of Finance* (2010) p. 2213.

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importance attributed by the audit network to reputation in the jurisdiction,[230] plus the local efficiency of public and private enforcement.[231] Moreover, the civil sanctions to which other constituents (the company, the creditors as a mass or singularly, primary market investors) expose the auditor are to be considered as well, because the auditor operates in a multi-layered liability regime. Thus, the said 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.

8. MULTI-LAYERED ANALYSIS

The layer-by-layer analysis conducted in the previous sections shows that at least two regimes, namely liability to the company and prospectus liability, are usually present. At least one jurisdiction is experimenting with the limitation of auditor liability to the company, which can be agreed by the shareholders meeting. The single-layer analysis has also shown that contracting over liability to the company can raise significant 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 standardisation. As to liability to secondary market investors, there are arguments in favour of its containment, but the amount depends on the conditions of each local capital market.

The next step is to understand how these layers interact.

8.1 **Interactions between regimes 1 and 3**

Limitation of liability to the company can diminish the level of care taken by the auditor when the audit service concerns public offerings. Indeed, the main content

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[230] See *supra* nn. 32-34 and accompanying text.

[231] The US discussion concerning liability in open-market securities fraud cases is centred around the effects of the fraud-on-the-market theory, which allows investors to recover damages without proving reliance, thereby making class actions available, while at the same time substantially altering the nature of private securities fraud claims under the tort common law tradition: see Jill E. Fisch, 'Cause for Concern: Causation Federal Securities Fraud', 94 *Iowa Law Review* (2009) p. 811; cf. also Merritt Fox, 'After *Dura*: Causation in Fraud-on-the-Market Actions', 31 *Journal of Corporation Law* (2005) p. 829; Merritt Fox, 'Understanding *Dura*', 60 *Business Lawyer* (2005) p. 1547; John C. Coffee Jr, 'Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse *Broudo*', 60 *Business Lawyer* (2005) p. 533. All the positions expressed by US authors and mentioned *supra* in the text and accompanying footnotes are to be read in the light of this premise, which strongly influences the reasoning regarding liability in securities fraud cases and yet is too easily overlooked by the European law & economics debate about pure economic loss.

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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 exposure to two different damage claims: company 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 on 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 on 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 has already been 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.[232] The reasoning simply reflects the intuition that in a multi-layered regime the limitation of liability at one layer's level can produce spill-over effects.

8.2 Interactions between regimes 1 and 4

A reduction in auditor liability to the company can have negative spill-over effects on liability to secondary market investors as well, if liability to those investors is recognised. This can offer a further explanation of 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 spill-over effect is not present.

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 the next section. Accordingly, countries where hurdles to direct investors' claims are not easy to raise may have an interest in keeping a non-negotiable (mandatory) regime of audit liability to the company.

8.3 Double recovery (overlaps of regime 1 and regimes 3 or 4)

If recovery is granted to investors (either on primary or secondary markets), a hidden problem emerges: double recovery, in cases where there is an action by both company and investors. The double recovery issue arises in cases where 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 differ-

[232] See *supra* n. 124 and accompanying text.

https://doi.org/10.1017/S1566752912000353 Published online by Cambridge University Press

ence is wholly or in part due to assets looted by managers or assets lost 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.[233] The prototypical case of a double recovery scenario is *Cenco*.[234]

Double recovery is a significant problem once an auditor's liability to primary market investors is admitted, and more so if the auditor's liability for misstatements to secondary market investors is also 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, in relation to the part of the damages that will be indirectly restored through payment by the auditor to the company.

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[233] 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 us 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 in 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 will be restored. If investors have disposed of their shares, they might be entitled to claim damages independently of what the company gets back. If investors recover their 'investment' damage and the company its 'asset' damage, there will be double recovery.

[234] *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 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-recovery effect that a judgment in favour 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).

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8.4 Interactions between regimes 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 *Moore Stephens* case shows,[235] 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, in an insolvency scenario it is not always easy to distinguish liability to the company representing creditors as a class of residual claimants from liability to single creditors.

8.5 Interactions between regimes 3 and 4

As to the relation between regimes 3 and 4, it seems clear that if contracting over prospectus liability were permitted, liability to secondary market investors would necessarily have to be 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 in order to take benefit of the highest potential claim against the auditor. Accordingly, in order to sell its securities, the company should discount its offering and lure the first generation of investors.[236] 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 market investors better than primary market investors. Usually the opposite is true. However, the differentiation creates complexity problems. Any legal regime that treats purchasers who undersigned or bought in the primary market differently 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').[237]

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[235] See *supra* section 5.1.4.

[236] It would be rather curious if, to give an example, an issuer could arrange for its auditor's liability to be capped at 5 million euros 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 offered them at discount. Accordingly, limitation caps in primary markets are conditioned by limitation caps in secondary markets.

[237] See Hillary A. Sale, 'Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act', 75 *Washington Law Review* (2000) p. 429.

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9. 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, and in some countries a fourth is present. 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, and civil procedure peculiarities concerning each single jurisdiction are added to the picture, any idea that the issue can be easily and uniformly managed vanishes.

If one considers the three main regimes (liability to the company, to solicited primary market investors, and to secondary market investors), a clear case for mandatory limitation of liability can be made in regard to the last regime only. The UK had no liability to secondary market investors, unless wilful conduct was proven, at least until 2010. This is 'real life' hard evidence that negligence liability in this field is not strictly 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 have adopted liability caps in this area: Germany is the most notable example. However, when reducing or abolishing liability to secondary market investors, it must be considered 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 depending on 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 necessary. There are no reasoned arguments in the economic literature and in the law and economics literature in favour of introducing mandatory caps on 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 danger of intergenerational problems amongst investors and substantial negative spill-over into the other layers of liability. Moreover, the shareholders should not be able to find any easy way to circumvent the company's agreement by suing the auditor as market

https://doi.org/10.1017/S1566752912000353 Published online by Cambridge University Press

investors, for in that case the cap on liability to the company would create large incentives as regards individual shareholder claims.

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

From the perspective 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 market 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 to keep mandatory audits and ignore the issue, letting 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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