BARGAINING FOR SALVATION: HOW ALTERNATIVE AUDITOR LIABILITY REGIMES CAN SAVE THE CAPITAL MARKETS

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Auditor litigation risk is growing increasingly out of control. This risk not only poses problems for the auditing industry, but it may also create systemic problems throughout entire financial markets. Auditor litigation risks arise from criminal and civil causes of action at both the federal and state levels. This Note specifically addresses civil litigation. Scholars suggest a number of solutions for mitigating auditor civil litigation risk, including bargained liability caps, liability caps with strict liability, and decoupled liability.

This Note argues that federal law should allow auditors to bargain for alternative liability regimes with the audit committees of boards of directors. This approach allows the market to determine the most efficient means for limiting auditor liability while minimizing agency and transaction costs. It also incentivizes boards to create good bargains because of shareholder takeover and proxy threats. The Note also calls for further study on requiring proxy votes to enforce these auditor-board bargains. Lastly, it calls for a provision allowing auditors to opt out of federal and state securities remedies. These proposals comply with current disclosure-based securities laws. Moreover, current regulatory and judicial players could be used to review extreme bargains to ensure fairness.

The Note begins with a discussion of the major players in financial markets: management, the board of directors, shareholders, and auditors. It then follows with background of the multitude of federal and state legal regimes that govern these major corporate players, especially auditors, and the effects these regimes have on auditors. The Note then looks at the justifications of each of the proposed solutions. Continuing with a discussion of the criticisms of each approach, it specifically looks at the effects each approach has on company agen-

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cy and transaction costs. It then considers the limitations each approach faces from current legal and political structures.

I. INTRODUCTION

"My management team and I did all we could to avert this tragedy . . . but the clock ran out on us," lamented the former senior executive of a once-venerable company.[1] His words came as little solace for the more than 3000 employees forced to look for work in an anemic financial services industry.[2] Meanwhile, the company's creditors recorded massive write-downs.[3] Its clients scrambled for a new service provider.[4] This account did not take place in the most recent financial meltdown. Rather, it occurred after Laventhol & Horwath LLP (Laventhol), once the seventh-largest accounting firm in the United States, collapsed in 1990 under the weight of litigation.[5]

Those who witnessed the fall of this industry titan disagreed over the cause of its demise.[6] Pundits, for example, argued the firm took on questionable clients in industries it did not understand.[7] Conversely, Laventhol executives pointed to litigious shareholders and stakeholders.[8] Both arguments allude to the same problem: auditor litigation risk.

Auditor litigation risk remains as prevalent as ever. In 1990, analysts believed Laventhol's liabilities to be considerably understated given the more than one hundred pending lawsuits seeking nearly $2 billion in damages.[9] In recent years, the six largest audit firms defended against 124 audit-related claims, each seeking damages in excess of $100 million.[10] During the same period, the six largest firms defended against thirty-nine claims, each related to public audits worth more than $1 billion.[11] Eleven claims were worth more than $10 billion.[12] These monolithic claims indicate extreme litigation risk within the audit industry.

More importantly, these claims may create systemic market risk. The largest four accounting firms, known colloquially as the "Big Four,"[13]

1. *Laventhol's Number Is Up*, TIME, Dec. 3, 1990, at 87 [hereinafter *Laventhol*] (internal quotation marks omitted).
2. *Id.*
3. *See* Alison Leigh Cowan, *Bankruptcy Filing by Laventhol*, N.Y. TIMES, Nov. 22, 1990, at D1.
4. *See id.*
5. *Id.*
6. *Compare Laventhol*, *supra* note 1, *with* Cowan, *supra* note 3.
7. *Laventhol*, *supra* note 1.
8. Cowan, *supra* note 3.
9. *Id.*
10. CTR. FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 42 (2008), http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf.
11. *Id.* at 43.
12. *Id.*
13. Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1643 n.9 (2006) ("The consensus 'Big Four' auditing firms are KPGM LLP, Ernst & Young LLP, PriceWaterhouseCoopers LLP, and Deloitte & Touche, LLP.").

audit ninety-eight percent of total U.S. market capitalization.[14] Given the current level of litigation risk, scholars believe the Big Four face real risks of collapse.[15] Such a collapse could cause widespread panic within the financial markets.[16]

Given the risks, scholars within the fields of accountancy and law have proposed a number of solutions to mitigate litigation risk.[17] Each proposal advances an alternative auditor liability regime.[18] The regimes attempt to maintain optimal levels of auditor precaution against audit failure.[19] At the same time, these regimes have generally limited auditor liability or incentives to litigate auditor disputes.[20] Each proposed solution may have its own merits.

This Note explores the efficacy of market participants bargaining for alternative auditor liability regimes at the audit engagement phase. Part II begins with a background of the dynamics of the audit industry. Part III analyzes various alternative liability regime proposals. Part IV recommends a liberalization of the securities laws to facilitate regime bargaining between the audit committee and the auditor.

14. ADVISORY COMM. ON THE AUDITING PROFESSION, DEP'T OF THE TREASURY, FINAL REPORT, at II.1 (2008) [hereinafter ADVISORY COMM. REPORT], http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.

15. *See* Written Statement from James D. Cox, Professor of Law, Duke Univ., to the Advisory Comm. on the Auditing Profession 2 (Dec. 3, 2007), http://www.treasury.gov/about/organizational-structure/offices/Documents/Cox%20Testimony%2012-03-07.pdf ("[I]t is not unthinkable that one or more Big Four accounting firms could suffer fatal liability blows in yet to surface financial frauds of their audit clients.").

16. *See* Written Statement from Lawrence A. Cunningham, Professor of Law, George Washington Univ. Law Sch., to the Advisory Comm. on the Auditing Profession 12 (Nov. 26, 2007), http://www.treasury.gov/about/organizational-structure/offices/Documents/Cunningham%20Testimony%2012-03-07.pdf ("Since Arthur Andersen's dissolution, there has been valid concern that one of the four remaining similar firms could face a like fate from kindred criminal or civil culpability. Should that occur, with only three such firms left, a crisis would occur."); *see also* Press Release, Foo Kon Tan Grant Thornton LLP, Grant Thornton Response to IOSCO Consultations on Global Audit Market Highlights Threat to Capital Markets 1 (Jan. 22, 2010) [hereinafter Grant Thornton Press Release], http://www.gt.com.sg/press/articles/IOSCO_GTI%20release%20SG.pdf ("The collapse of a big 4 firm could now leave as many as 20% of the 7,200 largest businesses in the G20 without an auditor, creating instability in global markets.").

17. *See, e.g.*, Suil Pae & Seung-Weon Yoo, *Strategic Interaction in Auditing: An Analysis of Auditors' Legal Liability, Internal Control System Quality, and Audit Effort*, 76 ACCT. REV. 333 (2001); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001); Rajib Doogar, To Whom Should the Auditor Be Liable? An Analysis of Efficient Liability Rules (Nov. 19, 2007) (unpublished manuscript), http://www.business.illinois.edu/doogar/Research/papers/liability.pdf.

18. *See supra* note 17.

19. *See* Pae & Yoo, *supra* note 17, at 341–44; Partnoy, *supra* note 17, at 540–46; Doogar, *supra* note 17, at 7–12.

20. *See* Pae & Yoo, *supra* note 17, at 349; Partnoy, *supra* note 17, at 540; Doogar, *supra* note 17, at 14–17.

II. BACKGROUND

This Part begins with a discussion of the roles of firm actors, shareholders, and auditors. The role of the auditor provides a basis for a brief discussion on auditor liability under federal securities laws and state law. Next, this Part examines the volume and magnitude of auditor liability suits.

A. Role of Management

Standard hornbook law dictates that managers owe various duties to corporate shareholders.[21] These duties include a fiduciary duty to the corporation and to shareholders as their agents.[22] Under black-letter common law, agents have a duty to provide information to their principals.[23] It can be reasonably assumed that an agent manager would "ha[ve] reason to know" that a principal shareholder would "wish to have" certain financial facts material to investment decisions.[24] The duties owed to shareholders provide a relevant guidepost to the auditor-client relationship.

Federal securities laws, in line with management's traditional agency duties, hold managers of registered corporations responsible for the preparation of financial statements.[25] These financial statements must conform in all material respects to Generally Accepted Accounting Principles (GAAP).[26] A general principle underlies the disclosure of financial statements and other material information; specifically, such disclosure facilitates market integrity and market efficiency.[27] Pursuant to the

21. HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 231 (3d ed. 1983) (discussing duties in management generally).

22. *Id.* §§ 235–42 (providing an overview of fiduciary duties and agency law).

23. RESTATEMENT (THIRD) OF AGENCY § 8.11 (2006) ("An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal; and (2) the facts can be provided to the principal without violating a superior duty owed by the agent to another person."); RESTATEMENT (SECOND) OF AGENCY § 381 (1958) ("Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.").

24. RESTATEMENT (THIRD) OF AGENCY § 8.11.

25. 17 C.F.R. § 229.308 (2012).

26. *See id.* § 240.13a–15 (2012). GAAP consists of accounting conventions used to create consistent, comparable financial information across organizations. *See* James F. Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201, 201–07 (1975).

27. *See* SEC v. Zandford, 535 U.S. 813, 819 (2002) ("Among Congress' objectives in passing the Act was to [ensure] honest securities markets and thereby promote investor confidence after the [1929] market crash . . . . More generally, Congress sought to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." (internal quotation marks and citations omitted)); *see also* SEC. LITIG. COMM. & SUBCOMM. ON ACCOUNTING ISSUES, AM. BAR ASS'N, MODEL JURY INSTRUCTIONS: SECURITIES LITIGATION § 1.07, (1996) [hereinafter MODEL JURY INSTRUCTIONS].

Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), management bears the responsibility of producing and certifying financial statements.[28] Senior management must certify that, to its knowledge, annual and quarterly reports submitted to the Securities and Exchange Commission (SEC) materially represent the financial condition of the corporation.[29] Management must make similar assertions to the internal financial controls of the company.[30] Namely, the company's financial statements must acknowledge "the responsibility of management [to] establish[] and maintain[] an adequate internal control structure and procedures for financial reporting."[31] Adequate internal controls allow management to uncover material errors in financial statements.[32]

B. Role of the Board of Directors

Similar to management, the board of directors owes various obligations to shareholders.[33] These obligations include a fiduciary duty as well as other agency duties.[34] As part of its duties, the board oversees and monitors management.[35] The duties have numerous implications on the firm.

In the audit context, boards of registered companies have added duties consistent with standard oversight functions. An independent audit committee of the board must periodically engage, or contract with, the auditor.[36] The audit committee will also routinely evaluate the auditor's work.[37] Sarbanes-Oxley and a patchwork of exchange listing rules effectively require audit committees to contain at least one financial expert who assists the committee and the board in this audit-related oversight function.[38]

28. Sarbanes-Oxley Act (Sarbanes-Oxley) of 2002 § 302(a), 15 U.S.C. § 7241 (2006).

29. 15 U.S.C. § 7241(a)(1)–(4). For an example of such a report, see 3M Co., Annual Report (Form 10-K) (Feb. 16, 2010).

30. Sarbanes-Oxley § 404(a)(1), 15 U.S.C. § 7262.

31. *Id.*

32. ALVIN A. ARENS ET AL., AUDITING AND ASSURANCE SERVICES: AN INTEGRATED APPROACH 257–58 (12th ed. 2008).

33. HENN & ALEXANDER, *supra* note 21, § 231 (discussing duties in management generally).

34. *Id.* §§ 235–42 (providing an overview of fiduciary duties and agency law).

35. *Id.* § 203.

36. Sarbanes-Oxley § 301, 15 U.S.C. § 78j-1(m)(2)–(3) (noting the audit committee independence and the audit committee's role in selecting an auditor).

37. *See* 15 U.S.C. § 78j-1(m)(2) (noting audit committee oversight responsibilities); *see also id.* § 78j-1 (stating the auditor must report to the audit committee).

38. *See* Sarbanes-Oxley § 407, 15 U.S.C. § 7265(a) (mandating financial experts disclosure or justifications for not having a financial expert); NASDAQ, EQUITY RULES § 5605(c)(2)(A) (2012); N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.07(a) (2012).

C. Role of the Shareholder and the Market

Shareholders make resource allocation decisions and determine when to buy, hold, or sell stock.[39] Additionally, shareholders can exert some, albeit limited, control over the corporation. For example, shareholders may vote to change directors[40] or reduce officer compensation.[41] Shareholders may also approve the appointment of auditors through proxy votes.[42] If the company suffers from mismanagement, other market participants may take over the corporation and oust directors and managers.[43] Such takeover costs could serve as a measure for the costs of unchecked managerial discretion.[44]

D. Role of the Auditor

In sharp contrast to management, independent auditors have no role in information generation.[45] Instead, auditors will "examine" or review financial statements pursuant to Generally Accepted Auditing Standards (GAAS)[46] or Public Company Accounting Oversight Board (PCAOB) Auditing Standards.[47] The auditing standards define auditor obligations and professional care in conducting examinations.[48] The audit assists the board and shareholders with monitoring activities of management and the corporation.[49] One cannot understate the difference between the role of the auditor and the role of management.

Pursuant to auditing standards, the amount of effort expended by the auditor in the course of an examination varies from audit to audit.[50] An auditor's effort directly relates to inherent risk and control risk.[51] Inherent risk measures the likelihood of a materially misstated financial ac-

39. *See* Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 37–39 (John W. Pratt & Richard J. Zeckhauser eds., 1985).

40. Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS, *supra* note 39, at 55, 57.

41. *Id.* at 69–70.

42. *See* 17 C.F.R. § 240.14a-101 (2012); Sarah Johnson, *More Shareholder Say on Auditors: An Unrelated Regulation Has Prompted More Companies to Give Their Investors a Vote on Accounting Firms*, CFO.COM (June 25, 2010), http://www.cfo.com/article.cfm/14506813 (discussing the rise of shareholder ratification of auditors and its potential impact on corporate governance).

43. *See* Clark, *supra* note 40, at 70.

44. *See id.*

45. *See* 17 C.F.R. § 229.308 (placing responsibility for the financial statements solely with management).

46. United States v. Arthur Young & Co., 465 U.S. 805, 811 (1984) ("[SEC] regulations stipulate that [financial reports submitted to the Commission] must be audited by an independent certified public accountant in accordance with generally accepted auditing standards.").

47. Sarbanes-Oxley § 103(a)(1), (3), 15 U.S.C. § 7213(a)(1), (3) (2006) (requiring the PCAOB to establish auditing standards).

48. *See* Strother, *supra* note 26, at 208–11.

49. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 338–39 (1976).

50. *See generally*, CODIFICATION OF AUDITING STANDARDS, The Standards of Field Work, §§ 312, 350 (Am. Inst. of Certified Pub. Accountants 2004) (noting variability in audit effort).

51. *See* ARENS ET AL., *supra* note 32, at 257–61.

count prior to the application of internal controls.[52] Control risk measures the likelihood internal controls will fail to uncover a materially misstated account.[53] Recall, management bears the responsibility for internal controls.[54] Thus, if an auditor concludes the audited accounts have an inherently low risk of misstatement and management has implemented effective controls, the auditor may reduce the effort expended in the audit.[55] Conversely, if the auditor concludes the audited accounts present a high inherent risk and management has implemented poor financial controls, the auditor will increase audit effort and precaution.[56] Thus, the auditing standards allow the auditor to vary audit effort based on the inherent risks present and management's handling of the given risks.

Based on the results of the examination, the auditor will opine on the financial statements.[57] The opinion will include a determination as to whether the auditor believes "the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period."[58] The PCAOB requires auditors to provide "reasonable assurance" that financial statements materially conform to GAAP.[59] Additionally, Sarbanes-Oxley requires auditors attest to management's assessment of internal controls.[60] The audit opinion represents the culmination of the auditor's work.

Despite the distinction between the role of management and the role of auditors, some courts, members of the plaintiffs bar, and the public have markedly different views as to the auditor's role. Courts occasionally note that auditors "certify" or "prepare" financial statements.[61] These statements may originate from the plaintiffs bar.[62] Plaintiffs often advance an even greater derogation of the auditor's role, namely that the

52. *Id.* at 259.

53. *Id.*

54. *See supra* Part II.A.

55. ARENS ET AL., *supra* note 32, at 257–61.

56. *Id.*

57. United States v. Arthur Young & Co., 465 U.S. 805, 811 (1984) ("By examining the corporation's books and records, the independent auditor determines whether the financial reports of the corporation have been prepared in accordance with generally accepted accounting principles. The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period.").

58. *Id.*

59. *Id.*

60. Sarbanes-Oxley § 404(b), 15 U.S.C. § 7262(b) (2006).

61. *See, e.g.*, Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 828 (7th Cir. 2007) ("Indeed, [PricewaterhouseCoopers] *certified* that Anicom's financial statements were accurate, complete and in conformity with [GAAP] and that its audits were performed according to [GAAS]." (emphasis added)); Overton v. Todman & Co., 478 F.3d 479, 484 (2d Cir. 2007) ("[W]e limited [the duty to correct discovered misstatements] to only those statements that the accountant actually prepared and certified."); *In re* Cendant Corp. Sec. Litig., 343 F.3d 658, 660 (3d Cir. 2003) (noting an Ernst & Young LLP auditor "prepared" company "financial statements at issue in the underlying litigation").

62. *See, e.g.*, *In re* Raytheon Sec. Litig., 218 F.R.D. 354, 356 (D. Mass. 2003) (noting a complaint alleged Raytheon and its auditor "*issued* materially false and misleading financial statements" (emphasis added)).

auditor must attest the financial statements are totally free from material error.[63] Scholarly work suggests that the investing public perceives the same ill-informed role.[64] Academics refer to this auditor perception phenomenon as the "expectation gap."[65]

E. Auditor Liability and Regulation

Auditors operate in a highly regulated industry with parallel avenues of litigation and enforcement. Both federal and state laws govern auditor civil and criminal liability.[66] Additionally, auditors must submit to periodic reviews by the PCAOB.[67] This Section briefly discusses civil causes of action, potential criminal liability, and reviews by the PCAOB. This patchwork of litigation, enforcement, and regulation is highly atypical in the securities laws.[68]

1. Civil Liability

Several sources of law expose auditors to civil liability. At the federal level, some of the common causes include sections 10(b) and 13(b) of the Securities Exchange Act of 1934 (Exchange Act),[69] section 11 of the Securities Act of 1933 (Securities Act),[70] and the Racketeer Influenced and Corrupt Organizations Act (RICO).[71] An auditor may also face numerous causes of action under state law.[72] This Subsection provides a partial view of auditor litigation risk by introducing federal and state causes of action.

63. MODEL JURY INSTRUCTIONS, *supra* note 27, § 5.04 (noting the additional request that "auditors must conclude that the statements are free from material misstatement").

64. *See, e.g.*, Marc J. Epstein & Marshall A. Geiger, *Investor Views of Audit Assurance: Recent Evidence of the Expectation Gap*, J. ACCT., Jan. 1994, at 60, 62–63 (noting that forty-seven percent of respondents to a survey believed auditors should provide absolute assurance that financial statements are free from material misstatements); John E. McEnroe & Stanley C. Martens, *Auditors' and Investors' Perceptions of the "Expectation Gap*,*"* 15 ACCT. HORIZONS 345, 354–56 (2001).

65. *See, e.g.*, McEnroe & Martens, *supra* note 64, at 354–56.

66. *See* Talley, *supra* note 13, at 1649–73.

67. Sarbanes-Oxley §§ 102, 104, 15 U.S.C. §§ 7212, 7214 (2006).

68. Talley, *supra* note 13, at 1649. Talley does not discuss auditor regulation in his piece on auditor liability. *See generally id.* The work by other scholars on auditor regulation only appears to reinforce Talley's claim on the unique treatment of auditors. *See generally* George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325, 1347–51 (2003) (noting extensive regulation post-Enron).

69. Talley, *supra* note 13, at 1650–53.

70. *Id.*

71. *Id.*

72. *Id.* at 1666–72.

a. Federal Causes of Action

i. Section 10(b) Liability

Under section 10(b) of the Exchange Act, private plaintiffs have an implied right of action against corporate filers and their auditors.[73] Plaintiffs typically bring federal suits under section 10(b).[74] The section states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[75]

The SEC issued rule 10b-5 pursuant to section 10(b). The rule uses similar language to section 10(b) but specifically makes it illegal to (a) "employ any device, scheme, or artifice to defraud," (b) "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading," or (c) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" related to "the purchase or sale of any security."[76] This implied right forms the heart of auditor suits.

Commentators have noted seven prima facie elements to a 10b-5 claim.[77] A plaintiff must successfully plead and prove the defendant made (1) a materially (2) false statement or omission related to the purchase or sale of a security (3) with scienter (a reckless state of mind) (4) on which the plaintiff relied (5) to enter into a transaction (6) which caused a loss (7) provable in money damages.[78] Some of these elements deserve attention because they create special "hurdles," both high and low, in the litigation process.[79]

The scienter element requires particular attention. Under the Private Securities Litigation Reform Act (PSLRA),[80] a plaintiff's complaint must "state with particularity facts giving rise to a strong inference that

73. *See* Securities Exchange Act (Exchange Act) of 1934 § 10(b), 15 U.S.C. § 78j (2006); Talley, *supra* note 13, at 1650.

74. Talley, *supra* note 13, at 1652 ("[Section 10(b)] "is in many respects the crescent wrench of the securities fraud toolbox. It is far and away the most popular approach in civil securities fraud litigation . . . .").

75. 15 U.S.C. § 78(j).

76. 17 C.F.R. § 240.10b-5 (2012).

77. Talley, *supra* note 13, at 1652.

78. *Id.*

79. *See id.* at 1652–53.

80. Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

the defendant acted with [scienter]."[81] Extreme recklessness constitutes scienter.[82] A plaintiff meets this standard only when inferences of fraudulent intent meet or exceed other, more benign explanations of the defendant's behavior.[83] These inferences also provide evidence of scienter at trial.

Auditors may have an even more rigorous scienter standard than firm actors.[84] Courts have held that "[r]ecklessness on the part of an independent auditor entails a mental state so culpable that it approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company."[85] The audit must "amount[] at best to a 'pretend audit'"[86] or amount to "no audit at all."[87] The higher standard may stem from the auditor-client relationship.[88] Recall, auditors do not generate financial information.[89] Rather, auditors opine on the financial information. The difference in roles may justify the stricter standard.

Plaintiffs can satisfy the pleading requirement by demonstrating that auditors know of, but ignore "red flags."[90] These red flags cannot constitute "insignificant accounting violations."[91] Instead, the red flags must approximate "smoking guns."[92] Mere departures from GAAP alone do not necessarily constitute red flags.[93] The U.S. Supreme Court has recognized GAAP requires preparer and auditor judgment: "[F]ar from . . . a canonical set of rules that will ensure identical accounting treatment of identical transactions[, GAAP], rather, tolerate[s] a range of 'reasonable' treatments, leaving [a] choice among alternatives . . . ."[94] Departures from GAAP coupled with specific, particular GAAS violations may create a sufficient inference of scienter.[95] Additionally, significant departures from GAAP may also create such an inference.[96]

81. PSLRA § 101(b), 15 U.S.C. § 78u-4(b)(2)(A) (2006).

82. CHRISTIAN M. HOFFMAN & MATHEW C. BALTAY, FOLEY HOAG LLP, AUDITOR LIABILITY IN SECURITIES LITIGATION FROM A DEFENSE PERSPECTIVE 10 (2008).

83. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007) ("[W]e hold, an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.").

84. *In re* Scottish RE Group Sec. Litig., 524 F. Supp. 2d 370, 385 (S.D.N.Y. 2007).

85. Fidel v. Farley, 392 F.3d 220, 226 (6th Cir. 2004) (quoting PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004) (internal quotation marks omitted)).

86. Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000) (quoting McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979).

87. DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002).

88. *See supra* Part II.D.

89. *See supra* Part II.D.

90. *In re* Raytheon Sec. Litig., 157 F. Supp. 2d 131, 154 (D. Mass. 2001).

91. *In re* IKON Office Solutions, Inc., Sec. Litig., 277 F.3d 658, 677 n.26 (3d Cir. 2002).

92. Nappier v. PricewaterhouseCoopers LLP, 227 F. Supp. 2d 263, 278 (D.N.J. 2002) (quoting *In re* SCB Computer Tech., Inc., Sec. Litig., 149 F. Supp. 2d 334, 363 (W.D. Tenn. 2001)).

93. HOFFMAN & BALTAY, *supra* note 82, at 12.

94. Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 544 (1979).

95. HOFFMAN & BALTAY, *supra* note 82, at 12.

96. *See id.* at 14–15.

Plaintiffs often have difficulty pleading scienter with particularity prior to discovery; yet, this has not prevented suits against auditors.[97] Conversely, the SEC has no heightened pleading requirement.[98] Plaintiffs often wait for the SEC to act before bringing forth their own private actions.[99] Thus, private actions may just wait in queue until public actions commence.

While the scienter hurdle may sit fairly high, the reliance hurdle, element four, rests fairly low. The Supreme Court significantly relaxed the reliance requirement in *Basic, Inc. v. Levinson*.[100] In *Basic*, the Court articulated the "fraud on the market" (FOM) theory.[101] The FOM doctrine has its origins in the semistrong form of the Efficient Capital Markets Hypothesis.[102] This version of the hypothesis presumes the market factors in all publicly available information, such as a company's financial statements, into the price of a security.[103] Accordingly, FOM dictates that an investor presumptively relies on the information within financial statements.[104] Thus, the reliance hurdle may barely constitute a hurdle at all.

Plaintiffs must also demonstrate the alleged fraud caused the plaintiff to incur a financial loss.[105] The plaintiff must plead and prove an economic loss occurred; generally, a fall in market prices will satisfy this requirement.[106] In the auditor context, plaintiffs may have to "trace back" declines in market prices to an auditor's opinion.[107] This causal element provides an additional hurdle in litigation.[108]

In the past, plaintiffs often brought claims under a secondary actors theory of liability. Practitioners and academics have categorized secondary actors liability into two separate categories: "aiding and abetting" liability and "scheme" liability.[109] Two separate Supreme Court cases, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[110] and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc.*,[111] limited secondary actors' liability. The past secondary actor approaches to liability, the two cases limiting secondary actor liability, and the effects of

97. Talley, *supra* note 13, at 1653–54.
98. *Id.* at 1654.
99. *Id.*
100. 485 U.S. 224, 250 (1988); Talley, *supra* note 13, at 1653.
101. 485 U.S. at 241.
102. Talley, *supra* note 13, at 1653.
103. *Id.*; *see also Basic*, 485 U.S. at 241–42 (citing Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).
104. Talley, *supra* note 13, at 1653.
105. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342–46 (2005).
106. Talley, *supra* note 13, at 1654.
107. *Id.* at 1655.
108. *Id.*
109. HOFFMAN & BALTAY, *supra* note 82, at 16–26; Talley, *supra* note 13, at 1656; Travis S. Souza, Note, *Freedom to Defraud:* Stoneridge*, Primary Liability, and the Need to Properly Define Section (10)(B)*, 57 DUKE L.J. 1179, 1179–80 (2008).
110. 511 U.S. 164 (1994).
111. 552 U.S. 148 (2008).

those cases deserve some discussion. Both cases reduced the scope of auditor liability; but, as this Note will demonstrate, auditor litigation risk remains severe.[112]

Under the first category of secondary actor liability, the now-defunct "aiding and abetting" theory, the auditor was liable for assisting the client in perpetrating a fraud.[113] The Supreme Court in *Central Bank* limited "aiding and abetting" liability by requiring the plaintiff to "show reliance on the *defendant's* misstatement or omission."[114] The Court affirmed this holding in *Stoneridge*.[115] Thus, courts cannot hold auditors liable as aiders and abettors of misstatements or omissions but can hold them liable if the auditor was the primary actor.[116]

Central Bank did not relieve a great weight of civil litigation off the backs of auditors. To begin, the *Central Bank* holding only affected the implied "private right of action."[117] The SEC can still bring claims under a secondary actor theory.[118] Moreover, plaintiffs' secondary actor complaints have "metamorphasized" into primary actor complaints.[119] Courts have not reached a consensus as to what constitutes a primary actor.[120] Auditors, consequently, have not avoided significant civil liability as a result of *Central Bank*.

Under the alternative form of secondary liability, "scheme liability," a plaintiff would allege the defendants schemed to defraud.[121] "Scheme liability" has its origins in subsections (a) and (c) of rule 10b-5.[122] Actors cannot "employ any device, *scheme*, or artifice to defraud" or "engage in any act, practice, or course of business which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[123] *Stoneridge* limited the application of "scheme liability."[124] The Supreme Court again focused on the plaintiff's reliance on the defendant's conduct.[125] Just as it did in *Central Bank*, the Court appeared to favor primary actor theories of securities liability.

Yet *Stoneridge* may not have made a significant impact on auditor litigation. The Court limited the *Stoneridge* holding to private, implied

112. *See infra* Part II.F.
113. Talley, *supra* note 13, at 1656.
114. *Cent. Bank*, 511 U.S. at 180 (emphasis added).
115. *Stoneridge*, 552 U.S. at 158.
116. *See Cent. Bank*, 511 U.S. at 180.
117. *Id.* at 171.
118. Talley, *supra* note 13, at 1656.
119. *Id.*
120. Souza, *supra* note 109, at 1183–88.
121. *Id.* at 1188.
122. HOFFMAN & BALTAY, *supra* note 82, at 21.
123. 17 C.F.R. § 240.10b-5 (2012) (emphasis added).
124. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 160 (2008) ("Were [the "scheme liability"] concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule.").
125. *Id.*

rights of action.[126] The SEC still has the power to investigate such "schemes."[127] Moreover, as previously mentioned, plaintiffs may still couch secondary actor theories of liability into primary actor theory language.[128] Thus, *Stoneridge*, like *Central Bank*, has not truly alleviated auditors from significant liability.

PSLRA likely reduced the amount of damages paid by auditors in successful section 10(b) cases. Under PSLRA, auditors typically face proportional liability under section 10(b) with other codefendants.[129] Prior to PSLRA, the securities laws held auditors jointly and severally liable with other defendants.[130] The old joint and several liability regime meant auditors and other deep-pocketed defendants became big targets when other, nearly insolvent defendants were effectively judgment proof.[131] Auditors seemingly benefited from the change.

ii. Section 11 Liability

In addition to section 10(b) claims, auditors must occasionally defend against section 11 claims brought under the Securities Act.[132] Section 11 has limited applicability.[133] Consequently, plaintiffs plead section 11 far less often.[134] Section 11 gives plaintiffs an express private right of action against every signor, director of the issuer, underwriter, and accountant of a company that files a registration statement that "contain[s] an untrue statement of a material fact or omitted to state a material fact."[135] Like section 10(b), section 11 requires the plaintiff to prove the materiality of misstatements or omissions, reliance, and loss causation.[136] Yet, section 11 claims only apply to misstatements and omissions in registration statements.[137]

Section 11 provides at least four benefits to plaintiffs over section 10(b). First, as PSLRA largely did not affect section 11, defendants remain jointly and severally liable for damages.[138] Thus, plaintiffs can pursue deep-pocketed defendants for large damage awards. Second, the section does not require plaintiffs to explicitly prove damages.[139] Instead, the Act assumes damages equal the initial stock price less the stock price

126. *Id.* at 153.
127. *Id.* at 161.
128. *See supra* notes 119–20 and accompanying text.
129. PSLRA §§ 101(b), 15 U.S.C. § 78u-4(f)(2)(B)(i) (2006); Talley, *supra* note 13, at 1653.
130. Talley, *supra* note 13, at 1653.
131. V.G. Narayanan, *An Analysis of Auditor Liability Rules*, 32 J. ACCT. RES. 39, 40 (1994).
132. Talley, *supra* note 13, at 1657.
133. *Id.* at 1657–58.
134. *Id.* at 1657.
135. Securities Act (Securities Act) of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006).
136. Talley, *supra* note 13, at 1657.
137. 15 U.S.C. § 77k(a).
138. Talley, *supra* note 13, at 1657.
139. *Id.*

at the time of suit.[140] Third, the section provides an express right of action.[141] Only Congress, and not the courts, can modify such a right.[142] Fourth, and most importantly, the section has no scienter requirement making auditors effectively strictly liable.[143]

iii. Section 13(b) Liability

Unlike section 10(b) and section 11, section 13(b) provides no private right of action.[144] Instead, the section vests enforcement powers to public agencies such as the SEC.[145] The Foreign Corrupt Practices Act of 1977 (FCPA),[146] largely passed to curb bribery of foreign officials, made two notable changes to section 13(b).[147] The first change, known as the "books and records provision," requires registered firms to "keep books, records, and accounts, which . . . accurately and fairly reflect [financial] transactions [in reasonable detail]."[148] The second change, often referred to as the "internal controls provision," requires registered firms to "maintain a system of internal accounting controls sufficient to provide reasonable assurances" that financial transactions comply with managerial authorization and financial statements accurately record financial transactions.[149] Because section 13(b) has no scienter requirement, all government actions related to financial misrepresentation plead violations of the FCPA.[150]

iv. Internal Controls Liability

New developments in the securities laws related to internal control requirements may have heightened auditor litigation risk.[151] Recall, Sarbanes-Oxley required management to report on internal controls and required the auditor to attest to management's assessment.[152] The new attestation requirements may create another area of litigation risk.[153] Academics have had few opportunities to measure the likelihood or effect of this litigation avenue.[154]

140. *Id.*
141. *Id.* at 1657–58.
142. *Id.*
143. *Id.* at 1658.
144. Securities Act § 13(b), 15 U.S.C. § 78m(b) (2006); Talley, *supra* note 13, at 1658.
145. Talley, *supra* note 13, at 1658.
146. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1495 (1977) (codified as amended at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78dd-3, 78ff (2006)).
147. Talley, *supra* note 13, at 1658.
148. 15 U.S.C. § 78m(b)(2)(A) (2006); Talley, *supra* note 13, at 1658.
149. 15 U.S.C. § 78m(b)(2)(B) (2006); Talley, *supra* note 13, at 1658.
150. Talley, *supra* note 13, at 1658–59 (citing Jonathan M. Karpoff et al., The Cost to Firms of Cooking the Books 5 (Mar. 8, 2006) (unpublished manuscript) (on file with the Columbia Law Review)).
151. *Id.* at 1659.
152. *See supra* Parts II.A, II.D.
153. Talley, *supra* note 13, at 1658.
154. *Id.* at 1660–61.

v. RICO Liability

The last notable area of federal civil liability, RICO liability,[155] necessitates some discussion. The act explicitly covers securities fraud within its provisions.[156] A successful claim could yield treble damages and attorney's fees.[157] The PSLRA severely limited the applicability of RICO by requiring a criminal conviction before the commencement of a private civil suit.[158] Thus, RICO consequently represents a relatively minor area of federal securities litigation.[159]

b. State Causes of Action

Auditors must also manage state civil liability.[160] States employ a myriad of securities regulations and rules.[161] Often, plaintiffs bring actions against auditors on contract and tort grounds.[162] Yet, important limitations to state law apply.[163] The remainder of this Subsection discusses state civil liability so that the reader may have a more complete picture of auditor civil liability.

i. Contract Liability

A seminal case, *Ultramares Corp. v. Touche*, opened the door to a series of private suits against auditors in state court.[164] The opinion, written by Benjamin Cardozo, allowed third parties to sue auditors under key conditions.[165] Under *Ultramares*, third parties need to prove reliance on the financial statements and negligence on behalf of the auditor.[166] The opinion dispensed with contractual privity limitations.[167] Thus, third parties had causes of action that did not previously exist.

Yet, the *Ultramares* decision had two important limitations on auditor liability.[168] First, only intended recipients of the audited financial statements at the time of contracting had recognizable causes of action.[169] Second, Cardozo based the cause of action on contract rather than tort

155. Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 922 (1970) (codified as amended at 18 U.S.C. §§ 1961–1968 (2006)).
156. Talley, *supra* note 13, at 1662.
157. 18 U.S.C. § 1964 (2006).
158. 18 U.S.C. § 1964(c).
159. Talley, *supra* note 13, at 1662.
160. *Id.* at 1666–71; *see also* CTR. FOR AUDIT QUALITY, *supra* note 10, at 31–32.
161. *See* Talley, *supra* note 13, at 1667 (discussing state regulators).
162. *Id.* at 1669–70.
163. *Id.* at 1667–68 (discussing preemption).
164. 174 N.E. 441 (N.Y. 1931); *see also* Talley *supra* note 13, at 1668–69.
165. *See* Talley *supra* note 13, at 1668–69.
166. *Id.*
167. *Ultramares*, 174 N.E. at 447–48.
168. *See* Talley, *supra* note 13, at 1668. Talley listed three limitations. *Id.* His last two limitations, however, relate to the limits of contracting. *Id.*
169. *Ultramares*, 174 N.E. at 444–48.

grounds.[170] Notions of expectancy and proportionality limit plaintiff remedies in contract.[171] Moreover, an auditor and its client could contract around default rules and limit damages.[172] For example, the parties might specify the intended beneficiaries.[173] Consequently, *Ultramares* had important, but limited, applicability.

ii. Tort Liability

The American Law Institute's Restatement (Second) of Torts began to expand the scope of auditor liability.[174] Published some thirty years after *Ultramares*, the Restatement broadened the definition of intended beneficiaries.[175] The Restatement provided:

> One who, in the course of his business . . . supplies false information for the guidance of others in their business transactions, is subject to liability . . . [to a] limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply [the information].[176]

Thus, the auditor could be liable to intended recipients of information and other known parties receiving information from the intended recipients. The Restatement implicated auditors and was adopted by a number of state courts.[177]

State high courts soon turned the *Ultramares* doctrine into an action based on tort, thus expanding auditor litigation risk.[178] The cases had three important consequences. First, an auditor's duty expanded to the investing public.[179] Liability thus encompassed a class of reasonably foreseeable plaintiffs.[180] As a result, auditors lacked previous privity defenses.[181] Second, tort liability carried with it tort-based punitive damages.[182] Third, tort often created immutable damages; auditors could not contract around liability.[183] Thus, the new tort claims represented a significant expansion of auditor liability.

170. *Id.* at 448.
171. Talley, *supra* note 13, at 1669.
172. *Id.*
173. *Id.*
174. RESTATEMENT (SECOND) OF TORTS § 552 (1976); *see also* Talley, *supra* note 13, at 1669.
175. Talley, *supra* note 13, at 1669.
176. RESTATEMENT (SECOND) OF TORTS § 552 (1976).
177. Talley, *supra* note 13, at 1669.
178. *See, e.g.*, Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 366 (Wis. 1983). *See also* Talley, *supra* note 13, at 1669; Int'l Mortg. Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218, 226–27 (Cal. Ct. App. 1986), *overruled by* Bily v. Arthur Young & Co., 834 P.2d 745, 747 (Cal. 1992) ("We conclude that an auditor owes no general duty of care regarding the conduct of an audit to persons other than the client.").
179. Talley, *supra* note 13, at 1669.
180. *Id.*
181. *Id.* at 1670.
182. *Id.*
183. *Id.*

iii. State Statutory Liability

State statutes also create auditor liability, because these statutes can give causes of action to third parties. For example, in Illinois, a party may have a claim against a professional service provider if the provider (1) "identifies in writing to the client those persons who are intended to rely on the services" and (2) "sends a copy of such writing or similar statement to those persons identified in the writing or statement."[184] Additionally, the California Code sanctions aiding and abetting suits for violations of its antifraud statute.[185]

Developments at the federal level have put some notable restrictions on state remedies. The Securities Litigation Uniform Standards Act of 1998 (SLUSA)[186] preempted many state securities fraud class actions.[187] Yet SLUSA does not preempt two important classes of cases.[188] One, the act does not cover individual private actions.[189] Large investors may still bring action in state court.[190] Two, the act does not cover derivative actions under state corporate law.[191] Thus, claims against auditors may still find their way into state court.

2. Criminal Liability

Like civil liability, auditors face potential criminal liability at the federal and state level. Federal authorities may bring claims on securities fraud, RICO, obstruction of justice, or wire fraud grounds.[192] States may also pursue antifraud and embezzlement charges.[193] A discussion of both federal and state changes helps provide a more complete picture of auditor liability.

Several notable violations of the securities laws constitute felonies. The Securities Act prohibited willful violations of the securities laws, violations of SEC regulations, and misstatements or omissions in registration statements.[194] The Exchange Act created criminal penalties for "any person who willfully and knowingly makes, or causes to be made" a materially false or misleading "statement in any application . . . or document required to be filed" pursuant to the securities laws or for membership to

184. 225 ILL. COMP. STAT. 450/30.1 (2011).

185. CAL. CORP. CODE § 25403(b) (West 2011).

186. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. § 78bb (2006)).

187. 15 U.S.C. § 78bb(f).

188. Talley, *supra* note 13, at 1668.

189. *See* 15 U.S.C. § 78bb(f).

190. Talley, *supra* note 13, at 1668.

191. 15 U.S.C. § 78bb(f)(5)(C). For the sake of brevity, this Note does not cover derivative regulation as it relates to auditors. Liability appears theoretically possible, but "relatively modest" at best. Talley, *supra* note 13, at 1671.

192. Talley, *supra* note 13, at 1662–65.

193. *Id.* at 1672.

194. *See* Securities Act § 24, 15 U.S.C. § 77x (2006).

"any self-regulatory organization."[195] Such violations could result in a $5 million fine and a twenty-year prison sentence for individuals or a $25 million fine for a firm.[196] Further, RICO provides a number of provisions often tacked onto securities violations.[197]

The Department of Justice has used obstruction of justice charges effectively in the past.[198] Under Sarbanes-Oxley, any person who "corruptly . . . alters, destroys, mutilates, or conceals a record, document, or other object . . . with the intent to impair the object's integrity or availability for use in an official proceeding; or . . . otherwise obstructs, influences, or impedes any official proceeding" faces fines or a maximum sentence of twenty years in prison.[199] In *Arthur Andersen LLP v. United States*,[200] the Supreme Court may have suggested some level of support for reasonable document retention policies.[201] Courts may interpret the holding to require more evidence of willful conduct.[202]

Federal prosecutors often tack on federal mail and wire fraud charges when bringing other charges of securities fraud. A successful action must demonstrate a "scheme to defraud."[203] Actions do not require showings of reliance, causation, or damages.[204] These charges have occasionally implicated financial fiduciaries and may extend to an audit relationship.[205] Federal mail and wire fraud charges thus represent a noteworthy area of auditor criminal liability.

States may also bring separate criminal charges. New York, for example, allows its attorney general to enjoin business entities engaged in fraudulent conduct.[206] Other states have similar provisions.[207] Yet criminal prosecutions at the state level appear modest or infrequent.[208]

195. *See* Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (2006).
196. *Id.*
197. Talley, *supra* note 13, at 1663.
198. *See*, *e.g.*, Arthur Andersen LLP v. United States, 544 U.S. 696, 698 (2005); United States v. Stewart, 433 F.3d 273, 289 (2d Cir. 2006). It should be noted that the Supreme Court overturned the obstruction of justice charges against Arthur Andersen. *Arthur Anderson*, 544 U.S. at 706–08. By the time the Court ruled on the issue, however, the obstruction charge had contributed to the death of the industry giant. *See* Talley, *supra* note 13, at 1648, 1664.
199. Sarbanes-Oxley § 1102, 18 U.S.C. § 1512(c) (2006).
200. *Arthur Andersen*, 544 U.S. at 696.
201. Talley, *supra* note 13, at 1665.
202. *Id.*
203. 18 U.S.C. §§ 1341, 1343.
204. *See id.*
205. *See, e.g.*, United States v. Simon, 425 F.2d 796 (2d Cir. 1969).
206. N.Y. GEN. BUS. LAW § 353(1) (McKinney 2011).
207. Talley, *supra* note 13, at 1672.
208. *Id.*

3. Other Regulatory Considerations

The PCAOB, an organization that reports to the SEC, also plays a role in auditor regulation.[209] As previously noted, the PCAOB publishes auditing standards for use in examinations.[210] In addition to the important standard setting role, the PCAOB has several other important regulatory functions. First, the PCAOB registers and routinely inspects audit firms.[211] Large auditors receive annual inspections while smaller auditors receive inspections triennially.[212] Second, the PCAOB may conduct investigations, disciplinary proceedings, and issue sanctions against firms and individuals.[213]

Auditors must also subject themselves to stringent independence requirements.[214] These independence requirements help ensure impartial evaluation. For example, audit partners must rotate off audits every five years.[215] Moreover, a second partner must review all audits.[216] To avoid conflicts of interests, accounting firms generally cannot provide nonaudit services to audit clients.[217]

Auditors must also comply with state regulations. State boards renew licenses for firms and individuals.[218] The same boards may also sanction firms.[219] The California Board of Accountancy, for example, sanctioned Big Four accounting firm Ernst & Young after an SEC investigation found violations of independence requirements.[220]

F. Effect of Auditor Liability

The current liability regime has had a number of negative consequences for the audit industry and the economy as a whole. Civil and criminal liability has produced a highly concentrated industry. The failure of another large firm may cause massive disruption within the marketplace.

The story of Laventhol demonstrates the dramatic consequences of civil litigation risk within the audit industry. Auditors continue to face significant civil litigation risk decades after Laventhol's demise. Between 1996 and 2007, the six largest firms defended against 918 audit-related claims.[221] Of the 918 claims, 138 sought damages in excess of $100 mil-

209. Benston, *supra* note 68, at 1348–49.
210. *See supra* note 47 and accompanying text.
211. Sarbanes-Oxley §§ 102, 104, 15 U.S.C. §§ 7212, 7214 (2006).
212. *Id.* § 7214(b)(1).
213. *Id.* § 7215.
214. *See* Benston, *supra* note 68, at 1349.
215. *Id.*
216. *Id.*
217. *Id.*
218. *See* Talley, *supra* note 13, at 1672.
219. *Id.*
220. *Id.*
221. CTR. FOR AUDIT QUALITY, *supra* note 10, at 37 chart 6.

lion.[222] The numbers only grow worse: thirty-nine of the 918 claims related to public audits pled for more than $1 billion.[223] Finally, eleven claims pled for more than a whopping $10 billion.[224] The numbers evince massive litigation risk.

Critics of the stated figures may note that these claims occurred before *Stoneridge* put an end to "scheme liability."[225] Despite *Stoneridge*, however, auditor litigation risk remains severe. As previously indicated, plaintiffs have numerous litigation avenues.[226]

Several recent cases have highlighted the persistence of auditor suits. KPMG, the smallest Big Four firm, was slapped with a $1 billion suit after the collapse of subprime lender, New Century.[227] A number of other New Century suits accompanied the billion-dollar case.[228] To make matters worse for KPMG, the firm received suits related to the audits of other lenders.[229] The firm settled a number of these suits for undisclosed sums or for sums in the tens of millions of dollars.[230] Ernst & Young, another Big Four auditor, is listed as a defendant in a suit over Lehman Brothers' failure.[231] The civil suit by the attorney general of New York alleges Ernst & Young "substantially assisted" Lehman Brothers "to engage in a massive accounting fraud."[232] The suit seeks $150 million in damages.[233] These cases will likely continue to surface as auditor litigation tends to follow market bubbles and fluctuation.[234]

This litigation risk has effectively made large auditors uninsurable.[235] Auditors, as a result, now self-insure.[236] One scholar has suggested the

222. *Id.* at 43 chart 11.

223. *Id.* at 43.

224. *Id.*

225. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159–60 (2008).

226. *See supra* Part II.E.1.

227. Donna Kardos, *KPMG Is Sued over New Century*, WALL ST. J., Apr. 2, 2009, at C3.

228. *See, e.g.*, *In re* New Century, 588 F. Supp. 2d 1206 (C.D. Cal. 2008).

229. *See, e.g.*, *In re* Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132 (C.D. Cal. 2008) (naming KPMG as a defendant in a class-action securities case).

230. *See* Plaintiffs' Memorandum of Points and Authorities in Support of Unopposed Motion for Preliminary Approval of Settlements at 7, *In re* New Century, No. 2:07-cv-00931-DDP (C.D. Cal. Aug. 30, 2010) (noting a $44.75 million settlement with New Century shareholders); Amended Stipulation and Agreement of Settlement at 17, *In re* Countrywide Fin. Corp. Sec. Litig., No. CV 07-05295 MRP (C.D. Cal. June 29, 2010) (agreeing to a $24 million settlement); Caleb Newquist, *KPMG Resolves Lawsuit with New Century*, GOING CONCERN (June 30, 2010), http://goingconcern.com/2010/6/kpmg-resolves-lawsuit-with-new-century (noting a confidential settlement with the New Century bankruptcy trustee). The reader should note several large investors pulled out of the Countrywide settlement thus signaling ongoing litigation. David Benoit, *Big Investors Refuse Countrywide Settlement*, WALL ST. J. (Feb. 25, 2011), http://online.wsj.com/article/SB10001424052748704150604576166382331877062.html.

231. Complaint at 1, New York v. Ernst & Young LLP (N.Y. Sup. Ct. Dec. 21, 2010).

232. *Id.*

233. *Id.* at 5.

234. CTR. FOR AUDIT QUALITY, *supra* note 10, at 42; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 302–04 (2004).

235. Lawrence A. Cunningham, *Too Big To Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1741 (2006). *But see* Talley, *supra* note 13, at 1693.

236. Cunningham, *supra* note 235, at 1741.

inability of auditors to find external insurance is not only related to the magnitude of cases, but also related to case correlation.[237] Again, auditor suits tend to correlate with market downturns.[238] Thus, insurers would be stuck with a number of high dollar-value suits during recessions or larger market corrections. The insurance premiums necessary to cover such risks are simply too high for auditors to pay.

The high and uncertain costs of civil litigation may actually cause auditors to take inefficient levels of precaution.[239] For example, to avoid the risks and costs of litigation, auditors may overaudit.[240] This inefficiency creates economic deadweight losses.[241] Recall that management controls the information generation process.[242] Managers generate financial information and boards monitor management.[243] Despite the shared responsibility for financial statement accuracy, plaintiffs continue to target an auditor's deep pockets, thus causing the auditor to engage in unnecessary levels of precaution.

Criminal litigation also poses problems for auditors. Despite being overturned by the Supreme Court, the federal suit against Arthur Andersen effectively ended the former audit firm.[244] The firm was enjoined from issuing audits as a result of a lower court opinion.[245] But, even before the injunction, the firm's clients departed from the firm en masse.[246] The firm lost tremendous amounts of reputational capital. Thus, criminal litigation poses severe legal and reputational risks.

Auditor litigation risk may also create systemic risk within the market. The Big Four audit ninety-eight percent of total U.S. market capitalization.[247] Given the current litigation risk, scholars believe the Big Four face real risks of collapse.[248] The failure of one of the largest auditors would leave twenty percent of the G20's largest companies without an auditor.[249] These companies could not file their financial statements with

237. *Id.* at 1740.

238. Coffee, *supra* note 234, at 302–04; Cunningham, *supra* note 235, at 1740.

239. Partnoy, *supra* note 17, at 493 ("The securities law defenses available to [auditors] have created incentives for them to engage in costly activities they otherwise might avoid and have resulted in deadweight costs associated with concentrated market structures, high barriers to entry, and inefficient winner-take-all markets.").

240. *See id.* This uncertainty forces accountants to take great precautions to protect themselves from future litigation and therefore increases the barriers to entry. *See id.*

241. *See id.*

242. *See supra* Part II.A.

243. *See supra* Parts II.A–B.

244. Talley, *supra* note 13, at 1648, 1663–64.

245. *Id.* at 1648, 1663.

246. *See id.* at 1648.

247. ADVISORY COMM. REPORT, *supra* note 14, at VII.24.

248. Written Statement of James D. Cox, *supra* note 15, at 2.

249. Grant Thornton Press Release, *supra* note 16, at 1. The G20 consists of finance ministers and central bank governors representing twenty economies. *What Is the G20*, G20, http://www.g20.org/en/g20/what-is-g20 (last visited Feb. 2, 2012). The economies include: Argentina, Australia, Brazil, Canada, China, European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, and the United States.

regulatory bodies and would find it difficult to receive financing. Thus, a collapse could cause widespread panic within the financial markets.[250]

The preceding Part discussed market participants involved with an audit as well as auditor litigation and the effects of litigation. Given the potentially dramatic consequences of litigation, policy makers must consider reform.

III. ANALYSIS

Academics propose a number of alternative liability regimes. Some scholars have proposed pure limits on liability. Other scholars have proposed creative adjustments or revisions to auditor liability. These creative adjustments promise to limit auditor liability while maintaining efficient levels of auditor precaution. This Part briefly discusses three models: (1) bargained-for liability caps, (2) liability caps with strict liability, and (3) decoupled liability.

A. Bargained-For Liability Caps

A European Union (EU) commission recently recommended auditors bargain with their clients to modify auditor liability.[251] This agreement would require judicial and regulatory review.[252] Moreover, the company would disclose the agreement publicly within its financial statements.[253] This Section proceeds with a brief comparative overview of auditor liability in Europe. The stated justifications for liability caps made in a report accompanying the commission recommendation follows. Criticisms, both theoretical and practical, complete the Section.

Audit firms in Europe may face "catastrophic" claims associated with their audits.[254] Additionally, the firms generally have a duty to the public.[255] Further, shareholders and other third parties have actions based in tort and must prove elements such as loss causation.[256] Lastly, most claims generally allege some form of negligence.[257]

250. Cunningham, *supra* note 235, at 1702 ("[W]ith only four large firms, catastrophic losses incurred by even one of them pose significant systemic consequences."); Written Statement of Lawrence A. Cunningham, *supra* note 16, at 12 ("Since Arthur Andersen's dissolution, there has been valid concern that one of the four remaining similar firms could face a like fate from kindred criminal or civil culpability. Should that occur, with only three such firms left, a crisis would occur.").

251. Commission Recommendation of 5 June 2008 Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms, 2008 O.J. (L 162) 39, 40 (providing that the auditor and the client can agree to limits on liability so long as the agreement is subject to judicial review).

252. *Id.*

253. *Id.*

254. *See* RALF EWERT, LONDON ECON., STUDY ON THE ECONOMIC IMPACT OF AUDITORS' LIABILITY REGIMES: FINAL REPORT TO EC-DG INTERNAL MARKET AND SERVICES 79 (2006).

255. *Id.* at 78.

256. *Id.*

257. *Id.*

1. Justifications

The report accompanying the EU commission recommendation provides some theoretical reasons for capped liability.[258] To begin, the analysis suggests that the costs of unlimited liability might exceed the benefits of unlimited liability.[259] The report reasons that if the market operated efficiently, investors would price in caps.[260] Specifically, investors pay ex ante premiums in exchange for ex post assurances that the auditor will bear liability.[261] Auditors would need to contribute more hours to an audit and would charge higher hourly fees for the added risk exposure.[262] The longer hours and higher fees represent the ex ante premium.[263] The increased auditor precaution would result in improved financial information in the marketplace.[264]

A survey conducted for the EU report demonstrates that market participants have mixed views on audit quality in a capped regime. Respondents from Big Four and midmarket auditors believed liability caps would have no impact on how the market views audit quality.[265] Company executives and institutional investors, on the other hand, often believed caps reduced audit quality.[266] Thus, the data suggests differing views on how the market might react to the imposition of a liability cap.[267]

The EU report next considers the implications on the cost of capital in the market place.[268] The report notes that only a minority of survey respondents viewed financial statements audited under a capped regime to constitute statements of "lesser quality."[269] Poorer quality audits lead to increased information asymmetry and information risk; the increased information risk generates financial statement risk and higher costs of capital.[270] Additionally, the report presents cost of capital data from across capped and noncapped liability regimes.[271] The data demonstrates no statistically significant difference in cost of capital across the liability

258. *Id.* at 180.
259. *Id.*
260. *Id.* at 177.
261. *Id.*
262. *Id.*
263. *Id.*
264. *Id.*
265. *Id.* at 178.
266. *Id.*
267. *Id.*
268. *Id.* at 180; *see also* Douglas W. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity, and the Cost of Capital*, 46 J. FIN. 1325, 1325 (1991) (explaining that the cost of capital represents the premium or required rate of return on investment).
269. *See* EWERT, *supra* note 254, at 180.
270. *See id.* at 300–16; *see generally* Diamond & Verrecchia, *supra* note 268 (discussing the effect of disclosure on cost of capital).
271. *See* EWERT, *supra* note 254, at 180.

regimes.[272] From the survey and empirical data, the report concludes that capping auditor liability does not adversely affect cost of capital.[273]

The EU report also suggests two other positive effects of capped liability worth noting.[274] To begin, the report suggests that caps enhance competition among auditors by allowing midmarket firms to compete with Big Four auditors.[275] Moreover, capped liability may allow audit firms to attract and retain staff.[276] Talented staff have more incentive to stay and make partner if liability caps assure firm health.[277] The report consequently considers caps as a method to improve supply in the audit market.[278]

Finally, the EU report concludes that no one-size-fits-all approach to liability caps exists.[279] The report considers absolute caps and variable caps based on the size of the company audited or the size of the auditor.[280] Possibly because no single approach seems appropriate, the EU commission selects a bargaining approach with judicial or regulatory review.[281]

2. Theoretical Criticisms

Several theoretical limitations, however, could hinder the efficacy of the bargaining process. Shareholders and directors often use auditors to monitor management.[282] This monitoring function mitigates agency costs.[283] Additionally, bargaining creates transaction costs.[284] These transaction costs can reduce efficiency. This Subsection discusses these agency and transaction cost issues.

a. Increased Agency Costs Associated with Caps

Agency costs come in two types: (1) moral hazard or hidden action and (2) hidden information or adverse selection.[285] The corporate form creates hidden action problems because shareholders and the board can-

272. *Id.*
273. *Id.*
274. *See id.*
275. *Id.* at 180, 185.
276. *Id.* at 209–10.
277. *Id.*
278. *See id.* at 180.
279. *Id.* at 207.
280. *Id.* at 202–06.
281. Commission Recommendation of 5 June 2008 Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms, 2008 O.J. (L 162) 39, 40 (providing that the auditor and the client can agree to limits on liability so long as the agreement is subject to judicial review).
282. *See supra* note 49 and accompanying text.
283. *See* Jensen & Meckling, *supra* note 49, at 308.
284. A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 12 (2d ed. 1989); Douglas D. Heckathorn & Steven M. Maser, *Bargaining and the Sources of Transaction Costs: The Case of Government Regulation*, 3 J.L. ECON. & ORG. 69, 71 (1987).
285. Arrow, *supra* note 39, at 38.

not readily observe management.[286] Managerial action and effort remains hidden from shareholder view.[287] The problem is more acute when management harms the shareholder.[288] The corporate form also creates adverse selection costs, because management is privy to hidden information.[289] Ideally, management should use this hidden information to serve the shareholder.[290] Shareholders, however, do not have similar information access.[291] This lack of information prevents shareholders from actively and efficiently deploying resources.[292] Shareholders continually make investment decisions, that is, whether to buy or hold stock. Investors make these decisions without information on the full potentiality of management production.[293] Scholars typically refer to this problem as incentive compatibility.[294]

Monitoring can reduce some of these agency costs.[295] Scholars typically define agency costs as the sum of bonding costs, monitoring costs, and residual costs.[296] Costs expended by the agent to guarantee the agent does not harm the principal constitute bonding costs.[297] Monitoring costs include the costs expended by the principal to monitor management.[298] The remaining divergent interests of the principal and agent constitute the residual loss.[299] Theoretically, some combination of bonding and monitoring can minimize agency costs.[300] Furthermore, the additional information from monitoring can increase efficiency.[301]

Critics suggest that liability caps reduce auditor precaution which in turn reduces financial statement accuracy.[302] That is, the caps reduce the monitoring function of the auditor.[303] It follows that caps may increase agency costs.

Yet these criticisms do not necessarily bear out. The EU committee report provides an empirical analysis of audit quality across capped and noncapped liability regimes.[304] The analysis compares company accruals as a proxy for earnings management or financial information manipula-

286. *See id.* at 39.
287. *See id.*
288. *See id.*
289. *See id.*
290. *See id.*
291. *Id.*
292. *See id.* at 39–40.
293. *Id.*
294. *Id.* at 40.
295. *See* Jensen & Meckling, *supra* note 49, at 308.
296. *Id.*
297. *Id.*
298. *See id.* at 308 n.9.
299. *Id.* at 308.
300. *Id.* at 323–28.
301. Arrow, *supra* note 39, at 46.
302. EWERT, *supra* note 254, at 292.
303. *Id.*
304. *Id.* at 179.

tion.[305] Company accruals represent the accumulation of anticipated cash outflows.[306] As a company anticipates larger cash outflows, it should correspondingly increase its accrued liability.[307] Academics and practitioners view these accrual accounts as malleable because the accounts depend on managerial estimates and professional judgment.[308] The report finds no statistical difference in accruals management across liability regimes.[309] Thus, the cross-liability comparison provides some degree of empirical proof that a cap on auditor liability does not adversely affect auditor precaution and audit quality.[310]

In the United States, other mechanisms may mitigate any decline in auditor precaution. As mentioned, auditors may face criminal prosecution for botched audits.[311] Regulators also inspect or fine auditors for failing to adhere to professional standards.[312] Thus, even suboptimal changes to civil liability may not have a severe negative impact on auditor precaution.

Moreover, any bad bargains perceived by the market to reduce audit quality and thus information accuracy will likely depress the stock price.[313] This occurs because as investors make resource allocation decisions, they discount the value of companies striking bad bargains with shareholders.[314] As previously stated, investors discount shares ex ante for the reduction of ex post assurances and remedies.[315]

Some commentators discount this concept of market efficiency.[316] These commentators allege that, during market upturns, investors ignore information associated with audit opinions.[317] In other words, investors view audit opinions as mere formalities.[318] Because of that view, the markets will not necessarily factor in the price of a bad liability bargain.

These criticisms strike at the very foundation of the securities laws. Principles of disclosure and market efficiency constitute the building blocks of our current system.[319] Indeed, investors benefit from presumptive reliance during pleadings.[320] Before abandoning such principles and rethinking our entire securities regime, it is important to scrutinize such bold assertions.

305. *Id.* at 156.
306. *Id.*
307. *Id.*
308. *Id.*
309. *Id.* at 179.
310. *Id.*
311. *See supra* Part II.E.2.
312. *See supra* Part II.E.3.
313. *See* Jensen & Meckling, *supra* note 49, at 341.
314. *Id.*
315. *See supra* notes 260–63 and accompanying text.
316. *See* Coffee, *supra* note 234, at 323–24.
317. *Id.* at 323.
318. *Id.*
319. *See supra* notes 29, 101–05 and accompanying text.
320. *See supra* notes 29, 101–05 and accompanying text.

The criticisms also discount current shareholder and market control mechanisms. Directors—delegated with significant responsibility under corporate law—can create, limit, or alter the distribution of agency costs.[321] Shareholders might not agree to such changes if given the chance to individually bargain.[322] Despite this power structure, the shareholder can exert some limited control over the corporation.[323] Alternatively, other market participants may step in, take over the corporation, and oust the current directors.[324] Thus, if directors strike a bad bargain with auditors, just as if they strike bad bargains elsewhere, the directors risk losing their jobs.

Despite these forms of control, some commentators argue for increased shareholder power through proxy votes.[325] Increasing shareholder power through proxy votes could ameliorate agency cost issues.[326] As a result, share and company value would increase.[327] Proxy votes could reduce any increased agency cost associated with a bargain.

Yet state proxy-vote law may create inefficiency.[328] State laws make it difficult to determine the pool of eligible voting shareholders.[329] Record dates under state law do not necessarily coincide with actual stock ownership.[330] Significant trading activity between the record date and proxy vote date exacerbates the problem.[331] Many vote holders have no real stake in the success of the firm.[332] These distortions may favor incumbent managers and directors.[333]

b. Increased Transaction Costs Associated with Bargaining

Bargaining creates transaction costs.[334] Four costs comprise aggregate transaction costs: (1) the cost of identifying the parties to which one wishes to bargain, (2) the cost of marshaling the parties to the bargain, (3) the cost of the bargaining process, and (4) the cost of enforcing the bargain.[335] Low transaction cost situations facilitate efficient market

321. Clark, *supra* note 40, at 66.
322. *Id.* at 67.
323. *See supra* Part II.C.
324. *See supra* Part II.C.
325. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005); Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 478 (2008).
326. *See* Bebchuk, *supra* note 325, at 836.
327. *Id.*
328. John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237, 239 (1988).
329. *Id.*
330. *Id.* at 239–40.
331. *Id.* at 240.
332. *Id.*
333. *Id.*
334. POLINSKY, *supra* note 284, at 12; Heckathron & Maser, *supra* note 284, at 71.
335. *See* POLINSKY, *supra* note 284, at 12.

transactions.[336] On the other hand, the law must step in during high transaction cost situations.[337] In these high transaction cost situations, markets typically fail.[338]

If the expected costs of bargaining exceed the expected benefits of bargaining, then parties will likely not bargain at all.[339] For example, proxy votes necessary to waive certain fiduciary duties often require considerable expense.[340] Such costs often deter a vote from even occurring.[341] Thus, one must ask whether parties would bargain for caps at all.

The extent of complexity and private information in a bargain increases transaction costs.[342] To begin, complexity creates incomplete contracts.[343] Additionally, at least one party in the bargain must convert the private information to public information before crafting reasonable terms.[344] When an agreement sufficiently defines rights of the parties, these costs decline.[345]

Bargaining for capped liability would presumably add bargaining costs and thus transaction costs.[346] Complex liability agreements can generate significant transaction costs.[347] One would also assume that the level of auditor effort under any given liability regime will remain hidden from view.

Yet these transaction costs may decline over several iterations. Audit committees continually make decisions to retain or dismiss an auditor.[348] The committees also evaluate the auditor's work.[349] Also recall the audit committee must have one financial expert that will interpret auditor performance.[350] In these "repeated game" contexts, transaction costs often decline over time.[351]

336. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 55 (6th ed. 2003).

337. *Id.*

338. *Id.*

339. Clark, *supra* note 40, at 64.

340. *Id.*

341. *Id.*

342. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 84–85 (2d ed. 1997); Oliver E. Williamson, *Transaction Cost Economics*, *in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 41, 46 (Claude Ménard & Mary M. Shirley eds., 2005) ("[Transaction Cost Economics] concurs that bounded rationality is the appropriate cognitive assumption and takes the chief lesson of bounded rationality for the study of contract to be that all complex contracts are unavoidably incomplete." (emphasis omitted)).

343. *See generally* Williamson, *supra* note 342, at 84–85.

344. *See* COOTER & ULEN, *supra* note 342, at 84–85.

345. *Id.* at 85.

346. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1108 (1972); David W. Melville, *Liability Rules, Property Rules, and Incentives Not to Bargain: The Effect of Competitive Rivalry on the Protection of Legal Entitlements*, 29 SETON HALL L. REV. 1277, 1277 (1999).

347. *See generally* Calebresi & Melamed, *supra* note 346.

348. *See supra* Part II.

349. *See supra* Part II.

350. *See supra* Part II.

351. *See* A. Douglas Melamed, *Remarks: A Public Law Perspective*, 106 YALE L.J. 2209, 2211–12 (1997).

Unreasonable negotiations may also increase transaction costs.[352] When parties unduly press their own advantage, negotiations may breakdown.[353] Scholars have argued this problem may occur because of auditor concentration in the market.[354] Auditors, emboldened by their size, may attempt to press clients into alternative liability regimes.[355] Recall that the Big Four audit over ninety-eight percent of total U.S. market capitalization.[356] Such transaction costs would reduce the efficacy of any bargain.

Yet, accounting literature points to the opposite conclusion: auditor concentration results in lower fees and more competition.[357] Academic works suggest intense competition among market leaders.[358] Intense competition likely indicates companies may have sufficient bargaining power to ward off unreasonable demands in the bargaining process.

If proxy votes accompany the auditory liability bargaining process as previously indicated, transaction costs will increase. Search costs contribute to bargaining costs, and the number of parties involved in a bargain can dramatically increase search costs.[359] In a shareholder context, a proxy vote may resemble a multiparty bargain.[360] While the shareholders may not create the issue or item for a vote, the shareholders nevertheless must approve the issue or item.[361] The process may also involve shareholder politicking.[362] These proxy votes thus come at a considerable expense.[363]

352. *See* COOTER & ULEN, *supra* note 342, at 85–86.

353. *Id.* at 85; *see also* Melamed, *supra* note 351, at 2209 (discussing hold-out problems in antitrust).

354. Coffee, *supra* note 234, at 351.

355. *Id.*

356. *See supra* notes 13–14 and accompanying text.

357. Tim Pearson & Greg Trompeter, *Competition in the Market for Audit Services: The Effect of Supplier Concentration on Audit Fees*, 11 CONTEMP. ACCT. RES. 115, 129 (1994) ("Our findings indicate that audit fees are negatively related to industry concentration. This finding is inconsistent with structural theory, which predicts that high concentration will be associated with reduced price competition."); Marleen Willekens & Christina Achmadi, *Pricing and Supplier Concentration in the Private Client Segment of the Audit Market: Market Power or Competition?*, 38 INT'L J. ACCT. 431, 451 (2003) ("[O]ur results are consistent with prior findings in the public client segment of the audit market: that increased concentration does not necessarily lead to decreased price competition but rather to increased price competition . . . .").

358. Pearson & Trompeter, *supra* note 357, at 129.

359. *Id.*

360. *See* Clark, *supra* note 40, at 64.

361. *See id.*

362. *Id.*

363. *Id.*

3. Practical Impediments

Two practical limitations prevent the adoption of a bargained for, capped liability regime with judicial or regulatory review. This Subsection discusses both limitations in turn. First, a case-by-case review of caps adds an administrative burden to the judiciary and regulatory agencies. Second, many of the plaintiff remedies currently are immutable.[364]

a. Judicial and Administrative Burden

Judicial or administrative review would likely generate additional burdens on already-stressed government bodies. A number of legal scholars have published extensively on docket delay problems.[365] Recent changes to the rules of civil procedure have eased judicial dockets but have not completely ameliorated delay issues.[366] The SEC, the chief regulator of the domestic securities market, also faces severe workload problems.[367] Any additional burdens to the judicial docket or administrative workloads would likely face stiff opposition.

One could argue the systemic risk created by auditor litigation necessitates additional funding for judicial or regulatory review.[368] Such an approach, if adopted, would require policy makers to pay for the added level of review. The current fiscal situation within the United States would appear to make such a recommendation a nonstarter.[369] Policy makers wish to cut the federal budget, not add to it.[370]

b. Immutability

While bargaining to limit or alter liability has a solid footing in the common law, such bargains have their limits.[371] Additionally, bargaining away statutory liability is generally void on public policy grounds.[372] Per-

364. Talley, *supra* note 13, at 1650 tbl.1.

365. *See, e.g.*, William W. Schwarzer, *Managing Civil Litigation: The Trial Judge's Role*, 61 JUDICATURE 400, 401 (1978); Carrie E. Johnson, Note, *Rocket Dockets: Reducing Delay in Federal Civil Litigation*, 85 CALIF. L. REV. 225, 226 (1997).

366. *See* Rebecca Love Kourlis & Jordan M. Singer, *Managing Toward the Goals of Rule 1*, 4 FED. CTS. L. REV. 1, 1–2, 17 (2010).

367. *See* David S. Hilzenrath, *Study: SEC Needs Bigger Budget for Growing Workload*, WASH. POST.COM (Mar. 10, 2011, 12:36 PM), http://www.washingtonpost.com/wp-dyn/content/article/2011/03/10/AR2011031002548.html.

368. *See supra* Part II.F.

369. *See* Andrea Seabrook and Steve Inskeep, *Obama's Budget Plans Predict Record Deficit*, NAT'L PUB. RADIO (Feb. 1, 2010), http://www.npr.org/templates/story/story.php?storyId=123202075 ("[T]he administration is estimating the deficit this year, 2010, will hit $1.6 trillion, the worse [sic] deficit in history.").

370. *See id.* (discussing tax increases and budget cuts).

371. RESTATEMENT (SECOND) OF CONTRACTS § 195 (1981); *see also* Clark, *supra* note 40, at 64.

372. RESTATEMENT (SECOND) OF CONTRACTS § 178 (1981).

haps because of perceived transaction costs,[373] the federal securities laws provide a set of immutable remedies.[374] In state court, auditors have had some success with limiting liability; however, whether a state court would allow an alternative liability regime remains unknown.[375] As a final consideration, state statutes governing auditor liability will likely trump any bargain.[376]

B. Strict Liability with Caps (Modified Strict Liability)

Under a modified strict liability regime, an auditor would be liable for a fixed amount of damages when it makes any misstatement or omission regardless of fault.[377] An auditor could strike a bargain to reach the optimal cap; alternatively, a statute could set the cap.[378] Any cap would require public disclosure.[379] A percentage of total losses[380] or a multiple of audit fees[381] could create an upper limit for the cap; statutes might also set a lower limit for any cap.[382] This Section proceeds with justifications for modified strict liability. A discussion of criticisms follows.

1. Justifications

Proponents of modified strict liability believe the regime will create robust insurance and reinsurance markets.[383] By moving to a modified strict liability regime, auditors would essentially become financial statement insurers.[384] The market dynamics might then generate a robust reinsurance market.[385] Recall that under the current liability regime, auditors are virtually uninsurable.[386]

A modified strict liability regime would further reduce litigation, and possibly audit costs. Auditors would no longer have diligence-based defenses.[387] These diligence-based defenses generate significant litigation costs and may consequently induce excessive levels of auditor precau-

373. *See* Melville, *supra* note 346, at 1277 ("Under the traditional understanding of Calabresi and Melamed's theory, transaction costs dictate whether society will protect an entitlement by either a property rule, a liability rule, or less frequently, inalienability.").
374. *See* Talley, *supra* note 13, at 1650 tbl.1.
375. *Id.* The author could find no case supporting a bargained-for cap.
376. RESTATEMENT (SECOND) OF CONTRACTS § 178 (1981).
377. *See* Partnoy, *supra* note 17, at 492.
378. *Id.*
379. *Id.*
380. *Id.*
381. *See* Coffee, *supra* note 234, at 350.
382. *See* Partnoy, *supra* note 17, at 492.
383. *See id.* at 542–43.
384. *See id.* at 543.
385. *Id.*
386. *See supra* notes 235–38 and accompanying text.
387. *See* Partnoy, *supra* note 17, at 492–93, 546–47.

tion.[388] Removing diligence-based defenses will likely reduce litigation and audit costs.

Proponents believe a modified strict liability regime induces efficient levels of auditor precaution.[389] While strict liability tends to overdeter, proponents of modified strict liability argue capping strict liability optimizes auditor effort.[390] The reduced liability associated with caps offsets the general overdeterrence of strict liability.[391]

2. Theoretical Criticisms

Any limits to auditor liability through the bargaining process would face the same theoretical criticisms discussed above. Limits to auditor liability might generate agency costs.[392] Moreover, the bargaining process creates transaction costs.[393] Yet the same rebuttals previously discussed also apply here. Namely, investors will likely price in added agency costs,[394] and transaction costs may decline over time.[395]

Critics might also argue statutorily set caps in a modified strict liability regime will not necessarily lead to an optimal result. The lawmaking process, whether judicial or legislative, does not necessarily create efficient outcomes.[396] Thus, any statutorily set cap may systematically overdeter or underdeter, thus leading to inefficient auditor precaution.[397]

3. Practical Impediments

Proponents of modified strict liability essentially argue for a wholesale change of the federal securities laws governing auditor liability.[398] As indicated, however, plaintiffs may bring actions against auditors in state court.[399] Thus, any effective change to auditor liability would likely require preemption of state laws. Such preemption has some precedent: SLUSA preempted several causes of action in state court.[400]

388. *See id.* at 492–93; *see also supra* Part II.F.
389. *See* Partnoy, *supra* note 17, at 545.
390. *Id.*
391. *Id.*
392. *See supra* Part III.A.2.a.
393. *See supra* Part III.A.2.b.
394. *See supra* notes 313–15 and accompanying text.
395. *See supra* notes 348–51 and accompanying text.
396. Clark, *supra* note 40, at 64–65.
397. *See* Partnoy, *supra* note 17, at 545.
398. *See, e.g.*, *id* at 540–46.
399. *See supra* Part II.E.1.b.
400. *See supra* notes 186–91 and accompanying text.

C. Decoupled liability

Decoupled liability may incentivize appropriate levels of auditor precaution while decreasing incentives to litigate disputes.[401] Under a decoupled liability regime, an asymmetry would exist between auditor payouts and plaintiff litigation awards.[402] The auditor would typically pay a much larger amount than the plaintiff would receive.[403] The difference between the payout and award would accrue to a government, charity, or not-for-profit fund.[404] This Section continues with justifications for decoupled liability. A discussion of theoretical and practical criticisms follows.

1. Justifications

Proponents of decoupled liability often advocate the system on efficiency grounds.[405] Under a decoupled liability regime, plaintiff incentives to litigate decline.[406] The smaller possible awards reduce the expected value of litigation.[407] At the same time, defendant damages remain the same or increase.[408] Defendants thus have incentives to maintain high levels of precaution.[409]

Decoupled liability has added justifications in the audit context. Research suggests decoupling achieves an efficient liability regime because it decouples product "bundles."[410] Under the current liability regime, investors purchase an "information product," the audit, with an "insurance product," ex post damages.[411] The bundled product encourages aggressive, risky investment.[412] Decoupling reduces the impact of any "insurance product" while maintaining sufficient levels of auditor precaution.[413]

2. Theoretical Criticisms

While the concept of decoupling shows promise, little research exists on the optimal magnitude of asymmetry between plaintiff awards and defendant payouts. The auditor and board might bargain for the level of asymmetry. Bargaining, however, would suffer from the same criticisms

401. *See* Doogar, *supra* note 17, at 2.
402. *Id.*; *see also* A. Mitchell Polinsky & Yeon-Koo Che, *Decoupling Liability: Optimal Incentives for Care and Litigation*, 22 RAND J. ECON. 562, 562 (1991).
403. *See* Doogar, *supra* note 17, at 2.
404. *See* Polinsky & Che, *supra* note 402, at 562 (mentioning a government recipient).
405. *See id.* at 563.
406. *Id.*
407. *Id.*
408. *Id.*
409. *Id.*
410. *See* Doogar, *supra* note 17, at 2.
411. *Id.*
412. *Id.* at 22–23.
413. *Id.*

previously indicated.[414] Moreover, failure to strike an efficient bargain may increase agency costs.[415] Yet the argument benefits from the same rebuttals.[416] Other mechanisms can mitigate declines in auditor precaution.[417] Price effects within the market may address agency costs, and transaction costs may decline over time.[418] Thus, criticisms based on agency and transaction costs may not bear out.

3. Practical Impediments

As with modified strict liability, proponents of decoupled liability advocate for an overhaul of the securities laws.[419] Again, because of numerous litigation avenues, such an overhaul would require preemption of state remedies.[420] Proponents of decoupled liability may take cues from SLUSA when advocating for decoupled liability.[421]

IV. RESOLUTION

Federal law should allow auditors to bargain for alternative liability regimes with boards through audit committees. The parties should then disclose such a bargain. Proxy voting by shareholders could potentially add value by reducing agency costs, but the related transaction costs require further consideration. Any bargains should preempt any state-law claims.

Scholars and regulators have disagreed over the most effective way to limit auditor precaution.[422] While some methods seem promising, no method has proven itself in the marketplace. If the market were allowed to experiment with various proposals, the most efficient solution might emerge.

Boards, through their audit committees, could strike bargains with their auditors. The market would penalize bad bargains and reward good bargains.[423] Boards would have an incentive to enter good bargains to increase share price.[424] If a board strikes a bad bargain, shareholders could attempt to wrestle control away from the board.[425] Alternatively, the market may view the company as a takeover target.

This notion comports with the legal status of the market. The U.S. federal securities laws are based on concepts of disclosure. Many reme-

414. *See supra* Part III.A.2.
415. *See supra* Part III.A.2.a.
416. *See supra* Part III.A.2.a.
417. *See supra* notes 312–13 and accompanying text.
418. *See supra* Part III.A.2.
419. *See, e.g.*, Doogar, *supra* note 17, at 23.
420. *See supra* Part III.B.3.
421. *See supra* Part III.B.3.
422. *See supra* Part III.
423. *See supra* notes 314–16 and accompanying text.
424. *See supra* notes 322–25 and accompanying text.
425. *See supra* notes 322–25 and accompanying text.

dies are based off of notions of semistrong, efficient markets.[426] Thus, bargaining for alternative liability regimes conforms with the core principles of securities laws.

Existing mechanisms regulating auditor precaution can mitigate severe negative consequences. Auditors already undergo periodic reviews by the PCAOB. State boards of accountancy further regulate firms.[427] If an auditor intentionally aids in fraud, the auditor faces potential criminal prosecution.[428] Thus, significant increases in agency costs appear unlikely.

Requiring regulatory or judicial review of any bargain appears particularly onerous.[429] Review would burden overworked administrative agencies or increase judicial dockets. Additionally, such reviews may not add significant value given market policing and auditor regulation.

As the scholarship on the efficacy of proxy votes matures,[430] policy makers may consider adding proxy vote requirements to the auditor liability regime bargaining process. Policy makers should weigh the added transaction costs against the decline in marginal agency costs. Under the current regulatory system, shareholders occasionally approve the appointment of independent auditors. Recent research suggests that shareholder ratification of auditor selection reduces restatement likelihood and results in fewer abnormal accruals.[431] Recall that accruals may signal managerial manipulation of financial data.[432] If future regulation ultimately requires shareholder proxy votes, an additional requirement to approve the bargain negotiated between the auditor and the audit committee may not significantly increase transaction costs. So long as the vote occurs concurrently with the auditor's appointment, the marginal cost of approving the bargain may be insignificant. As such, the addition of proxy votes may improve an already-sound bargaining process.

Transaction costs will likely decrease over time as market participants begin to experiment with such agreements.[433] Moreover, if the parties fail to strike a bargain, they can resort to a set of default rules: the existing liability regime. Legal provisions facilitating the bargain can make such bargains opt-in contracts. Thus, failing to strike a bargain would lead to the status quo.[434]

426. *See supra* notes 317–21 and accompanying text.

427. *See supra* notes 312–13 and accompanying text.

428. *See supra* notes 312–13 and accompanying text.

429. *See supra* Part III.A.3.a.

430. *See supra* notes 326–34 and accompanying text.

431. Mai Dao et al., *Shareholder Voting on Auditor Selection, Audit Fees, and Audit Quality*, 87 ACCT. REV. 149 (2012).

432. *See supra* notes 307–08 and accompanying text.

433. *See supra* Part III.A.2.b.

434. This Note does not address potential status quo biases. *See* Russell Korobkin, *Behavioral Economics, Contract Formation, and Contract Law*, *in* BEHAVIORAL LAW AND ECONOMICS 116, 120–25 (Cass R. Sunstein ed., 2000) [hereinafter Korobkin, *Contract Formation*] (finding that a group of University of Illinois College of Law students assigned different buy-sell values for legal entitlements); Russell Korobkin, *What Comes After Victory for Behavioral Law and Economics?*, 2011 U. ILL. L.

In order to facilitate bargaining, the federal securities laws need change. The federal securities laws create immutable remedies.[435] Bargaining for alternative liability requires additional flexibility. Thus, a provision allowing the parties to opt out of the current liability regime appears necessary. Moreover, such bargains should trump state statutes. SLUSA has provided a roadmap for such preemption.

V. CONCLUSION

Federal securities laws should facilitate bargains for alternative auditor liability regimes. The current liability regime has generated unacceptable levels of systemic risk within the capital markets. Because no consensus exists as to the most efficient regime, boards, through their audit committees, should strike bargains with their auditors. These bargains do not necessarily risk generating significant amounts of agency or transaction costs.

REV. 1653, 1664 (discussing the status quo bias). The biases may generate additional hurdles in the bargaining process. *See* Korobkin, *Contract Formation*, *supra,* at 137–38. The biases, however, have not prevented well-known behavioralists from advocating for alternative, optional liability schemes in the past. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 207–14 (2008).

435. *See supra* Part III.A.3.b.